

GOVERNMENT OF THE REPUBLIC OF LITHUANIA

RESOLUTION No 1358

of 19 December 2007

ON THE CONVERGENCE PROGRAMME OF LITHUANIA OF 2007

Vilnius

Acting pursuant to Article 7 of Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ, 2004, Special Edition, Chapter 10, Volume 1, p. 84), as last amended by Council Regulation (EC) No 1055/2005 of 27 June 2005 (OJ L 174, p. 1), which lays down a multilateral surveillance procedure of the European Union Member States carried out in the form of stability and convergence programmes, the Government of the Republic of Lithuania has resolved:

1. To approve the Convergence Programme of Lithuania of 2007 (as appended);
2. To charge the Ministry of Finance with the task of submitting the Convergence Programme of Lithuania of 2007 to the European Commission.

Prime Minister

Gediminas Kirkilas

Minister of Finance

Rimantas Šadžius

APPROVED
by Resolution No 1358 of 19 December 2007 of
the Government of the Republic of Lithuania

CONVERGENCE PROGRAMME OF LITHUANIA OF 2007

I. FINANCIAL POLICY OVERVIEW

1. Lithuania's economic policy serves the goal of ensuring a rapid and sustainable real convergence, i.e. approximation to the high level of productivity and income within the Economic and Monetary Union. The Convergence Programme of Lithuania of 2007 (hereinafter referred to as the Programme) gives projections of the economic policy outlined in the 2008 Law on Approval of Financial Indicators of the State Budget and Municipal Budgets (*Valstybės žinios* (Official Gazette) No. 132-5356, 2007).

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

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

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

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

2.4. improvement of fiscal discipline norms that ensure long-term sustainability of general government finances and stable economic development, implementation of education, health and tax reforms;

2.5. preparation of the proposals on the measures capable to ensure that potential economic growth necessary for low inflation and high employment is utilised and that implementation of them would not require fiscal deficit deterioration (in 2008).

3. Lithuania has committed in this Programme to pursue an economic policy that ensures the stability of prices and general government finances so that strong confidence in the continuity of the currency board arrangement in Lithuania is maintained and the perspective of long-term price stability is ensured.

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

5. This Programme examines and assesses the preconditions for the achievement of the economic policy goals. The economic development projections given are based on the assumption that the demand for loans will be based on thorough knowledge of economic perspectives, thus it is expected that the economy will reduce dependence on borrowed funds. The Programme has been based on assumptions on euro exchange rate, prices of oil and other raw materials used by the European Commission in the projections of economic indicators. Preconditions for the implementation of this Programme have been defined by the Law on Fiscal Discipline of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 120-4881, 2007) that sets forth that in 2008 general government sector deficit must not exceed 0.5% of gross domestic product (hereinafter referred to as GDP), obligates over the medium term to pursue close-to-balanced or a surplus general government, and provides numerical and procedural rules for the achievement of that.

6. The national currency litas (hereinafter referred to as the litas) exchange rate pegged to the euro under the currency board arrangement ensures that the average multi-annual inflation will remain close to that in the euro area.

After the acceleration of inflation in 2007-2008 and with the stabilisation of oil and natural gas prices in 2009 as well as with the harmonization of excises to the EU rates, inflation in Lithuania will, over time, again come close to inflation in the euro area.

7. The growth of exports and investment remains on a fast track in Lithuania, with unemployment going down at the highest pace among the EU states. Over the past six years (from the second quarter of 2001 to the second quarter of 2007), the number of the employed has grown by 12.4%. A rapid growth of investment will ensure Lithuania's competitiveness in the long run and increase the import of investment goods and the current account deficit (hereinafter referred to as the CAD) of Lithuania's balance of payments in the short run.

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

9. One of the fiscal policy objectives, to manage demand for mortgages through taxes, to allocate all additional revenues and saved expenditures to reduce fiscal deficit or to form surplus, to strive to balanced budget laid down in the Convergence Programme of Lithuania approved of by Resolution No 54 of 21 January 2005 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 11-341, 2005) will be pursued under this Programme, too. In future updates of this Programme, specific additional measures aimed at managing fiscal risks will be introduced.

10. The rapid growth of demand under the conditions of a fixed exchange rate for the litas increased imports and CAD. Thus, to ensure the continuity of foreign capital inflows, it is essential further improve the business and investment environment, give maximum support to investment that is promoted by laws, and create particularly favourable conditions for "green field" investment,

as well as maintain market confidence in the continuity of the commitment of an early integration of Lithuania into the euro area.

Given the need to implement structural reforms securing productivity and the long-term sustainability of government finances, and in the light of the rapid growth of GDP and the current low level of debt, the medium-term objective - to achieve structural deficit below 1% of GDP remains. For later periods, the MTO will be tightened to take into account the Commission's latest estimates suggesting that general government debt will approach to 114% of GDP in 2050, unless fiscal policy is tightened. Therefore, once major structural reforms have been completed, in 2009-2010 the objective would be a structurally balanced or a surplus general government, depending on the economic cycle and following the Law on Fiscal Discipline of the Republic of Lithuania.

11. Currently, Lithuania's possibilities to reduce fiscal deficit and general government deficit more than expected are restricted by temporary budgetary difficulties associated with tax reduction and necessity to save the present quality of education and health care. Fiscal discipline will be maintained by applying numerical and procedural Lithuania's fiscal discipline rules set forth in the Law on Fiscal Discipline of the Republic of Lithuania, reducing GDP share that consists of government current expenditure and maintaining a higher share of social expenditure, close to 10% of GDP. The successful implementation of the pension reform will pave the way for the reduction of the national debt in the long run and will encourage private persons to save funds to supplement their old-age pension. Tax revenues to be allocated in 2008 for the pension reform will account for about 1% of GDP. The reduction of the rate of personal income tax which determines a balance between labour and capital taxation will contribute to the successful implementation of the objectives of the National Lisbon Strategy Implementation Programme, approved by Resolution No. 1270 of 22 November 2005 (*Valstybės žinios* (Official Gazette) No 139-5019, 2005), in the labour market, to increase employment and potential GDP, and to mitigate the effects of an ageing population for government finances. In the long-term Lithuania will pursue the expansion of housing renovation that would contribute to the efficient use of heat and reduction of economy's dependence on growing prices of natural gas. Health and education reforms ensuring higher quality and enabling attraction of additional means from private sources will be implemented.

12. The fiscal policy pursued in compliance with the strict regulations of the Stability and Growth Pact (Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ, 2004, Special Edition, Chapter 10, Volume 1, p. 84 and Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ, 2004, Special Edition, Chapter 10, Volume 1, p. 89) will make it possible to consistently reduce government debt until government finances become capable of ensuring a sustainable implementation of commitments under the Maastricht Treaty (OJ 1992 July 29 C 191), while maintaining reliable social guarantees, regardless of the projected significant growth in the number

of pensioners and the decreasing number of employed people in the third decade as a result of the low birth-rate and high emigration.

II. ECONOMIC OUTLOOK

Assumptions

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

Economic projections are based on the assumption that the Seimas of the Republic of Lithuania, when passing legal acts regulating general government expenditures and tax rates, will take into account the principal provisions of the Stability and Growth Pact and will further collaborate with the Government of the Republic of Lithuania in implementing measures aimed at stabilising inflation at below 3%. Law on Fiscal Discipline of the Republic of Lithuania and political agreement on the implementation of education reform provisions reinforces confidence of financial markets in long-term sustainability of general government finances, and contributes to ensuring price stability in long-term perspective.

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

Table 1. Key assumptions

Indicator	2006	2007	2008	2009	2010
Short-term interest rates	3.7	5	4.6	4	4.9
Long-term interest rates	4.1	4.7	4.7	4.8	5
USD/€ exchange rate (euro area and exchange-rate mechanism II (hereinafter referred to as ERM II countries))	1.25	1.35	1.4	1.4	1.4
Nominal effective exchange rate	-1	0	0	0	0
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
World excluding EU, GDP growth	6	5.6	5.3	5.4	5.4
EU GDP growth, %	3	2.9	2.4	2.4	2.4
Growth of relevant foreign markets	3	2.9	2.4	2.4	2.4
World import volumes, excluding EU growth, %	8	7.8	7.1	7.7	7.7
Oil prices (Brent, USD/barrel)	66.2	70.6	78.8	75.5	76

Sources: Ministry of Finance, European Commission

GDP growth projections are particularly dependent on frequently and radically changing credit increase projections made by commercial banks. As recent year experience shows that commercial bank credit increase forecast used to be surpassed and credit increase in the first three quarters of 2007 was 5.1 percentage point of GDP higher than a year ago; credit increase in the fourth quarter of 2007 is also probable. Euro area interest rates increased by the European Central Bank (hereinafter referred to as ECB) in the first half of 2007 provided liquidity sufficient for economy stimulation, and the credit lending process of the second half of the year is predetermined by previously concluded contracts. International financial market turbulences in August strengthened assumptions made in early 2007 that a higher deceleration of credit increase is assumed to start in 2008-2009, marking the start of a natural cyclical slow-down of GDP growth.

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

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

After credit increase more than 15% of GDP in 2006, assumptions about the volume of absorption of EU financial support will become peripheral. In the period 2007-2010, absorption of the EU structural funds and other financial assistance from the EU will have a smaller effect on the growth of demand than changes in credit increase volumes. A different-than-planned absorption of EU support would only slightly affect the growth of GDP in the corresponding year.

Growth of Lithuania's economy in the medium term will slightly slower than in the recent years, though it still will be rather fast. Growth in 2007 will not basically close gap between the inflationary GDP and GDP potential. It is assumed that ECB anti-inflationary policy of raising interest rates will eventually affect not only euro area but also Lithuania, therefore, the gap between the inflationary GDP and the potential will start decreasing in 2008-2009. GDP growth will account for 5.3% in 2008, 4.5% in 2009, and 5.2% in 2010. An early and manageable correction of GDP growth rates would ensure a rapid and sustainable average growth of 6% in later years. Sticking to

fiscal discipline standards may also manage interest risk spreads and create conditions for even and fast economy development.

In case economic environment deviates from assumptions, projections of economic indicators for 2007–2010 or projection outlook would be adjusted accordingly.

Monetary and exchange rate policy

14. Lithuania pursues monetary policy under the conditions of a fixed exchange rate for the litas. Such exchange rate regime increases confidence in Lithuania's economic policy and together with competitive economic environment allows pursuing relative long-term price stability. Openness of the economy, relative flexibility of prices and wages, litas exchange rate importance for the price stability are those features of Lithuania's economy that contribute to the successful application of the fixed exchange rate strategy. By becoming a EU Member State Lithuania has undertaken to replace the litas with the EU currency euro (hereinafter referred to as the euro). Lithuania has been participating in the ERM II since 28 June 2004, by implementing a unilateral commitment to maintain a fixed exchange rate regime and a fixed national currency exchange rate vis-à-vis the euro.

15. Lithuania's monetary and exchange rate policy goals remain unchanged. Lithuania will further maintain a strictly fixed litas exchange rate vis-à-vis the euro, and will seek to join the euro area as soon as economic convergence criteria are met.

Lithuania's resolution to adopt the euro is supported by:

15.1. successful application of the fixed exchange rate and ability to withstand a shock without changes of nominal exchange rate of the litas;

15.2. Lithuania has pegged the litas to the euro but it has not been gaining full advantage of single currency: economic entities suffer currency exchange losses; the litas interest rates are higher than the euro interest rates;

15.3. euro adoption in Lithuania will accelerate real convergence of Lithuania's economy with other EU Member States, make Lithuania more attractive for investors, speed up trade and finance integration into the EU.

16. Estimates and assessment carried out considering Lithuania's obligations undertaken when joining the EU to raise tobacco and fuel excise to the EU minimal level and growing prices of energy resources indicate that the most favourable time for Lithuania to adopt the euro starts with 2010. At the same, the Bank of Lithuania maintains the level of institutional preparation which under favourable macroeconomic conditions ensures smooth and rapid currency replacement.

Economic cycle and a medium-term macroeconomic scenario

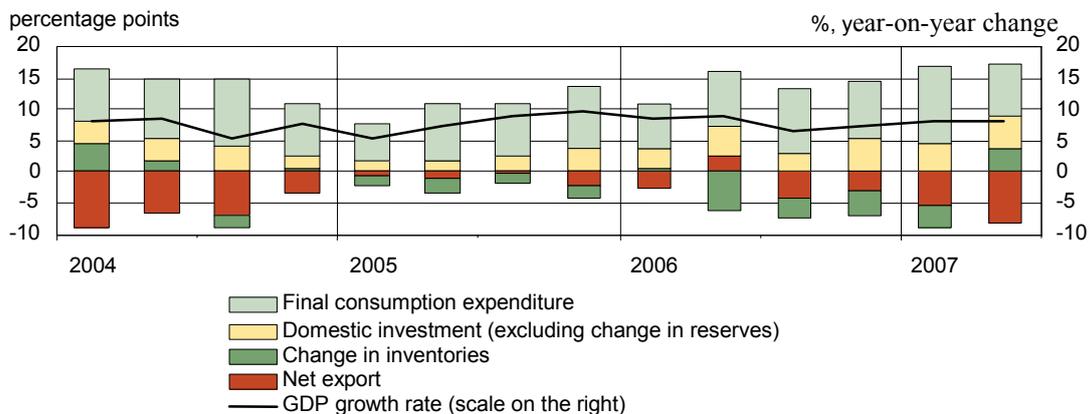
Goods and services markets

17. Lithuania's economy has been growing at a very high pace: Over 2006, real GDP has grown by 7.7%, followed by a growth of as much as over 9% in three quarters of 2007. Domestic demand remains the main driver of economic development, stimulated by intensive borrowing and rapidly growing nominal income. Results of the first three quarters of 2007 confirm that the slowdown in the economic development in the second half of 2006 was not related to the cooling of the economy or return to the balanced growth. The negative impact of net exports on the economic growth has intensified although clear signs of decreasing competitiveness are not visible. Considering negative impact of high activity in oil refining, very high activity in construction and construction maintenance, the economy growth in the recent quarters has mostly depended on the growth of closed sectors.

A positive gap between the actual and potential GDP raises certain concerns related to a growing tension in the labour market and an increasingly high impact of domestic demand on prices and the current account deficit of the balance of payments of Lithuania. It is expected, however, that a very rapid growth of domestic demand will slow down as the rate of growth of bank loans (which seems to be quite inert) become more responsive to the continued tightening of monetary policies by the ECB and uncertainty in the real estate market.

GDP growth was driven mainly by the growth of household consumption expenditure. The empiric analysis confirms that private consumption in the country depends not only on the current quarter but also on the income of approximately twelve months. In the recent four quarters nominal wages have been rapidly growing (on the average 20% per year), while growth of net wages was even more rapid after income tax rate was reduced in July 2006; employment has also been reasonably growing, which rather increased household disposable income.

Figure 1. Contributions to real GDP growth (expenditure approach)



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

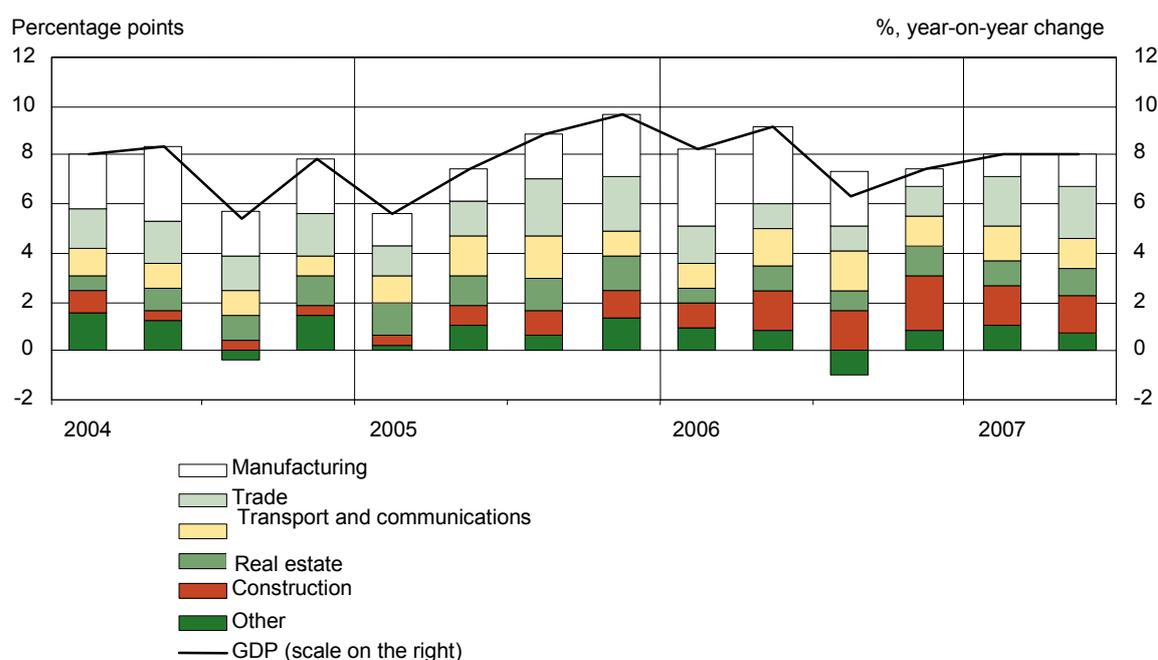
The still relatively favourable conditions of external financing of enterprises, high profitability of investment projects and good financial situation of enterprises, EU financial support to infrastructure and commercial projects determined that in the first half of 2007 the growth of investment has risen considerably. In the first half year of 2007, the trend of rapid growth in the investment into transport vehicles has emerged.

In the environment of high domestic demand and shortage of labour force, investments play a particularly important role in promoting sustainable economic growth: they are expected to ensure a growth of the economic potential and to avert the danger of economic “overheating”. Effective investments will be promoted by allocating EU structural funds support.

Real import growth exceeding export growth resulted in the increased negative impact of export on GDP. The still increasingly growing import is mostly associated with much stronger domestic demand, while disruption of oil refining activity had a temporary negative impact on export. Relatively fast nominal export growth shows that a potential drop of competitiveness of Lithuanian producers is still maintained irrespective of growing prices of raw materials and rising labour demand in the market.

As a result of a negative impact of oil refining activity, manufacturing industry has been slowly growing but the level of private sector economic activity stimulated by other types of domestic demand kept rapidly raising. Construction has become the most important sector of the economy growth, as due to very favourable weather conditions in early 2007 and an insignificant impact of growing interest rates in 2007 its development was very fast.

Figure 2. Contributions to real GDP growth (production approach)



Sources: Statistics Lithuania, estimates by the Bank of Lithuania

Future capacity of producers to satisfy the high domestic demand will largely depend on sufficiency of labour force as one of the most important factors of production. In the past quarters, labour market has been very dynamic, with the overall situation in the market being very tense. An increasing number of vacant jobs and rising wages that outpaced efficiency gains evidence the lack of labour. On the other hand, economically inactive population that enters into the labour market due to rapidly growing wages and high pressure in the labour market in the second half of 2007 will be an stimulus of the economy growth. The gap in the growth of wages between the private and public sectors has become very wide. Owing to shortage of employees and declining share of illegal wages, wages in the private sector have been growing well faster than in the public sector.

Sticking to the Lithuania's fiscal discipline rules set forth in the Law on Fiscal Discipline of the Republic of Lithuania would in the medium-term mitigate risks related to internal and external differences and would allow even development of the economy using relatively low interest. The medium term economic growth will depend on the country's capacity to get prepared for natural economic cycles in time and rationally. It is advisable to assessment of financial liquidity and solvency indicators of both private and public sector ground not only on nominal values but also on the temporary nature of the cyclical income spike.

Table 2. Macroeconomic prospects

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	rate of change				
1. Real GDP	B1*g	71649,1	7,7	9,8	5,3	4,5	5,2
2. Nominal GDP	B1*g	81905,2	14,7	16,4	12,3	7,9	7,7
Components of real GDP							
3. Private consumption expenditure	P.3	50599,1	11,9	12,4	6,7	6,2	5,4
4. Government consumption expenditure	P.3	12423,6	5,5	4,9	8,7	2,6	4,4
5. Gross fixed capital formation	P.51	18499,4	17,4	26,5	3,4	5,2	7,9
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	0,9	3,2	-0,1	0	0	0
7. Exports of goods and services	P.6	43669,8	12,2	8,6	12,2	2,4	8
8. Imports of goods and services	P.7	54661,4	13,8	16	12,3	4,1	8,4
Contributions to real GDP growth							
9. Final domestic demand		–	9,6	15,8	7	6,1	6,8
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	–	-3	0	0	0	0

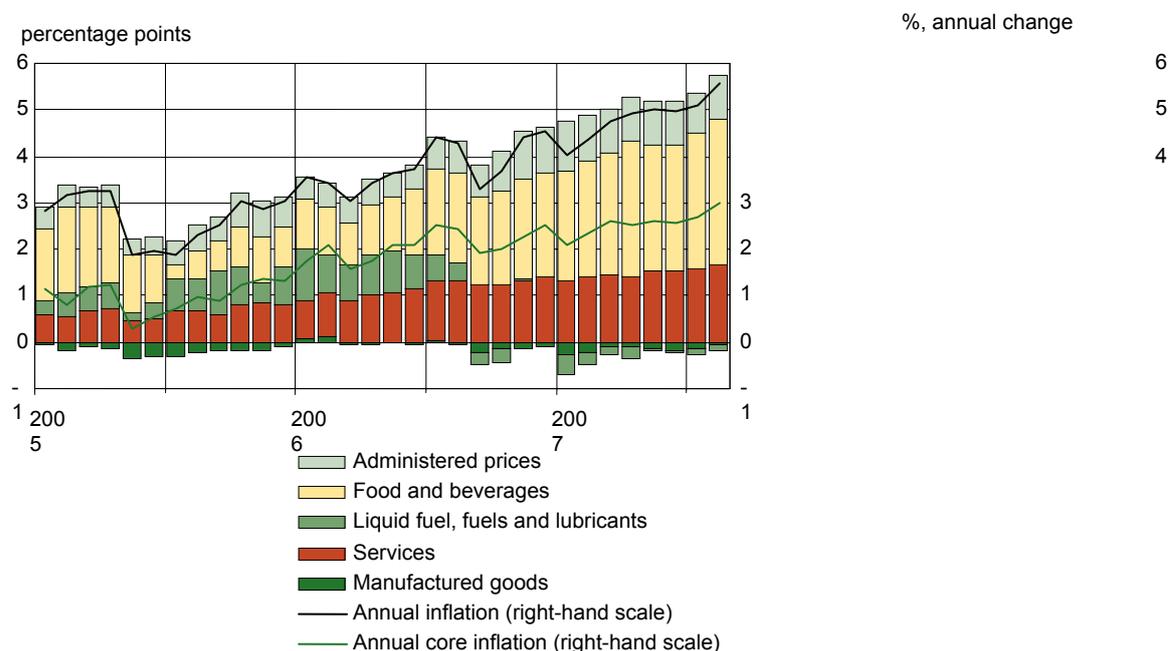
11. External balance of goods and services	B.11	–	-2	-6	-1,7	-1,6	-1,6
--	------	---	----	----	------	------	------

Stability of prices

18. In 2007, prices in Lithuania were increasing at a faster pace. In the first ten months of 2007, the average annual inflation measured on the basis of the Harmonised Index of Consumer Prices (hereinafter referred to as HICP) reached 5.2%. Headline inflation accelerated mainly due to increasing growth rates of prices on processed foodstuffs and services. With the prevalence of imported manufactured goods in the consumer's basket, the impact of the increasing Lithuanian producer prices on headline inflation remained limited.

In the first ten months of 2007, increased prices on food products accounted for nearly two thirds of headline annual inflation. In the middle of 2007, prices on foodstuffs and beverages were on average about 10% higher than a year before. During all this period, there was a marked increase in prices on bread and cereal products, while in the second half of 2007, the prices on milk and meat products saw a faster rise. Cigarette prices also went up as a result of increased excises on cigarettes.

Figure 3. Annual HICP inflation and contributions*



Sources: Department of Statistics, Bank of Lithuania estimates

*HICP excl. food, fuels and lubricants, and administered prices

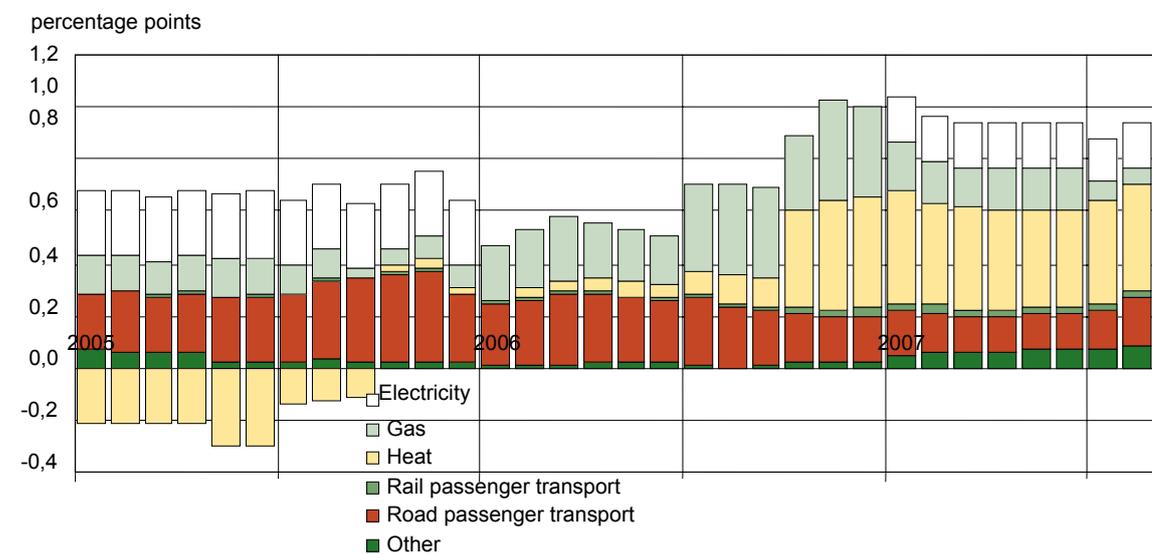
The rise in processed food prices is attributable to increasing prices on agricultural products, rising wage costs as well as the growing profits of food producing and trading enterprises. In the context of the growing prices on agricultural products abroad and the ongoing convergence of these

prices in Lithuania with West European prices, the prices of agricultural products in Lithuania went up by several dozen per cent. As wage costs constituted an almost fixed part in producer prices, food prices were steadily increasing. The growing wage costs were also included in producer prices. It is believed that a more significant increase of unit labour costs in the food production sector started in 2007, which had an additional impact on food prices. Moreover, as production costs increased and food producers maintained nearly stable profit margins, the absolute value of their profit was also growing. This boosted food producer prices.

An analogous situation was also observed in the food trading sector, however, here, unlike in the food production sector, the increase in consumer prices was largely driven by unit labour costs, which had been rising already since the beginning of 2006. The increase in consumer prices was also caused by growing trader profits.

The impact of administered prices on headline inflation in 2007 changed slightly. The largest contribution to the growth in headline annual inflation came from raising heating prices since autumn 2006 and electricity prices since the beginning of 2007. The rise in heating prices in July-August 2007 in Vilnius and some other Lithuanian cities also caused a slight increase in headline inflation. In August 2007, there was a small increase in headline inflation due to higher prices on public transport services (in Kaunas and Panevėžys).

Fig. 4. Impact of administered prices on headline annual inflation



Sources: Department of Statistics and Bank of Lithuania estimates

In view of increased geopolitical uncertainty in August 2007, as well as the unscheduled suspension of operation of some oil companies, US dollar-denominated oil prices were approaching the price level of the respective period of the previous year and eventually exceeded it. This resulted

in a decreasing negative annual change in fuel prices and their impact on headline annual inflation in the first eight months of 2007, and later this impact changed to positive.

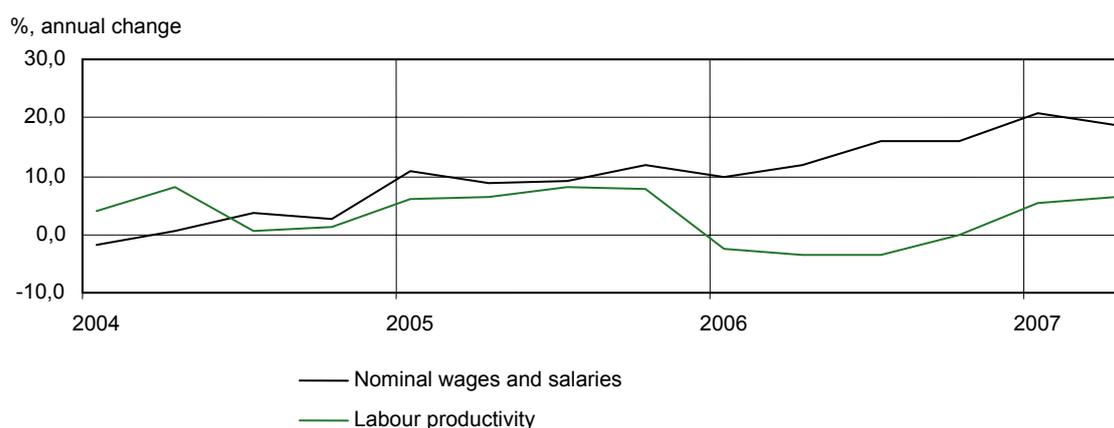
The impact of prices of manufactured goods on headline inflation also remained negligible. Such price developments are mainly determined by changes in prices on imported goods, rather than rising prices of Lithuanian producers. The price rise of manufactured goods of Lithuanian producers is due to increasing prices on imported gas, other raw materials (e.g. timber) and wage growth exceeding labour productivity growth; however, with the prevalence of imported goods (excluding food products and liquid fuels) in the consumer's basket, there was no increase in consumer prices of manufactured goods.

In the first ten months of 2007, the impact of prices of services on headline inflation was steadily increasing from 1.3 percentage points to 2 percentage points, which showed the increasing effect of aggregate demand on price change. The prices of market services have been for some time greatly influenced by growing wage costs. Though labour productivity growth in the market services has been increasing, the increase in the value added per employee has been substantially lower than wage growth.

In the market services sector, the greatest impact on headline inflation in 2007 was caused by the rising prices of restaurant, café and canteen services. The price increase of these services is determined not only by high demand and growing wage costs, but also by higher food prices.

The average monthly gross earnings in the country have continued to grow rapidly as a result of labour market tensions and other factors (administrative decisions, presumably declining share of illegal earnings). The annual wage and salary growth in the third quarter of 2007 was 17.9% (19.9% in the third quarter of 2006).

Fig. 5. Change of wages and productivity in the market services sector



Sources: Department of Statistics and Bank of Lithuania estimates

Table 3. Price indicators

Indicator	ESA code	Level in 2006	Rate of change, %				
			2006	2007	2008	2009	2010
1. GDP deflator		114.3	6.6	6.1	6.7	3.2	2.3
2. Private consumption deflator		105.7	2.9	5.2	5.5	2.5	2.2
3. HICP (average annual change)		103.8	3.8	5.8	6.5	5.1	3.6
4. Public consumption deflator		119	14.5	9.3	9.4	4.9	3.9
5. Investment deflator		109.7	6	6.5	6.5	5	3.3
6. Export price deflator (goods and services)		112	5.2	4.9	4.1	2	2.2
7. Import price deflator (goods and services)		105	8	3.1	4.2	2.5	2.5

Sources: Statistics Lithuania, Ministry of Finance

In the medium term, the price increase for services will have a crucial impact on underlying inflation, as increasingly expensive labour will account for an increasingly large share of the cost of services, and the global competition and rapid development of production will continue to push the prices of clothes, footwear and household appliances down.

The increased natural gas prices for regulated consumers and heat supplying enterprises may cause an upsurge in inflation by 1.5 percentage points.

The exchange rate of the litas against the euro, fixed under the currency board arrangement, ensures that the average multi-annual inflation will remain close to that in the euro area. Following the acceleration of inflation in 2006–2008, and with the stabilization of oil and gas prices, harmonisation of excises to the EU rates, and along with the increase in interest rates and a deceleration of credit increase, inflation in Lithuania will again move closer to the inflation rates observed in the euro area.

Labour market

19. Confidence in macroeconomic stability has promoted private investment and consumption; therefore, over the period from the second quarter of 2001 to the second quarter of 2007, the number of the employed has grown by 12.4%: 14.9% in urban areas and 6.9% in rural areas. Unemployment has shrunk by 12.7 percentage points. Labour force has shrunk by 2.5%; to a certain extent, this shrinkage could have been caused by emigration. In rural areas, labour force shrank one and a half times as fast as in urban areas: by 2% in urban areas and by 3.5% in rural areas.

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

Table 4. Labour market indicators

Indicator	ESA code	Level in 2006	Rate of change, %				
			2006	2007	2008	2009	2010
1. Employment, persons (thou)		1499	1.7	2.3	0.3	0.1	0
2. Employment, hours worked		2757133	0.9				
3. Unemployment rate (%)			5.6	4.5	5.2	6	5.9
4. Productivity (real GDP per person employed)		47798	5.9	7.3	5	4.4	5.2
5. Labour productivity (real GDP per hour worked), LTL		26.8	6.6				
6. Compensation of employees, LTL million	D.1	34966.8	18.9	23.2	19	7.6	7.2
7. Compensation per employee		23326.7	16.9	20.4	18.7	7.6	7.2

Sources: Statistics Lithuania, Ministry of Finance

* Value of indicator is shown. Projections of the unemployment level for 2008–2010 are based on the assumption that increasingly higher wages may enhance the activity of labour force and change migration flows; if the activity of labour force and migration changed, unemployment, according to the recent trends, would stand at some 4.8% in 2008, and 4.9% in 2009–2010.

It is assumed that emigration will not slow down the growth of employment in Lithuania and will continue to improve the current account of the balance of payments of Lithuania. Growing demand for labour force, increasing productivity, growing minimal monthly wages, improving market expectations and price convergence after accession to the EU will bring changes in wages.

Trends that started in 2004 are projected to continue, meaning a further growth of average monthly wages in 2008–2010. The average monthly gross wages are projected to increase from LTL 1495.7 in 2006 to LTL 2388.2 in 2010.

Growth of wages will make it possible to reward gradually the employed population for the high labour productivity growth achieved in the previous year.

Unemployment has been decreasing very rapidly recently. In the second quarter of 2007, the level of unemployment dropped to its record lows of 4.1% (compared to 5.6% in the same period a year ago and 8.5% in 2005). The labour market also underwent certain structural changes, such as a

shift of labour force from less productive sectors of the economy to those which are currently very active yet are affected by larger cyclical fluctuations (e.g. construction, real estate, trade).

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

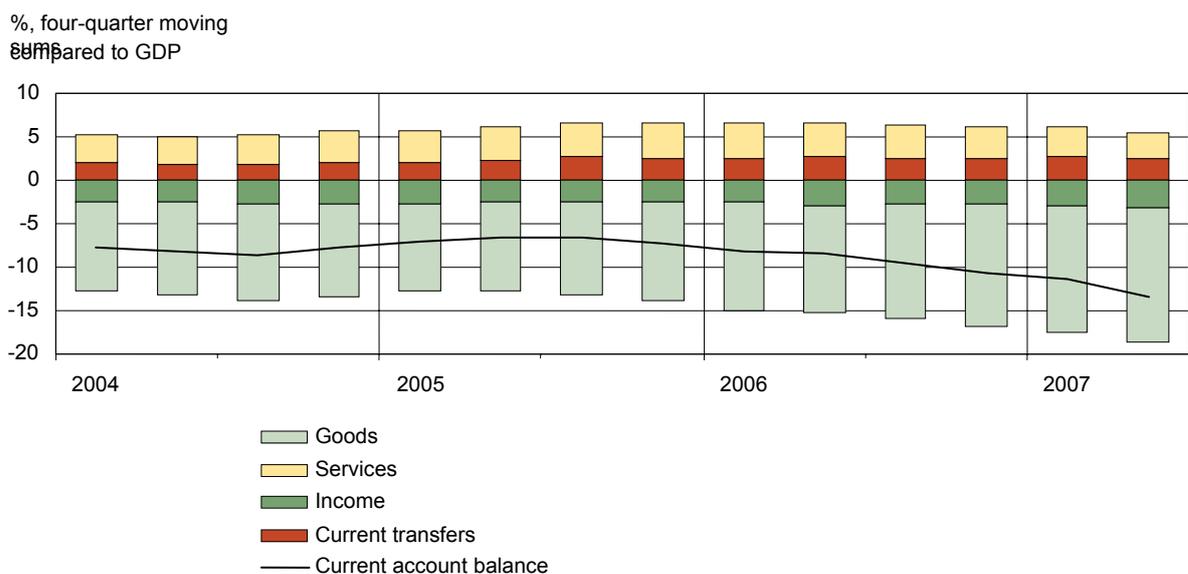
Balance of Payments

20. In 2007, the trend of a widening current account deficit of Lithuania's balance of payments continued: in the first quarter it went up to 13.2% of GDP, while in the second quarter up to 16.1% of GDP. According to the data for the second quarter, the four-quarter moving sum of the CAD rose to 13.4% of GDP. Such development of external accounts essentially means that the net financial flows from foreign trade and other current transfers are negative, large and tend to increase, which in turn results in a rapid increase in foreign debt.

The balance of savings and investment shows that the growth of the CAD over the past two years was also determined by growing investment, the annual moving sum of which went up to 28.3% of GDP (cf. 26.6% a year ago) as well as a decline in savings, the annual moving sum of which fell to 14.9% of GDP (from 18.1% a year ago).

The development of the current account of the balance of payments of Lithuania greatly depends on the lending policies of foreign banks. As foreign banks are being more cautious about the economic prospects of the Baltic countries, the CAD is likely to fall, thus affecting GDP growth.

Fig. 6. Components of the current account balance



Sources: Department of Statistics, Bank of Lithuania and Bank of Lithuania estimates

The recent widening of the CAD has been mostly inspired by the increasing deficit of the balance of goods, which, in the first half of 2007, was 45.3% above the figure for the corresponding period in 2006. About a third of the annual growth of the balance of goods in the first half of 2007 as compared to the same period of 2006 is associated with the developments in oil refining activities – the interruption of oil supplies via the pipeline from Russia in July 2006 and the severe fire in the oil refinery of AB “Mažeikių nafta“ in October 2006 had a hugely detrimental impact on the development of foreign trade. This impact is still felt today, though the situation in the sector is gradually stabilizing. The total exports of petroleum products in the first half of 2007 were 47.3% below the figure a year ago, while imports were 26.1% down. It is notable, that Lithuania is a net importer of oil and the profit of foreign investors controlling AB “Mažeikių nafta” is essentially treated as foreign direct investment (hereinafter referred to as FDI) inflows in Lithuania. Thus, oil prices or the growth of earnings of AB “Mažeikių nafta” contribute to the increase in the CAD. In the second quarter of 2007, the average oil price in litas was some 9% below the figure a year ago, which had a positive effect on the development of the current account.

In the first half of 2007, the positive balance of services was decreasing and fell by 29.7% as compared to the same period in 2006. This decline was mainly due to the decreased volume of exports of intermediation services and worsened travel balance. The positive balance of transport services, which is the main component of the services balance, declined only slightly. Over the year, a substantial decrease in the import of pipeline transport services was partially offset by the rise in import of sea transport services. Given a rapid growth of foreign trade, a significant increase in the volume of rail and road transport (in both import and export of these services) was recorded.

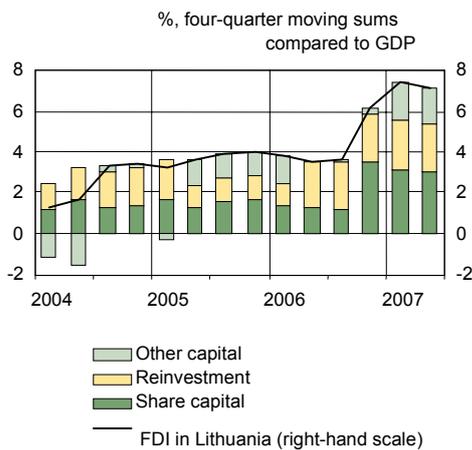
The income balance was deteriorating during the first half of 2007 and stood 45% below the figure a year ago. Although there was a moderate improvement of the balance of labour income, negative flows of investment income experienced a faster growth. This rise, as earlier, was largely determined by increasing growth of the profit of foreign investors in Lithuania and growing income of foreign investors from other investment, which mostly consists of higher interest paid to foreign banks as the debt of the economy increases. The increase in income deficit was slowed down by growing foreign investment portfolio income of residents.

In the first half of 2007, the development of the current account of the balance of payments of Lithuania was positively affected by a 17.5% increase of net current transfers. Their increase was determined by a fast growth of private transfers, which was especially strong in the first quarter, but fairly slow in the second quarter.

Over the recent period, the developments of debt-neutral capital flows, which are used to finance the CAD, were benign. Capital transfers (support of EU cohesion funds) increased over the year and, in the first half of 2007, covered 8.8% of the CAD. This was related to a faster use of EU financial support. Lithuania’s FDI flows, after an especially active fourth quarter of 2006, when the stocks of AB “Mažeikių nafta” were sold to a foreign investor, continued into the first quarter of

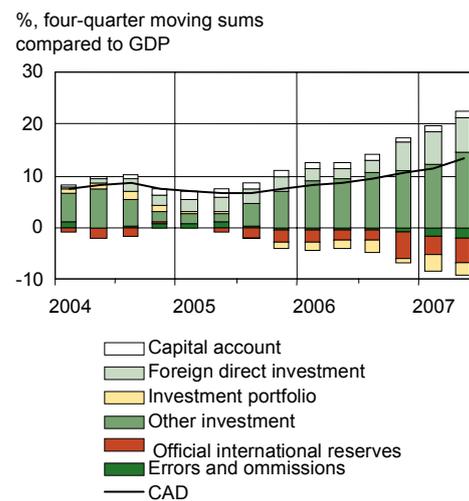
2007, with investment in oil refining and other industries being intense, while in the second quarter the FDI processes saw a slow down. Apart from the sale of the stocks of AB “Mažeikių nafta”, the reinvestment of profit earned by companies usually constituted the largest part of investment. In the first half of the year, the FDI in Lithuania financed 42.2% of the CAD.

Fig. 7. FDI trends in Lithuania



Bank of Lithuania

Fig. 8. FDI financing sources



Bank of Lithuania

The net foreign borrowing of commercial banks remained the most important and stable source of CAD financing: the net financial inflows to the commercial banking sector covered 62.5% of the CAD in the first half of the year. Such large injections of financial resources into the country's economy greatly encourage economic development; moreover, as these resources boost domestic demand, import of consumer and investment goods as well as the CAD increase accordingly.

In the first half of 2007, portfolio investment flows remained negative and accounted for 24.4% of the CAD. A further increase in foreign portfolio investment (which is mostly private sector investment in foreign equities) was nearly offset by non-resident investment in debt securities of banks. The increasing foreign financial investment flows are in part associated with the emergence and promotion of new financial savings instruments and active growth of investment and pension funds.

At the end of the second quarter of 2007, as the debt of the economy increased, the total foreign debt was 40.4% above the figure a year before and accounted for LTL 58.2% billion, or 66.1% of GDP. Almost a half of the year-on-year increase of foreign debt was determined by foreign borrowing of banks (mainly in the form of long-term liabilities). Nearly one third of the increase is attributable to the growth of long-term liabilities of other financial enterprises (non-banking institutions). In the second quarter, the total foreign debt administration costs amounted to LTL 7.6 billion, or 32.2% of the second-quarter GDP, of which repayment of loans made up LTL

473.2 billion, or 2% of GDP. These repayments of loans are direct economic costs incurred by the country's economy for the possibility to finance the current economic development with foreign funds. To achieve stability in the administration of foreign debt, it is necessary to ensure continuous refinancing flows from foreign banks whose strategic aim to enter Lithuania's financial market directly or through their subsidiaries is an important risk-reducing factor.

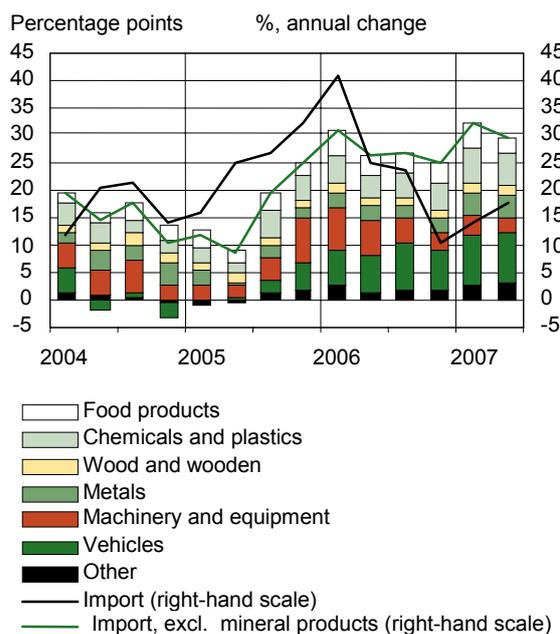
In the first half of 2007 foreign trade grew rapidly. When compared to the same period of the last year, the nominal export of goods has increased by 7,2 % and import – by 15,6 %. Nominal export of goods excluding trade in oil and oil products has increased by 33,4 % and import – by 30,3 %.

Demand in raw materials backed by high activity of manufacturing industry encourages to import intermediate goods of industry. In the first half of 2007 this resulted in the growth of nominal import by 12,8 % or more than half of the total nominal import (excluding oil and oil products). Since the year 2006 the direct impact of imported vehicles on the nominal import has significantly increased, which accordingly was strengthened by increase in prices of imported vehicles.

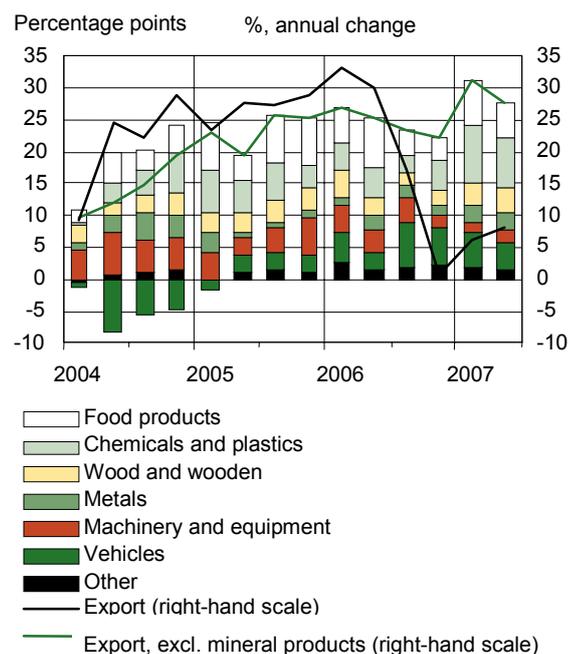
Rapid growth of export (excluding oil and oil products) is to the great extent related to the intensive export of chemical industry as well as plastics industry products. Rate of vehicle export growth is also very high, however, the impact on total export growth in 2007 has declined. Due to differences between prices in Lithuania and in main export markets the export of production of animal origin – live animals, meat and milk – is rapidly increasing: during ten months in 2007 such export increased by 43 %. When Russia and Belarus, the main exporters of wood, increased custom duties on exported produce, the demand for wood in other EU countries has increased. This resulted in increased prices of wood and made positive impact on the nominal export of Lithuanian wood, part of wood being exported to the EU countries.

Fig. 9 Factors of change in import excluding mineral products

Fig. 10 Factors of change in export excluding mineral products



Sources: Department of Statistics, Bank of Lithuania, calculations of the Bank of Lithuania



Sources: Department of Statistics, Bank of Lithuania, calculations of the Bank of Lithuania

In the end of the 2nd quarter of 2007 the real effective exchange rate of the litas was higher by 1,3 % than a year ago. The real effective exchange rate of the litas increased vis-à-vis trade partners of the euro zone and the Commonwealth of Independent States, but declined vis-à-vis the new EU Member States (mainly because of higher inflation in the neighbouring Baltic states). The effective exchange rate of the litas based on deflationary factor of export prices has increased by 2,1 % during the year. Up until now the increased prices of production under exportation has no vivid negative impact on a real export growth rate and competitiveness.

It is expected that the fundamental export development will meet changes in foreign demand, and in the end of 2007 export growth will increase due to the recovery of oil refining capacity. This should smooth the increase of CAD in the 4th quarter of 2007. It is expected that in 2007 the CAD may count for 14 % of GDP. Due to rapid increase in internal demand CAD will further increase in 2008 and may count for more that 15 % of GDP.

Table 5. Sectoral balances

Indicator	ESA code	% of GDP				
		2006	2007	2008	2009	2010
1. Net lending/borrowing vis-à-vis	B.9N	-9,5	-12,5	-12,7	-14,5	-15,4

the rest of the world						
of which:						
- balance of goods and services		-10,4	-13,5	-14,2	-15,4	-16,3
- balance of primary incomes and transfers*		-0,3	-0,5	-0,1	-0,6	-0,6
- capital account*		1,2	1,5	1,6	1,5	1,5
2. Net lending/borrowing of the private sector		-8,9	-11,6	-12,2	-14,7	-16,2
3. Net lending/borrowing of the general government	B.9N	-0,6	-0,9	-0,5	0,2	0,8
4. Statistical discrepancy		0	0	0	0	0

Sources: Ministry of Finance, *Bank of Lithuania

Risk related factors of economic development

21. In the medium and long-term the risk stems from the imbalances existing in the real estate market of the country, potential correction of asset prices and a significant slowdown in the growth of the national economy. The potential GDP growth will remain close to 6 %, however, the existing risk factors may unnaturally retard economic growth in the medium-term and the future of the economic sectors which have recently experienced a boom will depend on their flexibility with regard to changes in real estate prices. The risk remains, especially in 2008, that the return of real estate prices back to economically justified levels might slow down the GDP growth by several percentage points. The presence of such a risk is supported by the start in the USA of the correction of the real estate market that still is going on. The correction of the real estate market would allow to determine the extent to which the decisions of borrowers that are not always rational made in recent years could influence the medium-term perspectives.

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

23. The issues of “overheating” and two correction scenarios, “soft lending” and “hard lending”, which discussed in macroeconomic overviews by commercial banks, show that mid-term economic risks depend on the country’s capacity to get prepared for natural economic cycles in time and efficiently.

24. Inflation may increase in the mid-term due to a faster growth of wages prompted by the “heating” of the economy.

Persistence of expectations of market participants for a strong rise of prices and a faster growth of wages could change consumer behaviour and increase nominal GDP growth and the CAD by

several percentage points. Growth of wages and nominal GDP could also be several percentage points higher if credit growth went up rather than down.

25. If because of concerns about the state of regional economy the commercial banks will change their credit supply policies too quickly, Lithuania's economic growth in the years of correction would be several percentage points slower, but would subsequently come equal to the high potential GDP growth.

26. Due to repair works at the Mažeikiai oil refinery in 2007 the Lithuania's total exports experienced a sudden slowdown, but export of products of Lithuanian origin maintained its recent stable nominal growth of 6-9 %. In case the supply of raw materials for the refinery will be restored to the previous capacity, Lithuania's general export may significantly increase in 2008.

III. PUBLIC FINANCES

Strategy of financial policy

27. The medium-term objective is the reduction, by ensuring the implementation of economic policy priorities, of the structural deficit down to 1 % GDP or below after 2008 and further down in later years up to a structurally balanced deficit or structural surplus. Stricter fiscal policy goals have been set in the light of faster-than-projected trends of nominal GDP growth and committed limitation of expenditure growth as set by the Fiscal Discipline Law of the Republic of Lithuania.

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

28.1 to match the fiscal policy with the priorities of social policy;

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

28.3 to promote further reforms in energy and agriculture sectors;

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

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

28.6 during 2008 to prepare proposals on measures capable of ensuring continuous usage of potential economic growth necessary for low inflation and high employment and ensuring deterioration of fiscal deficit. Partnership of public and private sectors, the efficiency of which is evidenced by the participation of private sector due to profitability of joint project, should be applied to investments that do not increase fiscal deficit for the state;

28.7 to improve long-term sustainability of finances of general government and fiscal discipline norms that ensure long-term economy development as well as implement education and health care reforms;

28.8 to apply quasi-monetary measures, such as tax subsidies influencing demand of credits, for the implementation of active monetary policy aiming to ensure stability of prices and acceptable level of employment;

28.9 to rise confidence in sustainability of long-term finances of the general government and improve the planning framework for the state budget of the Republic of Lithuania for a mid-term period.

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

Actions planned for 2008 to 2010 aimed for the implementation of fiscal deficit objectives

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

In 2005–2007, Lithuania successfully mitigated negative effects of the shadow economy on general government finances. In the mid-term, tax collection will continue to be further improved; therefore, the structural revenue is expected to increase by more than 1,5 % of GDP in 2008; any extra revenues will be used to achieve fiscal deficit targets. Taking account of present possibilities efforts are made to increase the share of GDP for health care and education. Compliance with the Fiscal Discipline Law of the Republic of Lithuania in a medium -term would create conditions for limiting the increase of structural expenses and for ensuring the implementation of fiscal deficit targets. In order to implement the targets of the fiscal deficit planned for 2008, the sum impact of structural measures in 2008 should account for 1,8 %. The implementation of structural measures in 2008 would allow to enjoy surplus budget in 2009 and 2010. The implementation of the targets of the fiscal deficit of 2009 and 2010 will greatly depend on the ability of municipalities to implement the provisions of the Organic Budget Law of the Republic of Lithuania (*Valstybės žinios*, (Official Gazette) 1990, Nr. 24-596; 2004 Nr. 4-47) concerning the balanced budgets and to implement commitments concerning national financing when implementing projects financed from the EU resources. Risk management measures of fiscal deficit target implementation in the year 2008 are discussed in point 57 of this Programme.

31. The following measures are foreseen for the implementation of the targets of the Lithuania's finance policy:

31.1 measures for the implementation of fiscal deficit targets in the period of 2008–2010:

31.1.1 making further efforts to mitigate the adverse impact of the shadow economy on general government finances and seeking to ensure that the planned increase of structural revenue by more than 1,5 % of GDP in 2008 is outperformed at least by 0,3 % of GDP.;

31.1.2 seeking to ensure rational spending of general government expenditure;

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

31.1.4 present to the Seimas of the Republic of Lithuania draft laws on the approval of financial indicators of the state budget and municipal budgets of 2009–2011 implementing the norms of Fiscal Discipline Law of the Republic of Lithuania that require to limit the increase of expenditure to such an extent that fiscal deficit when compared with the previous year improves at least by 1 % of GDP or the expenditure increase of the state budget of the Republic of Lithuania expressed in per cents is not higher than half of revenue increase during the previous five years expressed in per cents;

31.1.5 solving the issue on the risk concerning the increase of fiscal deficit stemming from renovation of residential houses by means of public and private sectors partnership or targeted financing of international institutions; reducing the risk of fiscal deficit to the risk of temporary debt increase;

31.1.6 reconsidering the principles for financing the health care system, determining (after evaluation of purposefulness) independent source of financing that is independent of population income tax;

31.1.7 preparing by the end of 2008 and presenting if necessary to the Seimas of the Republic of Lithuania relevant proposals following the evaluation by the Government of the Republic of Lithuania of the analysis of purposefulness of tax exemptions;

31.2 with a view to achieve long-term stability of prices in 2008, consider the possibilities to develop measures of quasi-monetary policy based on the impact of real estate related taxes and subsidies on credit demand, that would allow to ensure price stability in the short-term and policy that guarantees acceptable level of employment; aiming to make influence on public expectations and place obstacles for over-consumption in the future;

31.3 preparing measures during the year 2008 that would ensure consistent use of potential economic growth necessary for low inflation and high employment and without increasing of general government deficit. If necessary these measures would allow to aim at real stability of the sector and tax bases. Application of public and private partnership, the productivity of which is ensured by the participation of the private sector seeking for profit of the common project, for investment that does not increase state fiscal deficit would allow to avoid the growth slowdown deeper than the natural cyclic growth and would ensure the collection of planned state budget revenues;

31.4 increasing confidence in sustainability of long-term finances of the general government by improving the state budget medium-term planning framework.

Strengthening of fiscal discipline by improving the state budget medium-term planning framework of the Republic of Lithuania

Overview

32. The Constitution of the Republic of Lithuania, the Organic Budget Law of the Republic of Lithuania, the Law on State Debt of the Republic of Lithuania (*Valstybės žinios*, (Official Gazette) 1996, Nr. 86-2045; 2005, Nr. 83-3041), the Law on State Control of the Republic of Lithuania (*Valstybės žinios*, (Official Gazette) 1995, Nr. 51-1243; 2001, Nr. 112-4070), Treaty establishing the EU, regulations of the Stability and Growth Pact, opinions of the Economic and Financial Affairs Council of the EU and conclusions of the European Council as well as the Law on Fiscal Discipline of the Republic of Lithuania help to ensure fiscal discipline in Lithuania.

The Law on Fiscal Discipline of the Republic of Lithuania supplemented the planning framework for the state budget of the Republic of Lithuania by commitments that will allow to use sound general government finances as means for strengthening conditions for price stability and sustainable growth that are favourable for employment growth. The fact that fiscal discipline is enshrined in the law strengthens confidence in effect of fixed rate of litas on long-term price stability. Strict compliance with budget discipline (aiming at structurally balanced or surplus general government finances) will allow the economy of Lithuania to overcome cyclic fluctuations and to preserve deficit of the general government not exceeding 3 % of GDP.

The Law on Fiscal Discipline of the Republic of Lithuania lays down algorithm of fiscal discipline that was formed taking account of the results of econometric study presented in the report on public finance by the European Commission in 2007 (in English: EUROPEAN ECONOMY. No 3. 2007. Office for Official Publications of the EC. Luxembourg. 330 pp). The empirical study has indicated that there are two practical approaches for strengthening the finances – ‘gradual’ and ‘cold shower’. The ‘gradual’ approach for strengthening finances is applied over rapid growth periods by limiting increase of expenditure, while the ‘cold shower’ approach is applied in case of risk of economic crisis by reducing expenditures. The algorithm of fiscal discipline of Lithuania puts a commitment to strengthen government finances by applying the ‘gradual’ approach during rapid growth periods.

The algorithm of fiscal discipline is based on the combination of three fundamental stability rules. The first rule lays down a common guideline: the general government is managed in such a way that ensures it being in surplus or balanced, except in case of justifying circumstances that allow temporary application of less strict requirements. The second rule lays down the procedure for formation of optimal fiscal policy: each year in line with the procedure prescribed in the EU founding treaty and regulations of the Stability and Growth Pact the most competent EU experts evaluate the economy and medium-term fiscal policy of Lithuania and prepare an opinion of the EU Council on the fiscal policy that is the most suitable for Lithuania and the Government of the

Republic of Lithuania submits it to the Seimas of the Republic of Lithuania. The second rule allows to receive each year timely and clear advice of the economists concerning the implementation of anti-cyclical fiscal policy in Lithuania taking account of the so called 'indicator of potential economic development'. The third rule lays down quantitative restrictions on expenditure: during periods of rapid growth of economy and in cases when there are no other justifying circumstances expenditure cannot be increased by more than half of long-term revenue increase expressed in per cents. This rule performs the role of a sanction in those cases when a discrete optimal fiscal policy is not implemented in time. The law sets a number of conditions for suspension the application of the rules.

The operation of the fiscal discipline algorithm could be described in one sentence: in periods of rapid growth the expenditure of general government grow slower than revenues; therefore, revenues exceeds the expenditure in the long term ensuring the sustainable balance of the state budget of the Republic of Lithuania; when forming the budget each year account is taken of suggestions of the EU experts on the discrete optimal fiscal policy.

Goals and tasks when improving norms of fiscal discipline

33. Areas that need to be improved:

33.1 to make the norms for accountancy of indicators of the state budget of the Republic of Lithuania stricter by applying as many principles of the European account standards ESS'95 as possible; to reconsider the terminology of laws related to the definition of net borrowing of the Government of the Republic of Lithuania taking account of the principles of the European account system ESS'95.

33.2 to regulate the key parameters for macroeconomic indicators and budget revenue planning ensuring to avoid over optimistic prognosis of budget revenue of the Republic of Lithuania;

33.3 to regulate the content requirements of conclusions of the Government of the Republic of Lithuania necessary for the formation of optimal discrete fiscal policy and proposals to the Seimas of the Republic of Lithuania, as prescribed in the Law on Fiscal Discipline of the Republic of Lithuania;

33.4 to improve the framework for appropriations planning and control of the state budget of the Republic of Lithuania.

Planned measures

34. It is foreseen to put efforts to provide stricter definition of the aims of the borrowing of the Government of the Republic of Lithuania in the name of the state in the Law on the State Debt of the Republic of Lithuania: to apply the European account standards ESS'95 in such a way as to harmonize the Law on the State Debt of the Republic of Lithuania with the Law on Fiscal Discipline of the Republic of Lithuania.

35. It is foreseen to set in the laws the provision stating the rejection to provide in the name of the Government of the Republic of Lithuania new state guarantees concerning loans used to finance state investments.

36. It is foreseen to prepare draft laws of the Republic of Lithuania on preparation of the budget that would include:

36.1 defined economic indicators that are considered to be tax bases for planning budget revenues;

36.2 limits for maximum values used when planning economic indicators: maximum value of potential GDP growth, maximum GDP deflator, maximum annual change of GDP share of taxation bases expressed in percentage points;

36.3 limits for maximum elasticity of tax revenue in relation to taxation bases; budget revenue should be planned only taking account of changes in taxation bases;

36.4 higher standards for submission to the Seimas of the Republic of Lithuania of conclusions of the Government of the Republic of Lithuania necessary for the formation of optimal discrete fiscal policy as prescribed in the Law on Fiscal Discipline of the Republic of Lithuania;

37. It is foreseen to prescribe that the Government of the Republic of Lithuania when submitting the draft law on approval of financial indicators of the state budget of the Republic of Lithuania and municipal budgets of a certain year to the Seimas of Republic of Lithuania should submit information prescribed in the Law on Fiscal Discipline of the Republic of Lithuania that is necessary for the formation of optimal discrete fiscal policy in a medium-term that included:

37.1 description of key corrections necessary for calculation of general government deficit on the basis of the European account standards ESS'95 and list of possible divergences, that could appear due to assessed fiscal risk;

37.2 proposed medium-term structural deficits of the general government calculated on the basis of data on the output gap of Lithuania published at that time by the European Commission;

37.3 annual changes in fiscal deficit recommended for the medium-term that would allow to manage the impact of changes in aggregate demand on prices, employment and external balance of economy.

38. It is foreseen to strengthen the Reserve (stabilization) fund by means of the Privatization fund resources according to the order prescribed by the laws.

Economic impact

39. The unconditional implementation of the provisions of the Law on Fiscal Discipline of the Republic of Lithuania would allow to expect intermediate results during the medium-term period and final results during the long-term period.

40. The results of the medium-term period:

40.1 it is expected that the calculations of the European Commission will prove that the debt of the general government would not be higher than 60 % of GDP over horizon of several decades;

40.2 it is expected that in the context of further rapid economy growth the structural fiscal deficit will decline by more than 0,5 % of GDP each year until the medium-term goal to achieve structural balanced budget is reached.

41. The results of the long-term period:

41.1 more favourable evaluation of international institutions for finance supervision;

41.2. better credit ratings granted to Lithuania by international credit rating institutions, more favourable interest rates, a more stable tax revenues;

41.3. created preconditions for stable improvement of the living standards;

41.4. building stronger preconditions for price stability and rapid and sustainable economic growth that increases employment;

41.5. a more successful implementation of the fiscal policy ensuring long-term sustainability of national public finances;

41.6. stronger convergence: catching up with other EU members, ensuring the stability of the prices and finances of the general government; preparation for full membership in the European Monetary Union.

41.7. increasing confidence in the effect of the fixed exchange rate of the litas on long-term stability of prices.

Implications of the budget on medium-term goals

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

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

The structure of general government finances in the period 2007-2010, compared with 2006, will change due to social benefits and the absorption of EU financial support.

43. This Programme fundamentally changes general government financial projections owing to the following factors: the implementation of the provisions of the Law on Fiscal Discipline of the Republic of Lithuania, the task to further improve tax administration, and the tax measures necessary with a view to compensating a loss, caused by tax reduction, of structural budgetary revenues.

Table 6. General government budgetary (S13) projections, 2007-2010*

	ESA code	Level in	% of GDP
--	----------	----------	----------

			2006	2007	2008	2009	2010
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-483	-0.6	-0.9	-0.5	0.2	0.8
2. Central government	S.1311	-755.3	-0.9	-0.9	-0.5	0.2	0.8
3. State government	S.1312	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
4. Local government	S.1313	-288.5	-0.4	-0.1	0	0	0
5. Social security funds	S.1314	560.8	0.7	0.1	0	0	0
General government (S13)							
6. Total revenue	TR	27396.9	33.4	35.5	37.4	38.6	39.4
7. Total expenditure	TE	27879.9	34	36.4	37.9	38.5	38.6
8. Net lending/borrowing	EDP B.9	-483	-0.6	-0.9	-0.5	0.2	0.8
9. Interest expenditure	EDP D.41	613.1	0.7	0.8	0.8	0.7	0.6
10. Primary balance		130.1	0.2	-0.1	0.3	0.9	1.4
11. One-off and other temporary measures			0	-0.6	0	0	0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		17138.6	20.9	21.7	23.4	23.6	23.7
12a. Taxes on productions and imports	D.2	9194.8	11.2	12	13.6	13.5	13.5
12b. Current taxes on income, wealth, etc	D.5	7939.6	9.7	9.7	9.8	10.2	10.2
12c. Capital taxes	D.91	4.2	0	0	0	0	0
13. Social contributions	D.61	7226.3	8.8	9.3	9.3	9.3	9.2
14. Property income	D.4	468.2	0.6	0.6	0.6	0.6	0.6
15. Other		2568	3.1	3.9	4.1	5.1	5.9
16=6. Total revenue	TR	27396.9	33.4	35.5	37.4	38.6	39.4
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)		24313,2	29.7	31.1	32.7	33	32.9
Selected components of expenditure							
17. Compensations of employees + intermediate consumption	D.1+P.2	13554.3	16.5	16.5	16.9	16.9	17.1
17a. Compensations of employees	D.1	8625.8	10.5	10.8	11.1	11,1	11,2
17b. Intermediate consumption	P.2	4928.6	6	5.7	5.7	5.8	5.9

	ESA code	Level in 2006 (LTL million)	% of GDP				
			2006	2007	2008	2009	2010
18. Social payments (18=18a+18b)		8158.2	10	10.8	11.9	12.4	12.3
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	1124.5	1.4	1.4	1.5	1.6	1.5
18b. Social transfers other than in kind	D.62	7033.7	8.6	9.4	10.4	10.8	10.7
19=9. Interest expenditure	EDP D.41	613.1	0.7	0.8	0.8	0.7	0.6
20. Subsidies	D.3	584.7	0.7	0.8	0.8	0.7	0.7
21. Gross fixed capital formation**	P.51	3408.5	4.2	4.5	5.1	5.3	5.3
22. Other		2174.2	2.7	3.8	3.1	3.2	3.3
23=7. Total expenditure	TE	27879.9	34	36.4	37.9	38.5	38.6
p.m.: Government consumption (nominal)	P.3	14779.5	18	17.9	18.3	18.3	18.4

Sources: Statistics Lithuania, Ministry of Finance

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

In the medium term, general government revenue (as a percentage of GDP) will grow: accounting for 33.4% of GDP in 2006, it will grow to 35.5% of GDP in 2007 and, due to the increasing EU structural financial aid in 2007-2013 as well as tax tariffs and improving tax administration, it will reach 39.4% of GDP in 2010. Improved tax administration as well as higher tariffs of excise on oil, alcohol and cigarettes will serve to increase the GDP share made up of revenue received from indirect taxes: in 2008 against 2007, it will rise 1.6 percentage points and reach 13.6% of GDP. In 2009-2010, the ratio of the revenue from indirect taxes to GDP has to remain close to 13.5% of GDP in order to meet the fiscal deficit target. In spite of the decreasing rate of the personal income tax and the elimination of the temporary social tax, the planned higher share of GDP in 2008 to be made up of these revenues is attributed to better administration of the personal income tax and profit tax, also to the growth in compensations to employees, which is faster than the GDP growth.

In 2007 versus 2006, the total general government expenditure went up 2.4 percentage points of GDP, to 36.4% of GDP: capital formation went up 0.3 percentage points of GDP as a result of EU support, agricultural subsidies edged up 0.1 percentage points of GDP, social benefits increased 0.8 percentage points of GDP, and transfers for compensations to working pensioners

went up 0.6 percentage points of GDP. The commitment under the Stability and Growth Pact to reduce the structural deficit by approximately 0.5 percentage points of GDP annually does not affect the plans to improve government finances. Gross fixed capital formation is expected to grow, owing to the absorption of EU support, from 4.2% of GDP in 2006 to 5.3% of GDP in 2010.

The Law on Fiscal Discipline of the Republic of Lithuania imposes an obligation for the medium-term to limit the increase of the national budget expenditure of the Republic of Lithuania. Consistent implementation of the provisions of the Law on Fiscal Discipline of the Republic of Lithuania would make it possible to maintain a small share of the general government expenditure in the GDP. The implementation of the projects approved is expected to increase social expenditure from 10% of GDP in 2006 to more than 12% of GDP in 2010.

Successful implementation of the pension reform will make it possible to prepare for the reduction of government debt projected for 2050 and encourage private persons to individually save funds for the old-age pension. Tax revenues to be allocated in 2008 for the pension reform will settle at 1 percentage point of GDP.

Growing support for agriculture and implementation of the tax and pension reforms call for additional funds. To be able to reach medium-term general government fiscal deficit objectives, collective consumption expenditure will have to be cut from 7.7% of GDP in 2006 to 7% of GDP in 2010. Support to agricultural entities financed from national resources in 2007 will be increased by 0.1% of GDP compared with 2006, to account for over 0.8% of GDP.

Borrowings for repayments under previous commitments will increase interest expenditure from 0.7% of GDP in 2006 to 0.8% of GDP in 2007-2008.

44. *One-off and short-term measures.* The Law on the Payment of a Part of the State Social Insurance Pensions of Retirement and Disability of the Republic of Lithuania of 6 November 2007 (*Valstybės žinios* (Official Gazette) No 120-4880, 2007) provides that all the persons who were employed in the period from 1995 to 2002 and, as a result of that, did not receive a part of the pension they were entitled to, will now receive the unpaid amount. Passed in late 2007, the Law on the Payment of a Part of the State Social Insurance Pensions of Retirement and Disability of the Republic of Lithuania stipulates the expenditure liabilities of the general government arising out of the pensions that were not paid to working pensioners beginning with 1995, amounting to LTL 560 million. This one-off expenditure liability will increase only the nominal deficit without affecting the structural deficit. The one-off increase of the 2007 expenditure is accounted for in the line “other”.

45. *General government subsectors balances.* The balance of social insurance funds subsector continues to run surpluses: a surplus of 0.65% of GDP was recorded in 2006. The central government subsector transferred a subsidy of 0.3% of GDP to the subsector of social insurance funds and plans to transfer a subsidy of 0.4% of GDP in 2007. It is primarily the national budget of the Republic of Lithuania, a component of the central government subsector, which accounts for the increase of the GDP part consisting of social benefits.

Despite better-than-planned collection of municipal revenues in 2006 owing to better tax administration and faster growth of wages and employment, the overall local government subsector balance ran deficit. In 2006, local government subsector deficit was below 0.4% of GDP. In the medium term, a close-to-balance local government subsector balance is projected in accordance with the Organic Budget Law of the Republic of Lithuania.

As a result of the structural and tax reforms carried out in recent years, the total general government deficit consisted of the central government subsector deficit, which accounted for 0.9% of GDP in 2005. In part, it resulted from the subsidies transferred to the social insurance funds subsector: 0.3% of GDP was transferred in 2006, and the plan for 2007 is to transfer 0.4% of GDP.

Owing to growing social payments and decreasing central government subsector subsidies, the surplus of the State Social Insurance Fund will decrease in 2008; however, the growth of employment and wages promises larger social contributions.

A reduction of the central government subsector deficit in 2008-2010 will mean a reduction of the total general government deficit in the medium term.

Table 10 shows the reduction of general government structural deficit until achieving structural balanced budget (by about 0.4% of GDP annually) in the period 2007-2010.

Structural deficit and continuity of fiscal policy

46. The cyclically-adjusted general government deficit, which amounted to 0.9% of GDP in 2006, is expected to temporarily depart from the medium-term target because of the payment of unpaid pensions to working pensioners, which should be followed, however, by a substantial structural improvement of the condition of the general government finances in 2009-2010. The implementation of these plans require further determined limiting of expenditure growth, increasing of income and introduction of more innovative forms of financing that do not increase the fiscal deficit; all that would accelerate structural reforms.

Estimation of the output gap

47. The GDP cycle was estimated using the Hodrick Prescott (HP) filter approach. The results obtained point to a positive output gap in the medium term.

In 2007, the output gap will be 3.8%, followed by a drop to 2.4% in 2008, 0.7% in 2009, and 0.01% in 2010.

However, owing to short time-series under the Hodrick Prescott filter approach or under the production function approach (based on the NAIRU concept), the estimate of Lithuania's output gap is inaccurate. The conclusions obtained under the production function approach (based on the NAIRU concept) are, for the time being, not acceptable owing to short time-series, a lack of reliable data and a plenitude of structural breaks. The NAIRU approach ignores "structural shocks". First, the recent rapid growth of construction significantly contributes to cyclical reduction of

unemployment, which, under the NAIRU approach, might be treated as permanent. Second, the European single labour market will affect cyclical fluctuations of employment: integration will reduce cyclical unemployment as a part of unemployed people may choose emigration. Cyclical unemployment might develop into permanent reduction of labour force.

Table 7. Cyclical developments

% of GDP	ESA code	2006	2007	2008	2009	2010
1. Real GDP growth, %		7.7	9.8	5.3	4.5	5.2
2. Net lending (+)/borrowing (-) of general government	EDP B.9	-0.6	-0.9	-0.5	0.2	0.8
3. Interest expenditure	EDP D.41	0.7	0.8	0.8	0.7	0.6
4. One-off and other temporary measures*			-0.59			
5. Potential GDP growth, %		7.2	7	6.6	6.3	5.9
of which:						
labour		N.A.	N.A.	N.A.	N.A.	N.A.
capital		N.A.	N.A.	N.A.	N.A.	N.A.
total factor productivity		N.A.	N.A.	N.A.	N.A.	N.A.
6. output gap		1.1	3.8	2.4	0.7	0
7. cyclical budgetary component		0.3	1.2	0.8	0.2	0
8. cyclically-adjusted balance (2-7)		-0.9	-2.1	-1.2	0	0.8
9. cyclically-adjusted primary balance (8+3)		-0.2	-1.2	-0.5	0.7	1.4
10. structural balance (8-4)		-0.92	-1.5	-1.23	0	0.8

Sources: Statistics Lithuania, Ministry of Finance

*. "+" denotes one-off and temporary measures to reduce deficit.

The Hodrick Prescott (HP) filter approach has a disadvantage in that it smoothes structural changes even when they show an obvious shift in the output. Moreover, this approach suffers from the so-called "end-point bias". The weaknesses of the two approaches must be taken into account if they are to be used to estimate structural deficit. Neither approach is good enough to assess income received on a temporary basis as a result of a deepening external imbalance. In recent years, the loan increase accounted for a sixth of the income of the private sector as well as general government. Therefore, a sudden loss of the foreign credit stimulus and the self-regulation of the external imbalance may cause a significant change in the growth of tax bases and the elasticity of

taxes with respect to tax bases. If the risk is realized, the errors of the structural deficit calculated using the two approaches may be more than one percentage point.

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

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

Table 8. Elasticity of the Lithuanian general government budgetary revenues

ESA '95 code		Cyclical elasticity values
1. D.212	Duties	0.84
2. D.211	VAT	0.97
3. D.214	Excises	1.36
	of which:	
	alcohol	1.09
	tobacco	0
	fuel	1.57
4. D5	Income and profit taxes	1.03
5. D61	Social contributions	0.98
6.	Current expenditure	0

Source: Ministry of Finance

As Table 8 above shows, revenue from tobacco has zero elasticity. It has been estimated that revenue from fuel is the most elastic one, i.e. consumption of fuel is very sensitive to income fluctuations. These elasticity estimates would have been more accurate if their quality had not been affected by numerous changes in tax legislation. This Programme continues to calculate deficit by making stricter assumptions about cyclical fluctuations of current expenditures: the elasticity figure has been reduced from 0.97 to 0. If the historic link between a slowdown of the growth of general government current expenditure and GDP persisted, the share of the cyclical deficit would be as low as one-tenth of the output gap in the medium term.

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

Debt levels and developments

48. General government debt has been continuously decreasing in recent years to account for 18.2% of GDP at the end of 2006.

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

The largest part of the general government debt consists of central government debt (about 95%), whereas the municipal and social insurance funds' debts account for about 5%.

The central government debt has a rather conservative structure: 15% of the total debt consists of short-term liabilities (by outstanding maturity), and 1% consists of the floating interest rate debt. The central government debt is 100% denominated in the litas and the euro. This structure of the debt portfolio poses low risks on public finances.

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

Table 9. General government debt projections

Indicator	% of GDP				
	2006	2007	2008	2009	2010
1. Gross debt	18.2	17.6	17.2	15	14
2. Change in gross debt ratio	-0.4	-0.6	-0.4	-2.2	-1
Contributions to changes in gross debt					
3. Primary balance	0.16	-0.07	0.31	0.9	1.4
4. Interest expenditure	0.75	0.84	0.77	0.7	0.63
5. Stock-flow adjustment*	-0.6	-0.6	-0.7	-3.4	-2.7
of which:					
difference between cash and accruals	–	–	–	–	–
net accumulation of financial assets					
of which: privatization revenues	2.79	0.14	0.05	0.04	0.04
p.m.: implicit interest rate on debt (%)	2.8	4.8	5.2	4.5	4.4
Other relevant variables					

Indicator	% of GDP				
	2006	2007	2008	2009	2010
6. Liquid financial assets	14.6	–	–	–	–
7. Net financial debt (7=1-6)	3.6	–	–	–	–

Source: Ministry of Finance

* Calculated as the difference between the general government debt change and primary balance.

50. The borrowing strategy of the Government of the Republic of Lithuania in 2007 has not changed from that in 2006.

The largest share of the Government's borrowing requirement will consist of the repayment of foreign and domestic debt, cash flow management and state budget deficit financing.

51. In the medium term, the Government envisages implementing the following borrowing policy measures:

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

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

51.3. financing the Government's borrowing requirement mainly by issuing Government Securities (hereinafter referred to as "GS") on the domestic and foreign markets;

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

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

52. *General government debt projections.* In 2007, general government debt is projected to go down to 17.6% of the projected GDP, to be followed by a decrease to 17.2% of the projected GDP in 2008, 15% in 2009, and 14% by the end of 2010.

Implications of structural reforms on general government finances

53. The structural budget balance shows the conditional difference between general government revenue and expenditure when the actual GDP equalled the potential GDP. Structural deficit is calculated with reference to the effect of the business cycle. Table 10 below may be used to calculate the shrinkage of the structural deficit in the light of structural changes in government finances, such as the commencement of co-financing of EU support and the progress of the pension reform. It has been calculated, taking into consideration these structural financial changes and the temporary measures, that general government budgetary plans will enable the reduction of the structural deficit, adjusted in the light of the structural reforms and temporary measures, by 0.4% of

GDP on average over 2007-2010. The required additional financial resources may be available through better tax administration and the implementation of expenditure limitation rules.

Table 10. General government structural and cyclical fiscal deficit projections

Indicator	% of GDP				
	2006	2007	2008	2009	2010
1. General government fiscal deficit target	-0.6	-0.9	-0.5	0.2	0.8
2. Temporary revenues owing to economic cycle (-)	0.33	1.18	0.77	0.22	0
3. Fiscal deficit, taking into account the temporary revenues owing to economic cycle	-0.92	-2.09	-1.23	0	0,8
4. Co-financing requirement	0.47	0.5	0.8	0.81	0.53
5. Pension repayment		0,59			
6. Pension reform	0.65	0,9	1	1,1	1,1
7. Structural deficit less pension repayment to working pensioners, structural reform expenditure, co-financing requirement, and loss of revenue or temporary revenue.	-0.3	-0.6	-0.3	1	1.9
8. Structural measures implemented annually in general government to fulfil the commitments under the Stability and Growth Pact	0	0.3	-0.3	-1.3	-0.8

Source: Ministry of Finance

IV. SENSIBILITY ANALYSIS AND COMPARISON WITH PREVIOUS UPDATE

Economic development risks and their budgetary implications

54. A medium-term growth of floating and fixed market interest rates by one percentage point would imply an increase of the interest payable on the government debt (including new borrowing) of LTL 20m in 2008, LTL 20m in 2009 and LTL 14m in 2010, respectively, or about 0.02 of GDP on average.

55. There exists a risk that ungrounded market expectations aroused delusively by the impression of success in recent years will serve to accelerate credit increase and widen the gap

between the demand and the medium-term output potential. If this is the case, GDP, prices, and wages will grow faster than estimated, to be followed by a faster cyclical slowdown.

The increase of credit levels has reached a magnitude when the utilization of EU financial support is no longer an adequate means of fully compensating cyclical fluctuations of economy; therefore, the continuity of setting prudent general government fiscal objectives and their consistent implementation is a very important economic risk management factor. It seems likely that in the event of sudden external balancing of Lithuania's economy or disinflationary processes, the revenues share will decrease by more than one percentage point of GDP.

In the middle term, strict adherence to fiscal discipline will mitigate a risk rising from CAD, will lead to the balanced development of economic potential by using relatively low interest and establish conditions for consideration of additional structural measures for economic risk management. If financial markets assessed the impact of Lithuanian fiscal discipline rules on the public finances as insufficient, high interest rates in Lithuania would stay for a few years even if the major central banks started reducing interest rates worldwide.

56. If concerns voiced about the likely correction in neighbouring economies proved true and commercial banks changed their credit supply policies too quickly, Lithuania's economic growth in the years of correction would be several percentage points slower, but, in the long run, would come equal to the rapid potential GDP growth. In times of unexpected slowdowns of GDP growth, increase of nominal fiscal deficit in the presence of favourable borrowing conditions and without prejudice to the provisions of the Stability and Growth Pact could be possibly used as an economic stabiliser. Nominal GDP growth might also be slowed down by several percentage points due to a return of real estate prices back to economically justified levels.

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

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

Fiscal risk

57. The major projected sources of fiscal risk include deposit insurance, restitution of real estate ownership rights, debt of state-owned enterprises, decommissioning of the Ignalina Nuclear Power Plant (hereinafter referred to as Ignalina NPP).

Financial commitments in regard to housing renovation, energy supply plans following the closedown of the Ignalina NPP, Lithuania's obligations and commitments in regard to the increased costs of partially EU-financed plans are increasingly becoming new sources of financial risk. According to preliminary estimates, the housing renovation programme might entail the financial resources of the government sector that make up to 6% of GDP. Preliminary estimates forecast that some energy supply alternatives could make up to 30% of GDP in terms of general (private and government sector) financial resources.

The risk of the fiscal deficit growing due to housing renovation or energy supply continuity projects will be addressed by applying private-public partnership, therefore, the risk of the fiscal deficit might be reduced to the provisional risk of the growth of public debt. Also, this risk can be partially managed by utilising finance limits and targeted financing of international institutions.

In the medium term, Lithuanian financial commitments owing to the increased cost of EU partially funded projects will entail up to 0.6% of GDP in terms of additional national sources; to this end, the utilisation of these funds may result in some corrections to the fiscal deficit targets set for the 2008-2010 period. To ensure better efficiency while using EU financial support in 2008, more national funding than originally planned will be necessary, accordingly, this fact will increase fiscal deficit by few percentage points of GDP.

The 2008 Law on Approval of Financial Indicators of the State Budget and Municipal Budgets of the Republic of Lithuania provides for financing from the Privatisation Fund in the amount of 0.4% GDP; those funds may be allocated by the Resolutions of the Government of the Republic of Lithuania. The financial general government projections for 2008 were made on the condition that those funds will not exceed the established general government deficit according to ESA'95.

58. *Deposit insurance.* As of 31 August 2007, the total amount of insured deposits was LTL 34597.48m or 36.3% of GDP.

59. *Savings restitution.* As of 1 January 2007, these commitments stood at LTL 1142.1m or 1.2% of GDP. The sale of "Mažeikių Nafta" shares gave the opportunity of using the funds received for savings restitution and reimbursement of expenses incurred to this end, i.e. making full payments to depositors defined in Article 6 of the Law of the Republic of Lithuania on Savings Restitution (*Valstybės žinios* (Official Gazette) No 58-1330, 1997) during the first quarter of 2007. Resolution No. 65 "On Free Disposition of Restored Savings" of 24 January 2007 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 11-435, 2007) stipulates that depositors of the third group can have the remaining sum of restored savings placed at their disposal from 31 January 2007, and depositors of the fourth – from 5 March 2007.

Government allocations for restoration of savings amounted to LTL 223.8m in 2006, LTL 1135m in 2007, and will amount to LTL 267.6m in 2008.

60. *Restitution of real estate ownership rights.*

In 2006, total payments made from the national budget of the Republic of Lithuania for the land, forest area and bodies of water repurchased by the state amounted to LTL 137m. In 2007, budget allocations for compensation totalled LTL 171m.

The financing requirement for compensation to be paid for the land, forest area and bodies of water repurchased by the state will total LTL 175.3m in 2008. As provided in Article 7 of the Law of the Republic of Lithuania on the Amounts, Sources, Terms and Procedure for Payment of Compensation for Real Estate which is Repurchased by the State as well as on Government Guarantees and Privileges Provided in the Law on the Restoration of the Rights of Ownership of Citizens to Existing Real Estate (*Valstybės žinios* (Official Gazette) No 61-1728, 1998; No 102-4582, 2003) compensation for the land, forest area and bodies of water repurchased by the state must be paid by 1 January 2009.

In 2006, budget allocations of the Republic of Lithuania for the restoration of ownership rights to citizens for surviving residential houses, parts thereof or apartments, and for compensations to be paid to religious communities for the real estate repurchased by the state totalled LTL 200m., and, in 2007, amounted to LTL 72m.

The financing requirement for the restoration of ownership rights to citizens for surviving residential houses, parts thereof or apartments, and for compensations to be paid to religious communities for the real estate repurchased by the state will total LTL 215m in 2008. As provided in Article 7.11 of the Law of the Republic of Lithuania on the Amounts, Sources, Terms and Procedure for Payment of Compensation for Real Estate which is Repurchased by the State as well as on Government Guarantees and Privileges Provided in the Law on the Restoration of the Rights of Ownership of Citizens to Existing Real Estate, state commitments to the owners of restored residential houses, parts thereof as well as apartment tenants must be met by 1 January 2009.

Article 8.2 of the Law on the Amounts, Sources, Terms and Procedure for Payment of Compensation for Real Estate which is Repurchased by the State as well as on Government Guarantees and Privileges Provided in the Law on the Restoration of the Rights of Ownership of Citizens to Existing Real Estate provides that undischarged compensation payable to citizens in the current year shall be indexed annually for inflation of the previous year, and Article 9.14 of the Law provides that pursuing government guarantees in favour of tenants a re-assessment of the market value of residential premises leased must be performed. To this end, with regard to the above and to the pendent court rulings on the restoration of the rights of ownership to citizens, it is likely that the funding demand will amount to LTL 30m in 2009 and LTL 20m in 2010.

61. *Decommissioning of the Ignalina NPP.* The operation of the Ignalina NPP and foreign financing for the termination of its operation entail certain risks. Expenditure allocations in the

budget of the Ignalina NPP Decommissioning Fund total LTL 52.5m (0.1% of GDP) for 2006, LTL 59m (0.1% of GDP) for 2007, and 66.15m (0.1% of GDP) for 2006.

Under the Treaty of Accession Protocol No. 4 EU allocated LTL 1100.5m (EUR 319m) during the period of 2004–2006; this sum being committed in equal annual tranches. According to the data of the Ministry of Economy, the amount of LTL 372.9 (EUR 108m) was earmarked for 2006.

To that end, Lithuania should receive LTL 2891.3m (EUR 837.4m) in current prices within the new EU Financial Perspective for 2007-2013:

LTL 390.2m (EUR 113.02 m) in 2007;

LTL 394.3m (EUR 114.2 m) in 2008;

LTL 402.2m (EUR 116.5m) in 2009;

LTL 413.9m (EUR 119.9m) in 2010.

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

As of 31 August 2007, government-guaranteed loan portfolio accounted for about 1% of GDP projected for 2007. This figure is expected to remain at 1% of GDP over the medium term.

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

As of 30 June 2007, borrowers of the fifth risk group collectively had LTL 190.062m worth of outstanding loans on-lent to them from loans taken on behalf of the state and LTL 19.273m worth of outstanding government-guaranteed loans.

As of 30 September 2007, state-owned enterprises and stock companies in which the state held over 51% of shares had an outstanding debt of LTL 143.188m worth of loans on-lent to them from loans taken on behalf of the state and LTL 262.881m worth of government-guaranteed loans.

Comparison with previous update

64. GDP projections have been revised to reflect the actual figures of the first nine months of 2007 announced by *Statistics Lithuania* and the changes in oil prices as well as the recent trends of economic development.

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

Table 11. Change in GDP, general government deficit and general government debt projections compared to the Convergence Programme of Lithuania of 2007

Indicator	ESA'95 code	% of GDP				
		2006	2007	2008	2009	2010
Real GDP growth						
Previous update		7.8	6.3	5.3	4.5	N.A.
Current update		7.7	9.8	5.3	4.5	5.2
Difference		-0.1	3.5	0	0	N.A.
General government net lending(+)/borrowing(-) (% of GDP)	EDP B.9					
Previous update		-1.2	-0.9	-0.5	0	N.A.
Current update		-0.6	-0.9	-0.5	0.2	0.8
Difference		0.6	0	0	0.2	N.A.
General government gross debt (% of GDP)						
Previous update		18.4	19.2	19	17.7	N.A.
Current update		18.2	17.6	17.2	15	14
Difference		-0.2	-1.6	-1.8	-2.7	N.A.

Sources: Statistics Lithuania, Ministry of Finance

V. QUALITY OF GENERAL GOVERNMENT FINANCES

65. For more effective management of state financial resources, the budgeting reform was initiated by Resolution “On the Budgeting Concept of the Republic of Lithuania” (*Valstybės žinios* (Official Gazette) No 95-2637, 1998) of 22 October 1998 approved by the Seimas of the Republic of Lithuania; the key principles of the reform were to plan the state budget of the Republic of Lithuania for the period of 3 years, to build up the budget according to the programmes, to consolidate financial resources of the state and offer possibility to get thorough information about the use of taxpayers’ money to the public at large. As part of the budgeting reform, off-budgetary funds have been incorporated into the state budget of the Republic of Lithuania and a number of legal amendments were passed to enable the accumulation of the Reserve (Stabilisation) Fund, with the Privatisation Fund being its primary source of income, to be drawn on in extreme situations and in the event of economic threats so as to ensure smooth functioning of the economy. As of 1 October 2007, the Reserve (Stabilisation) Fund had LTL 857m (0.9% of the projected GDP). In 2008, the Reserve (Stabilisation) Fund is estimated to accumulate LTL 1100m.

The Strategic Planning Method, regulating the planning process in a detailed way, was developed for the implementation of the budgeting reform and approved by Resolution No 827 of 6

June 2002 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 57-2312, 2002; No 23-879, 2007). The systemic planning of the specific institution's performance related with funding allows analysis and evaluation of the institution as a system for the achievement of goals set, its guidance on result-oriented activity and more rational distribution of financial, material and work resources.

It is worth noting that the setting of performance priorities of institutions and organisations during the period 2001-2007 has picked up speed; institutions have adopted a three-level assessment criteria system that clearly shows not only services rendered or performance records, but also implementation of strategic and programme goals.

The development of evaluation criteria for the performance of budgetary institutions creates conditions for moving on to qualitatively new opportunities of evaluating goals set, programme implementation results as well as better assessing the expedience of utilisation of funds for public to meet public needs. Interior audit offices, with account assessment criteria being available, have good possibilities to analyze the situation, evaluate risks, forecast possible problems, to present conclusions on the financial and administrative performance of the relevant institution. Information on evaluation criteria makes it possible to decide whether the programmes are efficient, if they are to be continued or if it is expedient to use of budgetary funds for public needs.

The survey of appropriations managers carried out by the National Audit Office in early 2007 show that: 78% of those questioned think the setting of performance priorities of government institutions and organisations and following thereof have improved; 72% think that accountability for performance has also improved; 59% think activity funding has become clearer, and 69% think performance has become more result-oriented.

With a view to introducing further improvements of the planning and audit system of state budget allocations of the Republic of Lithuania, the measure plan was drafted; it was approved by the Cabinet Meeting of 11 June 2007 (Protocol No 36, Item "On the Implementation of Recommendations of the National Audit Office of the Republic of Lithuania Submitted in its Report No VA-60-1P-1 „Programming Budget System” "); the above plan provides for certain measures concerning the optimisation of number of appropriations managers and their performance programmes, continuous evaluation of the programmes of appropriations managers, assessment of efficiency of public expenditure, funding of inter-institutional programmes, design of the homepage (website) with general relevant and up-to-date information on the budget process.

66. Thanks to fiscal consolidation, the share of public administration expenditure in Lithuania (% of GDP) remains low in comparison with that of other EU Member States. According to Eurostat, public administration expenditure in Lithuania was 4.4% of GDP in 2005 (this indicator was 4.7% of GDP in 2004). Given the intention to maintain the required quality of health-care and education services in the medium term, the implementation of the Stability and Growth Pact in Lithuania will limit these functions to the lowest extent. EU support will increase the share of GDP allocated for economic functions by another several percentage points.

Table 12. General government expenditure by function

Indicator	COFOG Code	% of GDP	
		2005	2010
1. General public services	01	4.4	–
2. Defence	02	1.4	–
3. Public order and safety	03	1.8	–
4. Economic affairs	04	3.6	–
5. Environmental protection	05	0.6	–
6. Housing and community amenities	06	0.3	–
7. Health	07	4.3	–
8. Recreation, culture and religion	08	1	–
9. Education	09	5.5	–
10. Social protection	10	10.5	–
11. Total expenditure		33.5	38.6

Sources: Statistics Lithuania, Ministry of Finance

General government expenditure

67. *Objectives.* State budget expenditure targets and priorities are defined in a number of policy papers that are interrelated and form a single integrated set. Documents defining the key national budget expenditure targets and priorities include the Long-Term Development Strategy of the State approved by Resolution No IX-1187 of 12 November 2002 of the Seimas of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 113-5029, 2002), the Single Programming Document of Lithuania for 2004-2006 approved by Resolution No 935 of 2 August 2004 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 123-4486, 2004), the National Lisbon Strategy Implementation Programme approved by Resolution No 1290 of 22 November 2005 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 139-5019, 2005), the Programme of the Government of the Republic of Lithuania for 2006-2008 approved by Resolution No X-767 of 18 July 2006 of the Seimas of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 80-3143, 2006), the Strategy for the Use of EU Structural Support for 2007-2013, and regional development plans. The state budget for 2008-2010 is formed and relevant programmes are prepared in line with the following strategic goals (priorities) approved by Resolution No. 855 of 11 September 2006 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 97-3765, 2006):

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

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

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

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

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

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

68. With a view to ensuring a more efficient use of EU support, the 2008 Law on Approval of Financial Indicators of the State Budget and Municipal Budgets authorises the Government of the Republic of Lithuania, or another institution authorised by the Government, to reallocate EU support and national co-financing designated for programmes and projects as well as funds designated for paying value added tax under these programmes and projects, also other expenditure related to these projects and provided for in legal acts, among appropriations managers, areas of investment and items of economic classification. Moreover, the above law also provides that temporarily idle EU financial support funds may be employed, with an obligation to pay them back, to finance the budgetary needs of the Republic of Lithuania, thereby ensuring timely financing by the Republic of Lithuania of EU financial support special programmes.

The government investment strategy is detailed, by investment area, in the Public Investment Programme for 2008-2010 which defines the financing requirement for investment projects implemented as part of government-supported programs as well as the sources of financing and the timeframes for implementation of the investments projects concerned. The Public Investment Programme for 2008-2010 attributes higher priority to those investment projects that are co-financed by the EU and that are in line with the EU requirements and those that aim at developing national defence as part of the NATO collective security and defence system as well as implementing priority investment projects with regard to the Lithuania's Millennium and Vilnius as European Capital of Culture 2009.

Since accession to the EU, Lithuania has been receiving support from the EU Structural Funds and the Cohesion Fund, the strategy and measures of usage whereof are outlined in the Single Programming Document for 2004-2006 approved by European Commission Decision C(2004)2120 of 18 June 2004 for assistance from the EU Structural Funds under SPD Priority 1 in Lithuania, in the Cohesion Fund Strategy for 2004-2006 approved by Joint Order No 1K-054/D1-

79/3-99 of 20 February 2004 of the Ministers of Finance, Environment, and Transport and Communications (*Valstybės žinios* (Official Gazette) No 33-1071, 2004). The EU Structural Funds and the Cohesion Fund, as financial instruments of EU structural policy, are employed to co-finance priority projects in the EU Member States. Lithuania's Single Programming Document for 2004-2006 defines the strategy, priorities and measures for the use of EU Structural Funds and the respective national co-financing, and the Cohesion Fund Strategy for 2004-2006 defines the strategy for the use of the Cohesion Fund and the respective national co-financing as well as the projects financed.

The Government of the Republic of Lithuania also drafts a policy paper about Lithuania's strategy for 2007-2013 for the use of EU structural support which sets goals and priorities of the use of structural support, in line with strategic guidelines of the European Community Cohesion Fund, European Community priorities and national policy priorities.

The National Strategy for 2007-2013 consists of four Action Programmes: the Human Resources Development, Economic Growth, Cohesion Promotion and Technical Assistance. The Economic Growth Action Programme was endorsed by the Decision of the European Commission No K(2007)3740 of 30 July 2007, adopting action programme "Economic Growth" regarding EC funding from the European Regional Development Fund and the Cohesion Fund under the convergence objective in the Republic of Lithuania; the Cohesion Promotion Action Programme was endorsed by the Decision of the European Commission No K(2007)3738 of 30 July 2007, adopting action programme "Cohesion Promotion" regarding funding from the European Regional Development Fund and the Cohesion Fund under the convergence objective in the Republic of Lithuania; The Human Resources Development programme was endorsed by the Decision of the European Commission No K(2007)4475 of 24 September 2007, adopting action programme regarding funding from the European Social Fund under the convergence objective in the Republic of Lithuania. The above decisions have been published in the Official Journal of the European Communities. As regards the decision on the Technical Assistance Programme, the Commission has plans to make it by the end of 2007.

69. *Actions Planned.* The following actions have been planned for the period 2008-2010:

- 69.1. to restructure general government budgetary spending according to funding priorities and co-financing needs as regards EU funding;
- 69.2. to build institutional and administrative capacities ensuring the most efficient utilisation of EU budget allocations;
- 69.3. to improve municipal financial management;
- 69.4. to improve financial management in the health-care system;
- 69.5. to complete privatisation of state-owned property;
- 69.6. to enhance the efficiency of management of general government financial flows in the attempt to ease the extra burden on the budget that can potentially be placed by extra spending related to membership of the EU and NATO.

70. Public financial management is continuously improved according to the methodology applied by EU Member States in the area of public finance accounting and assessment of financial performance and forecasting, by upgrading technical base and enhancing labour skills.

Budgetary resources continue to be tuned up to EU funding.

It is envisaged that unused planned government expenditure should be used for fiscal deficit decreasing.

Government revenue

Tax reform

71. Originally, the tax reform was carried out in accordance with the tax policy provisions of the Government Action Programme 2004–2008, approved by Resolution No X-43 of 14 December 2004 of the Seimas of the Republic of Lithuania (*Valstybės Žinios* (Official Gazette) No 181-6703, 2004). Currently, the reform is subject to the respective provisions of the Government Action Programme 2006–2008.

72. To gradually reduce personal income tax (PIT) burden, achieve better balance between labour and capital taxation, cut on labour costs, and create more favourable conditions for the growth of competitiveness, the PIT rate was reduced from 33% to 27%, coming into effect as of 1 July 2006. The first of January 2008 will see a further PIT reduction to 24%. Due to PIT reform, the government budgetary revenues fell short by LTL 490 m (0.6% of GDP) in 2006. In 2007, the reduction of PIT to 27% will translate into the budget revenue loss of LTL 1264 m (1.3% of GDP), while a further reduction of PIT to 24% in 2008 is to cut the government budget revenues by LTL 2425 m (2.3% of GDP).

Following the Law of the Republic of Lithuania on Personal Income Tax (*Valstybės Žinios* (Official Gazette) No 73-3085, 2002), the basic monthly personal tax allowance (PTA) goes up from LTL 290 to LTL 320 with effect from 1 January 2007; individual PTA and PTA for children grow accordingly.

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

73. With a view to encouraging the set-up of holding companies in Lithuania, with a view to relevant practice in other EU states, a special taxation regime as regards the transfer of shares

owned by other company was established on 19 October 2006 in pursuance of the Law of the Republic of Lithuania on Corporate Income Tax (*Valstybės žinios* (Official Gazette) No 110-3992, 2001): with effect from 1 January 2007, income received from transfer of shares held by a company which controls for an uninterrupted period of at least 2 years 25% of voting shares at another company which pays corporate or equivalent tax and is established in a state inside the European Economic area or a state which is a party to Double Taxation Avoidance Agreement, will be tax exempt.

The Government of the Republic of Lithuania by Resolution No 1176 of 31 October 2007 on the submission to the Seimas of the Republic of Lithuania of Draft Law Amending Articles 2, 5, 12, 13, 17, 18, 21, 22, 23, 26, 28, 30, 31, 38¹, 47, 50 and Supplementing Annex 3 of the Law of the Republic of Lithuania on Corporate Income Tax and the Draft Law Amending Articles 2, 5, 6, 17, 24, 27, 30, 31, 32, 33, 36 and Amending and Supplementing Annex of the Law on Personal Income Tax (*Valstybės žinios* (Official Gazette) No 116-4746, 2007), approved and submitted to the Seimas the Draft Law Amending and Supplementing the Law of the Republic of Lithuania on Corporate Income Tax, in an attempt to simplify recognition of allowable deductions reducing taxable profit and alleviate administrative burden as regards relevant regulation. Also, with a view to providing more favourable conditions for running small business, the said draft law proposes a higher corporate income limit which, if not exceeded, does not incur an obligation of advance income tax payment. Furthermore, the draft law seeks that certain income received by a non-profit entity from activities aimed at serving public interest should not be attributed to the category of income received from economic-commercial activities.

Furthermore, to further encourage companies to additionally invest in R&D aimed at creation of new materials and technologies which should generate high added value, the Government of Lithuania, by Resolution No 1347 of 17 December 2007, approved the Draft Law Amending the Law on Corporate Income Tax submitted by the Ministry of Finance, which, considering the international practice in the area of respective incentives, provides for the deduction of company R&D-related costs (other than fixed asset acquisition) three times, given the fulfilment of relevant requirements. It also proposes that the price of acquisition of fixed assets used for the purpose of R&D is written-off in two years. Should the said law come into effect from 1 January 2008, the budgetary revenues of the Republic of Lithuania, received from the corporate income tax, would reduce by about LTL 2.5 m. in 2008, about LTL 85 m in 2009, and about LTL 130 m in 2010.

74. Present and future budgetary commitments do not allow tax rates to be reduced and other tax regulations having a potential adverse effect on the budget to be amended without introducing offsetting measures. Therefore, temporary measures were foreseen in the interim period enabling implementation of PIT reform. The Temporary Law of the Republic of Lithuania on Social Tax adopted on 7 June 2005 (*Valstybės žinios* (Official Gazette) No 76-2739, 2005) provides for temporary social tax to be paid in tax reference periods 2006 and 2007. The temporary social tax is

payable by legal persons on their taxable profits as calculated in the manner prescribed in the Law of the Republic of Lithuania on Corporate Income Tax, at the rate of 4% for the tax reference year 2006 and 3% for the tax reference year 2007. In 2006, this tax contributed with revenues of LTL 365.5 m., in 2007, it is projected to generate LTL 470 m, while in 2008, LTL 44.6 m.

75. The Law of the Republic of Lithuania on Real Estate Tax (*Valstybės žinios* (Official Gazette) No [76-2741](#), 2005) aims at establishing a sustainable real estate taxation system, with effect from 1 January 2006, providing equal business conditions for commercial-economic entities, i.e. expands the real estate tax base to cover not only real estate owned by legal entities, but also real estate owned by natural persons and used for commercial-economic purposes, also real estate put to the disposal of legal persons for an unlimited period or for a period exceeding one month. This has brought additional governmental budgetary revenue of LTL 20 m.

The new Law on Real Estate Tax has enabled application of principles of property valuation for tax purposes operative in the international real estate taxation market: i.e. real estate taxable value is the average market value of the property, as established by way of mass valuation (except specific cases).

However, having regard to the fact that taxable value of property in attractive regions has increased following the application of the universally acclaimed methods of property valuation for tax purposes, and aiming at continuous encouragement of municipal financial independence, the Law Amending Articles 6, 8 and 15 of the Law on Real Estate Tax (*Valstybės žinios* (Official Gazette) No [65-2384](#), 2006) was adopted on 25 May 2006, establishing a transition period allowing for gradual approximation (through application of value reduction factor) of tax base for immovable property with new taxable value, and enabling municipal councils to set specific rate of real estate tax, within the range prescribed by the Law (from 0.3% to 1% of the taxable value of the real estate concerned).

76. With a view to implementing the commitment to gradually raise, in the period until 31 December 2009, excises on cigarettes until they reach the minimal rate set in the EU *acquis*, and preventing a sharp growth of cigarette prices, as of 1 March 2007, the specific component of the excise rate on cigarettes have been raised from LTL 47.5 to LTL 66 per 1000 cigarettes, while the *ad valorem* component has remained at 15% (maximum retail price percentage). Actual data 2007 on excise-related revenues reveal that the increase in excise on cigarettes should generate additional revenue of LTL 65 m. in 2007. With effect from 1 March 2008, the specific component of the excise rate on cigarettes will be increased from LTL 66 to LTL 79 per 1000 cigarettes, and *ad valorem* component, from 15% to 20% percent. Cigarette excise increase to the said rate is projected to generate additional budgetary revenue of about LTL 71 m in 2008, with regard to possible changes in retail cigarette sales volumes as well as structure, as prompted by higher excise rate on cigarettes. During 2008-2009, the excise rate on cigarettes is to grow twice, each time by approximately 30 %, in order to reach the EU minimum of LTL 221 per 1000 cigarettes by 2010.

Furthermore, with a view to implementing the Council Directive 2004/74/EC of 29 April 2004 amending Directive 2003/96/EC as regards the possibility for certain Member States to apply, in respect to energy products and electricity, temporary exemptions or reductions in the levels of taxation (*OJ Special Edition, 2004, Volume 02, Chapter 09, p. 16*), as of 1 January 2008, in Lithuania, excise rate on petrol has to be at least EUR 323, diesel fuel and kerosene – at least EUR 274 per 1000 litres; as of 1 January 2008, petrol excise rate is set to be at LTL 1116, diesel fuel and kerosene – at LTL 947 per 1000 litres. Calculations on changes in sales, prompted by higher excise rate on fuels, project additional budgetary revenues of LTL 106 m in 2008.

The Seimas of the Republic of Lithuania adopted the Law Amending Articles 8, 9, 11, 21, 22, 23, 24, 28, 33, 34, 35 of the Law on Excise Duty (*Valstybės žinios* (Official Gazette) No [132-5358](#), 2007). It lays down the amendments to the Law on Excise Duty (*Valstybės žinios* (Official Gazette) No [98-3482](#); No [26-802](#), 2004) providing for an increase in the rate of excise duty on ethyl alcohol and alcoholic beverages, with effect from 1 January 2008:

beer (1hl of product) – from LTL 7 to LTL 7.7 for 1% of actual alcoholic strength by volume);

wines and other fermented beverages, having an actual alcoholic strength (in case of other fermented beverages achieved by way of fermentation) by volume of 8.5% or more and where fermented drink constitutes 100% by volume – from LTL 150 to LTL 180 (8,5 % and less – from LTL 40 to LTL 48) for product hectolitre ;

intermediate products, having actual alcoholic strength by volume of 15% and more – from LTL 230 to LTL 276 (15% and less – from LTL 150 to LTL 180) per hectolitre.

ethyl alcohol – from LTL 3200 to LTL 3840 per hectolitre of pure ethyl alcohol.

An increased rate of excise duty on ethyl alcohol and alcoholic beverages is projected to generate additional budgetary revenues of LTL 190 m in 2008.

77. The Law on Tax Administration (*Valstybės žinios* (Official Gazette) No [63-2243](#), 2004), with effect from 3 July 2007, provides for optimization and better regulation as regards tax administration as well as lower administrative burden for tax payers: through consistent explanation and application of tax laws; expanded basis for tax payer exemption from sanctions; legal preconditions allowing to expand the list of circumstances exempting the tax payer from filing a tax return or other documents; reduced customs clearance.

78. *State land lease calculation procedure.* With regard to the decision No 25 of 16 October 2007 by the Strategic Planning Committee of the Government of the Republic of Lithuania, providing for a change in state land lease calculation procedure, resolutions of the Government of the Republic of Lithuania regulating the above procedure will have to be amended accordingly: a proposal will be made for the state land lease fee calculations to be based on average land market value as established by way of mass valuation, from 2009. Also, with a view to possible future drastic changes in land lease fee, a proposal will be put forward regarding transition period for the application of the average land market value as established by way of mass valuation and expansion

of the range of land lease fee (from 0.1% to 4%) enabling municipalities to establish specific rates, within these limits, taking into account their social and economic situation and strategic goals.

Once the transition is made to the state land lease fee calculation based on the average land market value as established by way of mass valuation, a possibility of calculating land tax based on average land market value will be discussed.

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

VI. SUSTAINABILITY OF PUBLIC FINANCES

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

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

81. Table 13 below gives projections on long-term sustainability of public finances (pensions, health care and education systems) for the period until 2050. The projections have been made using preliminary statistical data for 2005 and the economic and employment projections for the period 2010-2050 provided by the Economic and Financial Affairs Directorate-General of the European Commission. Spending on health protection and on long-term health care as well as on education have been projected applying the methodology used by the Ageing Working Group (AWG) of the Economic and Financial Affairs Directorate-General of the European Commission in making analogical projections for EU-15 in 2001 (*The 2005 EPC projections of age-related spending (2004-2050) for the EU-25 Member States: underlying assumptions and projection methodologies*; European Economy, Special Report No 4, 2005). The projection of spending on unemployment

benefits included in Table 13 under “Other age-related spending” has been calculated using the methodology employed for analogical projections for EU-15 in 2003.

Table 13 Long-term sustainability of public finances

Indicator	% of GDP					
	2000	2005	2010	2020	2030	2050
1. Total expenditure	39,13	33,64	38,62	38,24	39,59	41,65
of which: age-related expenditure	13,73	16,8	15,98	15,6	16,95	19,01
Pension expenditure	7,8	6,67	5,99	6,37	7,22	8,65
Social security pensions	7,8	6,67	5,99	6,37	7,22	8,65
Old-age and early pensions	6,9	5,7	5,04	5,42	6,28	7,66
Other pensions (disability, survivors)	0,94	0,98	0,95	0,95	0,94	0,99
Occupational pensions (if in general government)	–	–	–	–	–	–
Health care		4,26	4,47	4,67	4,86	5,24
Long-term care		0,54	0,55	0,55	0,63	0,86
Education expenditure*	5,7	5,25	4,88	3,88	4,11	4,12
Other age-related expenditure**	0,19	0,09	0,09	0,13	0,13	0,13
Interest expenditure	1,74	0,82	0,52	0,34	0,44	1,8
2. Total revenue	35,58	33,13	39,41	39,41	39,41	39,41
of which: property income	1,16	0,76	0,6	0,6	0,6	0,6
of which: from pensions contributions (or social contributions if appropriate)	7,09	7,02	7,22	7,29	7,27	7,06
Pension reserve fund assets	0,24	1,71	N.A.	N.A.	N.A.	N.A.
of which: consolidated public pension fund assets (assets other than government liabilities)***	0	0,48	4,05	11,62	20,13	36,64
3. Assumptions						
Labour productivity growth	9,7	7,1	5,2	3,6	2,7	1,7
Real GDP growth	4,1	7,9	5,3	3	1,9	0,4
Participation rate males (aged 20-64)	82,1	81,5	85,6	87,6	88	86,3
Participation rate females (aged 20-64)	73,4	72,7	77,8	81,4	82,2	79,7
Total participation rate (aged 20-64)	77,6	76,9	81,5	84,4	85	83
Unemployment rate****	16,4	8,3	5,1	7	7	7

Indicator	% of GDP					
	2000	2005	2010	2020	2030	2050
Population aged 65+ over total population (beginning of the year)	13,7	15,1	16,1	17,5	21,4	26,7

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

*Excluding spending on payments to households and private entities and direct capital spending on education establishments.

**Unemployment benefits.

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

****if the level of labour force activity and migration change according to observed recent trends, unemployment rate should be down in 2010.

Table 13 gives expenditure on social security pensions: social insurance pensions and state pensions (including social benefits and excluding private pension funds administered by pension accumulation companies), and revenues from social insurance contributions.

82. According to the projections, as the number of children and working-age people decreases and the number of elderly people increases, general government budgetary expenditure on pensions and health care, as a share of GDP, will go up and expenditure on education will come down: in 2005-2050; expenditure on pensions will grow by 1.98% GDP, health care 1% GDP, while education expenditure is to come down by 1.12% GDP. Unemployment benefit expenditure is most likely to follow the current trend. In general, population ageing-related expenditure will account for 2.21% GDP.

83. Pension expenditure is most likely to show the fastest growth, for this reason, a pension reform was launched in 2004, setting up Tier II of pension system – a subsystem of voluntary pension accumulation (Pillar II of Tier I of state social insurance pension system), where part of mandatory state social insurance contributions are shifted to private pension funds. The first pension accumulation contracts were concluded back in 2003. Due to successful implementation of the reform, in 2006, 63% (785 thousand) of insured by state social insurance participated in pension accumulation system. In 2007, another 95 thousand concluded pension accumulation contracts, and almost 880 thousand is projected to participate in pension accumulation in 2008, which will account for 69% of all insured by state social insurance.

84. A share of state social insurance contributions shifted to private funds has been growing rapidly. It is expected to reach 0.81% of GDP in 2007. Faster than projected growth in salary and employment and increased participation by the insured in choosing pension accumulation system, have been constantly adjusting these projections. According to the projection of long-term sustainability of the pension system for the period 2050, the share of revenues allocated to pension

reform will reach 0.84% GDP in 2008, 0.87% in 2009, and 0.89% in 2010. Costs related to the transition period of the pension reform, which will reach the maximum of 1%GDP around 2010, will be funded from the surplus accrued in social insurance sector due to interim demographic and economic recovery, as well as from privatisation proceeds, the state budget of the Republic of Lithuania, and other funding sources. The costs are expected to come down around 2030, when about half of the retired are put on reduced state social insurance pensions of old age (supplementary part of old-age pension is reduced in proportion to accumulated contribution) together with annuities, accrued from accumulated pension.

85. The Lithuanian National Report on the Strategy for Sufficiency and Stability of Pensions 2005, approved by the Government of the Republic of Lithuania on 11 July 2005, and submitted to the European Commission on 15 July 2005, envisages measures to be taken by the Government of the Republic of Lithuania, which would allow for the relative size of pensions to be raised and financial sustainability of the pensions system to be ensured. It is planned that social insurance pensions will be raised gradually during the period 2005-2015, in such a manner that (gross) replacement rate grows continuously from 31.3% to 42% and that the retirement age is increased, over 2012-2026, by 4 months a year for women and 2 months a year for men, until the retirement age reaches 65 years for both men and women in 2026. With the retirement age being increased, additional employment promotion measures must be introduced to allow older people remain active in the labour market.

86. Due to demographic developments, spending on education is projected to come down to 4.1% GDP in 2050. The risk, however, exists that the implementation of political goals of the National Education Strategy might result in education spending increase to 6.7% (GDP) in 2050.

87. Over the period covered, the total general government expenditure will increase by 8 percentage points of GDP, from 33.64% of GDP in 2005 to 41.65% of GDP in 2050. Non-age-related expenditure, which was fixed at the 2010 level and treated as constant, will grow by 5.8 percentage points of GDP. General government budgetary revenue will grow by 6.28 percentage points of GDP, from 33.13% to 39.41% of GDP. If non-age-related expenditure had not been fixed at the 2010 level and account would be taken of later dynamics of the GDP share of investment and revenue, the projections for long-term financial sustainability would be more favourable.

88. If the projections took into account the planned increase in the retirement age to 65 years for men and women as provided for in Lithuania's National Strategy Report on Adequate and Sustainable Pensions of 2005, the primary surplus target which is currently set at about 1.8% of GDP to be achieved in order to ensure general government sustainability would be significantly lower. As calculated by the European Commission, general government debt would come close to 114% of GDP in 2050, unless the planned fiscal policies are tightened or the consequences of the problem of ageing population for government finances are dealt with. Successful implementation of the measures envisaged in Lithuania's National Strategy Report on Adequate and Sustainable Pensions of 2005 would help to ensure financial sustainability of general government.

Table 14. Ratio of pension recipients and contributors

Indicator	2006	2010	2020	2030	2050
Ratio of pension recipients and contributors, if the retirement age is 60/62,5* years	1,67	1,81	1,61	1,34	1,07
Ratio of pension recipients and contributors, if the retirement age is 65/65* years	1,67	1,81	1,77	1,54	1,24

Source: Ministry of Social Security and Labour

* The first figure indicates the retirement age for women, the second one – for men.

VII. INSTITUTIONAL IMPROVEMENT OF GENERAL GOVERNMENT FINANCES

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

90. *Audit*. The National Audit Office of Lithuania (NAOL) is the supreme public audit institution. Its main function is to supervise the lawfulness and effectiveness of the management and use of the state property and the implementation of the state budget. NAOL carries audits of the following areas: state budget implementation; use of state funds; management, use and disposal of the state property; implementation of the budget of the state Social insurance Fund and the Compulsory Health Insurance Fund; use of state budget funds allocated to municipal budgets; use by respective fund management institutions and beneficiaries of funds of the European Union allocated to the Republic of Lithuania and implementation of programmes in which Lithuania participates.

NAOL, in its Audit Report on Programme Budget System No VA-60-1P-1 of 30 March 2007, evaluated whether principles of the structure of the programme budget had been applied efficiently. In view of this, Action Plan approved by the Government meeting of 11 June 2007 (Minutes No 36) has been drafted, which has provided for the specific measures regarding optimisation of the number of appropriations managers and the programmes they implement, continuous evaluation of the programmes, and estimation of the expenditure efficiency.

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

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

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

VIII. STRUCTURAL REFORMS

Education sector reform

92. On 14 June 2007 several political parties signed an Agreement on the principles of science and education system reform.

The Agreement provides for the study financing, which is comprised from a share funded by the state, a student's personal contribution (tuition fee) and funding from other sources. Higher education institutions will establish the level of tuition fees, within the limits established by the state, themselves.

During the period of 2008-2006 (the first stage of the reform), it is planned to directly distribute the funding provided by the state to higher education institutions, as a basic financing, in accordance with the agreement obligated to be drafted by a higher education institution, which shall provide for the minimum number of students.

It is planned to pilot state funding for study programmes with especially high demand under a principle of a study basket (i. e. state funding follows a student). By 2013 (the second stage), this principle will be gradually introduced into all study programmes.

The party Agreement declares that an effective loan system is going to be created, which will cover the tuition fee and, partly, other study expenses. This loan will be interest-free. The parties have agreed that the loan will be started to be repaid once the income of the graduate reaches a level that had been established. An employer or other natural and legal persons will be able to repay the loan or to support the rights and obligations established in the loan contract. In order to ensure free education guaranteed by the Constitution of the Republic of Lithuania, academically talented students will be exempt from tuition fees or the obligation to repay the loan.

The party agreement states that the range (limits) of a tuition fee shall be established by the state, while the level of the fee, within these limits, shall be established by higher education institutions themselves. Higher education institutions shall also be free to establish the number of students to be admitted. The agreement states that autonomy shall be guaranteed to the higher education institutions.

93. On 26 October 2007, the Strategic Planning Committee of the Government of the Republic of Lithuania approved the Guidelines for the reform of the system of science and education. This approval of the Committee is important with a view to achieve further goals related to the reform.

The aim of the reform of science and education system is to achieve that the system of higher education and scientific research meets the needs of the country's economy, society, and a person, and that it ensures the state's sustainable development and international competitiveness.

The major areas of the reform are as follows: improvement of the quality of studies, reorganisation of the study funding and financial support for students as well as funding for scientific research, strengthening of the autonomy and accountability of science and education institutions, improvement of the internal management, streamlining of the infrastructure of these institutions, and human resources development in the science and education system.

The Government of the Republic of Lithuania has approved the provision in the Guidelines for the reform of the science and education system to markedly increase the state funding with a view to improve the quality of studies and promote the development of the scientific research.

In order to improve the quality of studies, internal quality assurance mechanisms are going to be created and external assessment of study programmes and implementation thereof is going to be improved.

In the area of science, attention is going to be focused on the development of the programme competitive funding as well as the streamlining of the science and education infrastructure. The basic funding for higher education and scientific research institutions is going to be reformed.

The first stage of the science and education system reform starts as of the beginning of 2008; it is planned to increase salaries for teachers and researchers by 20 percent and to create better working conditions for them. Special support measures are going to be arranged for raising teacher qualifications. Additional funding is going to be granted for the Study Loan and Bursary Fund. It will allow to increase support for the socially disadvantaged students and to encourage academically talented students.

The Strategic Planning Committee of the Government of the Republic of Lithuania has endorsed the proposal to postpone the introduction of the economically reasoned and socially just tuition fees for the next stage of the reform of science and education system.

Health-care sector reform

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

94.1. to develop the health insurance system;

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

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

96. It has been estimated that the state budget expenditure of the Republic of Lithuania on insurance contributions for persons insured at the state's cost will total LTL 781.618 m in 2008, which is 15,95% more than in 2007 (a contribution per person will increase from LTL 353.2 in 2007 to LTL 428.1 in 2008).

Table 15. The projected budget income and expenditure of the Mandatory Health Insurance Fund (hereinafter in the table referred to as MHIF), 2006-2010

Indicator	2006		2007		2008		2009		2010	
	MHIF, m LTL	% of GDP								
1. Income	3032	3,7	3620,4	3,9	4366,8	4,1	4658	4	5057,1	4,1
2. Expenditure	3090,5	3,8	3620,4	4	4366,8	4,1	4658	4	5057,1	4,1

Source: Ministry of Health.

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

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

99. To accelerate the process of restructuring of personal health care institutions, the Government of the Republic of Lithuania approved, by Resolution No 335 of 18 March 2003 (*Valstybės žinios* (Official Gazette) No 28-1147, 2003), the Healthcare Institutions Restructuring Strategy, which is being implemented in two stages, first stage covering the period 2003-2005, and the second stage covering the period 2006-2008. Taking the results of the first stage into account,

the second stage was started and proceeded in 2006, by implementing the Healthcare Institutions Restructuring Strategy approved by Government Resolution No 647 of 29 June 2006 (*Valstybės žinios* (Official Gazette) No 74-2827, 2006). Measures of the second stage include further development of the primary level of health care, by shifting most of the services over to family physicians who have contracts with territorial patients' funds; treatment of widespread diseases in health care institutions that are closer to people, with the most advanced technologies being concentrated in university hospitals or largest hospitals that have the largest number of patients; development of the system of medical nursing and long-term palliative treatment services, by integrating these services into general hospitals and starting to provide them together with care services; improvement of the quality and speed of first medical aid, by integrating dispatcher services into the Emergency Response Centre that operates within the system of the Ministry of the Interior and by renewing, from time to time, the ambulance fleet. At the same time, efforts will be made to develop ambulatory rehabilitation, improve the system of prices of health care services and asset management of health care institutions, and develop and promote supplementary (voluntary) health insurance. Aiming at implementation of these goals, the second stage Restructuring Strategy plans for district health-care institutions have been harmonised with regional development councils and approved by the orders of the Minister of Health.

Furthermore, with the view to initiate a coherent and purposeful health system reform, create a more viable and more competitive health system, by following the major state objectives that had been formulated through the mission, vision, and major principles of the health system, a draft Framework for Health Care System Development 2007-2015 has been drafted, which outlines the principal directions for the development of the health system of Lithuania as well as the implementation strategy thereof.

100. In 2004-2006, the Structural Funds assistance for health-care was provided in accordance with the Single Programming Document of Lithuania 2004-2006 endorsed by the European Commission Decision C(2004)2120 of 18 June 2004. Assistance was provided for two types of activities: strengthening and development of cardiac health-care services and development and modernisation of infrastructure of family physicians' services. EU Structural Funds assistance in the current programming period amounts to EUR 34.3 m. Projects, financed in accordance with the Single Programming Document of Lithuania for 2004-2006 must to be completed by the end of 2008. In accordance with the Strategy for the Use of European Union Structural Funds of Lithuania for 2007-2013, EU Structural Funds assistance will be further used for investment in infrastructure modernisation of the health care institutions. The EU financial assistance will be provided in accordance with the Cohesion Promotion Action Programme for 2007-2013 for the following areas: reduction of cardiovascular disease morbidity and mortality, early diagnosis of oncological diseases and proper treatment thereof, reduction of external-cause (related to trauma and other causes) mortality and disability, streamlining of mental health care service infrastructure, continuation of the health care system reform, and streamlining of the health care infrastructure. Public capital

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

Housing renovation programme

101. Housing renovation programme was approved by Resolution No 1213 of 23 September 2004 of the Government of the Republic of Lithuania (*Valstybės Žinios* (Official Gazette) No 143-5232; 2005, No 78-2839). It takes account of the EU directives directly related with the increase of energy consumption efficiency in buildings: Council Directive 93/76/EEC of 13 September 1993 to limit carbon dioxide emissions by improving energy efficiency (SAVE) (*OJ 2004 Special Edition: Chapter 12, Volume 1, P. 163*) and Directive 2002/91/EC of the European Parliament and of the Council of 16 December 2002 on the energy performance of buildings (*OJ 2004 Special Edition: Chapter 12, Volume 2, P. 168*). Housing renovation programme works towards implementation of the goal established in the Lithuanian Housing Strategy, approved by the Resolution No 60 of 21 January 2004 of the Government of the Republic of Lithuania (*Valstybės Žinios* (Official Gazette) No 13-387; 2004), namely, to ensure the efficient use, maintenance, renovation and modernization of the existing housing, as well as energy efficiency. The implementation period of the above-mentioned Programme is 2005-2020.

102. The Lithuanian Housing Strategy establishes that by 2020 multi-apartment buildings and heating systems thereof that had been constructed on the basis of the construction permits issued by 1993 will be renovated and, based on the potential and economic expedience, modernised. It is planned to decrease the costs in relation to heat energy and fuel ratio by at least 30 percent for approximately 70 percent of multi-apartment buildings.

The major goal of the Housing renovation programme is to create favourable conditions for the complex modernisation of multi-apartment buildings and residential areas (quarters) aiming at the improvement in quality of life and rational use of energy resources.

103. Since the stock of the residential housing has been deteriorating and the price for energy resources has been rising, the issue of rational energy consumption is becoming ever more topical, with separate apartment owners being unable to tackle it. Legal acts passed in 2004 provide for a possibility, by making use of funding provided by commercial banks and the state, support from the state budget of the Republic of Lithuania for low-income families (individuals), as well as own funds of the residents, to modernise residential buildings and thereby increase the energy consumption efficiency. With lower energy consumption, less funding from the state budget for payments covering heating and hot water expenses for low-income families (individuals) will be required, and this will have a direct impact on the current account deficit.

104. Major repairs or reconstruction of heating facilities and heating systems, replacement of windows and entrance doors, renovation of roof structures by additional insulation, including construction of the new pitched roofs (except for the construction of premises in an attic), balcony (loggia) glazing in accordance with the common project, and insulation of the external walls are covered by the state-aid measures for multi-apartment building modernisation. According to the programme, state support is going to be provided for the owners of multi-apartment buildings: up to 50 percent of investment, covered by the state-aid measures, that had been used for the modernisation of these buildings will be reimbursed on the basis of the energy efficiency of the investment project. It is planned to provide additional support for low-income families (individuals): to cover the major part of expenses related therewith.

105. Funds for the modernisation of a multi-apartment building are comprised from the own funds of the multi-apartment building owners, long-term credits extended by commercial banks, municipality funds, targeted state-aid, and other funds.

The multi-apartment building owners, pursuing investment projects in accordance with the Housing renovation programme, must pay an initial contribution of at least 5 percent from the sum of the planned investment. Banks offer credits for the implementation of investment projects.

State aid is offered by the following means: by covering part of the investment for the modernisation of a multi-apartment building, on the basis of energy efficiency of the investment project; or, by covering expenses for low-income families.

It is planned that by 2020, during the process of implementation of the Programme, at least LTL 20bn is going to be invested; out of them, up to 25-30 percent can fall on the budget of the Republic of Lithuania in order to provide the state aid in accordance with the law. The 2006 state budget of the Republic of Lithuania allocated LTL 7 m appropriations to fund the above-mentioned Programme, or 0.01 percent of GDP 2006. In 2007, LTL 15.7 m were allocated, while it is planned to allocate LTL 223.5 m over the period of 2008-2010, LTL 53.5 m, LTL 70 m, and LTL 100 m, respectfully. In future, appropriations from the state budget of the Republic of Lithuania for the implementation of this Programme will be planned in consideration of the state's financial capacities to satisfy the provisions set forth in the Stability and Growth Pact.

106. Over the long-term period, Housing renovation programme will improve the sustainability of the public sector finances and will be beneficial due to the following:

106.1. less public sector expenditure for payments covering heating expenses for the socially disadvantaged citizens in the future: more efficient use of public sector finances;

106.2. promotion of small and medium-size construction business;

106.3. less public expenditure on fuel (used during the heating season); as a result, reduction of current account deficit;

106.4. favourable social (reduction of unemployment) and environmental (reduction of carbon dioxide emissions into the atmosphere) aspects;

106.5. at the end of the medium-term period, with the completion of renovation, reduction of household heating expenses by 25-30 percent; as a result, less impact from the energy products prices on the current account deficit and demand dynamics.

Agriculture, food industry, and rural development

107. Production volumes and productivity in the agricultural sector have been increasing in recent years, although agriculture's share of the gross value added has been consistently decreasing (in 2002, this indicator amounted to 6.4 percent, while in 2005, 5 percent). These changes show that the structure of Lithuania's economy has been approaching proportions characteristic of the developed countries. The value added created by the food, drinks, and tobacco industries amounted to 4 percent of the gross value added in 2006. Agriculture and food industry has become an important export sector. More active trading and larger financial support for agriculture and rural development determined the growth of income for economic entities.

In order to ensure the implementation of the EU common agricultural policy, to develop a competitive agricultural and food sector, and to promote sustainable economic and social development of rural areas, the following actions are taken:

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

107.2. measures set forth in the Rural Development Plan 2004-2004 approved by the Commission Decision No C(2004)2949 of 3 August 2004, rural development measures, and Priority "Rural Development and Fisheries" of the Single Programming Document of Lithuania for 2004-2006 are continued to be financed;

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

Strategic documents that will serve as a basis for the absorption of funds from the European Agricultural Fund for Rural Development give much attention to the achievement of Lisbon Strategy goals (promotion of competitiveness and employment, improvement of the quality of life) and other initiatives (ecological farming, use of renewable energy resources, preservation of forests and biological diversity, mitigation of climate change, etc.).

Rural Development Plan for Lithuania 2007-2003 was approved by the European Commission Decision C(2007)5076 of the 19 January 2007. The Decision fixes the largest

allocations for the following areas: 41.15 percent, for the development of modern and competitive agri-food and forestry sectors, 36.48 percent, for the improvement of environment and landscape, 12.19 percent, for the improvement of the quality of life and increase the employment of rural population in rural areas;

107.4. state aid measures harmonised with the European Commission are being applied (support for acquisition of breeding animals and certified propagating material of plants, animal breeding, compensation of credit interest and insurance premiums, development of production of quality products and the system of quality testing, research, training and advisory services to farmers, disposal of animal by-products, promotion of production of bio-fuels, and other measures). Risk management system for agriculture is being developed;

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

107.6. the development of a competitive food sector is being promoted, the food sector is being restructured, it is ensured that only safe food is supplied to the market, and food control in the whole chain “from stable to table” is being exercised;

107.7. Making use of funds from the Financial Instrument for Fisheries Guidance, by matching fishing capacities to fisheries resources, fishing capacities have been reduced in the Baltic sea (31 fishing vessels have been scraped), aquaculture and fish-processing companies have been modernised, and fishery products auction has been established. State aid measures are being applied with a view to develop environmentally-friendly fishing and to improve wellness in the fish farms;

107.8. Lithuania’s Fisheries Sector National Strategic Plan for 2007-2013 has been approved by Resolution No 654 of 19 June 2007 of the Government of the Republic of Lithuania, and Lithuania’s Fisheries Sector Action Plan for 2007-2013 has been drafted and submitted for the approval of the European Commission. The primary goal for 2007-2013 is the development of the fisheries sector and improvement of competitiveness in the sector, thus ensuring economic, environmental, and social sustainability, along with preservation and regeneration of fishing resources;

107.9. administrative capacities to ensure the implementation of the EU Common Agricultural Policy are being strengthened. EU and national support absorption mechanism is being improved. By the process of decentralisation of municipal responsibilities for public agricultural functions, part of public agricultural functions have been delegated to wards, thus bringing the services closer to local communities;

107.10. With a view to implementing strategic goals of the agricultural policy and becoming equal partners in the EU market, it is envisaged that the state budget will continue to finance

Measures	Funding									
	2006		2007		2008		2009		2010	
	m LTL	% of GDP								
B. Net direct effect on the budget	-98,3	-0,1	-122,2	-0,1	-132,5	-0,1	-121,2	-0,1	-115,2	-0,1
B.1. Income	8	0	9,8	0	10	0	10,5	0	10,6	0
B.2. Expenditure	106,3	0,1	132	0,1	142,5	0,1	131,7	0,1	125,8	0,1
5. SAPARD										
B. Net direct effect on the budget	-5,8	0	0	0	0	0	0	0	0	0
B.1. Income (EU funds)	12,2	0	0	0	0	0	0	0	0	0
B.2. Expenditure (EU funds and national co-financing)	18	0	0	0	0	0	0	0	0	0
6. Structural support and rural development measures										
B. Net direct effect on the budget	-214,5	-0,3	-	-	-210,7	-0,2	-279,5	-0,2	-267,2	-0,2
B.1. Income	1386,1	1,7	1040,3	1,1	902,7	0,8	853,1	0,7	887,5	0,7
B.2. Expenditure	1600,5	2	2334,5	2,4	1113,4	1	1132,6	1	1154,7	0,9
7. Total direct effect on the budget										
B. Net direct effect on the budget	-1045,7	-1,3	-2455,7	-2,6	-1311,9	-1,2	-1306,9	-1,1	-1225,1	-1
B.1. Income	2146,1	2,6	1752,7	1,8	1572	1,5	1641,2	1,4	1784,7	1,4
B.2. Expenditure	3191,9	3,9	4208,4	4,4	2883,8	2,7	2948,1	2,6	3009,8	2,4

Source: Ministry of Agriculture

* The Government of the Republic of Lithuania has not yet provided for the level of the national premiums of direct payments for 2008, 2009, and 2010.