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COVER NOTE

from:	Mr Rytis MARTIKONIS, Ambassador, Permanent Representative of the Lithuania to the European union,
date of receipt:	3 March 2010
to:	Mr Carsten PILLATH, Director-General, Council of the European Union
Subject:	Update of the Convergence Programme of Lithuania for 2009

We have the honour to enclose for your attention the update of the Convergence Programme of the Republic of Lithuania for 2009 which was published in the Official Journal on 27 February 2010, publication n° 21-1128.

(Complimentary close)

(s.) Rytis MARTIKONIS

Encl.:

THE GOVERNMENT OF THE REPUBLIC OF LITHUANIA

RESOLUTION NO 173

ON

THE CONVERGENCE PROGRAMME OF LITHUANIA OF 2009

24 February 2010
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 2009 (as appended);

2. To charge the Ministry of Finance with the task of submitting the Convergence Programme of Lithuania of 2009 to the European Commission.

Prime Minister	Andrius Kubilius
Minister of Finance	Ingrida Šimonytė

APPROVED
by Resolution No 173 of 24 February 2010
of the Government of the Republic of
Lithuania

CONVERGENCE PROGRAMME OF LITHUANIA OF 2009

I. FINANCIAL POLICY OVERVIEW

1. The primary task of the fifteenth 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 consolidate public finances and essentially improve the situation in the areas that might ensure an economic breakthrough. The Convergence Programme of Lithuania of 2009 (hereinafter referred to as "the Programme") projects the economic policy outlined in the Programme of the 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 2010 (*Valstybės žinios* (Official Gazette), No 152-6822).

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 the budgetary policy ensuring the confidence 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. To implement a result-oriented governance model enabling a more efficient use of resources.

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 fossil 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 criteria, set out in the Treaty on the Functioning of the European Union (OJ 2008 C 115, p. 1), 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 general 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. 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 should reduce the structural current account deficit and save the potential of national income of Lithuanian citizens for domestic consumption and investment.

5. This Programme examines and assesses the preconditions for the achievement of the economic policy goals. The central scenario of the development of the Lithuanian economy is based on the assumption that in 2010 the economy will preserve a stable level of credits to customers. The Programme has been based on assumptions on euro exchange rate, prices of oil and other raw materials used by the European Commission for the last update of scenarios of the economic development of economic indicators.

6. The national currency litas (hereinafter referred to as "the litas") exchange rate, fixed against 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 keeping deficit within 3 per cent of the gross domestic product (hereinafter referred to as "GDP") has been temporarily replaced by the objective to correct the situation of an excessive deficit by 2012. In order to cushion the cycle of the economy, an important task is to further secure cheap funding of investment by reducing risk premium. The budget policy under implementation takes into account the need to preserve the productive investment necessary for economic development. For the general government deficit not to exceed 8.1% of the GDP, the target set for 2010 should aim 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 2011-2012. Reduction of the general government expenditure and partial tax raise in 2009-2010 are 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 European Union (hereinafter referred to as "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 and the loans from the EU and international finance institutions (Council of Europe Development Bank, European Investment Bank and Nordic Investment bank), 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 EU).

8. Resulting from the reduction of the deficit below the 3% of the GDP limit in 2012, the general government finances will continue to be consolidated by setting a stricter medium-term objective. Due to the crises the general government debts has been rapidly increasing, therefore to maintain the prospects of the stable general government debt the new medium-term target was established: to achieve the structural surplus of ½% of the GDP. This medium-term objective is tightened taking into account the European Commission's latest estimates suggesting that the general government debt would approach 113.9% of GDP in 2030, 545.9% of GDP in 2060, unless the fiscal policy is tightened.

9. Lithuania pursues 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 strengthened a natural cyclical slow-down of GDP growth that started in early 2008. Global financial market turbulences had impact on crediting: increased prices and decreased availability of financial resources, stricter lending conditions in banks due to the changes in risk weighting etc. In 2009 greater than before uncertainty and negative prospects of the economic development resulted in decreased borrowing demand and borrowing stopped promoting consumption and investment as it was in previous years. Efforts to reduce the existing liabilities resulted in contracted consumption and investment. The central scenario of economic development takes into account the Anti-crisis Plan developed by the Government of the Republic of Lithuania, the planned frontloading of the use of EU assistance and the pursued structural reforms. The central scenario was based on the assumption that the impact of the reforms allows strengthening the potential GDP, however a strong positive effect of all the measures in 2009 was 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. On the other hand, preliminary data and contracts with private sector regarding the frontloading of the use of EU assistance allow to expect that economy recovery impulse in 2010-2011 will be more powerful than in 2009 and that it will be sufficient to avoid further rapid shrinking of the economy. As, due to decreased interest rate and increased export, positive risks lacked sufficient statistical evidence and could not be used as the basis for the central development scenario that laid the grounds for the approval of the 2010 Budget, in 2010 the general government will get extra revenues. Following the assumption of the continuation of the general government finance

consolidation, these extra revenues will have to be used for the implementation of stricter deficit targets.

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

Table 1. Key assumptions

Indicator	2008	2009	2010	2011	2012
Short-term interest rates	7.4	7.8	4.9	5.8	5.6
Long-term interest rates	9	14	7.7	8	7.5
USD/EUR exchange rate (euro zone and ERM II countries)	1.37	1.48	1.36	1,36	1.36
Nominal effective exchange rate	1,4	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), %	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 growth (excl. EU), %	4.1	-12.6	4.6	5	5
Oil prices (Brent, USD/barrel)	98.5	61.3	76.5	80.5	80.5

Sources: Ministry of Finance, European Central Bank, European Commission

The assumption about labour market flexibility ensures that the decrease of the number of the employed in 2009-2010 will be only temporal and in 2011 the unemployment will start shrinking. An assumption is made that the stabilisation of the labour market because of the self-employment contributing to the stabilisation of the number of the employed in the 4th quarter of 2009, when the average number of employees in full-time units continued to rapidly decrease.

The medium-term economy growth to a large extent depends on the assumption that the economy will undergo restructurisation and in 2010-2011 the risk of potential structural deficit of the current account will be eliminated.

An assumption is made that the return of the Lithuanian export volume that started in the 3rd quarter of 2009 due to the EU economy recovery will continue and in 2010 it will achieve 85% of the pre-crisis level.

Following the assumption that the investment will revitalise the use of the EU support, the planned volume of which in 2009-2010 is about 3.7 percentage point of the GDP.

The updated central economic development scenario the potential growth of the economy depends on the speed of the implementation of structural reforms, interest rate decrease and investment increase up to the multi-annual average.

Monetary and exchange rate policy

11. Lithuania's monetary policy is established under the terms 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.

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.

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 convergence criteria are met. The Bank of Lithuania maintains the level of institutional preparation which under favourable macroeconomic conditions will ensure smooth and rapid currency changeover.

Overview of ERM II implementation

12. The Government of the Republic of Lithuania had to implement 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 on 8 November 2007, the Law on Fiscal Discipline of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 120-4881, 2007) stipulates that general government finances in the medium-term must be managed in a way that ensures surplus or a nearly balanced general government balance indicator. In addition, the Law on Fiscal Discipline of the Republic of Lithuania sets forth measures necessary for the implementation of the opinion of the EU Council on Lithuanian convergence programmes.

Before the financial crisis much attention was devoted to prevention measures aimed at bank risk management. For this reason additional requirements for the strengthening of internal control and risk management procedures were implemented, new management requirements for previously not regulated types of risk as well as additional management requirements for operating risk were adopted. Special attention was devoted to the strengthening of bank capital basis. On 1 January 2010 capital adequacy indicator of the bank system was approx. 14.1 per cent (the minimum norm fixed by the Bank of Lithuania is 8 per cent).

The norm limiting the risk of the maximum open position in foreign currency and precious metals was fixed for Lithuania's credit institutions. The maximum common (except euros) open position should not exceed 25 per cent of the bank capital; the maximum open position of one currency (except euros) or precious metals should not exceed 15 per cent of the bank capital. Banks are required to meet this norm every day.

Aiming to increase stability of the financial system, in 22 July 2009 the Seimas of the Republic of Lithuania adopted the Law on the Sustainability of Finances of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No. 93-3985, 2009). This Law provides various measures aimed at providing support to credit institutions: State guarantees and redemption of bank property, participation of the State in bank capital, taking of bank shares to meet public needs.

The anticipated economic environment in 2009 became different 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, eliminates credit increase and the ERM is replaced by current account surplus. Measures that will impose an obligation to follow an anti-cyclic and anti-inflation budget policy are being planned: in 2010 efforts will be made to adopt adequate legislation. Other structural reform implementing measures will be specified in 2010 in the revised annual report on the National Lisbon Strategy Implementation Programme. Reforms in the fields of education, health care, environmental protection, science and innovation promotion as well as business environment are envisaged.

Economic cycle and a central medium-term economy development scenario

The real sector

13. Since the middle of 2008 in Lithuania there appeared signs of slower growth of economy sectors resulting in decline at the end of 2008. Due to natural slowdown of business cycle and impact of global financial crisis the economic equilibrium of finance, real estate and construction markets was disturbed; the change in demand made significant impact on the development of industry and trade.

At present Lithuania’s economy is influenced by the consequences of the impact of rapid economy growth in recent years and increasing global financial crisis on the real economy; these consequences resulted in a sudden slowdown of demand and supply of money on loan, decline in domestic trade and production, decline in investments and correction of housing market, increasing unemployment.

The confusion in the financial sector of the USA which started at the end of July in 2007 became global in September 2008 and resulted in decline of Lithuania’s trade partners in EU and other markets, decline in demand for Lithuanian goods and services abroad. Due to uncertainties and lower external demand the GDP declined to 15 per cent in 2009. However, in the third and fourth quarters of 2009 the quarterly GDP increased (when the influence of the season and working days was eliminated): in the third quarter GDP increased by 6.1 per cent; in the fourth quarter GDP increased by 0.1 per cent. Technically the country was successful in fighting the decline. The annual decline of quarterly GDP will remain in the first quarter of 2010, however in the second and third quarters of 2010 the annual growth of quarterly indicators will make up 4 per cent. On the other hand, in case of failure to receive statistical data on new growth factors, the annual growth in the fourth quarter would significantly decline.

Investment environment suffers from a number of factors related to the overall economic situation and decline of demand in domestic and foreign markets as well as to dominating uncertainty about the sustainability of economy recovery. Investments sensitively and rapidly react to changes in economic conditions. In times of economic growth, in 2007, highly optimistic expectations and favourable credit terms resulted in the share of GDP (that is made of investments) increase up to 30.9 per cent. Due to strict credit terms, apparent decline in domestic demand and doubts about demand on the global market made companies to abandon their investment plans or to postpone their implementation for an unlimited period. During nine months in 2009 the gross fixed capital formation declined approx. by 40 per cent compared to the same period last year. The companies started to adjust their investment plans already in the middle of 2008: investments rapidly increased until early 2008 (during 2005–2007 by 17.9 per cent on average); the third quarter of 2009 was the sixth quarter in a row with a negative annual investment growth rate. The slowdown of investments into production means which started in early 2008 and slowdown of investments into buildings and constructions other than residential which became more intense during the last quarters of 2009 destined around half of such a decline each.

Private consumption, that increased rapidly until 2007, began to decline at the end of 2008 and declined even more rapidly in 2009: during the first quarter of 2009 private consumption declined by 15.7 per cent, during the second quarter it declined by 17.5 per cent and during the third quarter it declined by 19 per cent compared with the same period in 2008. Private consumption declined due to uncertain economic situation, increasing unemployment, decreasing income, consumers' no-confidence, and changes in credit conditions. Commercial banks introduced stricter loan terms due to economic situation in the regions. Increased uncertainty in 2009 and negative economy development perspectives resulted in lower demand on borrowing. Aim to reduce existing debts resulted in lower consumption.

In addition to huge shrinkage of domestic demand Lithuania as well as many other EU open economies experienced a shock from export market decline. Decline of demand in Lithuania's key export markets, devaluation of currencies of neighbouring countries resulted in serious reduction of volume and value (around 30 per cent) of Lithuania's export in the first half of 2009, however in August there were positive changes in export figures. Responding to economy revitalizing measures implemented by EU Member States and first recovery signs of big EU economies, the volume of Lithuania's export began to grow in the third quarter of 2009. Certain export oriented industry sectors (machine and equipment, chemicals (fertilizers), metal manufacture) that received huge investments in the times of rapid economy growth and that accumulated great volumes of unused production capacity, will be able to recover as soon as external demand will start growing.

The basis for economy recovery foreseen in the central economy development scenario is the implementation of the country‘s economy promotion plan, global stabilization of credit market, sustainability of trade partners‘ recovery and trust in efforts to strengthen finances of the Lithuania‘s general government sector.

Table 2. Macroeconomic indicators

Indicator	ESA* code	Indicator value in 2008, million LTL	Change, in %				
			2008	2009	2010	2011	2012
Real GDP	B1*g	81020.1	2.8	-15**	1.6	3.2	1.2
Nominal GDP	B1*g	111189.8	12.7	-16.9**	1.5	3.9	2.4
Components of real GDP							
Private consumption expenditure + NPISHs	P.3	58059	3.6	-17.9	-6.4	2.1	2.8
Government consumption expenditure	P.3	14522.9	7.9	-2	-1.7	-10	0
Gross fixed capital formation	P.51	21579.6	-6.5	-38	14.5	29.1	2
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.
Exports of goods and services	P.6	50366.6	12.2	-16.7	13.5	3.1	1.7
Imports of goods and services	P.7	66330.3	10,5	-29.9	6.6	6.8	3.2
Contributions to real GDP growth, %							
Final domestic demand		–	3,3	-26.4	-1.9	5.1	2.1
Changes in inventories and net acquisition of valuables	P.52+P.53	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Balance of goods and services	B.11	–	-0.5	11.4	3.5	-1.9	-0.8

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

*European System of Accounts

**Preliminary data.

Inflation

14. Since the middle of 2008 annual inflation started to decline in the context of changes in global prices for food stocks and energy. When in January of 2009 higher excise taxes on fuel and alcohol as well as value added tax (hereinafter VAT) were introduced, inflation rapidly increased, however, later it rapidly declined. In October inflation was only 1 per cent (in January it was 9.5 per cent, and in June of 2008 it reached the peak over the last few years and made up 12.7 per cent). From April to August prices gradually declined each month, however, in September they increased due to higher standard VAT tariff and excise tax on cigarettes; in October they declined again. In 2009 the lowest headline annual inflation was influenced by lower net annual inflation and slower annual pace of prices for food products, beverages and tobacco increase, except July and October, when annual inflation declined due to lower administered prices.

When wages and purchasing power of consumers declined, pressure of demand on net inflation rapidly weakened. It was evident from data on income from sales of service enterprises and retail trade. In 2009 net annual inflation declined, except September, when it increased a bit due to higher VAT tariff. In October prices of commodity goods and services on the market already were lower than a year ago.

Changes in prices of food products and non-alcoholic beverages resulted in speedy reduction of headline inflation. As from July of 2009 the abovementioned prices were lower than a year ago; each month they declined starting from March (except September, presumably because of higher VAT tariff). Influence of prices of alcoholic beverages and tobacco products on annual inflation remained almost stable: it increased in September and October due to higher excise tax on cigarettes. Excise taxes on alcoholic beverages were increased in early 2009; excise taxes on cigarettes were increased two times in 2009 (in March and September), the last increase was made in accordance to minimum level set by the EU. Prices of tobacco and alcoholic beverages that are subject to excise taxes grew further.

The influence of administered prices on annual inflation weakened in 2009, especially in July and October. As from July of 2009 natural gas and electricity prices for consumers' living needs declined, thus in July the general price level fell more than during previous months (by 0.8 per cent; from April to June it fell by 0.1–0.3 per cent). In early 2009 the price of electricity for residents increased by 13.1 per cent, natural gas – by 23.5 per cent; in July the price for electricity declined by 5.8 per cent, natural gas – by 15.9 per cent. In October 2009 heating prices declined by 12.6 per cent resulting in much lower headline annual inflation compared with figures in September.

During the first ten months of 2009 fuel prices were lower than a year ago, however, their annual decline weakened due to vanishing favourable effect of the base that appeared from rapid increase of prices during the first half of 2008 (in July of 2008 global oil price reached the peak of all times).

Following the reduction of excise tariff to meet 2008 level, in August diesel fuel prices declined (as from January of 2009 diesel fuel was subject to tariff that Lithuania could reach until the beginning of 2013 in line with its commitments to EU). Further increase of this excise tax will depend on the existing commitments to EU and on influence of reduced excise tax on trade in diesel fuel.

Table 3. Price indicators

Indicator	ESA code	Indicator value in 2008	Change, in %				
			2008	2009	2010	2011	2012
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* (average annual change)		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

Indicator	ESA code	Indicator value in 2008	Change, in %				
			2008	2009	2010	2011	2012
7. Import price deflator (goods and services)		120.1	8.4	-12.4	-1.8	0.3	1.3

Sources: 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. The slowdown of the credit increase seen in the first quarter of 2008 was getting stronger in 2009, 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 need to save funds in order to return loans taken during the times of economic growth, high unemployment and stable wages. 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 0.6 percentage points higher because of the increased electricity price. Part of the increasing electricity price will be offset by deflation processes in other sectors. Business sector is expected to aim at compensating increased electricity expenses by reducing other expenditure. Slower decline of wages, more rapid decline of unemployment, rapidly growing oil and gas prices would weaken deflation processes.

Labour market

15. 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 2008	Rate of change, %				
			2008	2009	2010	2011	2012
1. Employment, persons (thou)		1520	-0.9	-6.9	-5.1	-0.6	-0.1
2. Employment, hours worked		2900894	1.1				
3. Unemployment rate (%)*		5.8	5.8	13.6	16.7	15.5	14.7
4. Productivity (real GDP per employed person), thou LTL		65.5	0.5	-8.7	7	3.9	1.3
5. Labour productivity (real GDP per hour worked), LTL		34.3	-1.1				
6. Compensation of employees, m LTL	D.1	49047.6	3.9	-18	-8.5	-1.5	0.8
7. Compensation per employee, LTL		32236	5.6	-11.9	-3.6	-0.9	0.9

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. According to preliminary data, in 2009 the unemployment rate increased to 13.6%. That is twice higher than a year ago. Level of unemployment is highly influenced by migration of population. In 2006 and 2007 the number of individuals declaring about their departure was lower when compared with the situation from 2004 to 2005, however, in the middle of 2008 this number increased rapidly in the context of poorer quality of life due to global price increase. In late 2008 the number of immigrants started to decline. From January to November in 2009 the number of persons declaring departure from the country increased by 29.8 per cent if compared to figures of the same period last year. The same period saw the decline of immigrants by 28.9 per cent. For this reason negative migration saldo doubled. There is certain risk that in 2010 trends concerning the increasing number of departing people and declining number of arriving people will become more aggravating, especially if economy of EU countries that attract many immigrants will recover first comparing to Lithuania and their labour markets will become stable again.

Balance of payments

16. In the first half of 2009 current account was nearly balanced; its surplus made up 0.2 percent of GDP. According to preliminary data on the third quarter of 2009, the current account surplus increased to 3.9 per cent of GDP. The balance is expected to be positive during the quarters to come.

Positive changes of current account deficit appeared due to a sudden decline in foreign trade deficit related to import decline that was triggered by lower level of domestic demand. In the first quarter of 2009 trade deficit made up 1.4 per cent of GDP; it remained the same in the third quarter of 2009.

Country’s nominal export started to decline in late 2008; during the first three quarters of 2009 it was lower by 32 per cent points if compared with the last year. Recent data shows slower annual export decline as from August. In 2009 the sharpest decline was characteristic to vehicle, machinery and equipment export which depends on reduced investments in foreign markets. Declining export was influenced by rapid decline of exported chemical substances and plastics due to lower production prices. These products made considerable influence to declining export of goods of Lithuanian origin. Following the economic difficulties in the Commonwealth of Independent States Lithuania’s export to these states declined from 25.8 per cent in 2008 to 22.7 per cent in 2009 from January to September; such a situation determined increasing export to the EU Member States.

Weakened domestic demand and falling prices resulted in significant import decline. During the first three quarter of 2009 import declined by 42.3 per cent if compared to the corresponding period in 2008. Later import that rapidly declined in early 2009 stabilized and became stable from January if no account of seasonal influence is taken.

Despite trade deficit the current account balance was in fact positive due to increased number of current transfers. Such a situation is a result of a more rapid use of support from the EU Structural funds. Preliminary data indicate that at the end of the third quarter of 2009 current account experienced a considerable positive influence of income surplus when foreign enterprises in Lithuania suffered losses. Moreover, from January to September of 2009 the balance of current account experienced positive influence of service balance surplus that resulted from activities in the transport sector that remained competitive during the economic slowdown. The surplus of balance of transport services exceeded by 1.4 times the total surplus of service balance.

The balance of capital and financial accounts experienced positive influence of bigger capital account that includes bigger transfers from EU support funds to investment projects. In the first half of 2009 the balance of direct foreign investments was also positive; it made up 1.7 per cent of GDP. These figures were significantly influenced by the sale of the remaining 9.98 per cent of shares of stock company ‘Mažeikių nafta‘ (as from 1 September of 2009 – stock company ‘Orlen Lietuva‘) owned by the State to Polish company PKN Orlen S.A. However, preliminary data of the third quarter of 2009 indicate that the balance of direct investments became negative mostly due to negative re-investments that indicate losses of foreign banks active in Lithuania.

In the first half of 2009 the flow of investment portfolio was positive, however, considerable weak (0.7 per cent of GDP) because slightly higher commitments concerning Eurobond emissions by the Government of the Republic of Lithuania in the second quarter of 2009 were partly compensated by increased investments of banks active in Lithuania, investment and pension funds into foreign bonds. During the period in question the balance of financial account experienced negative influence of other investments that had fallen down because banks and enterprises were faster in returning loans to foreign creditors. Similar trends prevailed during the third quarter.

Table 5. Sectoral balances

Indicator	ESA code	% of GDP				
		2008	2009	2010	2011	2012
1. Net borrowing	B.9N	-10.2	3.7	7.5	5.3	4.3
of which:						
balance of goods and services		-10.9	-1.1	3.3	1.1	0.1
balance of income and transfers*		-1	1.4	0.9	1	1
capital account*		1.7	3.4	3.3	3.2	3.2
2. Net surplus (+)/deficit (-) of the private sector		-7	12.8	15.6	11.1	7.4
3. Net surplus (+)/deficit (-) of general government	B.9N	-3.2	-9.1	-8.1	-5.8	-3
4. Statistical discrepancy		0	0	0	0	0

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

Risk-related aspects of economic development

17. Rapid change of events that is characteristic to crisis explains why any central economy development scenario is likely to happen. The state of economy must be diagnosed and policy must be formed on the basis of risk factors. The central economy development scenario of this programme depends on five key assumptions: 1) increase in export volume in

2010 up to almost 85 per cent of the level before the crisis; 2) frontloading of the use of EU support in 2010 according to the plan; 3) sustainable decline of long-term interest rates for loans in national currency to meet the level acceptable for investors investing into production capacity and for consumers (this assumption is equivalent to continuous accumulation of country's resources aimed at stabilizing debt of the general government sector); 4) timely implemented measures neutralizing risk of structural CAD; 5) increasing employment and stabilization of income from labour before the appearance of secondary effects of decline when consumption and employment start to weaken due to previous slow consumption, low employment and lack of household assets that could be used to finance the consumption.

The assumption that export volume in 2010 will increase up to almost 85 per cent of the level before the crisis explains the GDP increase by 4.5 per cent in 2010 and the key factor that compensates the residual influence of domestic market decline in 2009 on the year 2010. Assumptions concerning export may not become true if the recovery of EU economy which is the key export market for Lithuania will prove to lack sustainability or more competitive countries will occupy these markets. Assumption that in 2010 the plan on earlier use of EU support will be implemented explains the increase of GDP by 2 per cent. This assumption is expected to come true due to the implementation of the national economy recovery plan and signature of contracts with project executors. Assumptions concerning low interests, stabilization of consumers' ability to pay and sustainable consumption expenditures in the domestic market explain the overall GDP increase during 2011–2012. Lack of further consolidation and compliance with EU Council recommendations when interest rates temporarily decline in 2010, may trigger consumption of foreign goods and services that were preferred before the crisis and that was temporarily reduced by the opportunity to earn extra interest rates on deposits in national currency. Resumed consumption of imported goods and services financed from deposits of better well-off residents may cause high CAD. Higher external disbalance could result in higher interest rates, declining investments and consumption. Thus, if additional measures aimed at stabilizing debt of the general government sector will not be prepared in 2010, the assumption concerning low long-term interest rates will not come true and economy decline will start again. In case additional measures for accumulating country's financial resources become an excessive restriction on the market of goods of Lithuanian origin, economy decline or slower growth would become the central economy development scenario. The above mentioned risks should be managed by implementing structural reforms foreseen in the Programme of the Government of the Republic of Lithuania giving priority to measures that allow effective reduction of dependency of Lithuania's economy on imported goods. Taxation measures that promote air pollution reduction and energetic dependency on mineral fuel may allow to manage the risk of structural external disbalance.

There is positive risk as well, that allows to expect that the pace of economy development will be more rapid than foreseen in the central economy development scenario if confidence in EU business activities will increase more rapid than suggested in the autumn economy development scenario of the European Commission.

Structural changes increase the risk that indicators of labour market will be revised. During the second and third quarters of 2009 the number of employed stabilized, however, the average number of employees in full-time units sharply declined; this indicates the risk to return to the rapid unemployment increase scenario. In second quarter of 2009 the number of employed people declined only by 0.8 per cent when compared with figures of the first quarter; the average number of employees in full-time units declined by 3.6 per cent when compared with the third quarter of 2009, when the figures were 0.1 per cent and 3.6 per cent respectively.

III. PUBLIC FINANCES

Strategy of financial policy

18. When in 2012 the general government sector deficit is reduced below 3 per cent of GDP, government sector finances will be further consolidated aiming at stricter middle-term objective. The middle-term objective is made stricter and aims at ensuring that structural surplus will equal to 0.5 per cent of GDP. The goal of such plans is to strengthen confidence in currency board mechanism and price stability as well as to ensure that during the following decades the general government sector debt will be below 60 per cent of GDP and will not become a burden on the future tax payers and social commitments to the future pensioners will be respected in the long-term. The 2010 objective of the Government of the Republic of Lithuania is to keep the general government sector deficit at the level below of the level in year 2009. In addition, certain preconditions will be ensured that will allow gradual decline of deficit meeting the convergence criteria (3 per cent of GDP) in the years to come.

19. Aiming to further consolidate public finances, the following priorities of the medium-term financial policy (macroeconomic policy) shall be established:

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

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

19.3. 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.

19.4. 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.

19.5. To aim at mass renovation of apartment blocks by using EU financial support.

19.6. To boost the confidence in the long term sustainability of public sector finances and fiscal discipline norms that ensure long term economic development, reform the systems of education and health.

19.7. 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).

19.8. 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; to encourage by means of taxation measures the reduction of air pollution and energetic dependency on fossil fuel.

19.9. To establish a results-orientated management model that will ensure efficient use of resources, restructure the system and principles of strategic and state budget planning aiming at higher efficiency and rationality of expenditures by linking to apparent results.

19.10. To improve tax administration and reduce the scope of shadow economy.

20. 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 objectives concerning balance indicators in the general government sector and for measures aimed at ensuring long-term sustainability of general government sector finances.

Measures planned for 2010–2012 aimed at the achievement of objectives concerning balance indicators in the general government sector

21. Additional consolidation sources necessary for the implementation of the task concerning balance indicator in the general government sector in the year 2010 stem from slower decline in salaries and employment as well as lower deflation perspectives when compared to the previous central economy development scenario which was the basis of budgets for the year 2010. According to the updated central economy development scenario, there is a possibility that in 2010 the general government sector will receive additional income amounting up 1.4 per cent of GDP which will be sufficient for the implementation of the target balance indicator in the general government sector. According to the updated central economy development scenario, the implementation of task concerning balance indicator in the general government sector during 2011–2012 will require additional consolidation measures amounting up to 4.5 per cent of GDP (from which 0.6 per cent of GDP will be required in order to cover higher expenditures on debt management in comparison with expenditures on debt management in 2010).

22. The following measures are foreseen with a view to fulfilling the objectives of general government balance indicator for 2011–2012:

22.1. to make efforts to ensure maximum efficiency of general government expenditure; to carry out government reform, eliminate unfilled vacancies;

22.2. to develop cost-benefit analysis methodology, to apply it in respect of all major projects that are being implemented with taxpayers' funds, to direct the saved funds to the fulfilment of the objectives of general government balance indicator;

22.3. to perform a thorough analysis of the services provided by the state and local governments and discuss the possibilities for the long-term financing of their provision, in the absence of the possibilities for adequate long-term financing of such services, to privatize the provision of services;

22.4. to set targets for state institutions to increase efficiency at least by 2% per year (i.e. to begin the budgetary planning of each year by reducing by a certain amount the allocations for institutional expenditure and wages);

22.5. to make amendments to the laws on tax so as to achieve, in 2011, the effect of additional revenues which would allow in addition to the completion of the necessary structural reforms and streamlining of expenditure to use them as an additional source for fulfilling the objectives of general government balance indicator;

22.6. to direct the revenues obtained in excess of the amount planned in the central economic development scenario, as a result of more favourable economic development assumptions, to achieving a more rapid consolidation;

22.7. to improve tax administration and reduce the scope of shadow economy;

22.8. to continue to implement pension reform ensuring long-term sustainability of general government finances – to raise the retirement age and otherwise reduce the liabilities of general government sector towards the future retired employees;

22.9. to develop, within 2010, the Guidelines for the Introduction of Real Property Tax, providing for the expansion of tax base;

22.10. to increase the excise tax on diesel fuel (to achieve the minimum rates provided for in the EU *acquis*).

Implementation measures of the recommendations on excessive deficit procedure

23. A sudden economic slowdown in the second half of 2008 had a negative impact on budget implementation plans. In 2008, general government deficit reached 3.2% of GDP and exceeded the reference value set in the Stability and Growth Pact. On 7 July 2009, Lithuania was brought under excessive budget deficit procedure. With a view to bringing general government deficit below 3% of GDP, EU Council recommendation urges Lithuania to adopt average annual fiscal policy measures worth of at least 1.5% of GDP in the period 2009–2011. However, due to a deeper than expected in the spring 2009 deterioration of the general economic situation (particularly, in labour market and consumption), the European Commission made a proposal to EU Council to extend the deadline by one year to 2012 when Lithuania should correct excessive deficit situation. In accordance with the new European Council recommendation of 16 February 2010 on the correction of excessive deficit situation of general government sector, Lithuania's average annual fiscal effort should account for 2.25% of GDP in 2010–2012.

The consolidation measures adopted during 2009 and foreseen for 2010 account for around 12% of GDP. With a view to implementing the revised recommendations to ensure an annual average fiscal effort of at least 2.25% of GDP over 2009-2011, Lithuania will take additional consolidation measures.

The Law of the Financial Indicators of the State Budget and Municipal Budgets for 2009 has been amended twice. The net impact of these amendments was around 4% of GDP: the effect of consolidation measures taken in May was LTL 3.1 billion (3.4% of GDP), mainly due to cuts in investment projects, institutional expenditure and wages, and the July budgetary efforts yielded LTL 0.32 billion (0.4% of GDP), the latter fiscal measure being related to the reduction of salaries of state politicians, judges, public officials, civil and statutory servants, employees of budgetary institutions and the increase of standard VAT rate by 2 percentage points. The major impact from these consolidation efforts will be felt in 2010, representing around 1.4% of GDP.

The standard VAT rate has been raised by 2 percentage points from 1 September 2009, which, according to preliminary estimates, brought additional revenue of LTL 170 million to the 2009 national budget, and LTL 610 million in revenue is projected for 2010.

From 1 August 2009, the base level of the official salary (wage) of state politicians, judges, public officials and civil servants has been cut by 5%; on the basis of differentiation, the basic salary coefficients of civil servants have been reduced. From 1 September 2009, the salary appropriations of budgetary institutions and organizations have been reduced by 8% and there has been a reduction in the basic salary. The impact of wage cuts on the 2009 national budget was LTL 192 million, and impact on the 2010 budget is estimated at LTL 520 million.

On 9 December 2009, the Seimas of the Republic of Lithuania adopted the Law of the Republic of Lithuania of the 2010 Indicators of the Budget of the State Social Insurance Fund (*Valstybės žinios* (Official Gazette) No 151-6783, 2009) and on 10 December 2010 – the Law of the Republic of Lithuania of the 2010 Budget Indicators of the State Budget and Municipal Budgets (*Valstybės žinios* (Official Gazette) No 152-6822, 2009) which provide for rigorous expenditure limitations in all budget areas, since, on account of general economic conditions, revenues have fallen and efforts are being made to maintain the stability of public finances. The impact of all budget consolidation measures on the 2010 national budget translates into a reduction of State budget deficit by more than LTL 2 billion (down to LTL 4930 million or 5.3% of GDP).

In 2010, as a result of expenditure-reducing measures, the appropriations for State budget appropriation managers and programme implementation were cut by approximately 33%, including 10% reductions of salary appropriations for public servants, politicians, public officials, and municipal servants, 5% reductions of salary appropriations for teachers, employees in the social sector and culture and military servants, and 2% cuts in salary appropriations for statutory officials. Moreover, as of 2010, the number of budget appropriation managers has been reduced by 30 as compared to 2009. All the measures have reduced the planned national budget expenditure by LTL 1581 million against the 2009 national budget.

The Law of the Republic of Lithuania of Indicators for 2010 of the Budget of the State Social Insurance Fund provides for the reduction of progressive expenditure, such as pensions and other payments and a more precise distribution of social security benefits on the basis of stricter eligibility criteria, which is expected to help protect most socially vulnerable groups in society. The implementation of the reform, coupled with the reduction of other expenditure (non wages-related) in social sector will generate around 3.1% of GDP in savings in 2010.

The Government of the Republic of Lithuania also plans to improve budget position by adopting more efficient revenue collection measures. There is a common agreement that the newly proposed medium-term tax changes should contribute to achieving two goals – provide revenues in the medium-term and economic growth.

Taking into consideration the indicators of the State budget and other related budgets and funds (the envisaged deficit of the State Social Insurance Fund Budget, transfers from the Reserve (Stabilization) Fund for the financing of pension system reform and the Fund for the Decommissioning of the Ignalina NPP), the general government deficit in 2010 may account for 8.1% of the GDP figure foreseen in the central economic development scenario. That implies that, in order to correct the current excessive deficit situation, additional consolidation measures worth 4.5% of GDP would be required no later than 2012.

The Resolution No XI-536 of 8 December 2009 of the Seimas of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 147-6562, 2009) on “The Planned National Budget Indicators for the years 2010, 2011 and 2012“ foresees a gradual contraction of the national budget deficit over the years down to, respectively, 5.3%, 3.2% and 0.6% of GDP. Taking into account the social fund budgets for 2010 and other legislative acts related to the Law of the Republic of Lithuania of the Financial Indicators of the State Budget and Municipal Budgets for 2010, general government deficit is projected to be reduced below 3% of GDP threshold in 2012.

The assessment of the temporary budget consolidation and economic recovery measures is provided in table 6.

Table 6. Temporary measures of general government sector fiscal consolidation and economic recovery

Measure and legislative acts providing for its temporariness	% of GDP				
	2008	2009	2010	2011	2012
Reduction of taxable profit up to 50% as a result of investment in technological modernisation. Law of the Republic of Lithuania on Amending and Supplementing Articles 2, 5, 12, 34, 38^2, 41 and 58 of the Law on Corporate Income Tax and Supplementing the Law by Article 40^1 and Chapter IX^1 (*Valstybes žinios* (Official Gazette) No 149-6000, 2008)			-0.27	-0.26	-0.25

Measure and legislative acts providing for its temporariness	% of GDP				
	2008	2009	2010	2011	2012
Reduction of the excise tax rate on diesel fuel. Law on Amending Article 35 of the Law of the Republic of Lithuania on Excise Duties (*Valstybes žinios* (Official Gazette) No 91-3926, 2009) Corrigendum to Council Directive 2004/74/EC of 29 April 2004 amending Directive 2003/96/EC as regards the possibility for certain Member States to apply, in respect of energy products and electricity, temporary exemptions or reductions in the levels of taxation (OJ L 157, 30.4.2004)		-0.06	-0.17		
Return of VAT overpayments	0.46	-0.38			
Reduction of payments to pension funds. Law on Amending Article 4 of the Law of the Republic of Lithuania on Reform of the Pension System (*Valstybes žinios* (Official Gazette) No 54-2136, 2009)		0.6	0.75		
Total	0.46	0.15	0.31	-0.26	-0.25

Budget impact on the medium-term objectives of general government balance indicator

24. Expectations regarding prudent fiscal policy are the basis of the confidence of local and foreign investors.

25. The structure of general government finances in 2009–2012 as compared to 2008, has changed mainly due to payment of social benefits, interest payments and the use of EU financial support. While there has been a decrease in all expenditure expressed in the national currency, there has been an increase in social benefits, interest payments and the use of EU financial support.

26. General government financial projections in this Programme change mainly due to general economic decline, cutting of expenditure and tax measures aimed at implementing the recommendations on excessive general government deficit.

Table 7. General government indicators (S13) for the years 2008–2012*

	ESA code	Level in 2008 (LTL mill.)	% of GDP				
			2008	2009	2010	2011	2012
1. General government	S.13	-3597.9	-3.2	-9.1	-8.1	-5.8	-3
2. Central government budget	S.1311	-2240.2	-2	-6.1	-4.9	-3.3	-0.9
3. State budget	S.1312	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
4. Municipal budgets	S.1313	-248.8	-0.2	-0.2	-0.3	-0.3	-0.3
5. Social insurance 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	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		-2877.2	-2.6	-7.8	-6.2	-3.6	-0.6
11. One-off and other temporary measures			0.5	0.2	0.3	-0.3	-0.3

	ESA code	Level in 2008 (LTL mill.)	% of GDP				
			2008	2009	2010	2011	2012
Revenues							
12. Tax revenues (12=12a+12b+12c)		23185.4	20.9	17.3	15.7	15.9	17.1
12a. Revenues from indirect taxes	D.2	12763.6	11.5	10.7	10.9	11.2	12.1
12b. Revenues from direct taxes	D.5	10415.7	9.4	6.6	4.8	4.6	5
12c. Property tax	D.91	6.1	0	0	0	0	0
13. Social insurance 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		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)		33589.4	30.2	27.7	26.2	25.2	27.3
Expenditure							
17. Compensations to employees + Intermediate consumption	D.1+P.2	18356.2	16.5	17.1	15.4	12.3	12
17a. Compensations to 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	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 payment	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		2008.8	1.8	2.8	3.7	4.1	3.6
23=7. Total expenditure	TE	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

Sources: Statistics Lithuania, Ministry of Finance

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

In the medium term, the general government revenue (as a percentage of GDP) will grow. In 2008, the general government revenue was 34.2% of GDP, in 2009 – 34.3% of GDP, and, in 2012, it is set to increase to 35.7% of GDP due to an increasing EU structural funds support. Although the abolition of VAT reduced rates and a 3 percentage points-increase in the regular rate, lifting of the excise rates on fuel, alcohol and cigarettes contributed to the increase of the GDP share consisting of revenues from indirect taxes, the share of GDP of indirect taxes has been contracting due to a cyclical decline in tax bases: in 2009, it has fallen by approximately 0.8 percentage point as compared to 2008 – down to 10.7% of GDP. In 2012, as a result of additional consolidation measures, the ratio of revenues from indirect taxes to GDP has to increase and remain close to 12.1% of GDP. Due to reduction of personal income tax rate by 9 percentage points and the grant of profit tax reliefs, the share of GDP to be made up of these revenues will fall down to 4.8%. The share of GDP from social insurance contributions has risen by 1 percentage point in 2009, on account of separation of health insurance contribution. The employee's payable rate of health insurance contribution is 6%.

In 2009 versus 2008, the GDP share of general government expenditure has increased by 6% up to 43.4%: the share of social benefits has grown by around 2.8 percentage point, the share of interest payments – by 0.7 percentage points, the growth of gross fixed capital formation accelerated to 0.6% of GDP. The GDP share consisting of expenditure has increased due to a decline in GDP which was progressing faster than expenditure cutting. For example, the decline in compensations paid to general government employees in 2009 accounted for 0.5% of GDP, however, the share of the reduced GDP made up of the compensations increased by 1.7 percentage points. In carrying forward the fiscal consolidation process, general government expenditure on intermediate consumption and compensations for employees, as a share of GDP, is projected to stabilize at 12%. Other consolidation funds would be generated from revenue-increasing measures (such as tax administration and tax changes).

In order to bring down, on an annual basis, the structural deficit in compliance with the commitment to reduce excessive general government deficit, it is planned to sustain the quality of government finances: gross fixed capital formation is expected to increase from 5 percent of GDP in 2008 to 8.4% of GDP in 2011.

The ongoing pension reform will allow preparations to reduce the general government debt projected for 2060. The reform encourages private persons to individually save additional funds for their old-age pension. Tax revenues allocated for the implementation of the pension reform in 2012 and transferred to private pension funds will account for 1.1% of GDP. Contributions to pension funds have been temporarily reduced for two years – until the end of 2010, and in 2011 these contributions will rise again up to 1% of GDP. Thus, the share of social contributions during 2009–2010 will be higher by approximately 1 percentage point of GDP compared to the share in 2008 and 2011.

The reduction of GDP, an increase in debt and interest rates will contribute to a steady increase in interest expenditure – from 0.6% of GDP in 2008 to 2.4% of GDP in 2012.

The planned fiscal impulses to the budget policy stance from the frontloading of EU financial support during 2009–2010 are expected to offset the decline of demand due to consolidation of general government sector which is necessary for achieving stronger confidence in sustainability. The total stimulus for budget policy direction in 2009–2010 is milder by around 3.7% of GDP due to impulses resulting from the frontloading of EU financial support. The impulse for budget policy direction shows that the partial postponement of consolidation measures to 2012 is also combined with better economic development assumptions and the ability of economy to restructure itself.

Table 8. The impulse of consolidation of general government finances for demand and its planned mitigation through frontloading of EU support

(in % of GDP)

Indicator	2008	2009	2010	2011	2012
EU support	3.4	5.5	7.3	6.9	6.3
Net EU support	2.4	4.3	6.1	5.4	4.6
Impulse for demand due to an increase in net EU support compared to figures of the previous years (incentive(+), block (-)	0.3	1.9	1.8	-0.7	-0.7
Impulse to budget policy stance* compared to figures of the previous years (incentive for demand (+), block of demand (-)	6	-2.2	-1	-1.1	-2.1
Sum impact on demand (incentive(+), block (-)	6.3	-0.3	0.8	-1.8	-2.8

The impulse to budget policy stance – an indicator of budget policy stance less the indicator of budget policy stance in the previous year. The indicator of budget policy stance means structural and cyclical change of primary expenditure of the general government sector since the year preceding the beginning of policy implementation less structural and cyclical change of revenues since the year preceding the beginning of policy implementation. In this case the beginning of policy implementation – the year 2009 from 2009 and the year 2003 until 2008.

Balance of general government subsectors

27. The balance of social insurance funds subsector was negative with a deficit of 2.8% of GDP recorded in 2009. The 2009 increase of deficit was determined by the mis-match between inadequate commitments undertaken in the previous periods and reduced revenues caused by general economic decline. For this reason, central government subsector transferred a subsidy of 0.5% of GDP to the subsector of social insurance funds.

It is foreseen that local government subsector deficit in 2009 will amount to 0.2% of GDP. Considering the long-term trends, local government subsector deficit in 2010–2012 is projected to account for 0.2% of GDP.

As a result of ongoing structural and tax reforms, about two thirds of general government deficit consisted of central government subsector deficit, which accounted for 6.1% of GDP in 2009. It resulted from the failure by the Government of the Republic of Lithuania to implement the planned supplementary measures aimed at increasing structural revenues.

A reduction of central government subsector deficit during 2011–2012 will determine a reduction of the total general government deficit in the medium term.

According to the data provided in table 9, the average annual indicator of the reduction of general government deficit in 2011–2012 will be close to 2.5% of GDP.

Structural government deficit and continuity of fiscal policy

28. The narrowing of structural government deficit, which in 2008 accounted for 8.6% of GDP, to 7.5% of GDP is projected in 2009, owing to the measures aimed at reducing implemented expenditures and increasing structural revenues. The structural deficit indicator has improved by 1.1 percentage point of GDP. In 2010–2012, a major structural improvement of the financial position of general government sector is anticipated and general government balance indicator will be close to 1.7% of GDP. The implementation of these plans requires

continued decisive efforts to limit expenditure growth, increase revenues and speed up structural reforms.

Estimation of the output gap

29. The GDP cycle was estimated by applying the Hodrick Prescot (HP) filter approach. The results obtained point to a negative output gap in the period 2009–2012. In 2009, the output gap will be 4.7%, - 4.8% in 2010, - 3.2% in 2011, and - 3.4% in 2012.

However, owing to short time-series and structural shocks under the Hodrick Prescot filter approach or under the production function approach (using NAIRU), the estimate of Lithuania's output gap is not absolutely accurate. Conclusions obtained under the production function approach (based on the NAIRU conception) 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 rapid growth of construction during 2006–2007 significantly contributed to the 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 the unemployed people are likely to opt to emigrate. Cyclical unemployment might develop into permanent reduction of labour force, however, currently, there is no reliable method for its estimation.

Table 9. Economic cycles

Indicator	ESA code	BVP procentas				
		2008	2009	2010	2011	2012
1. Comparisons of prices for GDP growth, %		2,8	-15	1,6	3,2	1,2
2. Net lending (+)/borrowing (-) 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*		0,46	0,15	0,31	-0,26	-0,25
5. Potential GDP growth, %		4,7	2,2	1,7	1,5	1,4
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		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

Sources: Statistics Lithuania, Ministry of Finance

* One-off and other temporary measures are presented in table 6.

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". However, the significant 2007–2008 adjustments to the government structural deficit show that the earlier-made reservations had been justifiable. In estimating the government structural deficit, account should be taken of the weaknesses of both methods: neither approach is good enough to assess income received (lost) on a temporary basis as a result of fluctuations in external imbalance. In 2008, 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 caused a significant change in the growth of tax bases and the elasticity of taxes with respect to tax bases, though the agreed EU methodologies did not show such cyclical income. The risk being realized, the errors of the structural deficit calculated using the two approaches accounted for a few percentage points. Owing to these reasons, there was a sizeable increase in the 2008 estimate of the government structural deficit. Taking into account the practically justifiable reservation due to unreliable methods used to estimate indicator values of government structural deficit, this reservation is retained in the updated Programme. There is a risk that the assumptions of the central economic development scenario not being confirmed and given a return of economic downturn in 2011, structural consolidation measures estimated under the agreed methodology will be essentially different.

EU Council recommendations concerning the average annual consolidation measures worth of 2.25% of GDP will be implemented taking into consideration the structural deficit estimates made by the European Commission for Lithuania.

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

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

Table 10. Elasticity of the Lithuanian general government budgetary revenues

ESA code	Indicator	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 10 above shows, revenue from tobacco has zero elasticity. It has been estimated that revenue from fuel is most elastic, 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 with regard to economic cycle has been estimated on the basis of the macroeconomic and budgetary projections provided in this Programme.

Government debt levels and developments

30. One of the priority activities of the Government of the Republic of Lithuania for 2010 is the achievement of efficient management of government debt (Protocol No 78 of 14 October of the meeting of the Government of the Republic of Lithuania). Pursuant to the provisions of the Protocol to the National Agreement, a draft of which was approved by Resolution No 1335 of 21 October 2009 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 127-5499, 2009) (hereinafter referred to as the National Agreement), the national borrowing policy should be focused on avoiding the financing of budget deficit at the expense of credit resources assigned for loans to economic entities.

Until 2008, the level of government debt had been gradually decreasing for many years and accounted for 15.6% of GDP at the end of 2008. It is projected that, due to an increased general government sector deficit and contraction of the Lithuanian economy, government debt will grow in 2009 and subsequent years, however, it will remain at an acceptable level and at a safe distance from the established reference value of the debt convergence criterion (60% of GDP).

The central government debt structure poses no threat to public finances. The short-term liabilities (by outstanding maturity) account for 13%, while the floating interest rate debt, taking into account financial derivatives – around 4% of the total debt. The average outstanding maturity of the debt is more than 5 years. Taking into account financial derivatives, the central government debt is 100% denominated in the litas and the euro.

Table 11. General government debt projections

Indicator	% of GDP				
	2008	2009	2010	2011	2012
1. General government debt as of year-end	15.6	29.5	36.6	39.8	41
2. Change of general government debt	-1.32	13.9	7.1	3.2	1.2

Indicator	% of GDP				
	2008	2009	2010	2011	2012
Contributions to changes in gross debt					
3. Primary balance	-2.6	-7.8	-6.2	-3.6	-0.6
4. Interest expenditure	0.6	1.3	1.9	2.2	2.4
5. Debt change adjustment*	-2.7	1.6	-0.6	-1.2	-0.9
of which:					
difference between cash and accruals	–	–	–	–	–
net accumulation of financial assets of which: privatization revenues	0.1	0.8	0.1	–	–
p.m.: implicit interest rate on debt (%)	4.3	7	6.7	6.4	6.2
Other relevant variables	–	–	–	–	–
6. Liquid financial assets	–	–	–	–	–
7. Net financial debt (7=1-6)	–	–	–	–	–

Source: Ministry of Finance

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

31. In the medium term, the Government of the Republic of Lithuania envisages implementing the following strategic borrowing policy and debt management measures:

31.1. 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;

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

31.3. making preparations for the repayment of a big debt – redemption of Eurobonds – in 2012 and onwards.

IV. SENSIBILITY ANALYSIS AND COMPARISON WITH PREVIOUS UPDATE

Economic development risks and their implications for general government finances

32. A medium-term increase 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 295m in 2010, LTL 341m in 2011 and LTL 375m in 2012, respectively, or about 0.35% of GDP on average.

The central economic scenario, predicting a success in regaining economic growth, depends on the pace of structural reform implementation. The key precondition for the central economic scenario is structural reforms, which reduce energy dependence on imported mineral fuel. In order to speed up the process of renovation of multi-apartment buildings, the Government of the Republic of Lithuania has provided for a variety of sources for renovation funding, primarily the funds of the EU, the European Investment Bank, the State and the residents. The plan for 2010 is to implement around 400 multi-apartment building renovation (modernization) projects and to invest LTL 350-380 million for this purpose. If this assumption does not come true, this will create a risk of an increase in import volumes in response to recovery of consumer and business confidence, resulting in a renewed deterioration of CAD by several percentage points of GDP and thus raising the risk premiums and suppressing the growth of GDP potential. In such a case, general government consolidation would have to rely on smaller private sector resources.

If all the negative economic risks materialize, additional measures amounting to roughly 2.4 per cent of GDP will be required to bring back the deficit below the limit of 3 per cent of GDP in 2012.

Fiscal risk

33. The major projected sources of fiscal risk include: legal temporariness of some interim initial urgent consolidation measures: deposit insurance, restitution of real estate ownership rights, debt of state-owned enterprises, decommissioning of the Ignalina Nuclear Power Plant and measures to strengthen the financial stability of the banking system.

Urgent initial consolidation measures

34. The general government balance indicator will deteriorate if regular structural measures to replace certain interim initial urgent consolidation measures are not found. Reduction, by way of modifying official wage coefficients, of the remuneration of State politicians, State officials and public servants as well as employees of budgetary institutions and organizations (Law of the Republic of Lithuania Amending Annex I to the Law on Public Service (*Valstybės žinios* (Official Gazette) No 49-1937, 2009), Law of the Republic of Lithuania Amending Article 25 and Annex I of the Law on Public Service (*Valstybės žinios* (Official Gazette) No 91-3918, 2009), Law of the Republic of Lithuania Amending the Law on Remuneration of State Politicians and State Officials (*Valstybės žinios* (Official Gazette) No 49-1935, No 91-3916, 2009); Resolution No 843 of the Government of the Republic of Lithuania of 19 August 2009 Amending Resolution No 551 of the Government of the Republic of Lithuania of 8 July 1993 on the Improvement of the Procedure Remuneration of Employees of Budgetary Institutions and Organizations (*Valstybės žinios* (Official Gazette) No 100-4185, 2009), Resolution No 876 of the Government of the Republic of Lithuania of 19 August 2009 Amending Resolution No 337 of the Government of the Republic of Lithuania of 4 April 2007 Approving the Description of the Terms of Remuneration of the Directors, Assistant Directors, Scientific Secretaries, Research Fellows, Other Researchers and Lecturers of Institutions of Science and Studies (*Valstybės žinios* (Official Gazette) No 102-4258, 2009) has temporarily improved the general government balance indicator by 0.1% of GDP in 2009 and 0.23% of GDP in 2010.

Following the implementation of the provisions of the Interim Law of the Republic of Lithuania on Re-calculation and Payment of Social Benefits (*Valstybės žinios* (Official Gazette) No 152-6820, 2009) and temporary reduction of the social benefits expenditure, a temporary improvement of the general government balance indicator is expected: 1.84% of GDP in 2010 and 1.77% of GDP in 2011.

Deposit insurance

35. To secure depositor confidence in credit institutions, on 14 October 2008 the Seimas of the Republic of Lithuania passed the Law of the Republic of Lithuania Amending and Supplementing Articles 5 and 9 of the Law on Insurance of Deposits and Liabilities to Investors (*Valstybės žinios* (Official Gazette) No 121-4589, 2008) and the Law of the Republic of Lithuania Amending and Supplementing Articles 2, 4, 5, 7, 9, 10, 13, 18, 20, 21 and 26 as well as Annex of the Law on Insurance of Deposits and Liabilities to Investors (*Valstybės žinios* (Official Gazette) No 93-3949, 2009), which raises the deposit insurance amount as of 1 November 2008 from the litas equivalent of EUR 22 000 to EUR 100 000 and guarantees payment of 100% of the insured deposit sum to the depositors. The said laws also have shortened the period of payment of the insurance amounts as of 31 December 2010 to 20 working days from the date of an insurable event with a possible extension by the maximum of 10 working days in exceptional circumstances (currently, the term for the payment of insurance amounts is three months, which may be extended twice up to three months).

The total amount of insured deposits on 30 November 2009 was LTL 34 903.9 million, while the total sum of potential insurance benefits before the said date stood at LTL 26 850.4 million.

Government guarantees

36**.** No new government guarantees have been extended since 2003, except where they were needed for the repayment of the existing government-guaranteed loans. The Government-guaranteed loan portfolio in December 2009 accounted for about 1.4% of the GDP of 2009. Due to the instruments of the plan for promoting the economy carried out by the Government of the Republic of Lithuania as well as due to the contraction of the economy, the level of guaranteed debt is expected to slightly increase during the coming years, while remaining rather low.

According to the forecasts, LTL 30 million will be required in 2010 and LTL 3 million in 2011 and 2012 each in relation to the savings restitution commitments.

Securing of financial stability

37. In order to establish the legal framework necessary for the State to protect overriding public interests, the Law of the Republic of Lithuania on Financial Sustainability (*Valstybės žinios* (Official Gazette) No 93-3985) has been adopted. It introduces measures that may be adopted to reinforce financial stability and reliability of banks as well as branches of foreign banks established in the Republic of Lithuania. In accordance with the abovesaid law, the Government of the Republic of Lithuania may, where appropriate, apply the following measures to reinforce financial stability: State guarantee, redemption of bank assets, State participation in the bank capital, as well as expropriation of bank stocks for public needs.

In line with EU recommendations as well as the Memorandum of Understanding on Co-operation between Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross-Border Financial Stability, in force as of 1 June 2008, Resolution No 1253 of the Government of the Republic of Lithuania of 24 November 2008 on the Approval of a Plan for Financial Crisis Prevention and Management (*Valstybės žinios* (Official Gazette) No 140-5549, 2008) set up a Standing Commission on Financial Crisis Prevention and Management and approved a Plan for Financial Crisis Prevention and Management, which will allow the institutions concerned, upon manifestation of the first signs of a financial crisis, to exchange information quickly and efficiently and will help to secure stability of the financial market. Apart from that, on 28 December 2009, the Ministry of Finance as well as the authorities supervising financial institutions and insurance undertakings, namely, the Bank of Lithuania, the Securities Commission and the Insurance Supervisory Commission, signed an agreement on cooperation and information exchange in the sphere of financial crisis prevention and management. The agreement will enable the Ministry of Finance and other authorities, on the basis of the information supplied by supervisory institutions, to monitor the condition of the financial sector, to comprehensively assess the risk factors and threats to financial sector stability and State finances and, where appropriate, to secure the public interests and State finances from the negative consequences of a financial sector crisis, and to take steps to strengthen the financial sector stability and reliability.

Restitution of real estate ownership rights

38. The funds requirement for the purposes of restitution of real estate ownership rights of citizens to surviving residential buildings, parts thereof or apartments as well as payment of compensations to religious communities for the real estate being repurchased by the State amounted to LTL 79.8 million on 1 January 2009. An amount of LTL 20 million was earmarked for the fulfilment of this obligation in the State Budget of 2009 and LTL 29.6 million in the State Budget of 2010. Another LTL 30.2 million will be required in 2011. LTL 158.4 million was used for restitution of the ownership rights of citizens and religious communities to surviving real estate in 2008.

Resolution No 817 of the Government of the Republic of Lithuania of 15 July 2009 on the Submission to the Seimas of the Republic of Lithuania of the Draft Law of the Republic of Lithuania on Compensations for the Real Estate of the Jewish Communities (*Valstybės žinios* (Official Gazette) No 90-3887, 2009) approved the Draft Law of the Republic of Lithuania on Compensations for the Real Estate of the Jewish Communities and submitted it to the Seimas of the Republic of Lithuania. The draft law provides for payment of compensations for the real estate of the Jewish communities in the 2011-2013 period. As a result, the adoption of this law will increase State obligations as of 2011 in relation to restitution of ownership rights, however the compensation to be paid to the Jewish communities will not exceed LTL 128 million.

Comparison with previous plan

39. GDP projections have been revised to reflect the actual figures of the nine months of 2009 announced by the *Statistics Lithuania* and the emerging trends in economic development.

General government deficit and debt projections have been made according to ESA'95. The 2010-2012 targets for the general government balance indicator have been adjusted due to major economic development changes in 2009, the changed central economic development scenario as well as the deepening recession in 2009. The structural general government indicator and GDP worsened as a result of emergence in 2008-2009 of the risk of losing cyclical income due to a sharp increase in the external imbalance, as anticipated in the previous programmes. This risk was assessed with regard to the shortcomings of the methods of calculation of the structural government indicator.

Table 12. Change in GDP, general government deficit and general government debt projections compared to the Convergence Programme of Lithuania of 2008

Indicator	ESA'95 code	% of GDP				
		2008	2009	2010	2011	2012
1. 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
Decrease (-) / Increase (+)		-0.7	-10.2	1.8	-1.3	N.A.
2. General government net lending(+)/borrowing(-):	EDP B.9					
Previous update		-2.9	-2.1	-1	0	N.A.
Current update		-3.2	-9.1	-8.1	-5.8	-3
Decrease (-) / Increase (+)		-0.3	-7	-7.1	-5.8	N.A.
3. General government gross debt:						
Previous update		15,3	16,9	18,1	17,1	N.A.
Current update		15,6	29,5	36,6	39,8	41
Decrease (-) / Increase (+)		0,3	12,6	18,5	22,7	N.A.

Sources: Department of Statistics, Ministry of Finance

Due to higher than cyclical contraction of the economy, the general government debt in 2009 went up 12.6% of GDP compared with the previous update.

V. QUALITY OF GENERAL GOVERNMENT FINANCES

40. With the aim of reorganizing the strategic planning system, Resolution No 210 of the Government of the Republic of Lithuania of 18 March 2009 Amending Resolution No 827 of the Government of the Republic of Lithuania of 6 June 2002 on the Approval of the Methodology for Strategic Planning was adopted (*Valstybės žinios* (Official Gazette) No 36-1378, 2009). With respect to the provisions of the Programme of the Government of the Republic of Lithuania, the said resolution updated the procedure of consideration of strategic plans, i.e. it improved the scheme of drafting and deliberation of a draft State Budget (as well

as draft strategic activity plans) and strategic planning forms, also modifies the regulation of programme assessment and preparation of assessment criteria.

Drafting of the Law on Approval of Financial Indicators of the State Budget of the Republic of Lithuania and of Municipal Budgets of 2010 was intended to optimize the number of State Budget appropriation managers and prepared programmes. The State Budget of the Republic of Lithuania of 2010, adopted by the Seimas of the Republic of Lithuania, reduced the number of State Budget appropriations managers by 30, compared to the year 2009.

Moreover, to ensure efficient use of State Budget resources, the Law of the Republic of Lithuania amending Articles 2 and 4 of the Law on Budget Structure was drafted and adopted on 22 October 2009 (*Valstybės žinios* (Official Gazette) No 134-5831). Under this law, appropriations may be allocated only to those budgetary establishments and other entities receiving budget funds that are entitled to budget funds in accordance with the laws governing their area of activities or resolutions of the Government of the Republic of Lithuania passed in line with the directly applicable EU legislation and treaties setting the procedure for the administration of financial assistance extended to Lithuania by the EU or individual states.

To ensure the publicity and transparency of budgeting, the information related to the 2010 budget is published on the website of the Ministry of Finance.

41. One of the priorities of the activities of the Government of the Republic of Lithuania in 2010 (Decision of the 14 October 2009 meeting of the Government of the Republic of Lithuania, Item 8 of Minutes No 78) is further consolidation of public finances and efficient use of resources through the introduction of a results-oriented management model. The plan for the year 2010 in this area is to:

41.1. reorganize the strategic and budgetary planning system and principles aiming for higher efficiency and rationality of expenditure in view of specific intended results:

41.1.1. improve the strategic planning system, i.e. to ensure its transparency and clarity as well as implementation of the political priorities of the Government of the Republic of Lithuania;

41.1.2. ensure that the objectives, tasks and assessment criteria of financed programmes are linked with results;

41.1.3. link the assessment and promotion of the activities of appropriations managers with the results of implemented programmes as well as efficiency of use of appropriations;

41.1.4. publish as extensive information on budgetary expenditure as possible;

41.2. enhance tax administration and reduce the scope of shadow economy.

42. 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 Eurostat, public administration expenditure in Lithuania edged down to 3.9% of GDP in 2008 (this indicator was 4% of GDP in 2007). 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	
		2008	2012
1. General public services	01	3.9	
2. Defence	02	1.4	
3. Public order and safety	03	1.9	
4. Economic affairs	04	4.5	
5. Environmental protection	05	0.9	
6. Housing and community amenities	06	0.4	
7. Health care	07	5	
8. Recreation, culture and religion	08	1.1	
9. Education	09	5.8	
10. Social protection.	10	12.4	
11. Total expenditure		37.4	38.8

Sources: Department of Statistics, Ministry of Finance

General government expenditure

Objectives

43. State budget expenditure targets and priorities of the Republic of Lithuania are defined in a number of strategic documents 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.

44. The National Agreement stipulates the necessity to reduce public administration expenditure. The National Agreement provides for a differentiated reduction of the wages of State politicians, judges, State officials and public servants by an average of 10% on a temporary basis, for the period from 1 August 2009 to 1 January 2011. Also temporarily, from 1 September 2009 to 1 January 2011, the wages of the employees of budgetary institutions and organizations have been reduced by 8% on average. In addition, the agreement intends to increase the efficiency of budgetary expenditure management aimed at consistent transition to the State Budget expenditure planning principle, according to which State budgetary expenditure is managed while pursuing specific objectives and conducting result achievement monitoring; to accelerate the implementation of the decisions adopted by the Sunset Commission and by the Sunrise Commission, to dedicate major attention to the reform of public institutions that do not provide public services yet receive funding from the State Budget; and to make sure that in the future public institutions are not financed directly from the State Budget and that the State does not become a founder of public institutions.

General government revenue

Tax reform

45. 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.

46. In the sphere of the personal income tax, as of 1 January 2009:

46.1. The health insurance contribution has been separated from the personal income tax as a separate contribution. All types of personal income, except for income from distributed profit, shall be taxed at a 15% rate. Income from distributed profit shall be taxed at a 20% rate.

46.2. The tax-exempt minimum (hereinafter referred to as TEM) 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 over the tax period. Furthermore, an additional fixed TEM shall be applicable to citizens with children and to the disabled.

46.3. The sectoral exemption for agricultural activities has been abolished.

46.4. The list of permissible deductions from income has been shortened (the exemption in respect of the interest paid on loans taken out for building or acquisition of housing as well as the exemption in respect of acquisition of personal computers and/or internet access has been withdrawn).

47. As regards the corporate income tax:

47.1. As of 1 January 2009:

47.1.1. The basic corporate income tax rate for 2009 has been raised from 15% to 20%.

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

47.1.3. Sectoral exemptions for credit unions, the Central Credit Union as well as undertakings engaged in agricultural activities have been abolished.

47.1.4. The corporate income limit which, if not exceeded, does not impose an obligation of advance corporate income tax payment has been raised from LTL 100 000 to LTL 1 000 000 as of 1 January 2009.

47.2. As of 1 January 2010:

47.2.1. The corporate income tax rate applicable to small businesses (with an average listed staff of up to 10 employees and with a tax period income of up to LTL 500 000) has been reduced to 5%, compared to 15% applicable to all other businesses.

47.2.2. No taxes shall be levied on interest paid to foreign entities registered or otherwise organized in a state of the European Economic Area or in a state with which an agreement on avoidance of double taxation has been signed and is effective.

47.2.3. More favourable conditions of deducting tax-related losses from income have been established for undertakings and groups of undertakings.

47.2.4. Benefits gained by employees which are an object of the personal income tax are treated as expenses reducing the taxable corporate profit.

48. The excise rates in respect of fuel, ethyl alcohol and alcoholic beverages were raised as of 1 January 2009. In 2009, the excise rates for cigarettes were increased to the

minimum tariffs laid down in the EU *acquis*. As of 1 August 2009, the excise rate for diesel fuel was reduced to the permissible minimum for Lithuania according to EU directives. As of 1 January 2010, the excise exemption in respect of mandatory addition of biofuel to fuel was abolished.

49. 2009 saw a gradual increase of the standard rate of the VAT from 18% to 19% as of 1 January 2009 and from 19% to 21% as of 1 September 2009. The reduced VAT rates previously applicable in Lithuania have been abolished, save for a few temporary exemptions.

50. The National Agreement envisages drafting of guidelines for the introduction of the real estate tax over the year 2010.

VI. SUSTAINABILITY OF GENERAL GOVERNMENT FINANCES

51. Long-term sustainability of public finances represents a problem for EU countries, aggravated by the current crisis. As a result of the economic crisis, the sustainability disparities widened in many countries, including Lithuania. Thus, securing long-term sustainability is a major challenge. To achieve long-term sustainability of public finances, it is extremely important to reduce the general government deficit and debt, to increase employment and to proceed with the reform of the social security system.

Social security system reform

52. The current social security system of Lithuania suffers not only from long-term effects of the economic crisis (contributions insufficient to match the benefits, rising unemployment, inadequate commitments undertaken in the past), but also from long-term structural problems (inconsistent tax base, ageing society). In response to that, the Government of the Republic of Lithuania will undertake a long-term reform of State social insurance and State social benefits in the first half of 2010 with the aim to enhance the transparency of the said system and its links with the real economic condition and to achieve long-term stability and reliability of the system. Implementation of the reform should take place starting with the year 2011. Reorganization of the social security system must include the following steps:

52.1. The benefits from the budget of the State social insurance fund must be linked to its real revenues, while taking into account the demographic changes in the country and providing for an obligation to form a separate reserve fund of the pension system once economic growth resumes in order to mitigate the consequences of a possible economic recession in the future.

52.2. To simplify the system of social benefits, i.e. to increase its clarity and transparency, to reduce the number of benefits, while preventing the duplication of the benefits from the budget of the State social insurance fund and those from the State budget and encouraging the recipients to contribute to the welfare of the country.

52.3. To separate the social assistance elements from social insurance, thus expanding the funding base without limitation to social insurance contributions.

52.4. To encourage residents to remain in the labour market longer with regard to life expectancy by way of calculating the benefits and gradually increasing the old-age pension limit for men and women to 65 years.

52.5. To develop an effective control system preventing possible abuses related to both social contributions as well respective benefits.

Health care system reform

53. The network of health care institutions is too large, lacking specialization, while the number of hospital beds per 1 000 residents is one of the highest in the EU. The objective of the Government of the Republic of Lithuania is to create a reliable and efficient system of health care. For that purpose, it is necessary to proceed with the health care system reform with a primary goal to reduce the volume of in-patient services, while directing the available funds to primary health care, out-patient aid, as well as day inpatient and nursing services, and to redirect health care specialists to outpatient and day surgery services.

54. The Programme for Stage Three of Restructuring of Health Care Institutions and Services, approved by Resolution No 1654 of the Government of the Republic of Lithuania of 7 December 2009 (*Valstybės žinios* (Official Gazette) No 150-6713, 2009), consists of two parts: optimization of the network of health care institutions and restructuring of health care services.

It is proposed to divide in-patient treatment institutions into three strictly defined levels providing services without duplicating each other: district level, regional level and national level hospitals. District-level hospitals would provide the minimum services, while regional-level hospitals would render a much broader range of services. Treatment of all the most difficult and complicated cases requiring advanced technologies and physicians of narrow specialization would be concentrated in national-level hospitals.

This reorganization of the network of medical institutions is expected to save LTL 206 million, cut the administration costs, optimize the costs of provision of laboratory, radiological examination and sterilization services as well as maintenance costs, increase the efficiency of using investment funds etc. Uniting hospitals into larger legal entities would reduce the number of institutions providing health care services (by 24).

Health care services will be restructured according to the following main criteria: the number of major surgeries per calendar year, the number of deliveries per calendar year, and the geographical distance to the nearest hospital. The economic effect of the restructuring of health care services is estimated at LTL 137 million of the funds allocated to the health sector. Pursuant to the service purchase criteria, there are plans to reduce the number of services purchased from the resources of the budget of the Mandatory Health Insurance Fund and provided by inpatient departments of 30-40 national hospitals. Resolution No 1654 of the Government of the Republic of Lithuania of 7 December 2009 obligates the Ministry of Health to carry out, in 2010 and 2011, an analysis of the results of implementing the Programme for Stage Three of Restructuring of Health Care Institutions and Services, to evaluate them and, pursuant to the criteria laid down in the said programme as well as the analysis results, to upgrade the division of hospitals into levels, the list and the volume of services provided, as well as the procedure of payment for them.

55. The main criteria for the implementation of the objectives and tasks of stage three of the restructuring are the following:

55.1. change in the satisfaction with health care service quality and safety among the residents, patients and medical personnel;

55.2. development of the services of primary personal health care services and increase of funding;

55.3. an increase in the volume of outpatient health care services by at least 5%;

55.4. an increase in the volume of day inpatient health care services by at least 8%;

55.5. a decrease in the hospitalization rate per 100 residents to 18.

56. According to the plan, restructuring of the health care system will include introduction of additional (optional) health insurance providing patients with the right of choice.

Education reform

57. A new version of the Law of the Republic of Lithuania on Science and Studies passed by the Seimas of the Republic of Lithuania on 30 April 2009 (*Valstybės žinios* (Official Gazette) No 54-2140, 2009) lays down foundations for a systematic reform of science and studies. To modernize science and studies, provide for better quality of studies, ensure equal access to higher education for the citizen, and provide conditions for best specialists to engage in research and pursue professional and personal development, the system of funding for studies and student support framework have been reorganised and the status and governance model of science and studies institutions was changed. As of 2009, studies in higher education establishments have been funded from the so called student‘s basket. The number of entrants to higher education establishments is in line with the financial possibilities of the state. Actual studies are funded from public and private funds. To ensure access to studies and take into account limited public financial resources, a state-sponsored loan scheme has been developed, which also involves private credit institutions. Students who failed to get enrolled in state-funded places, as of 2009, have been provided with a possibility of taking a state-sponsored loan to cover their tuition. Students are also provided with social and incentive grants. Higher education schools are being transformed into public institutions with a higher degree of autonomy.

58. To make science more competitive, the focus is on project-based competitive funding for research. The development of science and technologies, cooperation between universities and businesses, scientific cooperation and public-private partnership are still of great relevance, therefore much attention is given to the advancement of the integrated centres (valleys) for science, studies and business.

59. The demographic changes, in the long run, will affect the system of education as well: the falling number of the population and children for that matter, the current network of

schools turns out to be inefficient, and, as a result, calls for restructuring, addressing schoolchildren commuting problems as well as other issues in relation with access to education.

Impact of Aging society to general government finances

60. Long-term sustainability of general government finances is affected by changes in the demographic structure of the population. The Programme includes an integrated budgetary projection of sustainability of general government finances (hereinafter referred to as the projection) that makes it possible to assess the impact of demographic developments on the long-term sustainability of the pension system, health care system, and education system, and to provide for appropriate actions securing stability of these systems in the future.

The Projection is based on the demographic projection for Lithuania for the period until 2060, done by Eurostat in 2008. According to this Projection, Lithuania's population is to shrink to 2.5 million (from 3.4 million) or by 24% in the period from 2009 to 2060. Moreover, the same period will see a marked decline in the number of children: the number of those aged between 0 and 14 will drop from 15% in 2009 to 12.4% in 2060, and those aged between 15 to 19 years of age: from 7.6% to 4.4% of the total population. The number schoolchildren (7-16) will drop over 40% (from 384.5 thousand in 2009 to 220.1 thousand in 2060) from 2009 to 2060. The number of people of working age (15–64) will reduce from 58.6% to 41.4%, whereas the number of elderly people (65+) will grow from 16% to 32.7%.

61. Table 14 below gives projections on long-term expenditures of public finances (pensions, health care and education systems) for the period until 2060. The projections have been made under the assumption of non-changing policy post-2012, and on the basis of medium-term economic and employment projections by the Ministry of Finance, as well as employment and economic assumptions 2013-2060 by the Economic Policy Committee. The projections build on the valid Lithuanian social security legislation. The period of projections has been extended to 2060.

Table 14. Long-term sustainability of general government finances

Indicator	% of GDP					
	2008	2010	2020	2030	2050	2060
1. Total expenditure	37.4	44.3	34.5	35.6	36.8	38
of which: age-related expenditure:	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 pensions	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 (in general government)	–	–	–	–	–	–
health care	5.1	7.3	5.3	5.5	6	6.1
long-term care	0.6	0.9	0.6	0.7	1	1.1
Education expenditure**	5	5.9	5	5	4.2	4.3
Other age-related expenditure***	0.1	0.4	0.1	0.1	0	0
Interest expenditure	0,6	1.9	2.2	3.8	7.6	9.9
2. Total revenue	34.2	36.2	35.8	35.8	35.8	35.8

Indicator	% of GDP					
	2008	2010	2020	2030	2050	2060
of which: property income	0.6	0.6	0.6	0.6	0.6	0.6
of which: from pensions contributions (or social security 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*****	2	3.9	14.2	26.1	55.6	69.9
3. Assumptions						
Labour productivity growth	0.5	4.6	3.3	2.7	1.7	1.7
Actual GDP growth	2.8	1.6	2.5	1.5	0.2	0.4
Participation rate males (aged 15-64)	71.4	73.4	73	70.4	68.9	69.4
Participation rate females (aged 15-64)	65.7	67.2	69.2	67.8	66.3	66.9
Total participation rate (aged 15-64)	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 (beginning of the year)	15.8	16.1	18.1	22.8	27.4	32.7

Sources: Statistics Lithuania, Ministry of Finance, Ministry of Social Security and Labour, Ministry of Education and Science, and Ministry of Health, Economic Policy Committee.

*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.

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

62. 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 2008, approved by Resolution No 30 of the Government of the Republic of Lithuania of 21 January 2009 (*Valstybės žinios (Official Gazette)* No 10-372, 2009), table 14 reveals an increase of 1,4% of GDP in pension spending in 2050 due to the following:

62.1. the revision of national accounts;

62.2. new demographic and macroeconomic assumptions 2007-2060 marked by the following essential differences: slower actual growth of the GDP, falling index of labour force participation, rising dependency of the aging population, longer life expectancy and growing negative migration;

62.3. the effect of the economic crisis in the short term (particularly on GDP, unemployment and emigration), which has a long term impact on the pension system.

63. 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 2008 to 2060, pension spending will grow by 4.2% of the GDP, health care spending by 1.0% of the GDP, while education spending will come down by 0.7% GDP. The unemployment benefit spending is expected to reduce by half in proportion to unemployment projections; however, the recession period (2009-2012) will require particularly large spending on unemployment. In general, age-related spending is projected to grow by 5.0% of the GDP.

64. Pension spending is likely to grow the fastest, though it will be mitigated by the pension reform launched in 2004, and the subsystem of voluntary pension accumulation (Pillar II of Tier I of state social insurance pension scheme) providing for a part of mandatory state social insurance contributions to be shifted to private pension funds. In 2009, thanks to the successful implementation of the reform, there were 956 thousand participants to the pension accumulation system (71.5% of all the insured by the state social insurance). 43 thousand new pension accumulation contracts were signed in 2009 alone, therefore, the expectations are that in 2010 the number of those who opt for this kind of saving will reach 997.7 thousand (74.5% of all insured by the state social insurance).

65. In 2009 and 2010, contributions to pension funds will reduce up to 0.5% and 0.4% of GDP respectively, as the state social insurance pension contribution rate has been temporarily brought down from 5.5% to 2% for 2009-2010 in order to carry out the Government Programme and deliver on the pending commitments of the State Social Insurance Fund. For this reason, the pension funds will be transferred a larger accrued contribution of 6% during the three successive years from 2012 to 2014. It has been projected that in 2011, when pension accumulation rate reaches again 5.5%, the pension funds will recover its 1.1% share of the GDP, and in 2012, the social insurance pension contribution will amount to 1.3% GDP.

66. With a view to stabilizing the growing deficit of the state budget and the budget of the State Social Insurance Fund, and to ensure that during the crisis period benefits are paid on time to the most vulnerable population groups, in December 2009, a decision was taken to temporarily reduce all social benefits from 2010 to 2012, thus maintaining minimum social guarantees.

67. In 2010, pensions, which account for the largest share in the allocations of the budget of the State Social Insurance Fund, are to be reduced depending on the size of the income (pensions and insured income (of employed pensioners) so as to protect the minimum pension beneficiaries; and beneficiaries of larger pensions or other income are expected to show solidarity while assuming larger cuts on their pensions. A minimum pension has been established which prevents further reductions. Additional state pensions are also subject to reduction. Temporarily, total amount of public social insurance and other social benefits per person should not exceed 1.3 of the average monthly earnings in the national economy. Other previously planned measures that increase pension spending, such as a new pension calculation scheme and new public pension recipient groups (mothers with many children), have been postponed for two years. It is estimated that the measures of this particular pension

category should save 0.76% GDP in the state social insurance budget and 0.09% in the State budget.

68. Maternity (paternity) allowances that have already been allocated, shall be subject to temporary cuts of 10% as of 1 July 2010. Minimum amount will be applicable, and further reductions will not be allowed.

69. In 2009, child benefit scheme was rearranged to prevent duplication of maternity (paternity) allowances and ensure that the said payments are maid only to those families which raise pre-school children.

70. All these measures are expected to save 0.85% GDP in State Social Insurance Fund and 0.82% GDP in State Budget.

71. Due to the current demographic developments, education spending is projected to be cut from up to 5.0% GDP in 2008 to 4.3% GDP in 2060. However, due to further implementation of structural reforms in education: science and studies, the network of pre-school and comprehensive schools, the infrastructure of vocational training establishments, spending on education should not be further reduced in the short term (until 2012) making approximately 5.7% GDP. There is a risk, however, that the implementation of the political aims laid down in the Action Programme Implementing the Provisions of the National Education Strategy 2003-2012 (further implementation of education system – science and studies, preschool, primary and secondary education system, professional apprenticeship infrastructure – structural reforms) approved by Resolution No 82 of the Government of the Republic of Lithuania of 24 January 2005 (*Valstybės žinios (*Official Gazette) No 12-391, 2005) might increase education spending to 6% (GDP) in 2060.

72. In 2008-2060, the total general government spending will increase by 0.6 percentage points of GDP, from 37.4% of GDP in 2008 to 38% of GDP in 2060. Non-age-related spending, which was fixed and held constant at the level of 2012, will come down by 4.3 percentage points of the GDP. Public revenues will grow by 1.6 percentage points of the GDP: from 34.2% GDP in 2008 to 35.8% GDP in 2060.

VII. INSTITUTIONAL FEATURES FOR THE IMPROVEMENT OF GOVERNMENT FINANCES

73. The Programme provides for the following:

73.1. Introduction of the rules of fiscal discipline aimed to prevent political economic cycles. The Annex provides information on budgeting system reform aimed at greater transparency of budget economic policy and crisis prevention. The Annex presents problems related to budget drafting and implementation, which impede implementation of crisis prevention measures 2008–2009, and introduces conceptual solutions to deal with the problems.

73.2. Implementation of the government accounting reform. As a result of the reform, achieving not only greater transparency in public finances but also better efficiency in the public sector (in the first place, centralizing regional units servicing public institutions with regional units).

73.3. Development of government statistics, providing a possibility for the public to analyze and assess effectiveness of the use of public finances.

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

73.5. Restructuring of the strategic planning system by shifting the focus on results.

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

VIII. CONSISTENCY OF LITHUANIA'S CONVERGENCE PROGRAMME FOR 2009 WITH NATIONAL LISBON STRATEGY IMPLEMENTATION PROGRAMME FOR 2008-2010

74. 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:

74.1. Implementation of structural reforms is based on measures laid down in the Programme of the Government of the Republic of Lithuania and the National Lisbon Strategy Implementation Programme for 2008-2010. Following the EU 2020 strategy and the new Integrated Guidelines that are to be approved by the European Council in 2010, the new national structural reforms programme is planned to be drafted, which will take into account recent macroeconomic trends having an effect on the implementation of structural reforms.

This Programme has been drafted following the central scenario for the economic development published by the Ministry of Finance in February 2010.

74.2. The reflection of the impact of the structural reforms on the budget in the Programme: the direct impact of Lisbon measures on the budget balance has been taken into account by calculating government financial indicators covered in this Programme. The impact of structural reforms on the budget is illustrated by Table 15, which shows annual developments from 2009. The amount of funds allocated for the reform is presented for the year 2008.

Table 15. Direct impact of major structural reforms on public sector finances

(Increased spending or decreased revenues (+); decreased spending or increased revenues (-)

Major structural measures	Spending/ revenue category (according to ESA'95)	2008		2009		2010		2011		2012	
		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	16.03	0.01	279.63	0.3	455.78	0.49	-21.93	-0.02	2.46	0
2. Healthcare reform[2]	intermediate consumption and gross fixed capital formation	0	0	3.5	0	57	0.06	14.5	0.01	-7	-0.01
3. Taxation reform[3]	direct tax-driven revenues	800	0.72	-91	-0.1	289	0.31	75	0.08		
	indirect tax-driven revenues	-468	-0.42	-1407	-1.52	-686	-0.73	-461.5	-0.47		
4. Environment[4]	intermediate consumption	120.7	0.11	644.59	0.7	-379.6	-0.4	-153.72	-0.16	19.73	0.02
5. Measures encouraging industry, commerce and innovations[5]	intermediate consumption and gross fixed capital formation	6.38	0.01	-2.34	0	-1.72	0	-0.98	0	-0.71	0
6. Upgrading or building new infrastructure for transport and communications[6]	gross fixed capital formation	433.05	0.39	561.31	0.61	344.54	0.37	-286.98	-0.29	-183.66	-0.18
7. Implementation of social, youth and labour market reforms**[7]	intermediate consumption	629.93	0.57	-419.53	-0.45	64	0.07	-100.03	-0.1	-24.66	-0.02
8. Agriculture[8]	grants, intermediate consumption and gross fixed capital formation	3335.6	3	3.5	0	-725.2	-0.77	517.5	0.53	-174.8	-0.18
Overall direct impact on budget		4873.69	4.38	-427.34	-0.46	-582.19	-0.62	-418.13	-0.43	-368.64	-0.37
Pension reform: social contributions (D.61 – contributions to private pension funds)		1114.99	1	-659.7	-0.7	-121.19	-0.09	604.36	0.72	192.92	0.23

Sources: Ministry of Finance, Ministry of Social Security and Labour, Ministry of Education and Science, Ministry of Health, Ministry of Agriculture, Ministry of Environment, Ministry of Transport and Communications

*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 15, 16, 17, 18, 19, 21, 22, 30, 94.1, 96.1, 96.2, 111, 112, 113, 114, 115, 117, 118 of 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).

[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 (Law on Value Added Tax, Law on Excise Duty, Law on Lottery and Gaming Tax, Law on Personal Income Tax, Law on Corporate Income Tax).

[4] Measures 67, 68, 69, and 73 of the National Lisbon Strategy Implementation Programme for 2008-2010.

[5] Measures 24, 25, 26, 31, 32, 33, 34, 35, 38, 39, 40, 41, 42, 44, 45, 50, 51, 53, 54, 55, 56, 57, 58, 60, 65, 66 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 14, 95, 96.5, 97.1, 97.2, 98.1, 100.1, 100.3, 103.1, 103.6, 106.1, 106.3, 107.1, 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).

Annex to the Convergence
Programme of Lithuania of 2009

CONCEPTUAL SOLUTIONS OF THE REFORM OF BUDGET PLANNING AND EXECUTION FRAMEWORK TO INCREASE BUDGET POLICY TRANSPARENCY AND PREVENT CRISES

Vision: development of such a budget deficit planning, approval, performance monitoring and result evaluation system which would make the prudent budget policy rules a publicly supported moral value of civic society. The key goal of the reform is to create necessary conditions for the establishment of civil society which would control and guarantee that the prudent budget policy rules are properly respected. The reform aims at accommodating the interests of active citizens to avoid additional taxes, which will increase if no measure is taken to prevent repetition of an imprudent budget policy that resulted in higher debt servicing expenses of the public sector. The implementation of the reform would facilitate active citizens to support responsible politicians, who take care of the financial sustainability of the public sector and stability of economic growth: mass media would regularly receive clear information on the public budget funds allocated for the maintenance of economic stability, the implementation of those plans during the year and allocation prospects for the medium term. The reform aims at providing concise and generalised information on the prospects for stabile financing of the state functions and the long-term impact on the future taxation level against current large quantity of public information on the general government sector finances. Therefore the budget indicators, measuring the impact of the budget on inflation and employment, should be clearly defined; information thereof should be public, renewed on a regular basis and consistently evaluated by the professionals independent of executive authority. The continuity of the system should be assured by the responsibility of politicians and the civil servants of political trust in control of the budget preparation and implementation. The vision builds on the effective international experiences.

The Mission: to meet the provisions of the Constitution of the Republic of Lithuania: the provision of Article 5 that “state institutions shall serve the people” and the provision of section 1 of Article 94 that “the Government of the Republic of Lithuania ... shall protect the inviolability of the territory of the Republic of Lithuania, guarantee State security and public order”. To secure stability of economic growth that was lost due to failure to allocate the state budget funds for demand management of aggregate demand in the period 2004-2008 and subsequently causing the crisis that brings about the social exclusion of the citizens of the Republic of Lithuania, increases in tax rates, cutbacks in funding – ignoring strategic planning principles – for national defence, social care, public order and other areas strengthening national security. In compliance with a new legislation regulating budgeting rules, to provide systematic allocation of funds with the aim of implement the following guiding principles of the Treaty on the Functioning of the European Union (OL 2008 C 115, p. 1): stable prices, sound public finances and monetary conditions and a sustainable balance of payments.

CONCEPTUAL SOLUTIONS TO THE CHALLENGES OF BUDGET PREPARATION AND IMPLEMENTATION SYSTEM

No.	Shortcomings Preventing Macroeconomic Stability	Conceptual Solutions	Comments
1.	At present, the budget planning procedure does not foresee indicators controlling its macroeconomic impact on inflation, employment, external balance, risk premium, structural condition of public sector finances and the future taxation level. The state budget does not foresee an option to plan allocations for the maintenance of economic stability and thereby guarantee efficient, stable and strategic funding of all other state functions, irrespective of the fluctuations of economic indicators. The guarantee of macroeconomic stability and stable funding of state functions impervious to the fluctuations of economic indicators in the medium term has never been set as the goal of the budget project, though it is the sole instrument under the arrangement of the Currency Board. For the last decade, the responsibility to secure macroeconomic stability and economic development lay with the Ministry of Finance, but it had no opportunity for the planning of such allocations: allocations for the anti-inflationary demand management policy cannot be transparently planned and effectively implemented under the provisions of the current Organic Budge Law of the Republic of Lithuania.	Define new indicators: fiscal stance (budget policy stance), fiscal impulse (impulse to budget policy stance). The surplus in the balance of the general government sector during the economic upturn and positive fiscal impulses should ensure the flow of funds into fiscal reserves that could be used to stimulate national economy, to increase employment and to finance stable national defence, social care, public order and other areas strengthening national security during the time of economic recession. While planning a state budget, introduce an obligatory rule to submit information on the tax increase risk indicator, showing how a state budget provides for the long-term welfare of citizens and secures stability of tax rates each year.	Such indicators are used by the Finance Ministry of New Zealand and the International Monetary Fund as it exerts financial surveillance. Future tax increase indicator is used in EU fiscal surveillance.
2.	At the moment, there is no automatic binding obligation to implement an anti-inflationary budget policy ensuring the stability of economic growth and meeting the convergence criteria, despite Lithuania's participation in the second Exchange Rate Mechanism (ERM II) for 5 years and the 15 year-long functioning monetary policy system based on a fixed national currency rate vis-à-vis the basic currency.	The output gap indicator is defined, it automatically leads to a legislative obligation to plan and implement a plausible anti-inflationary budget policy. Introduction of public discussions of non-governmental independent institutions on the evaluation of other inflationary factors and the procedure of coordination of possible and flexible political actions.	The instrument is a novelty as it validates a prudent approach to varying indicators. A part of analysis shows that budget discipline rules are reliable only if they are responsibly flexible.
3.	Absence of public and independent monitoring of the general government sector balance indicator, fiscal stance and fiscal impulse. It is not foreseen that the accountable civil servant of the highest political trust of the	The Seimas of the Republic of Lithuania is delegated to initiate the procedure of a quarterly control of implementation of targeted state budget balance indicator, fiscal stance indicator and fiscal impulse: institutions independent of executive authority forward independent conclusions	Quarterly monitoring system is applied in Australia, while the yearly monitoring system is in use in the United Kingdom (top official submits a budget

No.	Shortcomings Preventing Macroeconomic Stability	Conceptual Solutions	Comments
	Ministry of Finance should regularly submit to the Seimas of the Republic of Lithuania the report on the budget policy continuity and the implementation of targeted general government sector balance indicators. The Treaty on the Functioning of the European Union specifies international commitments of Lithuania regarding the compliance with the reference values of the general government sector balance indicator; however, the current Organic Budget Law of the Republic of Lithuania does not provide for planning of funding to meet those commitments and the national control of the implementation of funding thereof. Lithuania has spent a good amount of funds to build its reputation as a country that adheres to a very strict budget discipline, plans and maintains stable finances; in order to maintain the reputation, it was possible to save by borrowing money at a low interest rate, but Lithuania's reputation is not considered as the equivalent to public property and is not treasured, though a good name is an asset in the company accounting practice.	regarding the expected results of implementation of the policy and planned indicator targets. The same principle guides the arrangement and evaluation of yearly results as well as additionally reports on the implementation and prospect of the targeted performance of the Ministry of Finance. Lithuania's reputation, as the country's that adheres to a very strict budget discipline, plans and maintains stable finances, is treated as an asset. Reputation maintenance indicators are low-rate risk premiums and credit worthiness rated by credit-rating agencies.	balance vision for the medium term and explains why the tasks were not carried out). Brazil applies a pay freeze for civil servants and the Penal Code. In Estonia, the State Audit Office is responsible for fiscal monitoring.
4.	Absence of sanctions for the violations of the rules of the budgetary disciple. Absence of regulations for automatic measures to reduce the losses in case the Seimas of the Republic of Lithuania rejects to approve the draft budget in time.	Finding of responsibility for failure in performance regarding the planned general government sector balance indicators and anti-inflationary policy indicators. Development of Best Alternative To Negotiated Agreement. It would strengthen the negotiating powers of the Ministry of Finance in the process of budget preparation: appropriation managers are obliged to stand ready for the implementation of the provisions of the Constitution of the Republic of Lithuania to freeze expenditure at the last year's level.	Sanctions in developed countries are applied though moral pressure on top civil servants. Developing countries also resort to financial pressure by cutting salaries for civil servants.
5.	Absence of legislative provisions to give a clear definition of the targeted general government sector balance indicators, though the implementation of the provisions of EU treaties and stability of the long-term financing of general government functions is dependent on allocation of funds for the achievement of this indicator.	The targeted general government sector balance indicator in ESA95 and accounting reclassifications, which show a relation between national accounting and ESA95 and clearly demonstrate that the budget allocates enough funds to implement the provisions of international treaties and secure the long-term financing of state functions.	Member States, which are using ESA95, are most accurate in meeting the general government sector balance indicators, thereby assuring stable economic growth and financing of state functions.

No.	Shortcomings Preventing Macroeconomic Stability	Conceptual Solutions	Comments
6.	Non-regulated planning of budget revenues and development of the central scenario of economic indicator projections. Absence of the validation of positive impact of unexpected revenue windfall on the automatic implementation of an anti-inflationary policy.	Validation of planning of revenue windfall raised due to inflation and its use for temporary financial investments, thus implementing an automatic anti-inflationary policy.	Econometric analysis shows that allocation of the unexpected revenue windfall, which was raised due to the economy cycle, for deficit reduction is an efficient instrument to maintain price stability.
7.	Absence of legislative provisions for the binding consideration procedures of the European Commission recommendations to take them into account while approving a state budget; therefore during a budget approval there was no option to allocate funds for the implementation of those international commitments and thereby avoid foreseen sanctions.	Legislation stipulates that the Draft Law on the Financial Indicators of the State Budget and Municipal Budgets of the Republic of Lithuania is submitted to the Seimas together with the conclusions of the Government of the Republic of Lithuania on purposefulness in the implementation of the recommendations or invitations outlined in the latest opinion of the Council of the European Union.	Implementation of the budget policy recommendations of the Council of the European Union that are submitted to Lithuania according the Treaty on the Functioning of the European Union.
8.	At the moment, the use of the unique national terminology of financial accounting prevents public from receiving brief and clear information on the fiscal stance and allocation of funds to meet international commitments.	Logical separation between financing and expenditure is secured. Net borrowing is not to be confused with an increase in debt.	Simplicity of the system and conformity with international standards enhance its transparency.