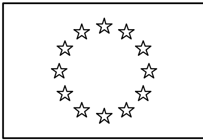

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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LITHUANIA: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE FEBRUARY 2010 UPDATE OF THE CONVERGENCE PROGRAMME

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called 'stability programme' for countries that have adopted the euro as their currency and 'convergence programme' for those that have not. The most recent update of Lithuania's convergence programme was submitted on 26 February 2010.

The attached technical analysis of the programme prepared by the staff and under the responsibility of the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission was finalised on 24 March 2010. Comments should be sent to Agne Geniusaite (agne.geniusaite@ec.europa.eu) and Julda Kielyte (julda.kielyte@ec.europa.eu). The main aim of the analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

The analysis takes into account (i) the Commission services' autumn 2009 forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 10 November 2009) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

Based on this analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 24 March. The ECOFIN Council is expected to discuss the opinion on the programme on 16 April 2010.

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

http://ec.europa.eu/economy_finance/sgp/index_en.htm

TABLE OF CONTENTS

1. INTRODUCTION 4

2. KEY CHALLENGES IN THE ECONOMIC DOWNTURN AND THE POLICY RESPONSE 5

3. MACROECONOMIC OUTLOOK 6

4. GENERAL GOVERNMENT BALANCE 9

 4.1. Budgetary implementation in 2009 9

 4.2. The programme's budgetary strategy for 2010 12

 4.3. The programme's medium-term budgetary strategy 13

 4.4. Risk assessment 16

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY 17

 5.1. Recent debt developments and medium-term prospects 18

  5.1.1. Debt projections in the programme 18

  5.1.2. Assessment 19

 5.2. Long-term debt projections and the sustainability of public finances 20

  5.2.1. Additional factors 22

  5.2.2. Assessment 23

6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES 23

 6.1. Fiscal framework 23

 6.2. Quality of public finances 24

7. ASSESSMENT OF THE STRATEGY ENSURING A SMOOTH PARTICIPATION IN ERM II 24

  7.1.1. Recent exchange rate and financial market developments 24

  7.1.2. Policies supporting participation in ERM II 25

  7.1.3 Assessment 26

8. OVERALL ASSESSMENT 26

ANNEX. COMPLIANCE WITH THE FORMAT AND CONTENT REQUIREMENTS FOR STABILITY AND CONVERGENCE PROGRAMMES 27

1. INTRODUCTION

This document assesses the January 2010 update of Lithuania's convergence programme, which was submitted on 26 February and covers the period 2009-2012[1]. The programme builds on the 2010 budget approved by Parliament on 10 December. The programme was approved by the government on 24 February 2010 and presented to the parliament's European Affairs Committee, where it was debated on 19 February 2010 without being voted upon; there is thus no formal parliamentary approval of the programme.

This assessment is structured as follows. Section 2 discusses the key challenges for public finances in Lithuania. Section 2 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the convergence programme against the background of the Commission services' economic forecasts[2]. Section 4 analyses budgetary implementation in the year 2009, the budgetary plans for 2010 and the medium-term budgetary strategy. It also assesses risks attached to the budgetary targets. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 5 discusses institutional features of public finances. Section 7 assesses the smooth participation in ERMII. Finally, Section 8 concludes with an overall assessment of the programme. The annex provides a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme.

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[1] The English language version was submitted on 19 March 2010.

[2] This assessment uses the Commission services' 2009 autumn forecast, as published on 3 November 2009, as a benchmark. However, more recent information that has become available has also been taken into account to assess the risks to the programme scenarios.

Table 1. Comparison of key macroeconomic and budgetary projections

		2008	2009	2010	2011	2012	2013
Real GDP (% change)	**CP Jan 2010**	**2,8**	**-15,0**	**1,6**	**3,2**	**1,2**	**n.a.**
	COM Nov 2009	2,8	-18,1	-3,9	2,5	n.a.	n.a.
	CP Jan 2009	*3,5*	*-4,8*	*-0,2*	*4,5*	*n.a.*	*n.a.*
HICP inflation (%)	**CP Jan 2010**	**11,1**	**4,2**	**-1**	**1**	**1,5**	**n.a.**
	COM Nov 2009	11,1	3,9	-0,7	1,0	n.a.	n.a.
	CP Jan 2009	*11,2*	*5,4*	*3,6*	*-0,1*	*n.a.*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Jan 2010**	**8,8**	**-7,7**	**-5,9**	**-2,9**	**-1,7**	**0,0**
	COM Nov 2009[2]	11,8	-8,2	-10,8	-8,2	n.a.	n.a.
	CP Jan 2009	*5,4*	*-2,8*	*-5,7*	*-4,0*	*n.a.*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Jan 2010**	**-10,2**	**3,7**	**7,5**	**5,3**	**4,3**	**n.a.**
	COM Nov 2009	-10,6	3,3	4,8	4,3	n.a.	n.a.
	CP Jan 2009	*-10,2*	*-1,8*	*-4,7*	*-5,7*	*n.a.*	*n.a.*
General government revenue (% of GDP)	**CP Jan 2010**	**34,2**	**34,3**	**36,2**	**35,6**	**35,7**	**n.a.**
	COM Nov 2009	34,2	36,1	36,8	36,3	n.a.	n.a.
	CP Jan 2009	*33,8*	*35,8*	*37,3*	*36,4*	*n.a.*	*n.a.*
General government expenditure (% of GDP)	**CP Jan 2010**	**37,4**	**43,4**	**44,3**	**41,4**	**38,7**	**n.a.**
	COM Nov 2009	37,4	45,9	46,0	46,0	n.a.	n.a.
	CP Jan 2009	*36,7*	*37,8*	*38,3*	*36,4*	*n.a.*	*n.a.*
General government balance (% of GDP)	**CP Jan 2010**	**-3,2**	**-9,1**	**-8,1**	**-5,8**	**-3,0**	**n.a.**
	COM Nov 2009	-3,2	-9,8	-9,2	-9,7	n.a.	n.a.
	CP Jan 2009	*-2,9*	*-2,1*	*-1,0*	*0,0*	*n.a.*	*n.a.*
Primary balance (% of GDP)	**CP Jan 2010**	**-2,6**	**-7,8**	**-6,2**	**-3,6**	**-0,6**	**n.a.**
	COM Nov 2009	-2,6	-8,4	-7,0	-7,1	n.a.	n.a.
	CP Jan 2009	*-2,3*	*-1,2*	*0,0*	*1,1*	*n.a.*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Jan 2010**	**-5,6**	**-7,0**	**-6,5**	**-5,0**	**-2,6**	**n.a.**
	COM Nov 2009	-6,4	-7,6	-6,3	-7,5	n.a.	n.a.
	CP Jan 2009	*-4,4*	*-1,3*	*0,5*	*1,1*	*n.a.*	*n.a.*
Structural balance[3] (% of GDP)	**CP Jan 2010**	**-6,0**	**-7,2**	**-6,8**	**-4,8**	**-2,3**	**n.a.**
	COM Nov 2009	-6,3	-8,0	-7,0	-7,5	n.a.	n.a.
	CP Jan 2009	*-4,9*	*-1,8*	*0,1*	*1,1*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP Jan 2010**	**15,6**	**29,5**	**36,6**	**39,8**	**41,0**	**n.a.**
	COM Nov 2009	15,6	29,9	40,7	49,3	n.a.	n.a.
	CP Jan 2009	*15,3*	*16,9*	*18,1*	*17,1*	*n.a.*	*n.a.*

Notes:

[1]Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2]2Based on estimated potential growth of 3.0%, -0.2%, -1.2% and -0.3% respectively in the period 2008-2011

[3]3Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are [0.5% of GDP in 2008, 0.2% in 2009 and 0.3% in 2010; all deficit-reducing. And 0.3% in 2011 and 0.3% in 2012; all deficit increasing according to the most recent programme and 0.1% of GDP in 2008, 0.6% in 2009 and 0.7% of GDP in 2010; all deficit-reducing in the Commission services' autumn 2009 forecast

Source :

Convergence programme (CP); Commission services' autumn 2009 forecasts (COM); Commission services' calculations.

2. KEY CHALLENGES IN THE ECONOMIC DOWNTURN AND THE POLICY RESPONSE

This section describes recent economic and budgetary developments for Lithuania, which form the background against which the current programme assessment should be viewed, and outlines the key challenges to be addressed by future economic policies.

Several years of rapid and increasingly unsustainable growth, mainly driven by domestic demand and a real estate boom, came to a halt in 2008. Lithuania quickly moved into recession and in 2009 output fell 15% year-on-year, one of the sharpest declines in the

EU. The bursting of the domestic bubble was reinforced by the global financial crisis and a fading away of external demand, nearly returning output to pre-boom levels. Trade levels shrank markedly and imports collapsed, significantly reducing the merchandise trade deficit. The current account reached an estimated surplus of 3.1% of GDP. The labour market adjustment has been very rapid since the start of the crisis: in 2009 employment fell by 7.3% compared to 2008 and unemployment reached 13.7%. Wage growth turned negative in the private sector from early 2009 and in the public sector from mid-2009, due to labour market-led and policy-driven downward pressure. Consumer price inflation fell to 1.2% year-on-year in December 2009. The sharp decline in revenues resulting from the economic contraction, together with an expansionary fiscal policy before the parliamentary elections in 2008, left Lithuania facing significant fiscal challenges. Even though on the back of the world recovery and improving external demand, the economic situation seems to be stabilising, recovery still looks very fragile. Significant challenges remain due to the weakened public finances, high unemployment, reduced access to credit for companies and significant restructuring needs for the economy.

In the face of the crisis, from autumn 2008 a strong policy response was put in place by the government. Lithuania has been pursuing fiscal consolidation to contain the deterioration in public finances and to limit debt accumulation, as well as to facilitate the reduction of imbalances in the economy, thereby inter alia supporting the credibility of the currency board arrangement. Due to accumulated imbalances and constrained financing conditions, there was no space for fiscal stimulus. In line with the European Economic Recovery Plan (EERP), the government has put fiscal policy at the centre of its policy response and for 2009 adopted a restrictive initial budget and two supplementary budgets implementing further consolidation, including both temporary and permanent measures, in preparation of structural reforms of the social security, education and healthcare sectors. The Government remains committed to further fiscal consolidation; on 10 December 2009 it adopted the 2010 budget including a fiscal consolidation package of around 4.0% of GDP entirely on the expenditure side. In the light of the wide macroeconomic imbalances prior to the downturn and the difficulty of securing new financing once the global financial crisis set in, this was a prudent response. Moreover, so as to provide some support to the ailing economy, in February 2009 the Lithuanian government adopted a business support package worth 5% of GDP, financed from EU funds and EIB loans. Lithuania has increased and frontloaded absorption of EU funds. With a view to restoring positive and sustainable growth and avoiding any relapse towards major internal and external imbalances, the main economic challenges relate to improving competitiveness and sectoral transformation towards tradable sectors as well as further re-orientation efforts towards medium- and high-tech products. Large increases in unemployment, which could become structural, pose major risks to long-term convergence.

Currently Lithuania is subject to an EDP procedure, which was opened on 7 July 2009 (Art. 104(6) Council decision). The new Council recommendations (126(7), issued 16 February 2010), recommend correcting the excessive deficit by 2012. Ambitious fiscal consolidation is needed, averaging 2¼% of GDP per annum, to be underpinned by structural reforms. The procedure is spelled out in detail in *Box 1*.

3. MACROECONOMIC OUTLOOK

Against the background of the current macroeconomic situation and the main policy challenges set out in the previous section, this section makes an assessment of the

plausibility of the macroeconomic scenario underpinning the public finance projections of the programme.

According to the programme's baseline macroeconomic scenario[3] real GDP after dropping by 15.0% in 2009, grows by 1.6% in 2010, accelerating to 3.2% in 2011, but slowing back to only 1.2% in 2012. The scenario projects domestic demand to contract further in 2010, as a consequence of subdued labour market situation, tight credit conditions and ongoing fiscal consolidation. The continued contraction in domestic demand in 2010 is set to be compensated by a strong recovery in external demand reflected in growth of exports, which seems to be somewhat higher in the projections than expected export markets' growth. Furthermore, investment is set to recover starting from 2010 after a decline of nearly 40% in 2009, mainly due to accelerated absorption of EU funds. Therefore, a non-tax rich recovery is expected mainly driven by net exports and investment. Continuing fiscal consolidation already embarked upon by the government is reflected in weak growth of government consumption. Domestic demand is expected to contribute positively to growth from 2011.

Compared to the Commission services' autumn 2009 forecast, the programme's macroeconomic outlook appears to be based on substantially more optimistic growth assumptions in 2010, centred on strong recovery in exports and fixed investment. These also seem on the high side compared to the current consensus forecast (see *Table 2*). While the 2.2% average growth rate envisaged for the final two programme years itself appears plausible, the profile and composition of growth between the two years is much less so. The growth in fixed investment projected for 2011 seems an outlier (having no impact on imports) while demand components in 2012 seem prematurely weak for this phase of the cycle.

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[3] External assumptions underpinning the baseline macroeconomic scenario correspond to those in the Commission services' autumn 2009 forecast.

Table 2: Comparison of macroeconomic developments and forecasts

	2009		2010		2011		2012
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	-18.1	-15.0	-3.9	1.6	2.5	3.2	1.2
Private consumption (% change)	-19.5	-17.9	-6.3	-6.4	1.2	2.1	2.8
Gross fixed capital formation (% change)	-43.0	-38.0	-7.3	14.5	5.4	29.1	2.0
Exports of goods and services (% change)	-20.6	-16.7	1.3	13.5	3.9	3.1	1.7
Imports of goods and services (% change)	-35.2	-29.9	-0.5	6.6	3.2	6.8	3.2
Contributions to real GDP growth:							
- Final domestic demand	-24.9	-26.4	-7.1	-1.9	1.6	5.1	2.1
- Change in inventories	-6.1	n.a.	2.3	n.a.	0.5	n.a.	n.a.
- Net exports	12.8	11.4	0.9	3.5	0.5	-1.9	-0.8
Output gap[1]	-8.2	-7.7	-10.8	-5.9	-8.2	-2.9	-1.7
Employment (% change)	-8.3	-6.9	-2.4	-5.1	-0.2	-0.6	-0.1
Unemployment rate (%)	14.5	13.6	17.6	16.7	18.2	15.5	14.7
Labour productivity (% change)	-10.8	-8.7	-1.5	7.0	2.7	3.9	1.3
HICP inflation (%)	3.9	4.2	-0.7	-1	1.0	1	1.5
GDP deflator (% change)	-1.3	-2.1	-1.5	-0.1	0.4	0.7	1.1
Comp. of employees (per head, % change)	-6.8	-11.9	-5.7	-3.6	0.9	-0.9	0.9
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	3.3	3.7	4.8	7.5	4.3	5.3	4.3

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

Source:

Commission services' autumn 2009 forecasts (COM); Convergence programme (CP).

Cyclical conditions are expected to improve gradually from 2010, with the negative output gap as recalculated by the Commission services based on the information in the programme[4], following the commonly agreed methodology, narrowing over the programme period. At the same time it should be noted that the calculation of potential output growth has to be interpreted with caution for countries such as Lithuania that are undergoing far-reaching structural adjustment, while the steep turnaround in the cycle adds further uncertainty to these estimates.

Although much of the observed decline in actual GDP in the context of the crisis is cyclical, growth in potential output will resume from a lower starting point. In addition, the crisis may also affect potential growth in the medium term through lower investment, constraints in credit availability and increasing structural unemployment. Weak output growth and a negative if narrowing output gap are accompanied by disinflation and falling wages, a further deterioration in the labour market and an external account surplus. The labour market is expected to deteriorate further, with unemployment reaching nearly 17% in 2010 before declining somewhat over 2011-2012, mainly due to emigration to recovering EU countries.

Given the collapse of imports as a result of the recession, the previously high external deficit has turned into surplus, which the programme expects to be maintained also in 2011, before the balance would turns slightly negative as on the back of recovering domestic demand recovers. Compared to the Commission services' autumn forecast, the programme projects a much faster improvement in export markets and therefore higher

[4] Compared to the recalculated information, the programme itself projects a less negative output gap in 2009 and 2010, but more negative in 2012.

exports and external account surplus, particularly in 2010. While the programme also projects a more rapid rise in imports than in the Commission services' forecast, the net external contribution to growth in 2010 appears unduly favourable, but unduly *un*favourable in the latter two programme years.

The programme's projections for inflation appear realistic over the programme period. Consumer price inflation declined rapidly from double-digit levels in 2008, to 4.2% in 2009 and is expected to turn negative in 2010 (-1.0%). Nominal declines in domestic prices and wages are thus well underway and these are expected to continue in 2010 according to both the programme and the Commission services' autumn 2009 forecast. Continuing internal factor price adjustment is set to improve indicators of cost competitiveness, laying a basis for the recovery.

Monetary and exchange rate assumptions of the programme are broadly consistent with the rest of the macroeconomic scenario. Exchange rate pressures on inflation are likely to remain limited, as the nominal exchange rate vis-à-vis the euro will be maintained under the currency board arrangement, while only slight fluctuations vis-à-vis other currencies are projected for 2010. The assumed depreciation of the euro vis-à-vis the US dollar in 2010 may slightly increase import prices, while their pass-through to consumer prices is likely to be contained by the projected contraction in consumption expenditure in 2010. No changes are projected in the nominal effective exchange rate over the forecast period, suggesting that possible exchange rate fluctuations vis-à-vis non-euro area trade partners' currencies are assumed to offset each other, limiting pressures on consumer prices. Monetary assumptions are broadly supportive to the projected economic recovery, with interest rates returning closer to their pre-crisis levels. The projected decline in economic growth in 2012 seems to be triggered by factors other than monetary conditions, which are assumed to remain broadly flat in 2011-2012. The assumed interest rates are likely to remain higher than in the euro area over the forecast period, suggesting further interest rate convergence in fulfilling conditions for euro adoption beyond 2012.

4. General government balance

This section consists of four parts. The first three parts discuss the budgetary implementation in the year 2009, the budgetary plans for 2010 and the medium-term budgetary strategy in the programme. The final part analyses the risks attached to the budgetary targets.

4.1. Budgetary implementation in 2009

According to the February 2010 convergence programme update, the general government deficit is expected to have reached 9.1% of GDP in 2009, which is much worse than the planned deficit of 2.1% of GDP in the previous programme update. This significantly worse-than-expected outturn reflects mainly a substantial tax shortfall due to a considerably worse economic outcome (an estimated 16.9% contraction of nominal GDP against an expectation of 0.9% growth in the previous programme update) and despite substantial consolidation measures adopted by the government during the year, mainly due to very negative revenue surprises, with the latter falling significantly beyond what could be expected on the basis of standard elasticities.

Given a progressive deterioration of the economic situation, the government has adopted three major consolidation packages since the end of 2008, amounting to around 8% of GDP over 2009. Several consolidation measures on the revenue side have been adopted, in particular indirect tax increases and abolition of most exemptions. At the same time, consolidation measures on the expenditure side included decisive cuts in operational

expenditure, cuts in public sector wages and revisions to healthcare-related spending, which helped to reduce the overall level of nominal expenditure compared to 2008.

Table 3 compares the projected outcome for the general government balance, revenue and expenditure (as a percentage of GDP) in 2009 as presented in the new convergence programme with the targets from the previous update of the programme. Differences between outcome and targets (excluding the impact of an unanticipated GDP developments which may have affected the ratio, referred to as the 'denominator effect') are decomposed in the impact of a different starting position (i.e. the outcome of 2008 may also have been different from that anticipated in the previous programme update) and the impact of differences in the revenue / expenditure growth rate from the planned growth rates[5].

Revenue is estimated to have dropped substantially in contrast to an expected increase in the previous programme: 16.5% year-on-year according to the February 2010 programme compared to a planned increase of 6.8% in the previous convergence programme update. This led to a huge negative revenue surprise of 8.7% of GDP excluding the denominator effect, even taking into account revenue-increasing measures adopted in the course of 2009. A massive tax revenue shortfall reflects much lower-than-expected economic activity and tax revenue falling even more than would be suggested by the standard elasticities. The shortfall in tax revenue was mainly related to the underperformance of taxes on production and imports (-4.3% of GDP), despite an increase in the standard VAT rate by 3pp., higher excise duties and abolition of most reduced VAT rates in 2009. Moreover, receipts of taxes on income and wealth were also lower than budgeted (-3.7% of GDP), reflecting deteriorating labour market situation and falling nominal wages as well as much lower corporate sector profits in 2008. It also reflects tax changes at the beginning of 2009, when the personal income tax (PIT) was reduced by 3pp. and the capital income tax (CIT) increased by 5pp. The negative revenue surprise was somewhat lower in the case of social contributions (1.3% of GDP) due to additional revenue received due to the temporary suspension of part of the transfers to the second pillar pension funds as well as due to changed personal income taxation[6]. A positive revenue surprise came only from "other revenue", mainly reflecting increased absorption of EU funds.

Due to consolidation measures implemented on the expenditure side in 2009, there was a positive effect on the deficit of 2.3% of GDP excluding the denominator effect. Expenditure is expected to have fallen by 3.5% rather than the planned rise of 3.9% in the previous programme update. As a result of significant cuts in government consumption, including public sector wages, expenditure was also broadly down compared to the 2008 level, at the same time as increased absorption of EU structural funds provided a counter-cyclical support to the economy and interest payments increased considerably.

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5 Mathematically, the difference in the revenue ratio in Table 3 can be expressed as:

$$\rho^o - \rho^p = \underbrace{\frac{1+r^p}{1+g^p}\Delta\rho_{-1}}_{\text{Base effect}} + \underbrace{\frac{\rho^o_{-1}}{(1+g^o)(1+g^p)}\Delta r}_{\text{Revenue growth effect}} - \underbrace{\frac{\rho^o_{-1}}{(1+g^o)(1+g^p)}\Delta g}_{\text{Denominator effect}} + \underbrace{\frac{\rho^o_{-1}(r^o g^p - r^p g^o)}{(1+g^o)(1+g^p)}}_{\text{Residual}}$$

where r is the growth rate of revenue and g is the growth rate of GDP. The subscript -1 refers to the previous year's value. Superscripts o and p refer to the outcome and the planned value respectively. Similar for the expenditure ratio.

6 From the beginning of 2009 the 6% health insurance tax was redirected to the social security fund, rather than being included in personal income tax as previously.

The restrictive stance on the expenditure side, was nevertheless insufficient to offset the consequences of the economic crisis on the revenue side. The estimated deterioration in the structural balance in 2009 should be viewed with caution as the exceptionally volatile economic environment may lead to standard elasticities insufficiently capturing the impact of the extreme downturn.

Table 3: Budgetary implementation in 2009

	2008		2009	
	Planned CP Jan 2009	**Outcome** CP Jan 2010	**Planned** CP Jan 2009	**Outcome** CP Jan 2010
Government balance (% of GDP)	-2.9	-3.2	-2.1	-9.1
Difference compared to target [1]	-0.3		-7.0	
Difference excluding denominator effect [1,2]			**-6.3**	
Of which: due to a different starting position end 2008			-0.3	
due to different revenue / expenditure growth in 2009			-6.2	
p.m. Residual [3]			0.1	
p.m. Nominal GDP growth (planned and outcome)			*0.9*	*-16.9*
Revenue (% of GDP)	33.8	34.2	35.8	34.3
Revenue surprise compared to target [1]	0.4		-1.4	
Revenue surprise excluding denominator effect [1,2]			**-8.7**	
Of which: due to a different starting position end 2008			0.4	
due to different revenue growth in 2009			-9.5	
p.m. Residual [3]			0.4	
p.m. Revenue growth rate (planned and outcome)			*6.8*	*-16.5*
Expenditure (% of GDP)	36.7	37.4	37.8	43.4
Expenditure surprise compared to target [1]	-0.7		-5.6	
Expenditure surprise excluding denominator effect [1,2]			**2.3**	
Of which: due to different starting position end 2008			-0.7	
due to different expenditure growth rate in 2009			3.3	
p.m. Residual [3]			-0.3	
p.m. Expenditure growth rate (planned and outcome)			3.9	-3.5

Notes:

[1] A positive number implies that the outcome was better (in terms of government balance) than planned.

[2] The denominator effect captures the mechanical effect that, if GDP turns out higher than planned, the ratio of revenue or expenditure to GDP will fall because of a higher denominator. Although the denominator effect can be very significant for revenue and expenditure separately, on the balance they usually largely cancel against each other.

[3] The decomposition leaves a small residual that cannot be assigned to the previous components. The residual is generally small, except in some cases where planned and actual growth rates of revenue, expenditure and GDP differ significantly.

Source: Commission services

Box 1: The excessive deficit procedure (EDP) for Lithuania

On 7 July 2009 the Council adopted a decision stating that Lithuania had an excessive deficit in accordance with Article 104(6) of the Treaty establishing the European Community (TEC). At the same time, the Council addressed a recommendation under Article 104(7) TEC specifying that the excessive deficit had to be corrected by 2011.

On 16 February 2010 the Council, following a recommendation by the Commission, considered that action had been taken in accordance with the recommendations, but unexpected adverse economic events with major unfavourable consequences for government finances had occurred after the adoption of the recommendation. In accordance with Article 126(7) of the Treaty on the functioning of the European Union (TFEU), the Council issued new recommendations to correct the deficit by 2012. In particular, Lithuania was recommended to implement the measures planned in the 2010 budget and adopt additional measures if necessary to achieve the envisaged consolidation; to ensure an average annual fiscal effort of at least 2¼% of GDP over the period 2010-2012, notably by containing primary current expenditure; to specify and adopt additional

measures necessary to achieve the correction of the excessive deficit by 2012 and to adopt and swiftly implement the planned structural reforms entailing significant budgetary savings and to report on the progress made in the implementation of these recommendations in a separate chapter in the updates of the convergence programmes which will be prepared between 2010 and 2012.

4.2. The programme's budgetary strategy for 2010

The Lithuanian government adopted a draft budget for 2010 on 25 October 2009 and approved a revised version on 4 December 2009. The budget was adopted by Parliament on 10 December 2009. The budget targets a general government deficit of 9.5% of GDP based on the macroeconomic scenario from September 2009, which expected real GDP to contract by 4.3% in 2010 and deflation to reach 3%.

The programme projects a somewhat smaller general government deficit of 8.1% in 2010, mainly reflecting an improvement in the macroeconomic outlook and therefore tax revenue since the adoption of the budget in December. According to the programme, due to the more positive macroeconomic developments expected in the central scenario, the budget would receive around 1.4% of GDP additional tax revenue in 2010. By government sub-sector, the central government is expected to have a deficit of 4.9% of GDP, the social security funds to record a deficit of 2.9% of GDP and the local governments are expected to register a small deficit of 0.3% of GDP. Measures of a one-off and temporary nature in that year include the suspension of part of the transfers to the second pillar pension funds[7]. In general, the 2010 budgetary strategy appears to be in line with the Council Recommendation under Article 126(7) of 16 February 2010.

Main measures in the 2010 budget adopted by parliament in December 2009 are further substantial cuts in expenditure amounting to around 4% of GDP, particularly in government current spending, including the public sector wage bill, and social benefits. However, some other expenditure items, including interest payments, healthcare spending and capital expenditure, are set to increase in 2010. The expenditure-to-GDP ratio is projected to increase by around 1pp. in the programme, while general government investment is planned to increase substantially (+2.4pp.), supported by EU funds, compensation of employees (-1.4pp.), social payments (-1.4pp.) and intermediate consumption are set to decline further. These reflect the decisions taken together with the adoption of the 2010 budget as well as the full-year impact of consolidation measures adopted in 2009.

On the revenue side, changes are limited to a reduction in the corporate income tax rate and some increases in non-tax revenue. Furthermore, according to the programme, a positive impact in 2010 of tax measures that entered into force in 2009 (mainly VAT increase by 2pp. and cuts in public sector wages) amounts to 1.4% of GDP. The net consolidation effect is estimated at around 1.5% of GDP. The share of non-tax revenue in the programme is projected to increase substantially to 10.1% of GDP in 2010, which mainly relates to higher absorption of EU structural funds. While taxes on production and imports are set to remain at a similar level, current taxes on income and wealth are set to decline further (-1.8pp.) due to further declining wages and falling profits. Measures of a

[7] The programme includes the following measures of a temporary nature that the Commission does not consider being one-off measures: a reduction of the profits tax on investment in technological innovation, a reduction on excise on diesel fuel and reimbursement of overpaid VAT.

one-off and temporary nature in that year include the suspension of part of the transfers to the second pillar pension funds.

The overall fiscal stance in 2010, as measured by the change in structural balance, is expected to be restrictive. Commission services' calculations on the basis of the information in the programme according to the commonly agreed methodology show that the structural balance is expected to improve by around ½ percentage point of GDP in 2010, reflecting fiscal consolidation measures adopted by the government. However, this seems to significantly underestimate the government's consolidation efforts and should be treated with extreme caution[8].

Table 4. Main budgetary measures for 2010

Revenue measures[1]	Expenditure measures[2]
Reduction of the corporate income tax from 20% to 15% (-0.1% of GDP)	Cuts in intermediate government consumption (+1.6% of GDP) Cuts in public sector wage bill (+0.9% of GDP) Progressive reduction of social benefits, including old age pensions (+1.5% of GDP)

Notes:

[1] Estimated impact on general government revenue
[2] Estimated impact on general government expenditure

Source: Commission services and the Ministry of Finance.

4.3. The programme's medium-term budgetary strategy

This section describes the medium-term budgetary strategy outlined in the programme - and how it compares with that in the previous update - as well as the composition of the budgetary adjustment, including the broad measures envisaged.

The medium-term budgetary strategy of the programme (see also Box 2) is to reduce the excessive deficit below the 3% threshold by 2012, in line with the recommendation by the Council on 16 February 2010. The medium-term objective has been substantially strengthened compared to the previous programme update, to reinforce the confidence into the currency board arrangement, to ensure price stability, to limit the increase of debt and improve long-term sustainability of public finances. The programme does not specify a target year for achieving the MTO.

On the basis of recalculated output gaps and structural balance, the fiscal position was far below the MTO in 2009 and is expected to remain below the MTO until the end of the programme period. According to the programme, the correction of the excessive deficit is expected to be achieved in 2012, supported by the restrictive fiscal policy throughout 2010-2012.

[8] There are significant differences in output gap calculations presented in the convergence programme and recalculated by the Commission services: the convergence programme assumes a 8.8% positive output gap in 2008, -7.7% in 2009, -5.9% in 2010, -2.9% in 2011 and -1.7% in 2012. The Commission autumn forecast has a -11.8% output gap in 2008, -8.2% in 2009, -10.8% in 2010 and -8.2% in 2011.

Box 2: The medium-term objective (MTO) for Lithuania

As noted in the Code of Conduct[9], the MTO aims to (a) provide a safety margin with respect to the 3% of GDP deficit limit; (b) ensure rapid progress towards fiscal sustainability; and (c) allow room for budgetary manoeuvre, in particular taking into account the needs for public investment. The MTO is defined in cyclically adjusted terms, net of one-off and other temporary measures. On 7 July 2009, the ECOFIN Council took note of a new methodology for setting MTOs, ensuring that implicit liabilities (costs related to ageing populations, in particular projected healthcare and pension expenditure) are also accounted for.

Specifically, the country-specific MTOs should take into account three components: (i) the debt-stabilising balance for a debt ratio equal to the (60% of GDP) reference value (dependent on long-term potential growth), implying room for budgetary manoeuvre for Member States with relatively low debt; (ii) a supplementary debt-reduction effort for Member States with a debt ratio in excess of the (60% of GDP) reference value, implying rapid progress towards it; and (iii) a fraction of the adjustment needed to cover the present value of the future increase in age-related government expenditure. This implies a partial frontloading of the budgetary cost of ageing irrespective of the current level of debt. In addition to these criteria, MTOs should provide a safety margin with respect to the 3% of GDP deficit reference value and, for euro area and ERM II Member States, in any case not exceed a deficit of 1% of GDP.

As communicated by the authorities, the MTO of Lithuania is a structural surplus of 0.5% of GDP. In view of the new methodology and given the most recent projections and debt level, the MTO more than adequately reflects the objectives of the Pact.

The adjustment path in the programme is clearly back-loaded and needs to be underpinned by additional measures. The programme expects an improvement in the structural balance of around 2 percentage points of GDP in 2011 and 2½ percentage points of GDP in 2012. This is intended to be achieved by an increase in the revenue-to-GDP ratio (by around 1½ percentage points) and a substantial reduction in the expenditure ratio (by around 4¾ percentage points). The programme explicitly acknowledges that achievement of the budgetary targets presented in the programme and correction of the excessive deficit by 2012 require additional measures of around 4½% of GDP. This adjustment takes place alongside gradually improving cyclical conditions, although the (recalculated) negative output gap will not close by the end of the programme period (see Table 5).

Broad measures intended to support the achievement of budgetary targets beyond 2010 are spelled out to some extent in the programme. On the revenue side, indirect taxes are projected to increase by 1.3pp of GDP over 2010-2012, mainly reflecting tax changes introduced in the course of 2009, including an increase in the standard VAT rate from 19% to 21% in September 2009, with a full year effect in 2010, though a further substantial increase in 2012 is not explained in the programme. On the other hand, lower revenue from current taxes on income and wealth (-1.6 pp.) is expected due to the reduction of the corporate income tax rate from 20% to 15% as of January 2010, low profits and expected further wage declines. On the other hand, other revenue is set to increase by 1.8 pp. which seems to be related to higher inflows of EU funds, assuming an acceleration of absorption.

[9] "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council on 10 November 2009, available at: http://ec.europa.eu/economy_finance/sgp/legal_texts/index_en.htm

On the expenditure side, substantial savings are planned in general government wage bill (-4.7 pp.), which reflect the government's plans to streamline public administration by cutting public sector wages in 2009-2010 and eliminating duplication of functions. However, the biggest cut of around 3pp. is foreseen in 2011 and is not further specified in the programme. Social payments are also planned to be reduced by 2.4 pp. over 2010-2012, which seems to partly reflect the progressive cuts in social benefits from 1 January 2010 as well as further planned reform of the social security system to be prepared during 2010 and implemented from 2011. Furthermore, intermediate consumption (-0.5 pp.) is set to decline, whereas other expenditure positions are set to increase over 2010-2012: investment, which depends on the absorption of EU structural funds (+1.0 pp.), "other expenditure" (+0.8 pp.) and interest expenditure (+1.1 pp.), mainly reflecting higher debt servicing costs.

However, some of the measures adopted in 2009 and 2010 are due to expire or be reversed at the end of 2010 or 2011. The programme does not explicitly mention if these measures will be carried forward. Furthermore, the temporary partial suspension of transfers to second-pillar pension funds will expire by end-2010 (0.6% of GDP). There is also uncertainty about whether public sector wage bill cuts will be carried forward after the crisis.

Table 5: Composition of the budgetary adjustment

(% of GDP)	2008	2009		2010		2011		2012	Change: 2009-2012
	COM	COM	CP	COM	CP	COM[1]	CP	CP	CP
Revenue	**34.2**	**36.1**	**34.3**	**36.8**	**36.2**	**36.3**	**35.6**	**35.7**	**1.4**
of which:									
- Taxes on production and imports	11.5	11.6	10.7	11.5	10.9	11.3	11.2	12.1	1.3
- Current taxes on income, wealth, etc.	9.4	6.1	6.6	5.0	4.8	5.0	4.6	5.0	-1.6
- Social contributions	9.4	11.8	10.4	11.8	10.4	11.0	9.3	10.2	-0.1
- Other (residual)	4.0	6.7	6.6	8.5	10.1	9.0	10.4	8.4	1.8
Expenditure	**37.4**	**45.9**	**43.4**	**46.0**	**44.3**	**46.0**	**41.4**	**38.7**	**-4.7**
of which:									
- Primary expenditure	36.8	44.5	42.1	43.8	42.4	43.4	39.1	36.3	-5.8
of which:									
Compensation of employees	10.8	12.8	12.5	12.6	11.1	12.3	8.1	7.9	-4.7
Intermediate consumption	5.7	6.5	4.6	5.8	4.4	5.6	4.3	4.1	-0.5
Social payments	12.8	17.3	15.9	16.3	14.5	16.2	13.6	13.5	-2.4
Subsidies	0.7	0.4	0.7	0.4	0.6	0.4	0.6	0.6	0.0
Gross fixed capital formation	5.0	5.0	5.6	5.6	8.0	5.8	8.4	6.6	1.0
Other (residual)	1.8	2.5	2.8	3.0	3.7	3.1	4.1	3.6	0.8
- Interest expenditure	0.6	1.4	1.3	2.2	1.9	2.6	2.2	2.4	1.1
General government balance (GGB)	**-3.2**	**-9.8**	**-9.1**	**-9.2**	**-8.1**	**-9.7**	**-5.8**	**-3.0**	**6.1**
Primary balance	**-2.6**	**-8.4**	**-7.8**	**-7.0**	**-6.2**	**-7.1**	**-3.6**	**-0.6**	**7.2**
One-off and other temporary measures	-0.1	0.4	0.2	0.7	0.3	0.0	-0.3	-0.3	-0.4
GGB excl. one-offs	**-3.2**	**-10.2**	**-9.3**	**-9.9**	**-8.4**	**-9.7**	**-5.5**	**-2.8**	**6.5**
Output gap[2]	11.8	-8.2	-7.7	-10.8	-5.9	-8.2	-2.9	-1.7	6.0
Cyclically-adjusted balance[2]	-6.4	-7.6	-7.0	-6.3	-6.5	-7.5	-5.0	-2.6	4.5
Structural balance[3]	**-6.3**	**-8.0**	**-7.2**	**-7.0**	**-6.8**	**-7.5**	**-4.8**	**-2.3**	**4.9**
Change in structural balance		*-1.7*	*-0.8*	*1.0*	*0.4*	*-0.5*	*2.1*	*2.4*	
Structural primary balance[3]	-5.7	-6.6	-5.9	-4.8	-4.9	-4.9	-2.5	0.1	6.0
Change in structural primary balance		*-0.9*	*-0.2*	*1.9*	*1.0*	*-0.1*	*2.4*	*2.7*	

Notes:

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Convergence programme (CP); Commission services' autumn 2009 forecasts (COM); Commission services' calculations

4.4. Risk assessment

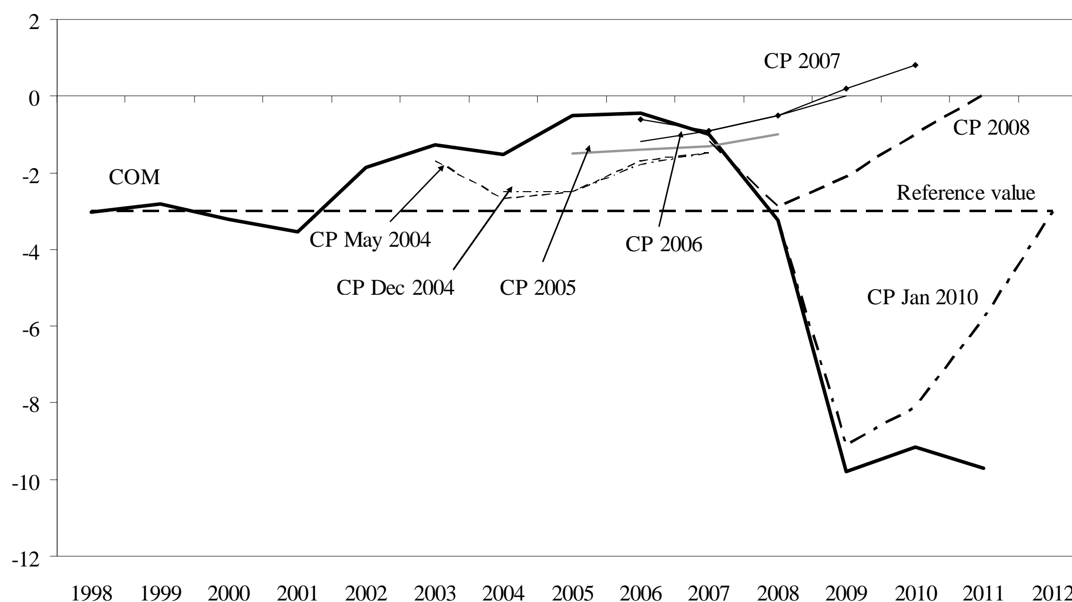
This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2011, Table 5 compares the detailed revenue and expenditure projections in the Commission services' autumn 2009 forecast, which are derived under a no-policy change scenario, with those in the updated programme. However, although the assessment uses the Commission services' forecast as a benchmark, it also takes explicitly into account all available information about more recent developments.

Overall, the budgetary outcomes are subject to downside risks in the short and medium term. As discussed in Section 2, the baseline macroeconomic scenario provided in the most recent Convergence Programme update appears markedly optimistic in 2010 and plausible at the level of total GDP thereafter. This central scenario is based on the assumption of a faster recovery already in 2010, mainly driven by net exports and faster absorption of EU funds. Under this scenario, the budget is expected to receive around 1.4pp. of GDP additional revenue in 2010 according to the programme compared with

revenue expected using the more pessimistic scenario on which the original budget was adopted/based. Budgetary measures for 2010 are sufficiently spelled out in the programme. However, there is a risk that the budgetary outcome could turn out worse that projected in the programme, given reliance on a more rapid recovery of the economic activity.

The budgetary targets beyond 2010 are subject to some risks given the limited extent of information provided in the programme regarding the measures underpinning the achievement of these targets and acknowledgment of the need for additional measures to achieve these targets. Furthermore, reliance on a further substantial reduction in government expenditure and only to a limited extent on tax revenue increasing measures in the outer years of the programme seem to be subject to risks. Compensation of employees is set to decline by a further 3pp. over 2011-2012, following already substantial wage cuts adopted in 2009 and 2010 and might be difficult to implement. At the same time, the relatively good track record of the Lithuanian authorities up to the onset of the crisis in meeting their targets for the deficit (as opposed to targeted expenditure, given spending of windfall revenues), with a notable exception in 2008 mainly due to electoral cycle, and the decisive consolidation implemented during 2009 despite an unprecedented economic contraction, reduce those risks. Furthermore, the government has an ambitious reform agenda for 2010 and later years, which should also help to achieve the required ambitious fiscal targets. On the negative side, there is uncertainty if some measures, particularly temporary cuts in expenditure adopted in the face of the crisis, will be carried forward after 2010 and 2011.

Figure 1: Government balance projections in successive programmes (% of GDP)



Source: Commission services' autumn 2009 forecast (COM) and successive convergence programmes

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part

takes a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

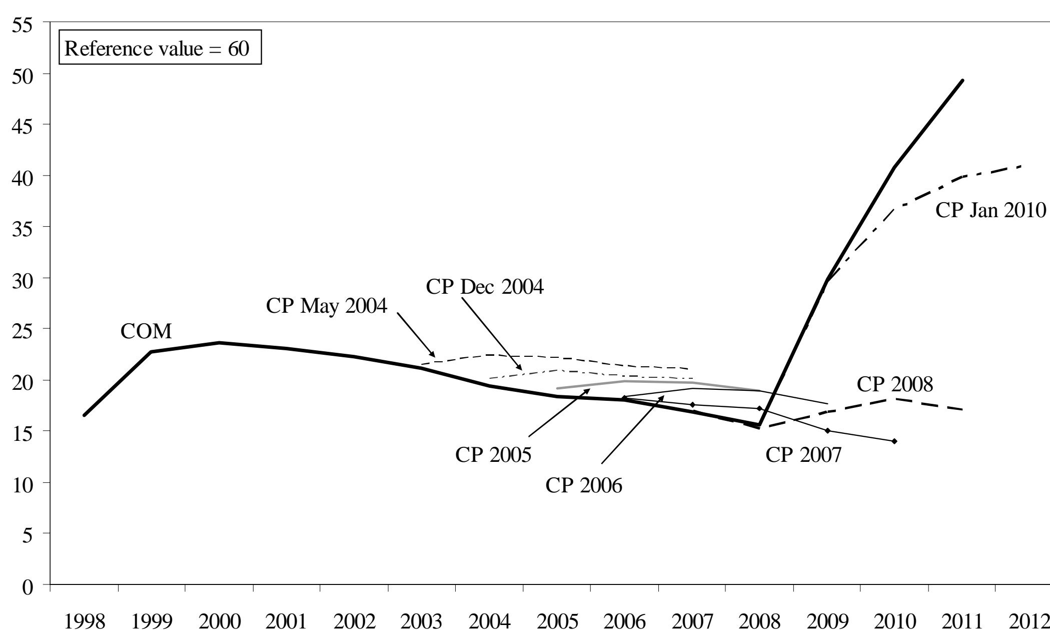
5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

The programme estimates Lithuania's government debt ratio to have increased from 15.6% of GDP in 2008 to 29.5% in 2009. This is somewhat below the Commission services' autumn 2009 forecast; however, it is considerably above the target presented in the previous programme update, reflecting substantial budgetary deterioration during 2009 not foreseen in the previous update. In 2009, the stock-flow adjustment indicated in the programme refers to the allocation of 0.5 billion LTL from the stabilisation reserve fund to the social security funds for financing of the pension reform as well as accrued liabilities to the private sector, which accumulated at the end of 2008 as the government delayed payments for goods and services, though these are accounted for in the 2008 general government budget deficit. Part of the 2008 deficit was thus financed in 2009, reflecting limited borrowing possibilities by the government at the end of 2008 due to the outbreak of the financial crisis.

According to the Commission services' autumn 2009 forecast, the government debt ratio is expected to rise to 40.7% in 2010 and 49.3% in 2011, while the programme expects the debt ratio to reach 36.6% of GDP in 2010 and 39.8% in 2011. Because of the risk of higher-than-targeted deficits in later years foreseen by the Commission services (on a no policy change basis), there are significant differences in the expected debt figures between the Commission services' forecast and the programme (which credits substantial though unspecified consolidation).

Figure 2: Debt projections in successive programmes (% of GDP)



<u>Source</u>: *Commission services' autumn 2009 forecast (COM) and successive convergence programmes*

Table 6: Debt dynamics

(% of GDP)	average 2003-07	2008	2009		2010		2011		2012
			COM	CP	COM	CP	COM	CP	CP
Gross debt ratio[1]	**18.8**	**15.6**	**29.9**	**29.5**	**40.7**	**36.6**	**49.3**	**39.8**	**41.0**
Change in the ratio	-1.1	-1.3	14.3	13.9	10.8	7.1	8.5	3.2	1.2
Contributions [2] :									
1. Primary balance	**0.1**	**2.6**	**8.4**	**7.8**	**7.0**	**6.2**	**7.1**	**3.6**	**0.6**
2. "Snow-ball" effect	**-1.4**	**-1.2**	**5.1**	**4.5**	**3.9**	**1.5**	**1.5**	**0.9**	**1.5**
Of which:									
Interest expenditure	0.9	0.6	1.4	1.3	2.2	1.9	2.6	2.2	2.4
Growth effect	-1.5	-0.4	3.5	2.8	1.2	-0.5	-1.0	-1.1	-0.5
Inflation effect	-0.8	-1.5	0.2	0.4	0.5	0.0	-0.1	-0.2	-0.4
3. Stock-flow adjustment	**0.3**	**-2.6**	**0.8**	**1.6**	**0.0**	**-0.6**	**0.0**	**-1.2**	**-0.9**
Of which:									
Cash/accruals diff.	0.9	-0.3	0.7	n.a.	0.0	n.a.	0.0	n.a.	n.a.
Acc. financial assets	-0.5	-2.3	0.0	n.a.	0.0	n.a.	0.0	n.a.	n.a.
Privatisation	-1.1	0.0		0.8		0.1		n.a.	n.a.
Val. effect & residual	-0.1	0.0	0.0	n.a.		n.a.		n.a.	n.a.

Notes:

[1]End of period.

[2]The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Convergence programme (CP); Commission services' November 2009 forecasts (COM); Commission services' calculations

5.1.2. Assessment

The general government debt-to-GDP ratio is projected to increase rapidly from a low level of 15.6% of GDP, according to the programme, to above 40% of GDP by the end of the programme period. There are significant differences between programme projections and estimates in the Commission services' autumn 2009 forecast for the years beyond 2010. In view of the negative risks to the budgetary targets compounded by uncertainty about the stock-flow adjustment, the evolution of the debt ratio is likely to be less favourable than projected in the programme. These unfavourable dynamics underline the need for substantial consolidation also in the light of existing risks to long-term sustainability.

The largest part of the general government debt is in long-term liabilities, denominated in LTL or euro, although the percentage by currency denomination is not specified in the programme. In 2009, the government's ambitious fiscal consolidation strategy enabled the government to issue long-term debt and reopen access to international capital markets and helped reduce reliance on domestic short-term funding. Long-term loans from multilateral financial organisations, in particular from the EIB, the Nordic Investment Bank and the Council of Europe Development Bank, have also been secured.

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

This section presents sustainability indicators based on the long-term age-related government spending as projected by the Member States and the EPC in 2009 according to an agreed methodology[10].

Table 7 shows that age-related spending is projected to raise by 6.0 percentage points of GDP between 2010 and 2060, which is slightly above the EU average (4.6 pps.). Sustainability indicators for two scenarios are presented in Table 8. The '2009 scenario' is based on a no-policy-change assumption and the 2009 structural primary balance as a starting year, while the 'programme scenario' takes into account the consolidation planned in the programme up to 2012 and is based on the projected 2012 structural primary balance as a starting position. Including the increase of age-related expenditure and assuming that the structural primary balance remained at its 2009 level, the sustainability gap (S2)[11] would amount to 10.4% of GDP; about 5½ percentage points more than in the previous year's assessment, which is due to both a lower estimated structural primary balance in the starting year and a higher rise in age-related expenditure in the 2009 projection than in the previous one. The starting budgetary position is insufficient to stabilize the debt ratio over the long-term and entails a risk of unsustainable public finances even before considering the long-term budgetary impact of ageing.

The 'programme scenario' based on the 2012 (final programme year) structural primary balance would show a smaller sustainability gap. If the budgetary consolidation planned in the programme were achieved, risks to long-term sustainability of public finances would be mitigated.

Table 7: Long-term age-related expenditure: main projections

(% of GDP)	2007	2010	2020	2030	2040	2060	Change 2010-60
Total age-related spending	**15.8**	**15.1**	**15.1**	**16.9**	**18.1**	**21.2**	**6.0**
- Pensions	6.8	6.5	6.9	8.2	9.1	11.4	4.9
- Healthcare	4.5	4.6	4.9	5.1	5.3	5.6	1.0
- Long-term care	0.5	0.5	0.5	0.6	0.7	1.1	0.6
- Education and unemployment benefits	4.0	3.5	2.8	3.0	2.9	3.1	-0.4
Property income received	0.6	0.5	0.4	0.4	0.3	0.3	-0.2

Source: Economic Policy Committee and Commission services.

[10] Economic Policy Committee and the European Commission (2009), '2009 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2008-60)', *European Economy* No. 2/2009. European Commission (2009), 'Sustainability Report 2009, European Economy No. 9/2009. European Commission (2008), 'Public finances in EMU – 2008', *European Economy* No. 4/2008..

[11] The S2 indicator is defined as the change in the current level of the structural primary balance required to make sure that the discounted value of future structural primary balances (including the path of property income) covers the current level of debt.

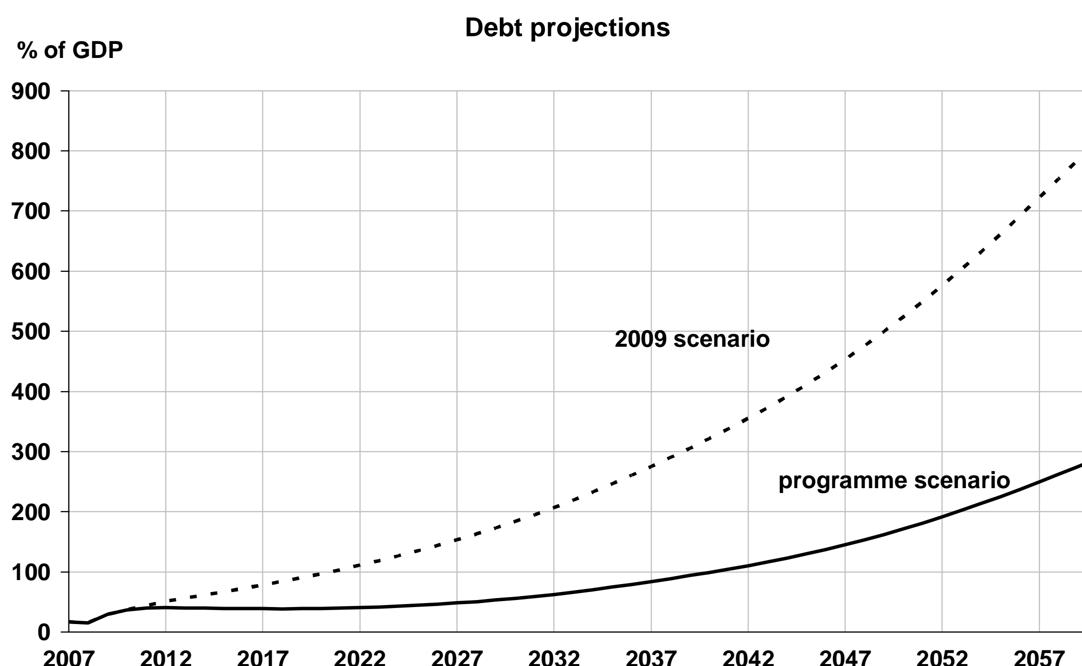
Table 8: Sustainability indicators and the required primary balance

	2009 scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value	8.9	10.4	4.7	2.7	4.3	4.5
of which:						
Initial budgetary position (IBP)	6.7	6.9	-	0.6	0.8	-
Debt requirement in 2060 (DR)	-0.1	-	-	-0.2	-	-
Long-term change in the primary balance (LTC)	2.3	3.5	-	2.3	3.5	-

Source: Commission services.

Based on the assumptions used in the projection of age-related expenditure and the calculation of the sustainability indicators, Figure 3 displays the projected debt-to-GDP ratio over the long-term.

Figure 3: Long-term projections for the government debt ratio



Note: Being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication of the risks faced by Member States.
Source: Commission services.

Based on the alternative assumptions of economic developments presented in the Commission services' autumn 2009 forecast publication[12], Figure 4 shows a projected medium-term trajectory of the debt-to-GDP ratio. Both according to the 2009 and the

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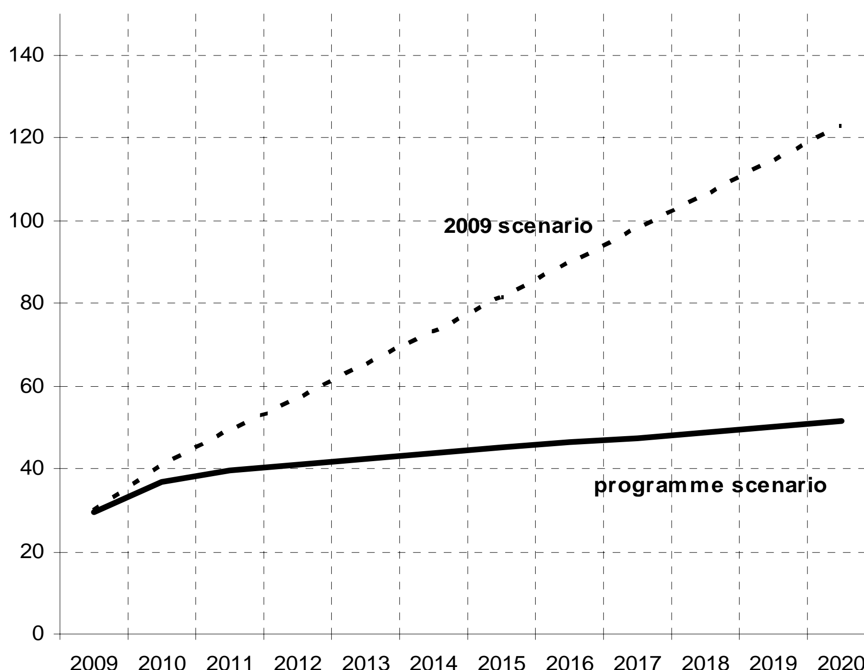
[12] Section 3.5 in European Commission (2009), 'European Economic Forecast – autumn 2009', European Economy No. 10/2009. This scenario assumes that the output gap caused by the crisis will be closed by 2017.

programme scenarios the debt ratio will remain on an increasing trend and thus would not stabilise by 2020.

Figure 4: Medium-term projections for the government debt ratio



Source: Commission services.

5.2.1. Additional factors

For an overall assessment of the sustainability of public finances, other relevant factors are taken into account (Table 9). Overall, these factors do not change the assessment of the long-term sustainability of public finances.

Table 9: Additional factors for the assessment of long-term sustainability risks

	Impact on risk
Debt and pension assets	na
Decline in structural balance until 2011 in COM Autumn 2009 forecast	na
Alternative projection of cost of ageing	na
Strong decline in benefit ratio	na
High tax burden	na
Difference between S1 and S2	na

Note: '-': factor tends to increase the risk to sustainability, '+': factor tends to decrease the risk to sustainability.
'na': not applicable.

Alternative projections are often presented in the programmes, whose assumptions often diverge from the common method. Projections currently discussed in the Economic Policy Committee but not yet published, are for the time being also considered "unofficial".

An explanation on these factors can be found in chapter V of: European Commission (2009), Sustainability Report 2009, European Economy No. 9/2009.

Source: Commission services.

5.2.2. *Assessment*

The long-term budgetary impact of ageing is slightly above the EU average, mainly due to the projected increase of pension expenditure during the coming decades. The budgetary position in 2009, as estimated in the programme, compounds the budgetary impact of population ageing on the sustainability gap. Aiming at improving the primary balance over the medium term, as foreseen in the programme, and pension reform, aimed at curbing the increase in age-related expenditures, would contribute to reducing the high risks to the sustainability of public finances. Medium-term debt projections until 2020 that assume GDP growth rates will only gradually recover to the values projected before the crisis and that tax ratios will return to pre-crisis levels show that the budgetary development envisaged in the programme, taken at face value, is not enough to stabilise the debt ratio by 2020.

6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES

6.1. Fiscal framework

In the years of high growth preceding the current downturn, Lithuania's medium-term budgetary framework did not succeed in preventing expenditure overruns. Buoyant revenue growth facilitated repeated upward revisions of expenditure targets. With a view to strengthening the framework, a Law on Fiscal Discipline was adopted for the central government in November 2007, and entered into force from 2008. The law focuses on preparation and execution of the annual budget and does not as such introduce more forward-looking elements. The law includes two new rules for the central government. The revenue rule calls for the deficit of the approved state budget to be reduced by the estimated "excess" revenue of the current year. The expenditure rule links the expenditure ceiling to revenues. It requires that if the average general government operating balance for the past five years is negative, then the annual growth rate of the planned state budget appropriations may not exceed ½ of the average growth rate of the state budget revenue during these five years. However, the enforcement mechanism is very weak: in case of non-compliance, the authority responsible is not obliged to take corrective measures and there is no automatic correction mechanism. No sanctions are foreseen in the case of non-compliance.

The 2010 convergence programme proposes a few new elements as regards the fiscal framework. In particular, the programme lists a number of measures to increase transparency and monitoring of the budgetary process by presenting and publishing government budget indicators based on the ESA 95 classifications. Fiscal stance and fiscal impulse indicators are to be introduced in the budgetary preparation process. So as to improve enforcement, an automatic obligation to implement an anti-inflationary fiscal policy, based on the output gap indicators, is proposed. Moreover, the programme aims at establishing ways to determine responsibility for non-compliance with the deficit targets, giving the Ministry of Finance greater responsibilities in the surveillance process. The programme sees scope for enhancing planning and for reinforcing the binding character of the medium-term expenditure ceilings, which would contribute to restraining expenditure growth. Better targeting, quantified evaluation criteria and improved cost-benefit analysis as well as better integration of strategic expenditure planning and budgeting would enhance the medium-term spending framework and are expected to be achieved via an improved strategic planning process. If implemented, these proposals should substantially improve the institutional features of public finances.

6.2. Quality of public finances

Even though the composition of public expenditure in Lithuania is supportive to growth, as productive expenditure such as public investment and expenditure on education and healthcare is relatively high, outcome performance in these areas is estimated to be rather poor. In particular, expenditure on R&D, public infrastructure, public order and safety and administration, widely accepted as important for economic growth, are estimated to perform poorly, while education is evaluated to perform close to the EU average. Important challenges of Lithuanian public finance relate to efficiency, improving which could lead to better outcomes in the performance of the public services. To this goal important structural reforms in the education and healthcare systems have been launched. The removal of tax exemptions and preferential rates implemented in 2009, and ongoing efforts in countering tax avoidance and further simplifying and streamlining the tax administration contribute to improving the quality of public finances, as well as to mitigating risks to the budgetary outlook. Ongoing efforts to counter tax avoidance are already resulting in improving tax revenue.

7. ASSESSMENT OF THE STRATEGY ENSURING A SMOOTH PARTICIPATION IN ERM II

Lithuania entered ERM II on 28 June 2004, with the central rate set at the parity rate prevailing in the existing currency board arrangement. While Lithuania entered the mechanism with a standard fluctuation band of +/-15%, the authorities unilaterally committed themselves to maintain the currency board in the mechanism. The currency board arrangement strategy is built on an open economy and flexibility of prices and wages.

7.1.1. Recent exchange rate and financial market developments

Lithuania has maintained its currency board arrangement, with no deviation of the litas from the central rate. The central bank foreign exchange reserves have remained well above the statutory minimum. The real effective exchange rate of the litas vis-à-vis its trade partners increased somewhat in late 2008 and early 2009, reflecting depreciation of the currencies of some of its main trade partners (in particular Poland and Russia). In December 2009, the NEER stood 2.5% higher than its 2008 average.

The global financial and economic crisis triggered a surge of financial markets risk perceptions also vis-à-vis Lithuania. Risk aversion surged in late 2008 and peaked in early 2009, in view of past build-up of vulnerabilities in non-euro area new Member States. Risk indicators declined rapidly thereafter and broadly stabilised in late 2009, following easing of tensions on global financial markets. Stock market indices declined sharply in late 2008, in line with developments in global markets, while their spread with euro area stock market indices widened gradually. Stock market indices started increasing again in the second half of 2009, reaching levels of October 2009 by February 2010. Money market interest rates followed a similar pattern, surging in late 2008 and widening spreads vis-à-vis euro area money market rates. Another surge emerged in mid-2009, partly related to regional contagion risks, with spreads peaking at 7.5 percentage points in July 2009. In line with easing global financial markets tensions, spreads declined rapidly thereafter, dropping to 1.3 percentage points in February 2010. Credit default swaps also followed developments of regional risk aversion, peaking at above 800 basis points in March 2009, and broadly stabilising at close to 300 basis points since late 2009. In addition, sovereign credit rating agencies downgraded Lithuania’s rating in 2009, partly due to its deteriorating public finances. In February 2010, the credit rating

agency Standard & Poor's revised Lithuania's rating outlook from negative to stable, recognising the government's strong fiscal consolidation. The Lithuanian government succeeded in issuing long-term euro- and USD-denominated bonds in 2009, though at rather high primary yields (9.4% and 6.8%, respectively) in order to finance the central government deficit. Secondary yields of the bonds declined somewhat in late 2009. In February 2010, Lithuania issued another bond denominated in the US dollars, with the primary yield at 7.6%. The market for long-term bonds for convergence purposes remained highly illiquid in 2009, with yields surging on the back of limited small scale transactions. In January 2010, the yields declined to 8.2%, comparable to that of November 2008.

7.1.2. Policies supporting participation in ERM II

The objective of monetary policy remained maintaining price stability through ensuring the fixed exchange rate vis-à-vis the euro under the currency board arrangement. The exchange of the litas to the anchor currency and vice versa remained unrestricted, while base money continued to be fully backed with gold and foreign exchange reserves, as required by the law. The central bank's foreign exchange buffers followed the developments in demand of cash in circulation and the commercial banks' deposits in the central bank, with the latter broadly determined by minimum reserve requirement. The reserve requirement ratio was held at 4%, while the zero reserve requirement ratio was applied to deposits and equivalent liabilities with maturity over two years. The central bank of Lithuania does not set monetary policy interest rates. Financial market transactions are mainly denominated in euros, dependent on developments in euro area money markets.

Prior to 2009, fiscal policies were not supportive of the strategy of smooth participation in the ERM II. After a deficit of 3.2% of GDP in 2008, mainly due to expansionary fiscal policy, the rapid deterioration of the public finances in 2009 was addressed by implementing significant restrictive measures, including through supplementary budgets. Despite adopted discretionary revenue-increasing measures, tax revenue collapsed. Total fiscal adjustment measures are estimated at around 8% of GDP in 2009, achieved through a combination of spending cuts and tax increases and a temporary reduction of transfers to the second pillar pension funds. In spite of repeated fiscal consolidation efforts, the deficit reached an estimated 9.1% of GDP in 2009 and is expected to decline only slightly in 2010. With the 2010 budget, the government approved cuts in social benefits including pensions and generous maternity leave benefits to be implemented as of 2010. Other measures include a substantial reduction in current government spending, including the wage bill and a reduction in the corporate income tax rate by 5 pp. A challenge ahead for public sector finances is to put the recent improvement on a secure footing, through strict expenditure control, efficiency improvements and, possibly, exploring the scope for revenue enhancements, nevertheless taking into account an already high total tax wedge on labour.

To support the functioning of labour and product markets, Lithuania has recently implemented structural reforms in the areas of higher education and launched further reforms in the fields of healthcare, secondary education and social security system. The goals of the higher education reform are to intensify competition in the higher education sector; to reform the governance of higher education institutions (with greater involvement of social partners); to increase transparency in the funding of research projects and studies; and to reduce government regulation. The programme outlines reform plans in the healthcare, social reform and education fields aiming at to improve

efficiency in these areas. Moreover, In July 2009 the government adopted changes to the Labour Law, which provide a higher degree of labour market flexibility. The legal obligation for employers to inform employees of dismissal and of changes in pay and working conditions has been shortened considerably. Wage adjustment is taking place and is expected to continue for some time. Against the backdrop of a decentralised wage setting system, the role of the public sector in promoting wage moderation is largely limited to strict control of the public sector wage bill. By the end of 2009, the average public sector wage was declining more rapidly that in the economy as a whole.

7.1.3 Assessment

Since the end of 2008, the policy response to maintain macroeconomic stability in Lithuania has been strong; however, the situation remains challenging. Between the end of 2008 and the end of 2009, the government undertook strong fiscal consolidation by adopting several sizeable consolidation packages, totalling close to 12% of GDP. The high degree of downward wage and price flexibility is improving the competitiveness of the economy. Although suffering losses, the banking sector has remained well-capitalised. The government has also launched major structural reforms in the fields of education, healthcare and social security. Lithuania has revised labour legislation to enhance labour market flexibility, facilitating the adjustment of the economy. Competitiveness of the tradable sector is benefiting from the ongoing adjustment in costs, as well as from targeted state programmes, including through an effective use of the available EU structural funds. The challenge going ahead is to avoid any relapse to significant internal and external imbalances once the recovery becomes established.

8. OVERALL ASSESSMENT

Taking into account risks attached to the budgetary targets discussed above, this section assesses the appropriateness of the fiscal strategy in relation to the Council Recommendations under Article 126(7) of 16 February 2010 with a view to correcting the excessive deficit and the budgetary objectives of the Stability and Growth Pact, against the background of the current economic situation, the debt and long-term sustainability position of the country, and the institutional features of its public finances.

Taking into account the risks to the budgetary targets mentioned above, overall the programme's budgetary strategy can be regarded as broadly consistent with the Council recommendations and broadly in line with the requirements of the Pact. Against a backdrop of the recent severe contraction in economic activity, the government’s strategy sets appropriately ambitious target that corresponds to the requirements of the Stability and Growth Pact and is consistent with a smooth participation in ERM II. However, there are risks in the short term related to a possibly optimistic macroeconomic outlook. It is also possible that the targets will not be achieved as foreseen in the programme in the medium term, if the targeted consolidation is not underpinned by further measures and front-loaded in the medium term.

* * *

ANNEX. COMPLIANCE WITH THE FORMAT AND CONTENT REQUIREMENTS FOR STABILITY AND CONVERGENCE PROGRAMMES

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); (iii) the follow-up to the Council's recommendation to report on progress made in the correction of the excessive deficit in a separate chapter of the programme and (iv) other information requirements is concerned.

(i) Model structure

The programme broadly follows the model structure outlined in the code of conduct, covering all principal sections.

(ii) Data requirements

The programme also broadly adheres to the code of conduct as far as data requirements are concerned, although there are some gaps in the provision of optional data. Regarding compulsory data, in Table 1a (Macroeconomic prospects) line 6 (changes in inventories and net acquisition of valuables) and line 10 (changes in inventories and net acquisition of valuables) are missing. However, this data is not published by the national statistical office. Regarding optional data, in Table 1c (Labour market developments) line 2 (employment, hours worked) and line 5 (labour productivity, hours worked) are missing for 2009-2012; in Table 3 (General government expenditure by function) no data on sub-indicators has been provided for 2012, except total expenditure; in Table 4 (General government debt developments) breakdown for line 5 (stock-flow adjustment) has not been provided, except for privatisation proceeds for 2008-2010, lines 6 (liquid financial assets) and 7 (net financial debt) are not filled; in Table 5 (Cyclical developments) breakdown for line 5 (potential GDP growth) has not been provided; in Table 7 (Long-term sustainability of public finances) data on pension reserve fund assets are not indicated.

The tables on the following pages show the data presented in the February 2010 update of convergence programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

(iii) Separate chapter on progress made in the correction of the excessive deficit

In its recommendations under Article 126(7) of 16 February 2010 with a view to bring the excessive deficit situation to an end, the Council also invited Lithuania to report on progress made in the implementation of the Council's recommendations in a separate chapter in the updates of the convergence programmes. Lithuania partly complied with this recommendation.

(iv) Other information requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

* * *

The SCP…	Yes	No	Comments
a. Involvement of parliament			
… mentions status vis-à-vis national parliament.		X	
… indicates whether Council opinion on previous programme has been presented to national parliament.		X	
b. Economic outlook			
… (for euro area and ERM II Member States) uses "common external assumptions" on main extra-EU variables.	X		

The SCP…	Yes	No	Comments
… explains significant divergences with Commission services' forecasts[1].		X	
… bears out possible upside/downside risks to economic outlook.	X		
… analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.	X		
c. Monetary/exchange rate policy			
… (CP only) presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		
d. Budgetary strategy			
… presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.	X		
… (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.			Not applicable
… (when applicable) explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them).	X		
… backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.	X		
… specifies state of implementation of measures.	X		
e. "Major structural reforms"			
… (if MTO not yet reached or temporary deviation is planned from MTO) includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time.	X		
… includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.		X	
f. Sensitivity analysis			
… includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) (for CP only) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.		X	
… (in case of "major structural reforms") analyses how changes in assumptions would affect budget and potential growth.		X	
g. Broad economic policy guidelines			
… provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.	X		
h. Quality of public finances			
… describes measures to improve quality of public finances, both revenue and expenditure sides.	X		
i. Long-term sustainability			
… outlines strategies to ensure sustainability.	X		
… includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).	X		
j. Other information (optional)			
… includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		

Notes: SCP = stability/convergence programme; CP = convergence programme
[1]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.

Source:
Commission services

Tables from Annex 2 of the code of conduct

Table 1a. Macroeconomic prospects

	ESA Code	2008	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	*81020.1*	2.8	-15[1]	1.6	3.2	1.2
2. Nominal GDP	B1*g	*111189.8*	12.7	-16.9[1]	1.5	3.9	2.4
Components of real GDP							
3. Private consumption expenditure	P.3	*58059*	3.6	-17.9	-6.4	2.1	2.8
4. Government consumption expenditure	P.3	*14522.9*	7.9	-2	-1.7	-10	0
5. Gross fixed capital formation	P.51	*21579.6*	-6.5	-38.0	14.5	29.1	2
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.
7. Exports of goods and services	P.6	*50366.6*	12.2	-16.7	13.5	3.1	1.7
8. Imports of goods and services	P.7	*66330.3*	10.5	-29.9	6.6	6.8	3.2
Contributions to real GDP growth							
9. Final domestic demand		-	3.3	-26.4	-1.9	5.1	2.1
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	n.a.	n.a.	n.a.	n.a.	n.a.
11. External balance of goods and services	B.11	-	-0.5	11.4	3.5	-1.9	-0.8

Table 1b. Price developments

	ESA Code	2008	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		*137.2*	9.7	-2.1	-0.1	0.7	1.1
2. Private consumption deflator		*124.7*	9.7	4.5	-0.1	1.2	1.5
3. HICP[2]		*111.1*	11.1	4.2	-1	1	1.5
4. Public consumption deflator		*147.8*	12.9	-11.5	-5	-5.3	-0.3
5. Investment deflator		*129.7*	7.2	-3.4	-1.1	3.4	0.9
6. Export price deflator (goods and services)		*133*	11.9	-14.2	0	-0.1	1
7. Import price deflator (goods and services)		*120.1*	8.4	-12.4	-1.8	0.3	1.3

[1] Preliminary data.

[2] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2008	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		*1520*	-0.9	-6.9	-5.1	-0.6	-0.1
2. Employment, hours worked[2]		*2900894*	1.1	n.a.	n.a.	n.a.	n.a.
3. Unemployment rate (%)[3]		*5.8*	5.8	13.6	16.7	15.5	14.7
4. Labour productivity, persons[4]		*65.5*	0.5	-8.7	7	3.9	1.3
5. Labour productivity, hours worked[5]		*34.3*	-1.1	n.a.	n.a.	n.a.	n.a.
6. Compensation of employees	D.1	*49047.6*	3.9	-18	-8.5	-1.5	0.8
7. Compensation per employee		*32236*	5.6	-11.9	-3.6	-0.9	0.9

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

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2008	2009	2010	2011	2012
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-10.2	3.7	7.5	5.3	4.3
of which :						
- Balance on goods and services		-10.9	-1.1	3.3	1.1	0.1
- Balance of primary incomes and transfers		-1	1.4	0.9	1	1
- Capital account		1.7	3.4	3.3	3.2	3.2
2. Net lending/borrowing of the private sector	B.9	-7	12.8	15.6	11.1	7.4
3. Net lending/borrowing of general government	EDP B.9	-3.2	-9.1	-8.1	-5.8	-3
4. Statistical discrepancy		0	0	0	0	0

Table 2. General government budgetary prospects

	ESA Code	2008	2008	2009	2010	2011	2012
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	*-3597.9*	-3.2	-9.1	-8.1	-5.8	-3.0
2. Central government	S.1311	*-2240.2*	-2	-6.1	-4.9	-3.3	-0.9
3. State government	S.1312	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	*-248.8*	-0.2	-0.2	-0.3	-0.3	-0.3
5. Social security funds	S.1314	*-1108.9*	-1	-2.8	-2.9	-2.2	-1.9
General government (S13)							
6. Total revenue	TR	*37992.2*	34.2	34.3	36.2	35.6	35.7
7. Total expenditure	TE[1]	*41590.1*	37.4	43.4	44.3	41.4	38.7
8. Net lending/borrowing	EDP B.9	*-3597.9*	-3.2	-9.1	-8.1	-5.8	-3
9. Interest expenditure	EDP D.41	*720.7*	0.6	1.3	1.9	2.2	2.4
10. Primary balance[2]		*-2877.2*	-2.6	-7.8	-6.2	-3.6	-0.6
11. One-off and other temporary measures[3]		*n.a.*	0.5	0.2	0.3	-0.3	-0.3
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		*23185.4*	20.9	17.3	15.7	15.9	17.1
12a. Taxes on production and imports	D.2	*12763.6*	11.5	10.7	10.9	11.2	12.1
12b. Current taxes on income, wealth, etc	D.5	*10415.7*	9.4	6.6	4.8	4.6	5
12c. Capital taxes	D.91	*6.1*	0	0	0	0	0
13. Social contributions	D.61	*10404*	9.4	10.4	10.4	9.3	10.2
14. Property income	D.4	*651.1*	0.6	0.6	0.6	0.6	0.6
15. Other[4]		*3751.8*	3.4	6	9.5	9.8	7.8
16=6. Total revenue	TR	*37992.2*	34.2	34.3	36.2	35.6	35.7
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]		33589.4	30.2	27.7	26.2	25.2	27.3
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	*18356.2*	16.5	17.1	15.4	12.3	12
17a. Compensation of employees	D.1	*11991.5*	10.8	12.5	11.1	8.1	7.9
17b. Intermediate consumption	P.2	*6364.7*	5.7	4.6	4.4	4.3	4.1
18. Social payments (18=18a+18b)		*14216.4*	12.8	15.9	14.5	13.6	13.5
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*1949.1*	1.8	2	2.2	2	2
18b. Social transfers other than in kind	D.62	*12267.2*	11	13.8	12.4	11.6	11.5
19=9. Interest expenditure	EDP D.41	*720.7*	0.6	1.3	1.9	2.2	2.4
20. Subsidies	D.3	*774.6*	0.7	0.7	0.6	0.6	0.6
21. Gross fixed capital formation	P.51	*5513.5*	5	5.6	8	8.4	6.6
22. Other[6]		*2008.8*	1.8	2.8	3.7	4.1	3.6
23=7. Total expenditure	TE[1]	*41590.1*	37.4	43.4	44.3	41.4	38.7
p.m.: Government consumption (nominal)	P.3	*21469*	19.3	20.1	18.5	15.2	14.8

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

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

[3]A plus sign means deficit-reducing one-off measures.

[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

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

[6] D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2008	2012
1. General public services	1	3.9	n.a.
2. Defence	2	1.4	n.a.
3. Public order and safety	3	1.9	n.a.
4. Economic affairs	4	4.5	n.a.
5. Environmental protection	5	0.9	n.a.
6. Housing and community amenities	6	0.4	n.a.
7. Health	7	5	n.a.
8. Recreation, culture and religion	8	1.1	n.a.
9. Education	9	5.8	n.a.
10. Social protection	10	12.4	n.a.
11. Total expenditure (=item 7=23 in Table 2)	TE[1]	37.4	38.8

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

Table 4. General government debt developments

% of GDP	ESA Code	2008	2009	2010	2011	2012
1. Gross debt[1]		15.6	29.5	36.6	39.8	41
2. Change in gross debt ratio		-1.32	13.9	7.1	3.2	1.2
Contributions to changes in gross debt						
3. Primary balance[2]		-2.6	-7.8	-6.2	-3.6	-0.6
4. Interest expenditure[3]	EDP D.41	0.6	1.3	1.9	2.2	2.4
5. Stock-flow adjustment		-2.7	1.6	-0.6	-1.2	-0.9
of which:						
- Differences between cash and accruals[4]		n.a.	n.a.	n.a.	n.a.	n.a.
- Net accumulation of financial assets[5]		n.a.	n.a.	n.a.	n.a.	n.a.
of which:						
- privatisation proceeds		0.1	0.8	0.1	n.a.	n.a.
- Valuation effects and other[6]		n.a.	n.a.	n.a.	n.a.	n.a.
p.m.: Implicit interest rate on debt[7]		4.3	7	6.7	6.4	6.2
Other relevant variables						
6. Liquid financial assets[8]		n.a.	n.a.	n.a.	n.a.	n.a.
7. Net financial debt (7=1-6)		n.a.	n.a.	n.a.	n.a.	n.a.

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

[2]Cf. item 10 in Table 2.

[3]Cf. item 9 in Table 2.

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

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

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

[7]Proxied by interest expenditure divided by the debt level of the previous year.

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

Table 5. Cyclical developments

% of GDP	ESA Code	2008	2009	2010	2011	2012
1. Real GDP growth (%)		2.8	-15	1.6	3.2	1.2
2. Net lending of general government	EDP B.9	-3.2	-9.1	-8.1	-5.8	-3
3. Interest expenditure	EDP D.41	0.6	1.3	1.9	2.2	2.4
4. One-off and other temporary measures[1]		0.46	0.15	0.31	-0.26	-0.25
5. Potential GDP growth (%)		4.7	2.2	1.7	1.5	1.4
contributions:						
- 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		14.6	-4.7	-4.8	-3.2	-3.4
7. Cyclical budgetary component		4.9	-1.7	-1.7	-1	-1
8. Cyclically-adjusted balance (2 - 7)		-8.2	-7.4	-6.4	-4.8	-2
9. Cyclically-adjusted primary balance (8 + 3)		-7.5	-6	-4.5	-2.6	0.4
10. Structural balance (8 - 4)		-8.6	-7.5	-6.8	-4.5	-1.7

[1]A plus sign means deficit-reducing one-off measures.

Table 6. Divergence from previous update

	ESA Code	2008	2009	2010	2011	2012
Real GDP growth (%)						
Previous update		3.5	-4.8	-0.2	4.5	n.a.
Current update		2.8	-15	1.6	3.2	1.2
Difference		-0.7	-10.2	1.8	-1.3	n.a.
General government net lending (% of GDP)	EDP B.9					
Previous update		-2.9	-2.1	-1	0	n.a.
Current update		-3.2	-9.1	-8.1	-5.8	-3
Difference		-0.3	-7	-7.1	-5.8	n.a.
General government gross debt (% of GDP)						
Previous update		15.3	16.9	18.1	17.1	n.a.
Current update		15.6	29.5	36.6	39.8	41
Difference		0.3	12.6	18.5	22.7	n.a.

Table 7. Long-term sustainability of public finances

% of GDP	2008	2010	2020	2030	2050	2060
Total expenditure	37.4	44.3	34.5	35.6	36.8	38
Of which: age-related expenditures	18.3	24.3	19.8	20.8	22	23.3
Pension expenditure	7.4	9.8	8.7	9.5	10.7	11.7
Social security pension	7.4	9.8	8.7	9.5	10.7	11.7
Old-age and early pensions	6.16	8	7.5	8.4	9.6	10.6
Other pensions (disability, survivors)	1.28	1.8	1.3	1.1	1.1	1
Occupational pensions (if in general government)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Health care	5.1	7.3	5.3	5.5	6	6.1
Long-term care *(this was earlier included in the health care)*	0.6	0.9	0.6	0.7	1	1.1
Education expenditure	5.0	5.9	5	5	4.2	4.3
Other age-related expenditures	0.1	0.4	0.1	0.1	0	0
Interest expenditure	0.6	1.9	2.2	3.8	7.6	9.9
Total revenue	34.2	36.2	35.8	35.8	35.8	35.8
Of which: property income	0.6	0.6	0.6	0.6	0.6	0.6
Of which : from pensions contributions (or social contributions if appropriate)	6.9	7.2	6.9	6.8	6.8	7
Pension reserve fund assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which : consolidated public pension fund assets (assets other than government liabilities)	2	3.9	14.2	26.1	55.6	69.9
Assumptions						
Labour productivity growth	0.5	4.6	3.3	2.7	1.7	1.7
Real GDP growth	2.8	1.6	2.5	1.5	0.2	0.4
Participation rate males (aged 20-64)	71.4	73.4	73	70.4	68.9	69.4
Participation rates females (aged 20-64)	65.7	67.2	69.2	67.8	66.3	66.9
Total participation rates (aged 20-64)	68.4	70.2	71	69.1	67.6	68.2
Unemployment rate	5.8	16.7	3.5	3.5	3.5	3.5
Population aged 65+ over total population	15.8	16.1	18.1	22.8	27.4	32.7

Table 8. Basic assumptions

	2008	2009	2010	2011	2012
Short-term interest rate[1] (annual average)	7.4	7.8	4.9	5.8	5.6
Long-term interest rate (annual average)	9.0	14	7.7	8	7.5
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.37	1.48	1.36	1.36	1.36
Nominal effective exchange rate	1.4	0	0	0	0
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
World excluding EU, GDP growth	3	-0.4	3.8	4.1	4.1
EU GDP growth	0.8	-4.1	0.7	1.6	1.6
Growth of relevant foreign markets	0.8	-4.1	0.7	1.6	1.6
World import volumes, excluding EU	4.1	-12.6	4.6	5	5
Oil prices (Brent, USD/barrel)	98.5	61.3	76.5	80.5	80.5

[1]If necessary, purely technical assumptions.