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GOVERNMENT OF THE REPUBLIC OF LITHUANIA

RESOLUTION No 30
of 21 January 2009

ON THE CONVERGENCE PROGRAMME OF LITHUANIA OF 2008

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 2008 (as appended);

2. To charge the Ministry of Finance with the task of submitting the Convergence Programme of Lithuania of 2008 to the European Commission.

Prime Minister Andrius Kubilius

Minister of Finance Algirdas Šemeta

APPROVED by
Resolution No 30 of the Government of the Republic of Lithuania of 21 January 2009

CONVERGENCE PROGRAMME OF LITHUANIA OF 2008

I. FINANCIAL POLICY OVERVIEW

1. The primary task of the fifteenth Government of the Republic of Lithuania (hereinafter referred to as “the Government of the Republic of Lithuania”) in the short term is to get the economic crisis and its consequences under control.

2. The Government of the Republic of Lithuania considers that the most important long-term policy objective is to slow down the economic recession and essentially improve the situation in the areas that might ensure an economic breakthrough. The Convergence Programme of Lithuania of 2008 (hereinafter referred to as “the Programme”) gives projections of the economic policy outlined in Activity Programme of the Fifteenth Government of the Republic of Lithuania approved by Resolution No XI-52 of the Seimas of the Republic of Lithuania of 9 December 2008 (*Valstybės žinios* (Official Gazette) No 146-5870, 2008) (hereinafter referred to as "the Programme of the Government of the Republic of Lithuania”) as well as in the Law on Approval of Financial Indicators of the State Budget and Municipal Budgets of 2008 (*Valstybės žinios* (Official Gazette), No 149-6020).

3. The Programme is oriented towards the development of the implementing measures for the short-term and mid-term objectives, namely:

3.1. To implement a budgetary policy ensuring the trust of the financial markets in the financial stability of the general government, preserving strong confidence in the continuity of the currency board arrangement and ensuring long-term price stability.

3.2. Upon restoration of the confidence in macroeconomic stability, to accelerate business development and successfully implement the structural reforms necessary for economic sustainability such as the reforms of education and health, reduction of energy dependence on imported mineral fuel etc.

3.3. To govern the State in a transparent manner, aiming at a political agreement on the required reforms.

3.4. To seek public support to the declared objectives and its contribution to their implementation.

3.5. To continue the implementation of the economic policy commitments of the exchange rate mechanism II (hereinafter referred to as “ERM II”) and, in the medium term, to achieve sustainable implementation of the Maastricht Criteria, set out in the Consolidated version of the Treaty on European Union (OJ 2006 L 321, p. 295-296), and to prepare for the adoption of the euro.

4. The Programme gives an overview of the recent economic developments in Lithuania, a plan of a medium-term economic policy, an assessment of risks and of the quality

of government finances, and a description of Lithuania's readiness to overcome the effects of the ageing population. The guidelines of the Lithuanian structural reforms are laid down in the Programme of the Government of the Republic of Lithuania, while the implementation of the structural reform measures will be presented in the annual report on the National Lisbon Strategy Implementation Programme. In implementing the structural reforms envisaged in the Programme of the Government of the Republic of Lithuania, priority will be given to measures that would enable effective reduction of the dependence of the Lithuanian economy on imports without losing productivity. This priority will cut the current account deficit, while preserving for Lithuanian citizens the national income for domestic consumption and for lending to investors.

5. This Programme examines and assesses the preconditions for the achievement of the economic policy goals. The economic development projections for Lithuania given are based on the assumption that within a year the economy will overcome the recently increased 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 (although, due to the tendencies of the recent months, the assumption on the oil prices was reduced more than suggested by the Commission).

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 inflation will in the long run remain close to that in the euro area.

7. As the risk regarding export market shrinkage, lack of flexibility of the construction sector and an abrupt decrease in the current account deficit (hereinafter referred to as "CAD") has materialized, the goal of a balanced budget has been temporarily replaced by the objective to keep deficit within 3 per cent of the gross domestic product (hereinafter referred to as "GDP"). In order to cushion the cycle of the economy, an important task is to preserve cheap funding of investment by reducing risk premium. The budget policy under implementation takes into account the need to preserve the demand necessary for economic development. The target general government deficit for 2009, about 2.1 per cent of the GDP, aims to stabilize the public finances and to restore the confidence of foreign investors in Lithuania's business plans, to reduce the interest rates, to stimulate investments in 2010, and to use all the opportunities for laying the foundation for a GDP increase in 2011. The reduction of the general government expenditure and tax increases in 2009 limit consumption only to the extent necessary for bringing down inflation and an immediate reduction of external imbalance accumulated over the recent years. Such a budgetary policy is intended to bring back the cheap funding of business circulating assets and investments and to achieve a domestic demand that would fully compensate for the planned reduction of government consumption. The planned frontloading of the EU support is already stimulating demand more than the planned general government deficit reduction. The fact that demand is promoted by means of EU support, at the same time reducing the general government deficit,

ensures stable funding of the Lithuanian CAD and contributes to the implementation of the economic recovery plan pursued by the European Union (hereinafter referred to as “EU”).

8. It is necessary to implement structural reforms securing productivity and the long-term sustainability of government finances, and in view of the current low level of debt, the medium-term objective is still to achieve a structural deficit below 1% of GDP. For later periods, the medium-term objective will be tightened to take into account the European Commission’s latest estimates suggesting that the general government debt will approach 90% of GDP in 2050, unless the fiscal policy is tightened.

9. The lowering of the personal income tax rate and the raising of the profit tax rate, which reduce the capital and labour taxation imbalance, will allow the achievement of the labour market objectives of the National Lisbon Strategy Implementation Programme 2008-2010, approved by Resolution No 1047 of the Government of the Republic of Lithuania of 1 October 2008 (*Valstybės žinios* (Official Gazette) No 124-4718, 2008) and help preserve the high employment rate as well as the potential GDP and mitigate the effects of the ageing population on the government finances and the resulting consequences. Lithuania will pursue the acceleration of housing renovation that would contribute to an efficient use of heat and reduction of the economy’s dependence on the growing prices of natural gas. The health and education reforms ensuring higher quality and enabling attraction of additional means from private sources will be implemented at a higher speed.

II. ECONOMIC OUTLOOK

Assumptions

10. Global financial market turbulences in early 2007 strengthened the assumptions made in early 2007 that a sharper deceleration of credit increase should start in 2008-2009, marking the start of a natural cyclical slow-down of GDP growth. Due to the global financial crisis, a stricter assumption is necessary: a rapid self-adjustment of the external imbalance is expected to a level that may be financed only from direct foreign investment and EU aid. The central scenario takes into account the Anti-crisis Plan developed by the Government of the Republic of Lithuania, the planned bringing forward of the use of EU assistance and the pursued structural reforms. The impact of the reforms allows strengthening the potential GDP, however a strong positive effect of all the measures will be insufficient to avoid the economic recession due to the growth of inflation, expansion of import and accumulation of external imbalance over the last 6 years. The key assumptions about the external economic environment in implementing the EU fiscal monitoring procedure and in seeking to ensure the comparability of the EU states’ economic forecasts partially correspond to the external environment assumptions published by the European Commission. An assumption is made that the oil price in 2009-2011 will be smaller than the one proposed by the European Commission. This assumption reduces the CAD projection by around 1.6 percentage points of the GDP. Since at present the oil prices measured in the euro are lower than the previous

assumption, the CAD may even be below the projection due to the prolonged global economic recession.

Table 1. Key assumptions

Indicator	2007	2008	2009	2010	2011
Short-term interest rates*	3.7	6.8	7.7	5.9	5.6
Long-term interest rates*	4.1	8.8	9.6	7.5	6.8
USD/EUR exchange rate (euro zone and ERM II countries)	1.37	1.48	1.36	1.36	1.36
Nominal effective exchange rate	1.1	0	0	0	0
Exchange rate vis-à-vis the euro (annual average) (for countries not in euro area or ERM II)	N.A.	N.A.	N.A.	N.A.	N.A.
Global GDP growth (excl. EU), %	5.0	4.5	3.5	4.3	4.3
EU GDP growth, %	2.9	1.4	0.2	1.1	1.1
Growth of relevant foreign markets, %	2.9	1.4	0.2	1.1	1.1
World import growth (excl. EU), %	6.7	6.4	4.8	5.9	5.9
Oil prices (Brent, USD/barrel)	72.5	104.0	50	50	50

Sources: Ministry of Finance, European Commission

*A technical assumption, different from the assumptions used to calculate the general government interest expenditure.

The assumption about labour market flexibility ensures that the projected external imbalance reduction will not deepen the recession too much. If the labour market assumption does not hold true, unemployment will increase, while growth of wages and of the real GDP will slow down.

A medium-term growth of economy is particularly dependant on the assumption that the business community will manage to meet the financial markets expectations for a rapid and sustainable approximation of Lithuania’s productivity to the EU-average and will remain competitive in solving the problems caused by growth of wages over several recent years and the persistent increases of the interest rates.

The central macroeconomic scenario is based on the assumption that, as the inflation in the euro zone decreases, the interest rate policy of the European Central Bank will effectively promote the export market development in the euro zone and in Lithuania. Economic recession in the euro zone nearly coincides with the economic recession in Lithuania, which suggests that the policy of the European Central Bank could indirectly help solve the problems with the lending resources of the Lithuanian private sector. Recently, on the other hand, more and more data have been indicating shrinkage of the Lithuanian export markets. Therefore, the assumption on the demand promotion without expanding the fiscal deficit is gaining significance. The central macroeconomic scenario projects an export increase. Therefore, the higher risk associated with the export market expansion is raising the importance of the assumptions regarding the economic stimulus measures. The central macroeconomic scenario, forecasting a success in curbing the economic recession, depends on the pace of structural reform implementation. The key risk balancing assumption of the central macroeconomic scenario is structural reforms, which reduce energy dependence on imported mineral fuel. The Programme of the Government of the Republic of Lithuania stipulates that financial assistance from the European Commission will be sought to make renovation of apartment buildings a mass phenomenon, amounting to 2,000 renovated buildings per year. Should this assumption fail, it could be compensated for by the materialized assumptions as regards the bringing forward of the use of EU assistance. Every demand stimulus that would raise investment at least by 4 percent of the GDP without increasing the fiscal deficit could make it possible to attain the objectives of the convergence programs as well as those of the Lisbon Strategy even if the assumptions about the export market development were not to hold true.

Monetary and exchange rate policy

11. Lithuania's monetary policy is developed under the conditions of a fixed exchange rate. Such an exchange rate regime increases confidence in Lithuania's economic policy and together with a competitive economic environment allows pursuing relative long-term price stability. Openness of the economy, relative flexibility of prices and wages, 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.

12. When becoming an EU member state Lithuania undertook to replace the litas with the EU currency 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.

13. 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 the economic convergence criteria are met. The Bank of Lithuania maintains the level of institutional preparation which under favourable macroeconomic conditions ensures smooth and rapid currency replacement.

Overview of ERM II implementation

14. The Government of the Republic of Lithuania had to pursue the economic policy in line with the commitments made on 28 June 2004, when it joined ERM II. The general government deficit in 2005 was reduced by one percentage point, to 0.5 per cent of the GDP. In 2006, the balancing of the general government sector was only approximate. Adopted in late 2007, the Law on Fiscal Discipline of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 120-4881, 2007) stipulates that the general government finances in the medium-term must be managed in a way that achieves a surplus or a nearly balanced general government balance indicator. In addition, the Law on Fiscal Discipline of the Republic of Lithuania sets forth the measures necessary for the realization of the opinion of the EU Council on the Lithuanian convergence programmes.

The anticipated economic environment in 2009-2011 will greatly differ from the one that prevailed when joining ERM II, which makes the obligations as regards speedier implementation of the structural reforms a priority. The economic recession which began in 2008 prevents the achievement of a balanced budget, reduces the credit increase and brings the ERM naturally closer to the sustainable level. Measures that will impose an obligation to follow an anti-cyclic fiscal policy are being designed: efforts will be made in 2009 to adopt the legislation that will set forth the fiscal discipline rules. Other structural reform implementing measures will be specified in 2009 in the revised annual report on the National Lisbon Strategy Implementation Programme. The reforms of education, health care, environmental protection, science and innovation promotion and business environment are envisaged.

Economic cycle and a medium-term macroeconomic scenario

The real sector

15. The forecasted cyclic economic slowdown that started in 2008, in the forth quarter was aggravated by the outbreak of the global crisis. Growing interest rates and rapidly changing prices of the real estate (approaching to those that are to a higher extent economically reasonable) make corrections in the private consumption expenditure and results in lower expenditure. Declining domestic demand curbs import and substantially mitigates the external trade misbalance.

Sudden self-adjustment of the economy could be projected due to a sudden slowdown of demand and supply of the borrowed money. Due to unstable real estate prices and declining perspective tariffs of the construction sector, the investment project demand was postponed, and in 2008, when the credit incentive for the economy started going down and the real estate prices started changing approaching to those that were to a higher extent economically reasonable, the volume of the fixed capital formation started decreasing as follows: between January and October 2008, for the first time throughout 7 years, the real expenditure of the fixed capital formation decreased by 1.6%. The main reason for decreased investment was the signs of a slowdown of the transport sector predetermined by surplus investment in 2007 and lower demand for cargo transportation by roads in 2008, which resulted in much higher competition. Still considerable increase of investment in residential buildings in 2008 was related to a rather long process of construction coordination and implementation, thus the main corrections in this sector are forecasted for 2009.

It is foreseen that in order to match the external economy imbalance and the external financing, major adjustments will be in investments: in 2009 the fixed capital formation is foreseen to be 20.2% lower than that in 2008. With regard to real GDP, in 2009 the share of the fixed capital formation will amount to 22.4% of GDP. In later years, successful implementation of the Anti-Crises Plan of the Government of the Republic of Lithuania would result in the investment share increasing to 25.2% of GDP.

The previously foreseen risk proved to be true and, with the prevailing irrational expectations of market participants about a high increase in prices and wages, in 2008 consumption increased several percentage points more than planned a year ago. 19.6% annual final consumption increase between January and October 2008 reveals that a decreasing confidence indicator of the interviewed consumers tells more about their future expectations than about consumers' decisions. The recession in consumption foreseen in 2009-2010 is substantiated by deceleration in the loan increase and loss of the purchasing power due to the increasing prices of energy resources, food, and other increasing prices, motivated by inert inflation expectations.

Due to the increased prices of natural gas, oil and food, and due to the increase in other prices, the income of Lithuanian consumers decreased by several percents of GDP. Due to the decreased purchase power of most consumers, the years 2009-2010 will see the decrease in the consumption (especially that of basic commodities) volume.

The central scenario foresees that positive trends of Lithuania's export indicators will be maintained. Although according to some forecasts the economic development of the EU and the Commonwealth of Independent States (hereinafter – the CIS) will slow down because of the lack of international liquidity, still the increase in the nominal export in the EU and CIS markets is expected. A relatively high increase in the nominal export (in January-November 2008 Lithuania's export increased by 31.3%) shows that Lithuanian producers were able to remain competitive even under conditions difficult for them: the previous years saw the increase in the prices of raw materials and labour demand in the market. Between January and November 2008 the export to the EU amounted to 60.4% of total exported goods. Major impact on the export development in the medium term will be exerted by the activities of the company *Mažeikių nafta*.

Table 2. Macroeconomic indicators

Indicator	ESA* code	Indicator value in 2007, million LTL	Change, in %				
			2007	2008	2009	2010	2011
Real GDP	B1*g	78186.0	8.9	3.5	-4.8	-0.2	4.5
Nominal GDP	B1*g	98138.7	18.5	15.9	0.9	0.4	4.3
Components of real GDP							
Private consumption expenditure + NPISHs	P.3	56212.3	12.4	7.3	-7.8	1.2	5.1
Government consumption expenditure	P.3	13481.7	3.3	1.3	-9.7	-6.6	0.0
Gross fixed capital formation	P.51	22662.4	20.8	-4.5	-20.2	7.1	9.5
Changes in inventories and net acquisition of valuables (% of GDP)	P.52+P.53	11.5	2.9	4.7	0.8	0.0	-0.7
Exports of goods and services	P.6	45493.6	4.3	13.2	4.3	0.2	4.5
Imports of goods and services	P.7	60489.6	11.6	13.0	-6.4	2.2	5.3
Contributions to real GDP growth, %							
Final domestic demand		–	14.4	5.1	-12.0	1.2	5.5

Indicator	ESA* code	Indicator value in 2007, million LTL	Change, in %				
			2007	2008	2009	2010	2011
Changes in inventories and net acquisition of valuables	P.52+P.53	–	0.5	1.2	0.0	0.0	0.0
Balance of goods and services	B.11	–	-5.5	-1.6	7.2	-1.4	-0.9

Sources: Statistics Lithuania, Ministry of Finance

*European System of Accounts.

Inflation

16. Since July 2008, in Lithuania the annual inflation has been decreasing by on the average 0.7 percentage point per month. The disinflation that started in 2008 was influenced by changes in the prices of all commodity goods and service groups (administered prices, food and beverages, fuel, services and industrial goods).

Slowdown of inflation because of the slower increase in the prices of agricultural products and because of the base effect was partly influenced by slower increase in the food prices. The outgoing domestic demand will have a more positive impact on the food price stabilisation trends. Profit margins of food producers and retail traders that have started going down reveal the reasonably growing competition among consumers. The disinflation will also be stimulated by the cancelled provisions (that had not come into force) of the Law of the Republic of Lithuania on establishing accounting indicators and the basic level of fines and penalties with regard to social security payments (*Valstybės žinios* (Official Gazette) No 83-3294, 2008) concerning the automatic indexation of social security payments and wages in line with inflation.

The oil price was decreasing, so between November and December 2008 the inflation was mostly reduced by decreasing fuel prices that in December 2008 had the reducing impact of 0.9 percentage point on the monthly inflation and 0.6 percentage point on the annual inflation.

At the same time, the impact of the administered prices on the headline annual inflation was gradually increasing. The beginning of 2008 saw a significant jump in the prices of natural gas. Increasing costs resulted rather vividly in the increase of other administered prices: passenger transport services, waste removal services, cold water prices, etc. Within the group of administered prices, the headline inflation was also increased by the increase price of heat energy. The impact of the increase in the heat energy prices showed up in the last months of 2008.

Table 3. Price indicators

Indicator	ESA code	Indicator value in 2007	Change, in %				
			2007	2008	2009	2010	2011
1. GDP deflator		125.5	8.8	12.0	6.0	0.5	-0.2
2. Private consumption deflator		112.9	5.7	9.2	5.4	3.7	0.1

Indicator	ESA code	Indicator value in 2007	Change, in %				
			2007	2008	2009	2010	2011
3. HICP* (average annual change)		105.8	5.8	11.2	5.4	3.6	-0.1
4. Public consumption deflator		132.7	8.4	14.8	12.8	3.3	-0.8
5. Investment deflator		121.1	9.1	6.0	-0.1	1.0	2.0
6. Export price deflator (goods and services)		117.3	4.6	12.5	4.5	2.6	2.2
7. Import price deflator (goods and services)		110.0	4.0	7.8	3.6	6.0	2.6

Sources: Statistics Lithuania under the Government of the Republic of Lithuania (hereinafter – Statistics Lithuania) , Ministry of Finance.

*HICP - Harmonised Index of Consumer Prices.

The euro and litas exchange rate fixed following the currency board arrangement guarantees that eventually the average inflation will remain close to the euro zone inflation. Expensive fuel, excise duty obligations, inflation recorded in 2006-2008 do not serve as a reasonable basis for the formation of long term inflation expectations. The slowdown of the credit increase seen in the first quarter of 2008 is getting stronger, thus it is planned that at the end of 2011, when the impact of both the tobacco excise and the decommissioning of the Ignalina Nuclear Power Plant (hereinafter – Ignalina NPP) softens, the deflation pressure will intensify due to the slowdown of the credit increase. Moreover, domestic producers will not evade the deflation pressure even in 2010 but the decommissioning of the Ignalina NPP will result in the inflation approximately 2 percentage points higher because of the increased electricity price: the increasing electricity price will be offset by deflation processes in other sectors. In 2009 the inflation will remain relatively high as a result of inflation expectations that demonstrated their power in 2008. Their aftermath comes over to 2009 out of inertia.

Labour market

17. Unemployment is projected to increase over the medium term as a result of financial hardships, however, the single EU labour market will offer employment opportunities for the unemployed labour force.

Table 4. Labour market indicators

Indicator	ESA code	Level in 2007	Rate of change, %				
			2007	2008	2009	2010	2011
1. Employment, persons (thou)		1534.2	2.3	-0.8	-1.9	-0.5	-0.5
2. Employment, hours worked		2868390	4.0				
3. Unemployment rate (%)		4.3	4.3	5.6	7.8	8.5	8.6
4. Productivity (real GDP per employed person), thou LTL		57.5	5.9	4.4	-3.0	0.4	5.1
5. Labour productivity (real GDP per hour worked), LTL		30.6	4.7				
6. Compensation of employees, m LTL	D.1	43707.2	23.2	19.2	2.3	1.7	3.5
7. Compensation per employee, LTL		28488.6	20.3	20.1	4.3	2.3	4.1

Sources: Statistics Lithuania, Ministry of Finance

*Value of indicator is shown.

The 2009 unemployment projections are based on an assumption that labour force supply will increase as a result of the country's financial situation and an increase in bankruptcy of enterprises (particularly, in construction and industrial sectors), while the demand for labour will fall. In the third quarter of 2008, the unemployment rate leaped to 5.9%. That is 2 percentage points higher than a year ago. In 2008, the average annual unemployment rate is expected to reach 5.6%, and 7.8%. in 2009. In the medium term, the unemployment rate will exceed 6%. Assuming it is a natural, non-accelerating level of inflation, the rate of wage growth is expected to be slower.

Re-training of labour force - its re-allocation from low productivity sectors to higher productivity sectors - will remain an important GDP growth factor in the medium term, capable of retaining high employment levels, the principal basis of sustainable consumption. The European Social Fund funding will be used for this purpose.

Balance of payments

18. During the first half of 2008, there was a sharp increase in the CAD to 17.7% of GDP, however, in the third quarter, a downward trend emerged and, in January-October of 2008, the CAD fell to 14.8% of GDP. The fluctuations of the CAD were largely determined by lower foreign trade and income deficits.

The decline of foreign trade deficit was due to slower import growth, which was determined by a decreasing volume of imports of investment goods and passenger motor cars resulting from the worsened prospects for most economy sectors and a lesser need for new manufacturing capacities.

However, export growth to EU states was also slower. Export to CIS countries contributed to the largest proportion of export increase in 2008. Export data (excluding mineral products) for other countries of the world show that the largest contraction was in exports to EU member states that experience an economic recession (for example, Denmark, Spain, Ireland and the United Kingdom).

Though in the second quarter of 2008, following a significant increase in investment income and payment of dividends on foreign direct investment to foreign investors, the income deficit increased, in the third quarter of 2008, these trends reversed due to contraction of income. Since the period of 2008-2009 was not very profitable to enterprises, in the upcoming quarters the income flow from investment in Lithuania is likely to be less significant. This will lead to a further decrease of the CAD.

The rapidly declining CAD will be financed from foreign direct investment and EU capital transfers.

Table 5. Sectoral balances

Indicator	ESA code	% of GDP				
		2007	2008	2009	2010	2011
1. Net borrowing	B.9N	-12.7	-10.2	-1.8	-4.7	-5.7
of which:						
- balance of goods and services		-13.4	-11.5	-3.8	-7.7	-8.7
- balance of income and transfers		-1.2	-1.1	-0.2	-0.4	-0.4
- capital account*		1.8	2.4	2.2	3.4	3.4
2. Net surplus (+)/deficit (-) of the private sector		-11.5	-7.2	0.2	-3.7	-5.7
3. Net surplus (+)/deficit (-) of general government	B.9N	-1.2	-2.9	-2.1	-1.0	0.0
4. Statistical discrepancy		0	0	0	0	0

*Sources: Ministry of Finance, *Bank of Lithuania*

Risk-related aspects of economic development

19. In the medium term, risk arises as a result of a too slow rate of adjusting of the country's real estate market, irrational and inflexible construction sector that may cause dramatic changes of property prices and a significant slowdown of the country's economy.

20. Due to a continuing decline of Lithuania's export markets in Russia, Belarus, the Baltic countries or other EU member states, the Lithuanian industry could experience a further slump and the change of GDP would be smaller by several percentage points.

21. At this time, the potential GDP growth will remain stronger than the EU's average, however, the existing risk factors may significantly retard economic growth in the medium term. The risk of the failure to smoothly control the negative impact of the reduction of external imbalances on economy and the lack of sufficient flexibility in the labour market may result in the decrease of potential GDP.

III. PUBLIC FINANCES

Strategy of financial policy

22. The goal of the medium term is the achievement of a structural deficit not exceeding 1% of GDP. With a view to implementing fiscal discipline rules, convergence programmes set out measures for actual achievement of a balanced medium term budget. The planning and implementation of the advance measures required for the balanced budget of the government sector are meant to strengthen the confidence in the currency board arrangement, price stability as well as to ensure that, over several decades, the government debt does not exceed 60% and does not become an additional burden for tax payers.

23. The following priorities of the medium-term financial policy (macroeconomic policy) shall be established:

23.1. To align the current fiscal policy with the priorities of social policy.

23.2. To continue to encourage the ongoing implementation of energy reforms.

23.3. To continue to implement the pension reform ensuring the long term sustainability of public finances, to reduce temporarily, only in 2009–2010, the funding for this reform.

23.4. To create favourable conditions for the improvement of labour efficiency, improve competitiveness of the economy, attract more foreign direct investment, and successfully implement EU cohesion policies.

23.5. To implement, in 2009, measures enabling the consistent use of potential economic growth necessary for low inflation and high employment and preventing the increase in fiscal deficit. The private-public partnerships, the efficiency of which is proven by participation of the private sector aimed at overall project profitability, should be employed with respect to investment that does not contribute to a rise in fiscal deficit and for seeking financial support from the European Commission to enable mass renovation of apartment blocks by setting a yearly target to renovate 2000 apartment buildings.

23.6. Improve the long term sustainability of public sector finances and the norms of fiscal discipline ensuring long term economic development, implement education and health reforms.

23.7. To boost the confidence in the long term sustainability of public sector finances and improve the medium term planning of the State budget of the Republic of Lithuania (hereinafter referred to as State budget).

23.8. In implementing the structural reforms envisaged in the Programme of the Government of the Republic of Lithuania, to give priority to the measures aimed at efficient reduction of the dependence of Lithuania’s economy on imported goods without the loss of productivity.

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

Measures planned for 2009–2011 aimed at the achievement of fiscal deficit objectives

25. Risk management measures designed for the achievement of fiscal deficit objective in 2010–2011 will be discussed in detail later in the regular update of this Programme. The achievement of the objective of the year 2010 will require additional measures the value of which will amount to approximately 0.5 % of GDP; the achievement of the objective of the year 2011 will require additional measures the value of which will amount to approximately 1.6 % of GDP.

26. The following measures are foreseen for the achievement of the targets of the Lithuania’s finance policy:

26.1. measures designed to achieve the fiscal deficit objectives during the period of 2009–2011:

26.1.1. efforts seeking the most rational use of general government expenditures, implementation of governance reform and elimination of vacancies;

26.1.2. preparation of the methodology for expenditure and benefit analysis, application of it to all major projects financed from taxpayers' funds, allocation of saved funds for the achievement of the fiscal deficit objective;

26.1.3. efforts to solve 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; limitation of the risk of fiscal deficit to the risk of temporary debt increase;

26.1.4. detailed analysis of services provided by the state and municipalities and possibilities for long term financing of such service provision. In case there is no possibility to provide adequate long term financing for such services, the provision of services should be privatised;

26.1.5. tasks for state institutions to increase efficiency at least by 2 % per year (ie to start the budget planning of each year by reducing by a certain amount allocations to expenditures and wages of institutions);

26.1.6. amendment of tax laws achieving the effect of additional revenues in 2011 which would allow in addition to the completion of necessary structural reforms and rationalization of expenditures to use them for the achievement of fiscal deficit objectives.

26.2. Measures, to be implemented in 2009–2011, ensure coherent use of potential economic growth that is necessary for low inflation and high employment as well as to maintain the same level of the general government deficit. Partnership of public and private sectors or the use of EU support for investments that do not increase state fiscal deficit would allow to ensure the collection of planned revenues of the state budget of the Republic of Lithuania in case the risks come true.

26.3. Measure that increases confidence in sustainability of long term finances of the general government by improving the state budget medium term planning system.

Implications of the budget on the medium term goals

27. Expectations regarding careful fiscal policy are the basis for confidence of local and foreign investors.

28. Aiming to ensure that the target of 3 % of the general government deficit is not exceeded during the long term period and social commitments for future pensioners are implemented as much as possible, the general government structural deficit will turn into surplus during the medium term, after the impact of external imbalance reduction ends.

The structure of general government finances during the period of 2008-2011, compared with the year 2007, will change due to social benefits and absorption of EU financial support.

29. General government financial projections in the Programme change due to the following factors: application of the fiscal discipline rules, reduction of expenditure, tax measures necessary with a view to compensate structural budgetary revenues that are lost due to tax reduction.

Table 6. Expected indicators of the general government (S13) for the year 2007–2011*

	ESA code	Level in 2007 (LTL million)	% of GDP				
			2007	2008	2009	2010	2011
1. General government	S.13	-1209.9	-1.23	-2.94	-2.07	-0.98	0.00
2. Central government budget	S.1311	-1482.2	-1.51	-1.71	-2.19	-1.15	-0.16
3. State budget	S.1312	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
4. Municipal budgets	S.1313	-288.5	-0.29	-0.25	0.00	0.00	0.00
5. Social security funds	S.1314	560.8	0.57	-0.99	0.13	0.16	0.16
General government (S13)							
6. Total revenue	TR	33294.8	33.93	33.79	35.76	37.26	36.35
7. Total expenditure	TE	34504.7	35.16	36.73	37.83	38.25	36.35
8. Net lending/borrowing	EDP B.9	-1209.9	-1.23	-2.94	-2.07	-0.98	0.00
9. Interest expenditure	EDP D.41	689.7	0.70	0.67	0.91	1.01	1.06
10. Primary balance		-520.2	-0.53	-2.27	-1.15	0.02	1.06
11. One-off and other temporary measures			-0.57	0.50	0.45	0.46	
Revenues							
12. Total taxes (12=12a+12b+12c)		20517.8	20.91	20.95	20.94	21.12	20.96
12a. Revenues from indirect taxes	D.2	11418.0	11.63	11.77	12.60	12.92	12.75
12b. Revenues from direct taxes	D.5	9093.6	9.27	9.18	8.34	8.20	8.21
12c. Property taxes	D.91	6.3	0.01	0.00	0.00	0.00	0.00
13. Social contributions	D.61	8775.4	8.94	9.17	9.72	9.87	9.26
14. Property income	D.4	560.5	0.57	0.60	0.60	0.60	0.60
15. Other		3441.1	3.51	3.06	4.50	5.67	5.53
16=6. Total revenue	TR	33294.8	33.9	33.8	35.8	37.3	36.3
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)		29262.5	29.82	30.12	30.66	30.99	30.22
Expenditure							
17. Compensations to employees + intermediate consumption	D.1+P.2	15096.6	15.38	15.55	15.60	14.85	13.29
17a. Compensations to employees	D.1	9775.5	9.96	10.25	10.22	9.73	8.71
17b. Intermediate consumption	P.2	5321.1	5.42	5.30	5.38	5.12	4.58
18. Social payments (18=18a+18b)		10654.0	10.86	13.33	13.86	13.93	13.72
18a. Social payments in kind	D.6311, D.63121, D.63131	1579.2	1.61	1.98	2.05	2.07	2.03
18b. Social payments other than social transfers in kind	D.62	9074.8	9.25	11.36	11.80	11.87	11.68
19=9. Payment of interest	EDP D.41	689.7	0.70	0.67	0.91	1.01	1.06
20. Subsidies	D.3	887.1	0.90	0.90	0.45	0.45	0.45
21. Gross fixed capital formation	P.51	5115.1	5.2	4.38	5.05	5.63	5.41
22. Other		2062.2	2.10	1.90	1.96	2.38	2.42
23=7. Total expenditure	TE	34504.7	35.16	36.73	37.83	38.25	36.35

	ESA code	Level in 2007 (LTL million)	% of GDP				
			2007	2008	2009	2010	2011
p.m.: Government consumption (nominal)	P.3	17884.7	18.22	18.28	18.46	17.74	16.04

Sources: Departments of Statistics, 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 33.93 % of GDP in 2007, it will grow to 35.76 % of GDP in 2009 and, due to the increasing EU structural financial aid in 2007–2013 it will reach 36.4 % of GDP in 2011. Abolishment of VAT reduced rates and the increase of regular tariff by 1 % as well as higher tariffs of excise on oil, alcohol and cigarettes will serve to increase the GDP share made up of revenues received from indirect taxes: in 2009 against 2008, it will rise by 0.8 % and reach 12.6 % of GDP. In 2011 the ratio of revenues from indirect taxes to GDP has to remain close to 12.8 %. Due to decreasing rate of the personal income tax and grant of profit tax relieves (taking account of increase of profit tax rate by 5 %) the share of GDP in 2010 to be made up of these revenues will decrease to 8.2 % of GDP.

In 2008 versus 2007, the total general government expenditure went up by 1.6 percentage points of GDP, to reach 36.7 % of GDP: social benefits increased by 2.5 percentage points of GDP. Partially because support funds from the 2007–2013 EU structural financial support were not used, in 2008 the part of capital formation in GDP decreased. 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 4.4 % of GDP in 2008 to 5.6 % of GDP in 2010.

Continuation 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 allocated in 2008 for the pension reform accounted for 1 percentage point of GDP. Temporary reduction of contributions to pension funds for the period of two years will enable to maintain the level of these expenditures at 0.6 % of GDP, but in 2011 they will reach 1.1 % of GDP. The share of social contributions during 2009–2010 will be higher by 0.6 % of GDP compared to the share in the year 2008 and 2011.

Subsidies to agricultural entities financed from national resources in 2009 will be reduced by 0.5 % of GDP compared with 2008.

Increase of borrowings and interests will increase interest expenditure from 0.7 % of GDP in 2007 to 1 % of GDP during 2010–2011.

The pre-planned frontloading of EU support during 2009–2010 would compensate the decline of demand that results due to the consolidation of the general government sector which is necessary aiming to achieve stronger confidence in sustainability. Sum stimulus in 2009 would amount to 0.9 % of GDP and 0.5 % of GDP in 2010.

Table 7. Implementation of the economy recovery plan by using sum stimulus for demand resulting from general government sector deficit and pre-planned frontloading of EU support, % of GDP

Indicators	2007	2008	2009	2010	2011
EU support	3.1	3.3	5.2	6.9	6.9
Net EU support	2.2	2.3	4.1	5.7	5.6
Incentive of EU support in relation to demand, increase of net EU support as compared to support in the previous years	-1.0	0.2	1.8	1.6	-0.1
Fiscal deficit	-1.2	-2.9	-2.1	-1.0	0.0
Impact of fiscal deficit on demand, change of fiscal deficit as compared to figures of the previous years (incentive (+), block (-)	0.8	1.7	-0.8	-1.1	-1.0
Sum incentive in relation to demand from general government deficit ir planned earlier use of EU support	-0.2	1.9	0.9	0.5	-1.1

Balance of general government subsectors

30. The balance of social insurance funds subsector was negative: a deficit of 1 % of GDP was recorded in 2008. In 2008 deficit increased as a result of bigger pensions and actual maternity and paternity allowances as compared to those that were planned. For this reason the central government subsector plans to transfer a subsidy of 0.5 % of GDP in 2009 to the subsector of social insurance funds.

It is foreseen that the local government subsector deficit in 2008 will amount to 0.3 % 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 (*Valstybės žinios* (Official Gazette) No 24-596, 1990).

As a result of the structural and tax reforms carried out in recent years, in 2008 more than half of general government deficit consisted of the central government subsector deficit, which accounted for 1.7 % of GDP. It resulted due to the failure of the previous Government of the Republic of Lithuania to implement the planned additional measures aimed to increase structural revenues.

A reduction of the central government subsector deficit in 2009–2011 has to result in a reduction of the total general government deficit in the medium term.

Table 11 shows that the reduction of general government structural deficit is much more than 0.5 % of GDP annually.

Structural deficit and continuity of fiscal policy

31. It is planned that the structural general government deficit, which amounted to 6.3% of GDP in 2008, will drop to 2.4% of GDP due to the structural measures aimed at reducing expenditure and increasing income by the Government of the Republic of Lithuania. The structural indicator will improve by 3.9% of GDP. 2009 – 2011 will see a substantial structural improvement of the condition of the general government finances. The

implementation of these plans require further determined limiting of expenditure growth, income increase and introduction of more innovative forms of financing that do not contribute to the fiscal deficit, thereby accelerating structural reforms.

Estimation of the output gap

32. The GDP cycle was estimated using the Hodrick Prescot (HP) filter approach. The results obtained point to a positive output gap in the medium term. In 2008, the output gap will be 8.7%, -0.4% in 2009, -4% in 2010, and -2.9% in 2011.

However, owing to short time-series under the Hodrick Prescot filter approach or under the production function approach (based on the NAIRU concept), the estimate of Lithuania's output gap is biased and ineffective. 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 multitude of structural breaks. The NAIRU approach ignores "structural shocks". First, the recent rapid growth of construction significantly contributed 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 opt to emigrate. Cyclical unemployment might develop into permanent reduction of labour force.

Table 8. Cyclical developments

Indicator	ESA code	% of GDP				
		2007	2008	2009	2010	2011
1. 1. Comparisons of prices for GDP growth, %		8.9	3.5	-4.8	-0.2	4.5
2. Net lending (+)/borrowing (-) of general government	EDP B.9	-1.2	-2.9	-2.1	-1.0	0.0
3. Interest expenditure	EDP D.41	0.7	0.7	0.9	1.0	1.1
4. One-off and other temporary measures*		-0.57	0.50	0.45	0.46	0.00
5. Potential GDP growth, %		5.0	4.4	3.9	3.6	3.4
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		9.6	8.7	-0.4	-4.0	-2.9
7. Cyclical budgetary component		3.0	2.8	-0.12	-1.3	-0.9
8. Cyclically-adjusted balance (2-7)		-4.2	-5.8	-1.94	0.3	0.9
9. Cyclically-adjusted primary balance (8+3)		-3.5	-5.1	-1.0	1.3	2.0
10. Structural balance (8-4)		-3.6	-6.3	-2.4	-0.2	0.9

Sources: Statistics Lithuania, Ministry of Finance

**. In 2007, the deficit was higher by 0.57*% of GDP (due to single compensation payment to pensioners), in 2008, the deficit was lower (due to overpayment of VAT by 0.5% of GDP), in 2009 and 2010, the deficit will be lower (due to temporary reduction of social contributions to pension funds).

The Hodrick Prescot (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 even account for a few percentage points. That explains the huge increase in the elasticity of the structural deficit in 2008.

In the period 1995-2003, only one-third of the cyclical GDP fluctuation would turn into the 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 9. 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 9 above shows, the 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

33. The general government debt level has been continuously decreasing in many years and accounted for 17% of GDP at the end of 2007.

34. The central government debt structure poses no threat to public finances: 8.5% of the total debt consists of short-term liabilities (by outstanding maturity), and 2% consists of the floating interest rate debt. The average outstanding maturity of the debt is more than 5 years. The central government debt is 100% denominated in the litas and the euro.

Table 10. General government debt projections

Indicator	% of GDP				
	2007	2008	2009	2010	2011
1. Gross debt	17.00	15.30	16.90	18.10	17.10
2. Change in gross debt ratio	1.00	1.79	1.40	1.20	-1.0
Contributions to changes in gross debt					
3. Primary balance	-0.51	-2.27	-0.63	-0.01	1.03
4. Interest expenditure	0.70	0.67	0.91	0.99	1.03
5. Stock-flow adjustment*	-0.5	0.6	2.0	1.3	-2.0
of which:					
difference between cash and accruals	–	–	–	–	–
net accumulation of financial assets of which: privatization revenues	0.06	0.02	0.70	0.01	-
p.m.: implicit interest rate on debt (%)	5.2	4.6	6.1	6.0	6.1
Other relevant variables					
6. Liquid financial assets	13.1	–	–	–	–
7. Net financial debt (7=1-6)	3.9	–	–	–	–

Source: Ministry of Finance

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

35. In the medium term, the Government envisages implementing the following strategic borrowing policy and debt management measures:

35.1. 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;

35.2. financing the Government's borrowing requirement mainly by issuing Government Securities on the domestic and foreign markets into larges issues, thus enhancing their liquidity;

35.3 To make preparations for the repayment of a big debt – redemption of Eurobonds – in 2012 and onwards.

Implications of structural reforms on general government finances

36. The structural budget balance shows the conditional difference between general government revenue and expenditure when the actual GDP equalled the potential GDP. The structural deficit is calculated with reference to the effect of the business cycle. Table 11 below may be used to calculate the shrinkage of the structural deficit in the light of structural changes in government finances, such as the beginning 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 result in the reduction of the structural deficit, adjusted in the light of the structural reforms and temporary measures, by 0.5% of GDP on average over 2009-2011. This consolidation aims at enhancing confidence of foreign investors in Lithuania's adherence to commitments to pursue the sustainable policy of public sector finances and reduce risk premiums. A part of demand lost due to consolidation is amply compensated by the frontloading of EU aid.

Table 11. General government structural and cyclical fiscal deficit projections

Indicator	% of GDP				
	2007	2008	2009	2010	2011
1. General government fiscal deficit target	-1.2	-2.9	-2.1	-1.0	0.0
2. Temporary revenues owing to economic cycle (-)	2.96	2.85	-0.12	-1.26	-0.90
3. Fiscal deficit, taking into account the temporary revenues owing to economic cycle	-4.18	-5.79	-1.94	0.28	0.90
4. EU Co-financing requirement	0.43	0.42	0.68	0.64	0.58
5. Pension repayment	0.59	-0,50			
6. Pension reform	0.87	0,96	0.58	0.60	1.10
7. Structural deficit less pension repayment to working pensioners, structural reform expenditure, co-financing requirement, and loss of revenue or temporary revenue.	-2.73	-5.34.	-1.82	0.42	2.00
8. Structural measures implemented annually in general government to fulfil the commitments under the Stability and Growth Pact	1.3	2.6	-3.5	-2.2	-1.6

Source: Ministry of Finance

IV. SENSIBILITY ANALYSIS AND COMPARISON WITH PREVIOUS UPDATE

Economic development risks and their budgetary implications

37. 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 180m in 2009, LTL 184m in 2010 and LTL 189m in 2011, respectively, or about 0.16 of GDP on average.

38. With more and more data on the decline in Lithuania's export markets coming lately, the assumptions for the promotion of demand without increasing the fiscal deficit have grown in importance. The central macroeconomic scenario forecasts increase in exports, therefore, with risks involved with the development of export markets growing, the assumptions for economy boost measures are becoming increasingly important. The central macroeconomic scenario forecasting successful mitigation of economic decline is heavily dependent on the speed of the implementation of structural reforms. The key assumption for the risk management of the central macroeconomic scenario is structural reforms that will reduce energy dependency on fossil fuel imports. The provisions of the Programme of the Government of the Republic of Lithuania imply seeking the financial support of the European Commission for the mass modernisation of multi-apartment houses, with nearly 2000 multi-apartment houses being renovated in a year. If the above assumption does not work out, it could be compensated with the implementation of the assumption for the frontloading of EU support. Every demand stimulus, which boosts investment by 4% of GDP at least without increasing the fiscal deficit, would make it possible to meet the convergence programme and the Lisbon strategy goals even if the assumptions for the development of export markets were not to come true. Failure to implement these additional risk management measures would imply that the public sector deficit would only slightly and shortly exceed 3% of GDP.

Fiscal risk

39. 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 and the measures to strengthen the financial stability of the banking system.

On the basis of 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.

Deposit insurance

40. As of 30 November 2008, the total amount of insured deposits was LTL 34091.8m or 30% of GDP.

41. If positive risk were realized and the decrease in additional expenditure amounted to LTL 600m, the projected deficit for 2009 would total about 1.5% of GDP.

Government guarantees

42. 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 November 2008, government-guaranteed loan portfolio accounted for about 1.2 % of GDP projected for 2008. This figure is expected to remain at the same figure over the medium term.

Comparison with previous update

43. GDP projections have been revised to reflect the actual figures of the first nine months of 2008 announced by the Department of Statistics, 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. Deficit targets for 2009–2011 have been modified due to the unplanned increase in social benefits in 2008 and unfulfilled additional structural measures with a view to increase income. Fiscal deficit target for 2009 has been modified in accordance with its alteration in 2008.

Table 12. 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				
		2007	2008	2009	2010	2011
1. GDP growth						
Previous update		9,8	5,3	4,5	5,2	N.A.
Current update		8,9	3,5	-4,8	-0,2	4,5
Decrease (-) / Increase (+)		-0,9	-1,8	-9,3	-5,4	N.A.
2. General government net lending(+)/ borrowing(-)	EDP B.9					
Previous update		-0,9	-0,5	0,2	0,8	N.A.
Current update		-1,2	-2,9	-2,1	-1,0	0,0
Decrease (-) / Increase (+)		-0,3	-2,4	-2,3	-1,8	N.A.
3. General government gross debt						
Previous update		17,6	17,2	15,0	14,0	N.A.
Current update		17,0	15,3	16,9	18,1	17,1
Decrease (-) / Increase (+)		-0,6	-1,9	1,9	4,1	N.A.

Sources: Department of Statistics, Ministry of Finance.

Due to the changed GDP in 2007, gross debt went down by 1% of GDP as against the previous update, and due to the positive change in assets balance, debt decreased by 0.6% of GDP. If the relevant balance, which had reduced the need for borrowing, would not have changed at the beginning and end of 2008 (at the end of 2007 a considerable balance was accumulated, which was made use of to redeem a EUR 200 million Eurobond emission in February 2008), the debt would have stood at %15.9 GDP.

V. QUALITY OF GENERAL GOVERNMENT FINANCES

44. With the view of more effective management of state financial resources, the Seimas of the Republic of Lithuania initiated a budgeting reform by Resolution “On the Budgeting Concept of the Republic of Lithuania” (*Valstybės žinios* (Official Gazette) No 95-2637, 1998) of 22 October 1998; 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 a possibility to the public to get thorough information about the use of taxpayers’ money. 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 December 2008, the Reserve (Stabilisation) Fund had LTL 1028.6 m (0.9% of the projected GDP). In 2009, the Reserve (Stabilisation) Fund is estimated to accumulate LTL 1450m.

With a view to implementing the budgeting reform, a Strategic Planning Methodology, regulating the planning process in a detailed way, was drafted 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). Systemic planning of an institution’s performance related with funding allows analysis and evaluation of an institution as a system for the achievement of the goals set, its guidance on result-oriented activity, and more rational distribution of the financial, material, and labour resources.

45. Thanks to fiscal consolidation, a share of public administration expenditure in Lithuania (% of GDP) remains low in comparison with that of the other EU Member States. According to the Department of Statistics, public administration expenditure in Lithuania fell by 4% of GDP in 2007 (this indicator stood at 4.1% of GDP in 2006). In the medium term, the EU support is going to raise a share of GDP allocated for economic functions by several percentage points.

Table 13. General government expenditure by function

Indicator	COFOG Code	% of GDP	
		2007	2011
1. General public services	01	4,0	–
2. Defence	02	1,9	–
3. Public order and safety	03	1,7	–
4. Economic affairs	04	4,4	–
5. Environmental protection	05	0,9	–
6. Housing and community amenities	06	0,3	–

Indicator	COFOG Code	% of GDP	
		2007	2011
7. Health care	07	4,6	–
8. Recreation, culture and religion	08	1,0	–
9. Education	09	5,2	–
10. Social protection	10	11,1	–
11. Total expenditure		35,2	36,35

Sources: Department of Statistics, Ministry of Finance

General government expenditure

Objectives

46. State budget expenditure targets and priorities of the Republic of Lithuania are defined in a number of policy papers that are interrelated and form a single integrated set. The key national budget expenditure targets and priorities have been set by the Programme of the Government of the Republic of Lithuania.

47. The Programme of the Government of the Republic of Lithuania provides for the following:

47.1. There shall be a coherent transition to the practical tri-annual budget formation; maximum appropriations for three years shall be changed only in case there is a significant shift in macroeconomic forecasts. The number of appropriations managers and the programmes they draft shall be optimized. The publicity and transparency of the budgeting process shall be ensured by providing conditions for each taxpayer to express their opinion.

47.2. A costs-benefit analysis methodology shall be drafted and applied for all larger projects realized from taxpayers’ funds.

47.3. A state investment programme shall be drafted based on the Government’s priorities, first, by concentrating funds for the development of infrastructure required to attract foreign direct investment, for energy saving, and promotion of innovations. A mechanism to measure efficiency of the state investment and to assess the results achieved shall be launched.

47.4. The public sector accounting reform shall be completed. As a result, there shall be greater transparency in public finances as well as enhanced efficiency in public sector (first, auxiliary units of public institutions with regional branches shall be centralized).

47.5. Public property management shall be centralized (first, that of buildings); a premises rent system for the state and municipal institutions shall be gradually launched.

47.6. Public sector statistics shall be developed, thereby providing conditions for the citizens to analyse and assess efficiency of the use of the public finances.

47.7. Public-private sector partnership shall be developed by establishing legal, institutional, and administrational conditions as well as a corruption prevention mechanism.

47.8. A system for the promotion of structural reforms shall be created with a view to saving taxpayers' funds, whereby part of the saved funds shall be allocated to satisfy the needs of a reformed institution or a sector.

General government revenue

Tax reform

48. In compliance with measures set out in the Anti-Crisis Plan of the Programme of the Government of the Republic of Lithuania, a tax reform was carried out alongside the budgeting procedure for 2009.

49. The Law Amending Articles 2, 3, 5, 6, 7, 8, 9, 10, 12, 13^1, 16, 17, 18, 19, 20, 21, 22, 23, 27, 27, 29, 30 and Supplementing Article 18^1 of the Law No XI-111 of the Republic of Lithuania on Personal Income Tax (*Valstybės Žinios* (Official Gazette) No 149-6033, 2008):

49.1. As of 1 January 2009, health insurance contribution has been separated from personal income tax as a separate contribution. All types of personal income, except for income from distributed profit, shall be taxed at a flat 15% rate. Income from distributed profit shall be taxed at a 20% rate.

49.2. The tax-exempt minimum shall be applicable only to income related to employment relations or relations in their essence corresponding to employment relations; its specific amount shall be established with regard to personal income of the types set that was gained during the tax period; higher basic tax-exempt minimum shall be applicable for the lowest-income persons, while a basic tax-exempt minimum shall not be applicable to persons whose income exceeds a certain amount. Furthermore, an additional tax-exempt minimum shall be applicable to citizens with children: an additional tax-exempt minimum worth LTL 100 per month shall be applicable for the first child, and an additional tax-exempt minimum worth LTL 200 per month shall be applicable for each subsequent child.

49.3. A tax exemption on income from agricultural activity has been retained only for small farmers (including those in a cooperative). Larger farmers have been included into the personal income taxation system and a standard rate shall be gradually started to be applied over the period of 3 years.

49.4. Personal income tax exemption on interest paid on credit taken for the building or acquisition of housing has been withdrawn (the exemption has been retained for individuals who had already started making use of it for one of their credits taken before 1 January 2009 for the building or acquisition of housing). Taxation procedure for income from transfer into ownership of immovable property has also been changed (formal ownership retention periods have been withdrawn) with a view to ensuring possibilities to change a place of residence more easily.

49.5. An exemption for individuals for acquisition of a personal computer and/or installation of the Internet access, which was planned to be still applied in 2009, has been withdrawn; a possibility has been retained to deduct the financial lease (leasing) payments for the acquisition of personal computers by 2009.

49.6. An exemption for payments for studies or vocational training shall be applicable only where first higher education or first respective qualification is obtained upon graduation.

50. The Law Amending Articles 2, 5, 12, 34, 38^2, 41, 58 and Supplementing Article 40^1 and Chapter IX^1 of the Law No XI-73 of the Republic of Lithuania on Corporate Income Tax (*Valstybės Žinios* (Official Gazette) No 149-6000, 2008), the Law Amending Articles 2, 3, and 4 of the Law Amending Articles 3, 33, 34, 35, 55 of the Law No XI-74 of the Republic of Lithuania on Corporate Income Tax (*Valstybės Žinios* (Official Gazette) No 149-6001, 2008):

50.1. The basic corporate income tax rate has been raised from 15% to 20 %.

50.2. A corporate income tax exemption allowing a maximum 50% reduction of taxable profits for companies which invest into essential technological modernisation has been introduced.

50.3. Sectorial exemptions have been withdrawn, i. e. the profits of credit unions, Central Credit Union, and agricultural entities shall be subject to corporate income tax (a transitional 3 year period for moving over to the standard rate has been established for agricultural entities that had been subject to the reduced corporate income tax).

50.4. Dividend taxation procedure has been changed with a view to ensuring even distribution of tax burden, when dividends are paid from the pre-tax profits at a company level.

51. Bearing in mind Lithuania‘s obligation to gradually increase excise tariff on cigarettes, so that by 31 January 2009 it reaches the minimum set forth by the EU acquis, and in order to avoid sharp cigarette price surges, the excise tariffs on cigarettes have been consistently raised during the last years: the specific component and the *ad valorem* component of the excise duty grew, correspondingly, from 66 to 79 litas and from 15 to 20% as of 1 March 2008; they are due to increase further to 95 litas (per 1000 cigarettes) and to 25% as of 1 March 2009. From 1 September 2009, yet another increase of the specific component from 95 to 132 litas should bring the excise tariff to the minimum level, established by the EU *acquis*.

52. Since 1 January 2008, new excise tariffs on fuels were introduced in compliance with the limits set forth by the EU legislation (at least 323 EUR/1000 l for petrol, and at least 323 EUR/1000 l for kerosene and diesel fuel). Furthermore, considering the favourable situation in oil markets resulting in lower fuel prices, the following excise tariffs were established as of 1 January 2009 (per 1000 litres of fuel) on: unleaded petrol – 1500 litas, leaded petrol – 2000 litas, diesel fuel and kerosene – 1140 litas. The excise tariff on liquefied petroleum gas and gaseous hydrocarbon fuel was also increased from 432 to 1050 litas per tonne of product in order to maintain tariff proportions between these fuels and petrol, which is usually replaced by these substitute gaseous fuels.

53. Since 1 January 2008, excises on alcohol were increased by 20% (with exception for beer, whose tariff increased by 10%). While implementing further the measures planned in the Programme of the Government of the Republic of Lithuania, alcohol excises were raised again as of 1 January 2009 (per 1 hl of product): on beer – to 8.5 litas for 1% of actual alcoholic strength by volume; on wine with actual alcoholic strength up to 8.5% per volume - to 53 litas; on other beverages of natural fermentation with actual alcoholic strength up to 8.5% per volume - to 58 litas; on intermediary products – to 198 litas, if actual alcoholic strength up to 15% per volume and to 304 litas, if actual alcoholic strength per volume is higher than that; on ethyl alcohol - to 4416 litas for pure alcohol content per volume. The new legislation also abolished the excise exemptions for beer produced and sold by small breweries applicable before the Law Amending Articles 21, 22, 23, 24, 28, 33, 34, 35 and 37 of the Law on Excise Duty No XI-79 (*Valstybės žinios* (Official Gazette) No 149-6005, 2008) came into power.

54. To enforce the provisions of the Programme of the Government of the Republic of Lithuania, the Law Amending Articles 2, 19, 51, 56, 58, 91, and 125^1, and abolishing Article 125^1 of the Law on Value Added Tax No. XI-114 (*Valstybės žinios* (Official Gazette) No 149-6005, 2008) came into power from 1 January 2009, establishing a standard VAT tariff of 19% as of 1 January 2009. At the same time, all reduced VAT tariffs applicable in Lithuania by that time were abolished, except the present reduced VAT of 5% on refundable medicaments and medical services, and a new interim 9% VAT on books and non-periodical informative publications (the two reduced tariffs remain applicable till 30 June 2009). Partial compensation (14 percentage points) of the VAT on household heating will remain applicable till 31 August 2009. After the transition period, any supply of goods and services will be subject to a single VAT tariff of 19%.

55. In order to implement the provisions of the Programme of the Government of the Republic of Lithuania, the following measures became applicable from 1 January 2009:

55.1. the Law Amending the Law on Lottery and Gaming Tax No XI-80 (*Valstybės žinios* (Official Gazette) No 149-6006, 2008) came into power, introducing a higher taxes on gaming machines and other gaming equipment with consideration of the growth of the gaming market.

55.2. the base tariff of tax on state property held in trust was raised from 0.5% to 2% with consideration of the fact that public enterprises pay negligible taxes for the state property held and used by them in trust, however the tax payable must be no less than 10% of the taxable profit of the preceding tax period. In addition to that, the number of tax advantages with regard to this tax was reduced.

56. As regards tax system reforms, one should note the Law Amending Articles 2, 12, 13, 17, 18, 21, 23, 26, 28, 30, 31, 38^1, 47, 50, Amending Appendixes 1, 3 and Supplementing Article 17^1 of the Law No X-1484 of the Republic of Lithuania on Corporate Income Tax (*Valstybės Žinios* (Official Gazette) No 47-1749, 2008) whereby, calculating taxable profits for 2008 and subsequent tax periods, corporate income tax exemptions shall be applied for

corporate investment into R&D, with a view to encourage companies to additionally invest in R&D aimed at creation of new materials and technologies which should generate high added value. Furthermore, recognition of allowable deductions reducing taxable profit has been simplified, and administrative burden as regards relevant regulation procedure has been alleviated. Also, with regard to the adoption of the said amendments, corporate income limit which, if not exceeded, does not incur an obligation of advance income tax payment has been raised from LTL 100,000 to LTL 1,000,000 as of 1 January 2009.

57. In 2007 and on, both direct and indirect taxation policies shall be pursued taking account of the national priority guidelines, actual economic and social environment in Lithuania, primary goals of Lithuania's tax system, developments in the EU tax policies, case-law of the European Court of Justice, results of activities of the European Commission's working groups, and the best global practice in the field of taxation. As a result, sustainable taxation system shall be created with a view to ensure stable state budget revenues and legalize tax incentives in the national priority areas instead of inefficient tax exemptions. Furthermore, the new tax policy shall guarantee that taxes in Lithuania are calculated in accordance with universal taxation principles that are equally interpreted both in Lithuania and other EU member states. Consequently, business conditions (as far as taxes are concerned) shall come closer to the conditions applied in other states, thus making a positive impact on the competitive environment.

VI. SUSTAINABILITY OF PUBLIC FINANCES

58. Long term sustainability of public finances is mainly determined by the changes in the demographic structure of the population. Lithuania has developed an integrated budgetary projection (hereafter referred to as "the Projection") that allows forecasting the impact of demographic changes on pensions, healthcare and education systems in the long-term perspective and planning appropriate measures for ensuring future stability of these systems.

The Projection is based on Lithuania's demographic projection for the period up to 2050 prepared by the Eurostat in 2004. According to the latter projection, Lithuanians population is expected to shrink by 16.4% or down to 2.9 million in the period of 2004-2050. Decline is expected in various age groups: age group of 0-14 years – from 17.7% to 13.7%, productive labour force (15-64 years) – from 67.3% to 59.6%, whereas aged population (65 years and above) should increase from 15% to 26.7%.

59. Table 14 presents long-term projections of public finances (pension, healthcare and education systems) for the period up to 2050. They are based on primary statistics for 2005, on mid-term economic and employment projections prepared by the Ministry of Finance, as well as economic and employment projections for 2012-2050 prepared by the DG Economy and Finance of the European Commission. Projections of the expenditure on health protection, long-term healthcare and education have been prepared in accordance with the methodology used by the Ageing Working Group (AWG) of the Economic and Financial Affairs Directorate-General

of the European Commission to produce 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 14 under "Other age-related spending" has been calculated using the methodology employed for analogical projections for EU-15 in 2003. Preparation of the projections was based on the existing Lithuanian legislation regulating the system of social security.

Table 14. Long-term sustainability of public finances

Indicator	% of GDP					
	2000	**2005**	**2010**	**2020**	**2030**	**2050**
1. Total expenditure	39.1	33.3	38.3	35.7	37.0	38.7
of which: age-related expenditure	13.7	16.6	18.5	18.0	19.2	20.9
Pension expenditure	7.8*	6.6*	6.8	6.9	7.8	9.3
social security pensions	7.8*	6.6*	6.8	6.9	7.8	9.3
old-age and early pensions	6.8*	5.5*	5.6	5.7	6.7	8.4
other pensions (disability, survivors)	1.0*	1.1*	1.2	1.2	1.1	0.9
occupational pensions (if in general government)	–	–	–	–	–	–
Health care	4.1	4.9	5.2	5.5	5.7	6.1
long-term care		0.5	0.5	0.6	0.6	0.9
Education expenditure**	5.7	5.2	5.8	5.0	5.0	4.6
Other age-related expenditure***	0.2	0.1	0.2	0.1	0.1	0.1
Interest expenditure	1.7	0.8	0.6	1.5	2.7	6.2
2. Total revenue	35.8	32.8	37.3	36.3	36.3	36.3
of which: property income	1.2	0.8	0.6	0.6	0.6	0.6
of which: from pensions contributions (or social security contributions, if appropriate)	7.1	6.2****	6.7	6.8	6.7	6.1
Pension reserve fund assets	0	0	N.A.	N.A.	N.A.	N.A.
of which: consolidated public pension fund assets*****	0	0.5	3.9	13.8	26.0	53.1
3. Assumptions						
Labour productivity growth	–	1.7	0.4	3.6	2.7	1.7
Real GDP growth	–	7.8	-0.2	3.0	1.9	0.4
Participation rate males (aged 20-64)	82.1	81.5	79.5	87.6	88.0	86.3
Participation rate females (aged 20-64)	74.2	72.7	73.7	81.4	82.2	79.7
Total participation rate (aged 20-64)	77.9	76.9	76.5	84.4	85.0	83.0
Unemployment rate	16.4	8.3	8.5	7.0	7.0	7.0
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 Education and Science, and Ministry of Health.

*Pension expenditure calculated according to the methodology of the European Commission presented in the document "The Task of Pension Projections for 2009: the Basis for Reporting" (28/05/2008, Brussels).

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

*** Unemployment benefits.

**** Contributions for social security pensions, from 2004 and on – excluding transfers to private pension funds.

***** Financial assets of the Pension System (Pillar II of the Tier I), accumulated in private pension funds and the annuity reserve.

60. Table 14 demonstrates the revenues from social insurance contributions (excluding private pension funds run by pension accumulation companies) and the expenditures pertinent to actual social security pension schemes, i.e. social insurance pension scheme and state pension scheme (including social benefits). State pensions (including social benefits) are funded directly from the budget. As compared to the projections provided in Lithuania's Convergence Programme 2007, table 14 reveals an increase in pension spending, which has occurred due to the following:

60.1. revision of national accounts;

60.2. amendments to the calculation method of social insurance pensions, enacted in the period of 2007-2008: the introduction of the length-of-service bonus and the change in the basic part of the state social insurance pension;

60.3. an increased number of insured groups (on the premise of an increased beneficiary/contributor ratio from 96% to 98%): individuals receiving income from activities related to sports and performance under copyright agreements, as well as farmers and their partners in certain cases provided by the Law on State Social Insurance of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No. 17-447, 1991; No. 171-6295, 2004) will be entitled to state social insurance as of 1 January 2009. In the long run, more funds will be needed for an increased number of insured groups and for the delivery of the commitments assumed by the State Social Insurance Fund in relation to these individuals.

61. Growing elderly population and declining birth-rate as well as shrinking working-age population will result in increased government spending on pensions and health care (GDP share), and decreased spending on education: from 2005 to 2050, pension spending will grow by 2.7% of the GDP, health care spending by 1.2% of the GDP, while education spending will be cut by 0.6% GDP. Unemployment benefit spending will undergo few changes. In general, age-related spending is projected to grow by 3.6% of the GDP.

62. Pension spending is likely to grow the fastest. In 2004, a pension reform was launched to set up Tier II of pension system: a subsystem of voluntary pension accumulation (Pillar II of Tier I of state social insurance pension system) providing for a part of mandatory state social insurance contributions to be shifted to private pension funds. The first pension accumulation contracts were concluded back in 2003. In 2008, thanks to the successful implementation of the reform, there were 880 thousand participants to the pension accumulation system (69% of all the insured by the state social insurance). 78 thousand pension accumulation contracts were signed in 2008 alone, therefore, the expectations are that in 2009 the number of those who opt for this kind of saving will reach 958 thousand (71% of all insured by the state social insurance).

63. A share of state social insurance contributions shifted to private funds has been growing rapidly. It made 1% of the GDP in 2008. However, in 2009-2010, contributions to pension funds will reduce to 0.6% of the GDP, as the state social insurance pension

contribution rate has been temporarily brought down from 5.5% to 3% for 2009-2010 in order to carry out the Government Programme and deliver on the pending commitments of the State Social Insurance Fund. It has been projected that in 2011, when pension accumulation rate again reaches 5.5%, the pension funds will recover its 1% share of the GDP. Allocations for state social insurance pensions are expected to come down around 2030, when about half of the retired are put on reduced state old-age social insurance pensions (supplementary part of old-age pension is reduced in proportion to accumulated contribution) together with annuities, accrued from accumulated pension.

64. The Lithuanian National Report on Strategies for Social Protection and Social Inclusion 2008-2010 envisages measures to be taken by the Government of the Republic of Lithuania providing for the relative size of pensions to be raised and financial sustainability of the pensions system to be ensured. The considerations lie on the premise of the gradual increase in retirement age limit 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. Table 15 below shows potential development of the financial burden of the pension system provided the mentioned decisions are enforced.

Table 15. Pension beneficiary/contributor ratio

Indicator	2007	2010	2020	2030	2050
Pension beneficiary/contributor ratio, where the retirement age is 60/62,5*	1,6	1,6	1,7	1,4	1,0
Pension beneficiary/contributor ratio, where the retirement age is 65/65*	1,6	1,6	1,8	1,6	1,2

Source: Ministry of Social Security and Labour

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

Furthermore, the extension of the retirement age will call for additional employment promotion measures, which will ensure that older people remain active in the labour market. The Government of the Republic of Lithuania has undertaken a commitment to develop a social insurance improvement programme, which takes into account the needs of the aging society and encourages a wider roll-out of private pension funds, with particular focus on professional pensions, while at the same time maintaining the solidarity as regards the responsibility for the funding of the state social insurance pensions.

65. Due to the current demographic developments, education spending is projected to be cut to 4.6% of the GDP in 2050. It is highly probable, however, that the implementation of the political goals of the National Education Strategy might necessitate allocation increase to 6.4% (GDP) in 2050

66. Over the period covered, the total public spending will increase by 5.4 percentage points of GDP, from 33.3% of GDP in 2005 to 38.7% of GDP in 2050. Non-age-related spending, which was fixed and held constant at the level of 2011, will grow by 1.8 percentage

points of the GDP. Public revenues will grow by 3.5 percentage points of the GDP: from 32.8% in 2005 to 36.3% of the GDP in 2050.

VII. INSTITUTIONAL FEATURES FOR THE IMPROVEMENT OF GOVERNMENT FINANCES

67. The Programme of the Government of the Republic of Lithuania provides for the following:

67.1. The reconsideration of the Law on Fiscal Discipline with the view to having requirements applicable for fiscal deficit and not for expenditure, as it is now.

67.2. The introduction of the rules of fiscal discipline aimed to prevent political economic cycles.

67.3. Preventing different interest groups from seeking consumption and income tax incentives which cause relative price distortion, reduce economic effectiveness, and instead of achieving a more even income distribution in the society, make it even more skewed.

67.4. The completion of government accounting reform with a view to achieving the transparency in public finances and better efficiency of the public sector (in the first place, centralizing regional units servicing public institutions with regional units).

67.5. The development of government statistics, providing a possibility for the public to analyze and assess the effectiveness of the use of public finances.

67.6. Taking proactive steps to prevent an economic overheating and a potential recession (once the actual recession is done with), such as relevant taxation policies, structural reforms as well as close cooperation with the Bank of Lithuania.

67.7. The restructuring of the system of strategic planning by shifting the focus on results.

67.8. State governance reform through elimination of overlapping functions and reduction of controlling bodies.

VIII. CONSISTENCY OF LITHUANIA‘S CONVERGENCE PROGRAMME FOR 2008 WITH NATIONAL LISBON STRATEGY IMPLEMENTATION PROGRAMME FOR 2008–2010

68. The assessment of the compatibility between the programmes in question is provided below following the guidelines laid down in the European Commission’s document published on 29 August 2008 regarding better consistency of stability and convergence programmes with national reform programmes:

68.1. The National Lisbon Strategy Implementation Programme for 2008-2010, approved by Resolution No 1047 of 1 October 2008 (*Valstybės žinios* (Official Gazette) No124-4718, 2008), was drafted prior to the publication of an update of macroeconomic projections for 2008–2010 by the Ministry of Finance and the draft law on the approval of financial indicators of the state budget and municipal budgets for 2009 (the 2009 draft budget law of the Republic of Lithuania).

Initially, a draft budget law for 2009 was approved by the previous Government by Resolution No 1015 of 14 October 2008 (*Valstybės žinios* (Official Gazette) No121-4592, 2008) and subsequently submitted for the reading of the Seimas of the Republic of Lithuania on 17 October 2008. The 15th Government of the Republic of Lithuania (appointed after the parliamentary elections held on 12 October 2008) drew a new draft budget for 2009, which was signed into law by the Seimas of the Republic of Lithuania on 22 of December 2008 (The 2009 Law on Approval of Financial Indicators of the State Budget and Municipal Budgets of the Republic of Lithuania No XI-96 (*Valstybės žinios* (Official Gazette) No 149-6020, 2008).

Lithuania‘s Convergence Programme 2008 has been drawn on the basis of the latest macroeconomic projections published on 12 December 2008 by the Ministry of Finance and the 2009 draft budget law of the Republic of Lithuania approved by the Government of Lithuania and the Seimas of the Republic of Lithuania.

68.2. The reflection of the impact of the structural reforms on the budget in Lithuania’s Convergence Programme 2009: the direct impact of the Lisbon measures on the budget balance has been taken into account by calculating government financial indicators covered in this Programme.

IX. DIRECT IMPACT OF MAJOR STRUCTURAL REFORMS ON BUDGET

69. The direct impact of major structural reforms on the budget is illustrated by Table 16 which shows annual developments from 2008; while measures 5 and 6 will display developments as of 2009 based on available data.

Table 16. Direct impact of major structural reforms on budget
(Increased spending or decreased revenues (+); decreased spending or increased revenues (-)

Major structural measures	Spending/revenue category (according to ESA’95)	2007		2008		2009		2010		2011	
		National currency*, LTL/m	GDP %	National currency*, LTL/m	GDP %	National currency*, LTL/m	GDP %	National currency*, LTL/m	GDP %	National currency*, LTL/m	GDP %
1. Education reform[1]	intermediate consumption and gross fixed capital formation	8.00	0.01	305.78	0.27	903.33	0.79	-253.88	-0.22	706.34	0.59
2.Healthcare reform[2]	intermediate consumption and gross fixed capital formation	0.00	0.00	0.00	0.00	13.00	0.01	67.00	0.06	-5.00	0.00
3. Taxation reform[3]	indirect tax-driven revenues	-58	-0.06	-487.00	-0.43	-2038.3	-1.78	-46	-0.04		
	direct tax-driven revenues	578	0.59	868.50	0.76	133.5	0.12	555.0	0.48		

Major structural measures	Spending/revenue category (according to ESA'95)	2007 National currency*, LTL/m	2007 GDP %	2008 National currency*, LTL/m	2008 GDP %	2009 National currency*, LTL/m	2009 GDP %	2010 National currency*, LTL/m	2010 GDP %	2011 National currency*, LTL/m	2011 GDP %
4. Environment (housing renovation)[4]	intermediate consumption	15.70	0.02	36.80	0.03	31.90	0.03	15.60	0.01	120.00	0.10
5. Measures encouraging industry, commerce and innovations[5]	intermediate consumption and gross fixed capital formation			425.53	0.37	1111.61	0.97	-424.63	-0.37		
6. Upgrading or building new infrastructure for transport and communications .[6]	gross fixed capital formation	317.95	0.32	503.35	0.44	357.51	0.31	380.08	0.33	-211.92	-0.18
7. Implemen-tation of social, youth and labour market reforms**[7]	intermediate consumption			1115.08	0.98	335.00	0.29	0.52	0.00		
8. Agriculture[8]	direct and indirect tax driven revenues	-1319.00	-1.34	-562.00	-0.49	308.00	0.27	-136.00	-0.12	-193.00	-0.16
	Grants, intermediate consumption and gross fixed capital formation	2687.00	2.74	736.00	0.65	-690.00	-0.60	182.00	0.16	214.00	0.18
Overall direct impact on budget		2229.65	2.27	2942.04	2.59	465.55	0.41	339.69	0.29	630.41	0.52
Pension reform: Social contributions (D.61 – contributions to private pension funds)		851.61	0.87	237.89	0.21	-428.20	-0.37	27.30	0.02	633.00	0.53

*State or EU funding, or state and EU funding (in case of co-financing).

**State or EU funding, or state and EU funding (in case of co-financing), including social insurance funding of certain programmes.

1. Measures 13, 15, 16, 17, 18, 19, 21, 22, 30, 94.1, 96.1, 96.2, 96.3, 110, 111, 112, 113, 114, 115, 116, 117, 118 of the National Lisbon Strategy Implementation Programme for 2008-2010.

2. Measure 6 of the National Lisbon Strategy Implementation Programme for 2008-2010.

3. Updates covered in the Programme on the amendments to laws of the Republic of Lithuania (VAT law, excise law, lottery and gaming tax law, personal income tax law, profit tax law).

4. Measure 73 of the National Lisbon Strategy Implementation Programme for 2008-2010.

5. Measures 23, 24, 26, 31, 32, 33, 35, 38, 39, 40, 41, 42, 44, 55, 56, 57, 58, 60, 62.2, 63, 65, 66, 71, 78, 79, 80, 81, 82, 96.3 of the National Lisbon Strategy Implementation Programme for 2008-2010

6. Measures 74, 85, 87, 88, 89, 90, 91, 92.of the National Lisbon Strategy Implementation Programme for 2008-2010.

7. Measures 7, 14, 62.1, 62.2, 95.1, 96.5, 97.1, 97.2, 98.1, 98.2, 100.1, 100.3, 100.4, 100.5, 100.7, 100.8, 100.9, 103.1, 103.2, 103.4, 103.5, 103.6, 106.1, 106.3, 107.1, 107.3, 108.1, 109.1, 109.2, 119 of the National Lisbon Strategy Implementation Programme for 2008-2010.

8. The reform has not been covered in the National Lisbon Strategy Implementation Programme for 2008-2010. (it includes the following measures: measures implementing common agricultural policy; restructuring of agriculture and fisheries; land management and administration; building institutional and administrative capacities; structural support and rural development measures).