

/Translation from Lithuanian/

LITHUANIAN FISCAL POLICY

(REVIEW OF THE YEAR 2006 AND PROSPECTS)

**Information for the EUROSAI/OLACEFS conference,
Portugal (Lisbon), May 9-12, 2007**

INTRODUCTION

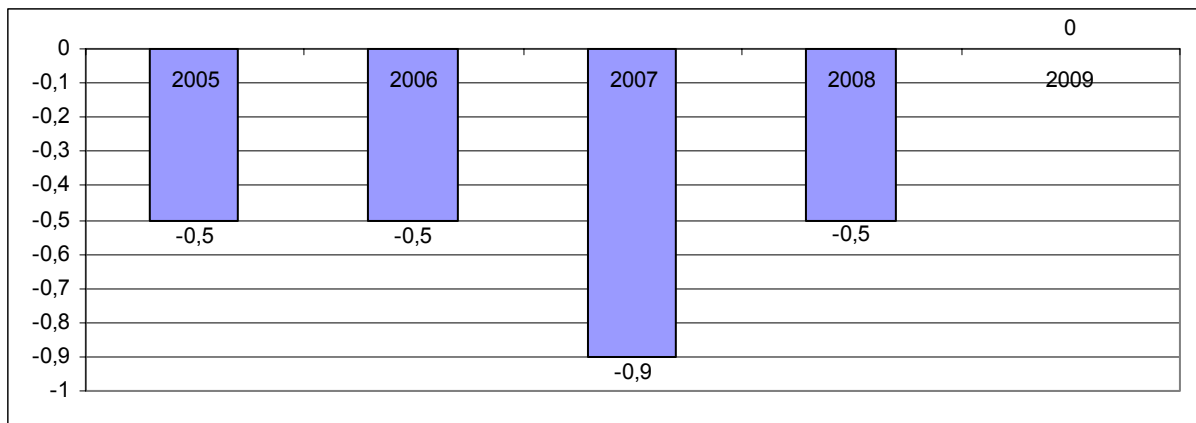
To ensure sustainable compliance of Lithuania's economical ratios to convergence criteria and for Lithuania to become a full-fledged member of the Economical and Monetary Union as soon as possible, following the Pact of Stability and Growth and the Common Economical Policy Guidelines, the Government of the Republic of Lithuania must prepare the Lithuanian convergence program every year (until the euro is introduced). Following the introduction of the euro, Lithuania will draw annual Stability Programs.

LITHUANIAN CONVERGENCE PROGRAM

In December 2006, the Government of the Republic of Lithuania approved of the 2006 Lithuanian Convergence Program ("the Convergence Program"). The Convergence Program was submitted to the European Commission, which gave its assessment of the Program in February 2007.

A suggestion was made that Lithuania should employ economical advantages and go for a more binding governmental sector deficit reduction target in 2007, keep up the deficit reduction rate going for the mid-term objective, using measures that guarantee that the structural balance will be cut down by 0.5 per cent of the GDP year-on-year, just as it is demanded of the members of the euro zone and Exchange Rate Mechanism II, as well as proceed with strengthening the mid-term financial planning and control system for the public sector.

The Convergence Program provides that Lithuania will try to balance the budget in 2009 – that is for the first time that Lithuania is setting such an objective. The governmental sector deficit targets for 2007-2009 as fixed under the Convergence Program satisfy the provisions of the Stability and Growth Pact regulations to observe a rigid fiscal policy.



Picture 1. Deficit of the governmental sector in 2005–2009 (per cent of GDP).

Sources: year 2005 – actual data from the Lithuanian Statistics; year 2006 – preliminary estimate by the Ministry of Finance; years 2007–2009 – the fiscal deficit targets set in the Convergence Program.

Such deficit targets fix a sustainable fiscal policy of the governmental sector, guarantee compliance of the governmental sector deficit to the Maastricht criteria and boost macroeconomic stability, as well as allow conducting structural (pension, healthcare) reforms leading to long-term financial stability and co-financial programs that are supported by the EU. The Convergence Program provides for further implementation of the tax reform to balance out the taxation of labour and capital.

The Convergence Program identifies the target of Lithuania's economic policy to introduce the euro as soon as possible. Lithuania is a member of Exchange Rate Mechanism II to maintain the pre-set rate of exchange between the litas and the euro strictly fixed, and seeks to accede the euro zone as soon as it satisfies the economical criteria for convergence.

MEASURES IN THE FISCAL POLICY AREA

To preserve confidence in the Currency Board, in the fiscal policy field Lithuania is still trying to create favourable conditions for increasing productivity, improving tax administration, promoting investments, creating a business-friendly environment, ensuring rational application of national resources for investments.

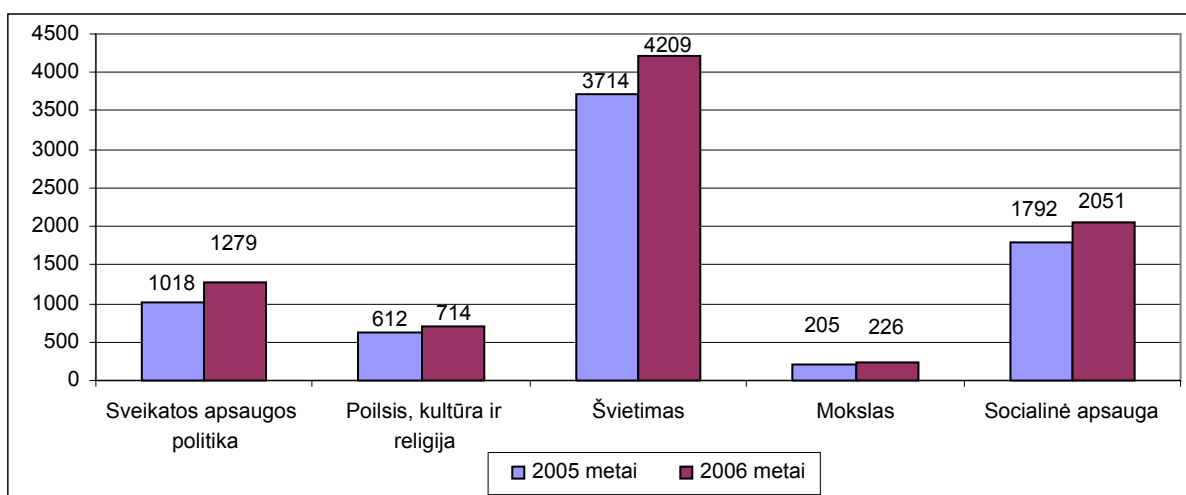
The plans are that extra income of the governmental sector and unused target expenses will be applied to attain the fiscal deficit target and to implement measures that guarantee long-term financial stability of the governmental sector.

In 2006, the average annual inflation rate stood at 3.8 per cent (2.7 per cent in 2005). Over the past few years, the largest element in the gap between the inflation rate and the euro zone inflation rate were temporary external factors: increase in the prices of foodstuffs, transportation services and heating. For instance, the inflation spike caused by the changes in natural gas prices in 2006 totalled some 0.9 per cent. The Lithuanian Currency Board ensures that the average year-on-year inflation rate stays close to the euro zone inflation rate. The plans are that after the period of accelerated inflation, once oil and gas prices have stabilised and the approximation of excise rates to EU standards is complete, the inflation rate in Lithuania will once again approach the euro zone level. The 2006-2008 inflation rate that is caused by the increase in fuel prices and the implementation of the obligations to increase excise rates does not provide a rational basis to start making expectations for inflation and adopting long-term decisions on spending. Other indicators (the debt and the deficit of the governmental sector, long-term interest rates) currently satisfy the Maastricht criteria with an ample safety margin.

In delivering the fixed obligations in the field of finance, national resources are sought to be allocated and used rationally and as intended. Funding of social security, education, science,

healthcare and culture has been increased continuously to ensure the funding of the vital needs of the state.

National budget allocations in the social security area in 2006, as compared to 2005, were increased by LTL 259 million (14.5 per cent) to LTL 2,051 million, in the area of healthcare – by LTL 261 million (25.7 per cent) to LTL 1,279 million, in the field of education – by LTL 495 million (13.3 per cent) to LTL 4,209 million, in the area of culture – by LTL 102 million (16.6 per cent) to LTL 714 million and in the field of science – by LTL 21 million (10.4 per cent) to LTL 226 million.



/Healthcare policy | Recreation, culture and religion | Education | Science | Social security/
 Picture 2. National budget allocations by area (LTL million).

Source – the Ministry of Finance.

Launched in 2005, the reform of the public sector bookkeeping and financial reporting continued into 2006. The goal of the reform is to create legal and administrative conditions for bookkeeping to be organised according to the principle of accrual throughout the public sector. Within the framework of the plan of measures on implementing the reform of the public sector bookkeeping and financial reporting (appendix to the concept of the reform of bookkeeping and financial reporting of the public sector as approved by decision No. 718 of the Government of the Republic of Lithuania dated June 29, 2005), part of the public sector bookkeeping and financial reporting standards, a general standard chart of accounts of the public sector and some of the related draft documents have been prepared.

Lithuania's status with the World Bank officially changed from beneficiary country to donor country in September 2006. On the international scale, this event speaks about Lithuania's high level of development and shapes a favourable image of the country.

Having estimated Lithuania's fiscal policy and stable economical development, the international credit rating agency Moody's in 2006 improved Lithuania's long-term borrowing in foreign currency rating from A3 to A2. As a result, the international credit rating agency Fitch

Ratings adjusted Lithuania's rating of long-term borrowing in foreign currency upwards from A- to A.

At the end of 2006, the state debt stood at LTL 14.94 billion, or 18.2 per cent of the GDP (down by 0.5 percentage point from the year-end of 2005), and with the 60 per cent allowable margin under the Maastricht criteria, it was among the lowest in the EU.

To promote the development of the financial sector, stability and entrance into the EU financial markets, following the EU law, the year 2006 saw amendments being made to the existing legislation and new laws being adopted in the area of regulation of the activities of institutions in charge of supervision of financial services, financial markets, players on such markets and insurance activities.

PRIORITIES FOR THE IMMEDIATE FUTURE

Pursue an austere fiscal policy. To guarantee attainment of economical policy goals over the mid-term period (2007–2009), efforts will be made to cut down the structural deficit so that it stays within the limits of 1 per cent of GDP as of 2008, aiming to have well-balanced or excessive financial resources of the governmental sector when the need for structural reforms abates in the future.

The following measures to achieve mid-term goals of the fiscal policy have been envisaged for 2007–2008:

- seek that the balance of taxation of labour and capital would allow attaining the fiscal deficit target;
- further reduce the negative effects of the shadow economy on the finances of the governmental sector and seek that the target income in 2007 increased by around 0.4 per cent of the GDP as a result;
- seek to apply the spending of the governmental sector as rationally as possible;
- allocate unused target spending to achieve the fiscal deficit target.

Indemnify all of the depositors who used to hold deposits in Soviet roubles. To implement this priority, the plans are that in 2007, 2/3 of the revenue from the sale of Mažeikių Nafta's shares will be applied to restore the savings of the public, compensate the related expenses and indemnify every depositor group as identified in the law on restoration of the savings of the public of the Republic of Lithuania to the full extent over the 1st quarter of 2007. To this end, a total of LTL 1,135 million will be allocated in 2007.

Deliver the obligations of the state to reinstate real estate and pay compensations. This priority has LTL 72 million allocated in the national budget of the Republic of Lithuania in 2007. The remaining amount of LTL 346.3 million designated to cover the obligations of the state to pay compensations for land, forests and water bodies being redeemed by the state, will be disbursed over a period of two years by January 1, 2009.

Gradually reduce the tax burden for the public. To implement this priority, the Government of the Republic of Lithuania intends to mull the matter of further reducing the income tax rate.

Seek that the resolution of the matters of Lithuania's entry into the euro zone is based on a realistic estimate of the country's economical growth and financial stability. Lithuania stands in continuous and close cooperation with officials from the secretariat of the EU Economy and Finance Committee and the European Commission by providing them with information on Lithuania's macroeconomic and financial situation and its outlook.

Carry out effective economical reforms and ensure growth of competitive advantages of business in Lithuania. To implement this priority, the plans for 2007 are to consider the possibilities to apply tax benefits to investments into research, experimental development, high and medium technologies, abridge the profit tax base.

Facilitate investments into the Lithuanian economy by increasing the number of agreements on avoidance of double taxation. To implement this priority, the plans for 2007 are to sign an agreement on avoidance of double taxation with South Korea, launch the second stage of negotiations over a similar agreement with Mongolia and, if possible, enter into negotiations over double taxation avoidance agreements with Mongolia, Macedonia and Tajikistan. In 2007-2009, double taxation agreements are to be signed with India, Thailand and the countries with which negotiations were started in 2007.

Finalise preparations for the application of the 2007-2013 EU structural support: have the draft Lithuanian strategy on application of the 2007-2013 EU structural support and draft programs of the activities to implement it approved by the European Commission, prepare all of the necessary national legislation.

Source of information: the Government's performance report for the year 2006.