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UNITED STATES AGENCY
FOR
INTERNATIONAL DEVELOPMENT

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VILNIUS, LITHUANIA

MODIFIED STRATEGIC PLAN

FY 1997

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MAY 1997

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USAID / LITHUANIA
MODIFIED STRATEGIC PLAN
FY 1996

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Modified Strategy for USAID Assistance to Lithuania: FY 1997-2000

The priority management challenge during the 1997 to 2000 period will be to achieve program results and successfully close-out the USAID program in Lithuania. USAID's unfinished business is to assist the Government of Lithuania (GOL) to complete economic policy reforms in three curical inter-related areas thereby ensuring that USAID meets its program objectives, and to establish a Baltic Regional foundation that will develop the capacity of the non-governmental sector to help sustain gains achieved in the democracy and economic sectors. We also envision the foundation to serve as a US legacy in the Baltic Republics. The number of activities will decline from the FY 95 level of 55 to 6 in FY 99. Specifically, the Mission will accord priority to:

-- **furthering the economic transformation**: by putting public finances on a sound footing, assisting government to manage central bank monetary and exchange rate policy, and removing fuel subsidies and facilitating the privatization of the energy complex; and

-- **supporting development of civic society**: by endowing a Baltic regional foundation that will: 1) strengthen the capacity of NGOs to expand and deepen the gains achieved in the economic and democracy sectors; and 2) serve as a US legacy in the Baltic Republics.

The key issues of economic reform can be achieved within the next three years with a modest budget increase in FY 1998 and 1999. The proposed modification takes into account the priorities of a newly elected government and an analysis of the length of time needed to achieve key sustainable policy and institutional reforms, Lithuania's continued economic progress since 1996 (Section 2), the unique role that US technical assistance provides in Lithuania, the progress and high quality of results achieved by key implementors (R4), a strong commitment by the newly elected government to promote more economic reforms (Sections 3-4), the long time frame needed to develop an effective NGO sector, and to coordination with donors and the international financial institutions, as USAID phases out its Lithuania program.

USAID Vilnius proposes to use an additional $5.3 million in FY 98 and FY 99 funds (Table 1) to:

1. continue and extend assistance in fiscal management (SO 1.2) by providing a senior policy team on fiscal policy (tax, budget, treasury) to the Ministry of Finance (FY 99);

2. continue and extend assistance for a more stable financial environment (SO 1.4) by maintaining the Treasury senior bank and monetary policy advisor (FY 99), provide training in collateral law (FY 97), and completing the work on capital markets (FY 98);

3. expand and consolidate improved energy safety and policy in a new limited focus strategic objective (SO 1.5) to improve nuclear safety (FY 99) and build the capacity of the new Energy Price Commission to set energy tariffs and establish the regulatory framework for energy investments (FY 99). This new strategic objective merges the energy activities from Strategic Objective 1.3 "Improve the policy environment for enterprise

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Table 1 Summary of Proposed Increased Budget Compared to Approved Levels

	Strategic Objective	**Current Budget FY 97-98**	**Proposed FY 97-99**	**Increase/shif t**
1.2	Strengthened Fiscal Management	$1,550,000	$4,715,000	$3,165,000
1.3	Improved Policy Environment for Enterprise Development	$1,500,000	$0	-$1,500,000
1.4	More Stable Financial Environment	$3,450,000	$3,710,000	$260,000
1.5	Improved Energy Safety and Policy (from 1.3 and Spec Initiatives)	$300,000	$2,575,000	$2,275,000
2.1	Citizen participation	$1,500,000	$1,800,000	$300,000
4.1	Special initiatives-Regional Environment	$100,000	$100,000	$0
	Cross cutting training	$700,000	$875,000	$175,000
	Staff, evaluation	$900,000	$1,575,000	$675,000
	TOTAL	$10,000,000	$15,300,000	$5,300,000

Table 2: **Selected Economic Indicators, 1991-1996**

Indicator	1991	1992	1993	1994	1995	1996
GDP/NMP (percent change)	-13.4	-37.7	-24.2	1.0	3.0	3.6
Consumer Prices (% change)	224.7	1,020	410.4	72.1	39.6	13.1
Real Wages (% change)	-19.9	-17.2	-45.3	20.6	5.4	6.0
Broad Money (% change)	162	351	124	64	33	-2.4
Credit to the economy (% change)	128	532	165	106	-49	-11.7
Unemployment rate (%)	0.3	1.3	4.4	3.8	6.6	6.2
Trade Balance ($ mill)	1,814	101	-294	-307	-358	-490
Wages (USD/mo)	N/A	15	42	81	129	175
Current Account (% GDP)	10.6	5.6	-9.5	-3.2	-2.5	-8.7
Gov't Revenue (% GDP)	41.4	32.1	28.5	24.6	24.0	22.5
Gov't Expenditure (% GDP)	38.7	31.3	33.4	29.3	27.0	25.7
Fiscal Balance (% GDP)	2.7	0.8	-3.1	-4.2	-3.4	-3.2

note: 1995 figures are preliminary and 1996 figures are estimates.
Source: IMF (1995 and 1996), Ministry of Finance, Bank of Lithuania, and Starkeviciute (1996).

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development" and the special initiative to reduce dependency on the Ignalina Nuclear Power Plant; and

4. establish a regional foundation which will strengthen the capacity of NGOs to effectively contribute and participate in the socioeconomic transition process through the establishment of the *Baltic-American Foundation for Democracy*.

The FY 96 Strategic Plan included a Strategic Objective to improve the policy environment for enterprise development (SO 1.3). This objective will be deleted because the majority of activities under this strategic objective will be achieved by the GOL, significant results were achieved in commercial law, environmental pricing reforms have been achieved and significant structural reform is unlikely over the next few years, and the high degree of institutional uncertainty in the GOL will reduce success in trade policy reform. The activities under energy price reform have been expanded in the new Strategic Objective (1.5) noted above.

Section 2: The Macroeconomic Setting for Transition

Since Independence, Lithuania has registered impressive progress towards building a democratic, market-oriented economy. Prices and most markets have been liberalized and now respond largely to the forces of supply and demand. Voucher privatization has put residences, agricultural land and small businesses into the hands of the private sector. Inflation has been tamed, largely by reducing public spending and by diligent adherence to a fixed exchange rate and a currency board monetary arrangement. Investment regulations have been crafted to promote both domestic and foreign direct investment. Trade flows have shifted from eastern to western markets, facilitated by bilateral and multilateral trading agreements.

From 1990 to 1996, Lithuania struggled to restore macroeconomic stability. Inflationary pressures were severe, public revenues collapsed, and government had to borrow large amounts from concessionary lenders and compress public expenditures to meet import demands. The output collapse was particularly severe with GDP in 1993, which was just over one-third of that reported in 1989 (Table 2). Unemployment remained low, but reflected mainly a fall in female labor participation, scant unemployment benefits and little progress in reducing over-employment in Government and the large public enterprises. With falling output and high inflation, living standards deteriorated, with pensioners and female-headed households bearing the brunt of the economic downturn. By 1996, more than half of average household expenditures were used to buy basic foodstuffs. Close to a third of the population reported incomes below the poverty line.

Lithuania's economy began to show some first tentative signs of recovery in 1994. From 1994 to 1996, GDP grew by an average of 2 percent per annum. Export growth and services sector activity led the recovery, with transport and entrepot services (through the Klaipeda port) experiencing the most rapid growth. In agriculture and industry, performance has been more mixed. One third of the manufacturing firms have restructured output to meet western demands. In agriculture, restructuring has yet to begin in earnest and only a handful of agro-enterprises are financially viable. Cash-based privatization of the larger enterprises was started in 1995, but no meaningful progress has yet been made. Lithuania's commercial laws and capacity for effective and objective adjudication are limited, although some reforms have been made.

At the beginning of 1996, there was a high risk that Lithuania's economic recovery would be derailed. In late 1995, the Joint-Stock Innovation Bank and the Litimpeks Bank both were closed. This triggered capital flight and a flight from the Litas (the national currency). Revenue collections fell sharply and enterprises prepared for a year of tight credit and inflationary upsurge. Financial market scandals prompted the removal of both the Prime Minister (Adolfas Slezevicius) and the BOL Governor.

Astute macroeconomic management helped to stave off economic collapse, but could not salvage the political fortunes of the ruling LDDP party. For the year, economic growth continued, the rate of inflation came down, unemployment levels were reduced and the fiscal deficit was not terribly out-of-bounds. Growing consumer demand and an investment-upsurge late in the year triggered a widening of the trade deficit, and generated concern that Lithuania's external payments would come under pressure. But despite a temporary disruption of payment arrangements in early-1996, the Government continued to operate the currency board, allowing Lithuania to maintain a fully convertible currency.

Lithuania's economic growth and reduction in inflation are poor measures of transition progress since they mask the limited progress made to address the nation's structural weaknesses in public finances. Public finance imbalances have, in turn, contaminated efforts to restructure the large enterprises, eliminate energy subsidies (and payment arrears) and develop a viable commercial financial system. The Government revenues fell from 41 percent of GDP in 1991 to 23 percent of reported GDP in 1996. By 1996, gray (or hidden) market economic activity was reported to be close to half of all economic activity, suggesting that actual revenue collections were closer to 12-13 percent of actual GDP. Public expenditures were sharply compressed between 1993 and 1996 by slashing public investment, by capping civil service salaries and by holding pension and other transfer payments to a level well below the rate of inflation. Still, Government expenditure requirements remained well in excess of available domestic revenues. To meet these obligations, the Government borrowed heavily and resorted to quasi-fiscal spending. As a result, the Government's domestic borrowing has crowded the private sector out of the thin domestic financial markets, official external debt has risen rapidly to 26 percent of GDP in 1996 and the deficit remains stuck in the range of 2-3 percent of GDP. More importantly, Government's quasi-fiscal expenditures, such as holding utility prices below the cost of production, the buildup of energy arrears and directing commercial bank credit towards distressed public enterprises, distort the investment environment and hinder the sustained transition to a competitive market setting.

Popular discontent in the handling of the economy and failure to stop corruption resulted in a change of government in the November 1996 national elections. The new Government pledged to accelerate the transition to a market economy, facilitate private investment, solve the problems of public finance and to combat corruption and organized crime.

Lithuania now stands at a crucial juncture in its transition process. National leaders must **tackle many of the most complex and contentious transition challenges** by rebuilding public finances, restoring confidence in the domestic banks, privatizing the large scale enterprises (including the large energy utilities), eliminating energy subsidies, building a well-functioning commercial law system and rationalizing the public pension system. Failure to make progress in this set of transition reforms could cause Lithuania to lose macroeconomic stability and would undoubtedly derail private investment and growth. Lasting progress in these areas will not be easy to achieve. Administrative competence in the core economic ministries is limited, and the Government faces a reform agenda that is, by any measure, no less than daunting. Annexes 1 and 2 review the economic situation in Lithuania in 1996 and the new GOL policies and programs, respectively.

Section 3: Democracy Trends

Democratic reforms have been extensive in Lithuania. The protection of basic human rights has been established, guarantees of free speech are in place, and free and fair elections have been held, without any serious charge of election fraud. Since restoring independence, peaceful transitions of power have taken place in the wake of each election, with power shifting from the right, to the left, and very decisively back to the right again in the recent 1996 Parliamentary elections. While democratic freedoms largely comparable to Western Europe are in place in Lithuania and key economic reform legislation is in ***process, the NGO sector is seriously constrained by key structural and functional weaknesses which constitute a major impediment to Lithuania's emerging democracy.***

NGOs, while relatively abundant, are fledgling, and maintain a low profile. ***Effective civil participation of NGOs remains the weakest unfinished element of institutionalized democracy in Lithuania.*** With rare exceptions, NGOs play only a limited role in public debate on policy and decision making. Some progress is being made where some local governments are beginning to establish collaborative efforts with NGOs, such as the recent *NGO Day in Kaunas*, and the Prime Minister has recently appointed an advisor for NGO affairs. ***Since 1991, the Lithuanian NGO sector has experienced diminished citizen support and a loss of leadership, as the leaders of the early democratic transition accept opportunities in private business and government.***

Decentralization and public administration reform have not been a high priority for the GOL, although an active public debate regarding local community empowerment has recently begun. Accomplishments in the establishment of the rule of law have also been mixed. Structural reform to strengthen the independence of the judiciary is limited. Additional constitutional and civil law reforms are still needed, but the current transition process is well underway. A complete transformation of the judiciary will not be concluded for the next ten years.

Section 4: Key Transition Challenges

Lithuania faces a number of critical and interrelated transition challenges. Annex 2 is a more detailed description of the economic policy program of the new Government of Lithuania. The three economic restructuring challenges that USAID assistance is focused on are :

Strengthened Fiscal Management (SO 1.2): Government revenues fell sharply with the first stages of privatization and, at present, there is widespread evasion and avoidance of tax obligations. The domestic tax system does not fulfil the classic functions of fair and efficient revenue raising---it is complex, with high rates and an unworkable collection system. Because revenues have been insufficient, the Government has resorted to deficit spending, excessive overseas borrowing for budgetary purposes and quasi-fiscal outlays such as directing lending from state banks to distressed enterprises, not paying energy bills and under-pricing electricity. Public expenditures are poorly linked to transition or economic development objectives. Budgets bear little relation to desired expenditure outcomes and for the last two years, public spending has been operating with monthly cash spending ceilings. The Ministry of Finance has stabilized the economy mainly by spending restraint and borrowing, but does not have the skills or competence to tackle the main future fiscal policy challenges. Unless fiscal management is strengthened, privatization will remain stalled, tax uncertainty will continue to restrict investments, and the banking and energy sectors will continue to be used as quasi-budgetary instruments.

A More Stable Financial Environment (SO 1.4): The banking system remains fragile following the closure of two large private banks in 1996. The Government is implementing a bailout program for the distressed banks and is planning to privatize its commercial and agricultural banks. The banking sector is the thinnest in eastern Europe (M2/GDP of 12 percent) and not terribly competitive. Regulatory and administrative measures have been taken to restore confidence in the banks, but banking consolidation continues. The Central Bank is preparing to play a more active role in financial market development, but this will mean abandoning its currency board and adopting a more traditional set of monetary policy instruments. While this could have a positive effect on the financial markets, confidence in the domestic currency is still limited and political interference in monetary policy could trigger devaluation and financial instability. While Lithuania's central bank has outlined a rational program for restoring classic monetary management authorities, it has limited experience in these areas. Lithuania's capital markets have experienced very rapid growth, particularly in the past 12 months. The capital markets are a substitute for the distress in the banking sector but the trading system (the French order-driven system) cannot handle the growing volume of business. Gaps in Government regulations expose these markets to the potential for serious fraud and abuse. Restoring stability in the financial markets is essential to effectively stimulate growth and investments.

Improved Energy Safety and Policy (SO 1.5): Lithuania draws close to 90 percent of its electricity from the Ignalina Nuclear Power plant (INPP), a Chernobyl style reactor. Although the Swedish Government has already invested close to $60 million in safety improvements in INPP, the G-7 Safety Commission has recommended a great number of additional safety measures and an early closure of the plant. If the plant is closed, Lithuania's energy costs would rise by between US$300 to US$400 million per annum over and above the high costs of mothballing INPP. While INPP is unlikely to be closed very soon, Lithuania needs to begin to prepare for a post-INPP energy sector. Future development in the energy sector is constrained by public ownership and operation, underpricing of energy resources, mounting debts and payment arrears of the energy companies to the banks and enterprises, high transmission losses, a lack of energy-conservation technology and incentives, and an excessive dependence on Russia for raw materials. At the end of 1996, the different energy companies in Lithuania had accumulated debts of close to US$400 million, resulting primarily from the under-pricing of energy which is 20 percent below actual cost levels and government's policy of allowing state companies and municipalities to build up energy payment arrears. Because the energy companies had large outstanding debts, they were unable to repay their obligations to the commercial banks. This is one of the main reasons for the 1995/1996 collapse of the commercial banks. Government has established an Energy Tariff Commission to advise on utility tariffs; has declared its intention to decentralise district heat generation; to privatize the energy companies; and to eliminate subsidies and overdue Government debts to the energy companies. These will be both technically and politically difficult measures, and those agencies with the most competence in these matters (the former Energy Ministry officials in the Ministry of National Economy, and the management of the energy companies) have resisted changes in the past. Until these changes are introduced, Lithuania will not have an energy-investment environment conducive to reducing reliance on INPP.

Strengthened Civic Participation (SO 2.1): Civic participation is of fundamental importance in a strong and functioning democracy. The NGO sector is one of the most crucial elements of civic involvement. Unfortunately, civic participation in Lithuanian NGOs is declining. The primary need is to support NGO development, skills enhancement, and sustainability. This is important because of the role that NGOs can play in building consensus and support for economic reforms, filling the gaps in social support during transition, and demanding an end to corruption and organized crime. A strong NGO sector supports diversity and ensures the continuity of the democratic and economic transformation process, and holds government accountable for policy reform and promotes equity. NGOs are an important and effective source of critical information about the technical aspects and impacts of pending legislation, the needs of the business sector, and the preferences and priorities of citizens. This is essential where legislators have limited experience or research and advisory resources. ***USAID's support for the development of the NGO sector remains crucial as a means of sustaining gains achieved in the democracy and economic sectors. External training and financial and technical support is essential for the stability and sustainability of the NGO sector. It is estimated that it will take an additional five to ten years before a significant number of NGOs will be independently sustainable.***

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Section 5: Modified USAID Strategic Objective Activities

The 1996 strategic plan was a shift from wide ranging activities to assist the private sector, NGO and government agencies in the first-stages of transition to a focus on four strategic objectives. The new strategic plan is a further focusing of these efforts and seeking to reach a close-out of activities that are sustainable. The major shift in emphasis is to expand the work in the energy sector to support the new government's commitment to privatize the energy sector. This effort will be funded primarily from deleting assistance to improvements in the enterprise policy environment since results are either complete or unlikely to occur in the near term. A second effort will be to continue the work in fiscal and financial management until it is sustainable. The third shift is to establish a long-term post-AID graduation foundation to strengthen the non-government organizations.

Strengthened Fiscal Management: The activities in this area are an extension of the current work to develop the policy framework and institutional capacity for strengthened fiscal management. Specifically, USAID and Treasury are assisting the Government to improve fiscal management by broadening the tax base, reducing excessive fiscal deficits, eliminating unnecessary public debt accumulation, and enhancing the efficiency and effectiveness of core public expenditures. Treasury will provide a senior policy advisory team to the Minister of Finance to assist in rationalizing budgeting, debt management, macroeconomic management, accounting and auditing. This team will complement the USAID funded HIID team working on tax policy and tax legislation. The US Treasury, with SEED program support, has in place a program aimed at strengthening the Lithuanian treasury functions. The modified Strategic Objective results framework is provided in Annex 3.

A More Stable Financial Environment: The activities in this area are an extension of the current work to develop the policy framework and institutional capacity for a more stable financial environment. The overall aim of these efforts is to to enhance the prudential soundness of the banking system by maintaining financial stability, to ensure that the currency remains convertible and to deepen financial markets. USAID/Treasury is providing senior policy assistance to the Governor of the Bank of Lithuania to manage monetary policy and to assist the Bank during the transition to a more classical central bank. USAID's work in bank supervision is focused on surveillance actions such as leasing and commercial bank involvement in capital markets. It will be completed in 1998. USAID will continue to provide legal assistance (ABA-CEELI) to amend the collateral law and train legal professionals in the application of collateral law. In the capital markets, USAID assistance remains focused on filling gaps in the regulatory environment, improving market surveillance and financial disclosure and on introducing a trading system that can cope with the rapid growth in activity.

Improved Energy Safety and Policy: This is a new strategic objective that builds on activities that have been supported by USAID since the SEED program began. The overall objective is to foster a regulatory environment for the energy sector that enables the private investment that will be needed to deal with the eventual closure of INPP. Support will be provided to the Energy Regulatory Commission to implement its tariff setting policies and to prepare the regulatory environment for the privatization of the energy companies. A special study will be undertaken on the decentralization of district heating and a pilot-plan will be developed for the privatization of one of the district heat generation facilities. While the investment environment is being improved, assistance would be provided to help Lithuania assess its least-cost options for generating energy over time, within the context of the Baltic region as a whole. Support would also be provided to ensure that the nuclear regulatory agency (VATESI) provides a thorough and competent review of Ignalina and that Lithuania meets its obligations to the nuclear safety account. A full description of the new Strategic Objective and results framework is provided in Annex 4.

Strengthened NGO Sector: ***The critical objective in this area is to increase citizen participation in political and economic decision making, develop a tradition of civic philanthropy, and to ensure long-term economic and political stability through support for democratic institutions and traditions. USAID experience with NGO development and endowments suggests that a new foundation can provide the needed assistance. A creative, innovative <u>Baltic-American Foundation for Democracy</u> will be founded which will leave a US legacy by rebuilding citizen confidence and involvement in their country's political and economic future over the next ten or more years. A full description of the new Baltic regional Strategic Objective and result framework is provided in Annex 5.***

Section 6: Role of Other Assistance Providers

USAID is a relatively small donor to Lithuania. The financial transfers of the World Bank, the International Monetary Fund and the European Union each exceed US$50 million per annum. In addition, the bilateral donors, and most notably the Swedish, Danish, German and Japanese are providing large (more that US$20 million per annum) aid flows to Lithuania. The IBRD is providing assistance through structural adjustment and economic infrastructure efforts; EU's focus is investment and European integration; the IMF has provided balance-of-payments assistance; the Scandinavian donors have financed safety systems in Ignalina and a number of water-treatment plants. Germany and Japan have focused on industry restructuring and the provision of trade-credits to companies with a home-country foreign investment interest.

Other donors are also involved in the efforts to achieve the objectives laid out above. The IMF has operated a number of training courses for the Ministry of Finance, is actively assisting the fiscal policy division of the MOF and is providing Baltic-regional advice on economic statistics and the national accounts. The EU and the Danish government are providing assistance to the Custom's service (of the MOF), both in terms of new procedures and in terms of establishing border control points. The World Bank, through its economic reporting and structural adjustment efforts, is also an important source of fiscal policy advice to the MOF. In the future, the World Bank is to make a special effort to assist Lithuania reform its state pension system.

In the banking area, a number of donors are involved in twinning operations at the commercial banks. Several donors support the Bank, Insurance and Capital Markets Training Institute, which is designed to build mid-level human resources for the financial markets. The World Bank, together with the PHARE and EBRD programs, is involved in the recapitalization of the state banks and the distressed private banks. At the Central Bank, the Danish government is providing assistance in strategic planning and bank supervision, and the EU has provided assistance in information systems and payment clearance. No other donor is providing assistance in either monetary policy or capital markets.

Several donors are actively involved in the energy sector. The EBRD is coordinating the G-7 effort to ensure the safety of INPP. Bilateral assistance is provided by the Swedish Government and about $60 million has already been provided for nuclear safety. The EU PHARE is assisting in the development of a legal and institutional framework for the energy sector, helping to create an energy efficiency fund, and implementing feasibility studies for energy sector rehabilitation. The Danish Government supports district heating and developing Combined Heat and Power Plants as viable businesses. The World Bank provided a Structural Adjustment Loan of $80 million which has conditions related to reducing energy arrears, developing commercial operations and transparent accounts and beginning privatization of oil and gas companies.

The EU-PHARE program, the United Nations Development Program, and the Open Society Fund-Lithuania, provide support to the NGO Information and Support Center in Vilnius. The Center's program includes funding for a NGO database, legal consulatations, skills seminars, publications on NGO management issues, an NGO forum and regional NGO fairs, and publication of a periodic bulletin. The EU-Phare program also supports the Charities Aid Foundation.

Section 7: Budgetary and Management Implications

The main budgetary implications of the proposed modifications to the strategic plan are summarized in Table 3. The total budget requirements for the Lithuania program in FY 97-99 are $15.3 million. Funds planned for "Improved Policy Environment for Enterprise Development (SO 1.3)" will be reprogrammed ($1.5 million). The proposed bilateral budget levels are $7.0 million for FY 97, $5.5 million for FY 98, which is an increase of $2.5 million above the approved level, and an additional $2.8 million in FY 99 (Table 3). The <u>additional</u> $5.3 million will be used for:

- -- Fiscal management: $3.165 million for a senior Treasury fiscal policy team and HIID tax policy team
- -- Central bank and monetary policy: $260,000 to extend the resident policy team and completing the work on the stock market, and training
- -- Rationalized energy policy and safety: $2.275 million for energy price and regulatory team, nuclear safety efforts, and training
- -- Citizen participation: $300,000 for democracy commission and judicial training center

-- Training: $175,000 to provide direct support for the strategic objectives
-- Evaluation, administrative support, and close out: $675,000.

In addition, funding for the *Baltic-American Foundation for Democracy* will be required from ENI. The budgetary needs are $7.5 million in FY 98 and FY 99. This funding is proposed to be provided from the bilateral Lithuania program ($1.5 million), the Latvia bilateral program ($1.5 million), and supplemental regional funds ($4.0 million).

The total additional budget request is $5.3 million for Lithuania bilateral objectives and $4.0 million in regional funds for the Foundation for a total of $9.3 million in FY 98 and FY 99.

A one year extension will be needed in USAID/Vilnius staffing and keeping the office open, which will cost an estimated $400,000 in OE funds.

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Table 3: Funding Request for Lithuania Bilateral Program

	Strategic Objective	FY 97	FY 98	FY 99	TOTAL
1.2	Strengthened Fiscal Management	$2,090,000	1,850,000	775,000	$4,715,000
1.4	More Stable Financial Environment	2,360,000	950,000	400,000	3,710,000
1.5	Improved Energy Safety and Policy (from 1.3 and Spec Initiatives)	1,075,000	1,000,000	500,000	2,575,000
2.1	Citizen participation	175,000	1,025,000	600,000	1,800,000
4.1	Special initiatives-Regional Environment	100,000	0	0	100,000
	Cross cutting training	650,000	125,000	100,000	875,000
	Staff, evaluation	550,000	550,000	425,000	1,575,000
	TOTAL	**$7,000,000**	**$5,500,000**	**$2,800,000**	**$15,300,000**

Table 4: Foundation

		FY 98	FY 99	TOTAL
	Lithuania contribution	$900,000	$600,000	$1,500,000
	Latvia contribution	1,500,000		$1,500,000
	Regional	2,600,000	2,900,000	$4,500,000
	Total	$4,000,000	$3,500,000	$7,500,000

Section 8: The Main Rationale for Extending Graduation Date

The revised strategy envisions the need to extend the close-out date to FY2000, which is one additional year beyond the currently approved close out date in FY1999. The main reasons for extending the graduation date are as follows:

-- **Economic Performance:** While Lithuania's economy has started to recover, it is far from exhibiting the "take-off" in inward investment or economic performance that has characterised the Czech Republic, Hungary, Poland or Estonia. The country is experiencing sluggish growth and a large segment of the economy (large enterprises, energy utilities, agriculture) has yet to restructure to complete in international markets. Many of the more successful companies are profitable simply because they do not pay tax and receive subsidised energy supplies---these companies may not survive in a more "normal" market setting. Lithuania's current account deficit is widening, making the country very vulnerable to speculative currency assault. In terms of trade, Lithuania still remains highly dependant on Russia as the sole supplier of many critical raw materials, especially energy. Domestically, there is a great deal of disguised unemployment in state enterprises and in Government. Investor confidence improved in 1996, but still lags far behind that in the "leading-group" of eastern and central European transition economies. Until Lithuania tackles this next set of difficult transition policy reforms, there is little prospect that the country will enjoy healthy rates of investment and private-sector led growth.

-- **Transition Reform Policy Performance**: Lithuania is only now embarking on the most difficult and contentious set of transition reforms. This includes cash privatization, public finance and tax reform, energy subsidy removal and energy sector regulation, restoring confidence in the currency and rebuilding the banking system. These are difficult issues that require both political commitment and a significant increase in the capacity of Government in designing and managing such efforts.

-- **Building Institutional Competence to Guide Complex Reforms**: Lithuania has made remarkable progress in implementing transition reforms but *public finance, central banking and energy-sector regulatory oversight* will require two to three years to build the institutional competence and capacity necessary to manage and sustain critical "last-stage" transition efforts. USAID is familiar both with the challenges and the gaps in institutional experience and competence. The officials assigned to lead efforts in each of these areas are sound and dedicated to their tasks. There is every reason to believe that the competence to manage transition efforts will be developed in the time proposed.

-- **Sustainability of the Transition Effort:** The sustainability of the transition effort is vulnerable for three reasons. First, the institutional capacity in the core economic ministries to articulate and undertake the key transition reforms is weak. Second, there are a number of Government agencies and private enterprises (nomenclatura capitalists) who profit from the inefficiencies and economic rents associated with incomplete

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transition. Maintaining the transition momentum is essential to ensure that these groups do not bring the reform process to a halt. And third, income disparity has widened considerably during the 1991-1996 period. While there is "general" support for the introduction of a market economy, the limited trickle-down of benefits has eroded the popular base of support for market-oriented reform.

USAID's proposal for additional financial support and to postpone the close out date by one year should enable the US efforts to develop Lithuania's institutional competence to carry out essential economic reforms and initiatie the establishment of a foundation which will strengthen the non-governmental sector's ability to push for, and support, sustained improvements in the political and socio-economic sectors.

Section 9: Post Close-out Foundation

Effective civil participation of NGOs remains the weakest unfinished element of institutionalized democracy in Lithuania. Work in this area will require a longer time frame than the 2-3 year horizon of SEED activities scheduled for Lithuania to complete, because it implies changing both deeply rooted attitudes and institutions that have been inherited from 50 years of Soviet rule. It is estimated that it will take an additional five to ten years before a significant number of NGOs will be independently sustainable. A post-presence Foundation for improving the environment for NGOs and strengthening their capacity to represent issues important to their constituencies, can resolve this crucial deficiency, post close-out, without a long term in-country USAID presence.

Key structural and functional weaknesses limit NGO success in participating in public policy and decision making, and constrict civic ownership of the society. Assistance for this SO will not be complete until four thresholds are achieved:

- -- There is a clear and supportive legal and regulatory environment for NGOs.
- -- A minimal number of NGOs have sufficient technical and managerial capacity to be effective.
- -- A minimum number of effective NGOs are financially sustainable with a diversity of funding and a tradition of organized philanthropy.
- -- A broad undrestanding exists about the possibilities and responsibilities of an active role of NGOs in advocacy on behalf of, and in communication with, their constituencies.

Section 10: What Will Be Unfinished Without Additional Funding and Extension

The implications for the USAID program of not receiving additional funding and a one-year extension are :

- -- Capacity in fiscal management (budget planning, and tax policy management) and legislation will not be sufficient for economic stability; the gray market will stay the same or expand; foreign debt is likely to significantly increase; and foreign investments will lag.

-- Capacity in bank policy will be uncertain; monetary policy may become ad hoc learning, with the potential for serious problems; excessive devaluation, capital flight, and runaway inflation may occur.

-- The capital markets will not be placed in a solid foundation. An underdeveloped Exchange and Comission will be be able to absorb new companies effectively, leaving them vulnerable to corruption. Continuous trading will be considerably delayed.

-- The climate for energy price reforms will decline and political forces may overwhelm sound economic price reform in this sector; alternatives for the Ignalina Nuclear Power Plant may not be as fully pursued ,which will increase pressure on Lithuania and the west to extend the life of the power plant.

-- The momentum for citizen involvement in economic and democractic reform will diminish; tensions may grow around the commitment to reform; the needs of those vulnerable during transition will increase with limited chance for action; and pressure to hold Government responsible for reform will decline.

Section 11: Probability of Success

The probability of being able to achieve the objectives set for the program within the time frame defined is high for three reasons. First, the transition policy reforms are top priorities of the newly elected Lithuanian government, new Ministers are committed to these reforms, they are highly receptive to USAID assistance, and USAID is building upon previously successful development assistance efforts. Second, the Government has made commitments to multilateral lenders to undertake the policy and institutional reforms which USAID would support, the banking and energy reforms are part of the policy reform conditions for IMF ESAF and World Bank Adjustment assistance, and the time-frame for making the proposed changes are consistent with the agreements reached with these institutions. Third, the Government has declared that it views assistance from the USAID to be of great importance, not only because of the "content" that such assistance brings to bear, but also because of the perception that the USG is an objective and evenhanded source of policy advice.

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ANNEX 1

S.O. 1.2

Improved Financial Management

Modified Results Framework

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Monday, April 21, 1997

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SO 1.2 Strengthened Fiscal Management

Timeframe: 3.5 yrs
WB, PHARE, Sweden, Denmark, IMF, MOF

- **IR 1.2.1 Tax Policy Reforms Implemented** — Timeframe: 3 yrs; WB, PHARE, GOL
  - IR 1.2.1.1 Capacity to Analyze and Assess Alternative Tax Policies Enhanced
  - Tax Law and Policy Recommendations Developed
  - Databases and Procedures Developed to Assess the Tax System
  - Ministry Skills Improved
  - Administrative Code Revised
  - 1.2.1.2 Government Policy Setting Guidelines Established at MOF
- **IR 1.2.2 Improved Tax Administration** — Timeframe: 2.5 yrs; PHARE, IMF, GOL
  - IR 1.2.2.1 Tax Compliance System Reorganized
  - IR 1.2.2.2 Taxpayer Education System Implemented
  - IR 1.2.2.3 Tax Administration System Automated
  - IR 1.2.2.4 Appeals System Revised
- **IR 1.2.3 Improved Public Debt System** — Timeframe: 2 yrs; Sweden, WB, IMF Denmark
  - IR 1.2.3.1 MOF and BOL Oversight of the Secondary System Developed
  - IR 1.2.3.2 Increased Confidence/ Predictability/ Marketibality of Domestic Securities
- **IR 1.2.4 Financial Management System Implemented** — Timeframe: 5 yrs; IMF, PHARE Denmark
  - IR 1.2.4.1 Treasury Subsystem Use and Support Extended
    - Treasury Sub-system Planned and Implemented
  - IR 1.2.4.2 Ministries Linked to Treasury System
- **IR 1.2.5 Budget Process Used by the Ministry of Finance Improved** — Timeframe: 3 yrs; IMF, GOL
  - IR1.2.5.1 Consolidated Budget Produced and Fulfilled
  - IR1.2.5.2 Performance Targets Established in the Government Budget

Annex 2

S.O. 1.5 Improved Eneregy Safety and Policy

PART II: STRATEGIC OBJECTIVE RESULTS FRAMEWORK

S.O. 1.5, Improved Safety and Policy of the Energy Sector

A.1 Statement of Strategic Objective

The ENI Bureau Strategic Objective 1.5 is to "Foster economically sound and environmentally sustainable energy systems." The USAID/Lithuania Strategic Objective 1.5 is more focused and seeks "Improved Safety and Policy of the Energy Sector."

Rationale for Change in Strategy

The Lithuania Country Strategy addressed energy issues within the SO 1.3 economic restructuring context and as a special initiative related to nuclear safety and regional energy cooperation. Over the past year, a number of developments have occurred that have highlighted the importance of energy and the development of alternatives to the Ignalina Nuclear Power Plant. The seriousness of this situation has led USAID to reconsider the approach to energy in the strategy and to focus the limited activities in one SO to achieve maximum policy and strategic impact.

Two key factors have led us to an integrated approach to the energy sector. First, the Safety Analysis Report prepared under funding from EBRD/NSA and several independent reviews of the Ignalina Nuclear Power Plant financed by the United States and other OECD countries were completed in late 1996 and developed a set of immediate, short-term and longer-term safety improvements that are critical to the future operation of Ignalina. The G-7 and the Members of the Nuclear Safety Account of the EBRD are considering this report and the strategy for negotiation with Lithuania on the NSA agreement. Given the significant costs entailed in these upgrades and the relatively short life expectancy for Ignalina Unit #1 due to the channel gap problem, it may not be economically justifiable to relicense Unit #1. Since Ignalina accounted for 85% of all electricity produced in Lithuania in 1996, the closure of the first unit will mean increased costs of imported fuel and higher electricity tariffs.

Secondly, the new government is moving aggressively to restructure the energy sector and improve its financial viability. Under the World Bank's Structural Adjustment Loan, the Government has created an independent Energy Price Commission, passed legislation that curtails financial transfers to state and municipal budget organizations if they do not pay their bills within 30 days, and agreed to transfer district heating to municipal authorities; to begin privatization of Lithuanian Oil and Lithuanian Gas; and to accelerate the commercialization of the Lithuanian Power Company.

Third, USAID has increasingly realized that a resolution of Lithuania's public finance, financial sector and energy problems must move hand-in-hand. Unless the distortions in energy pricing are eliminated, and the investment environment for the energy sector improved, then Government will continue to absorb the costs and uncertainties associated with mounting energy arrears. Furthermore, these arrears impede the ability of the energy complex to service its debts to the commercial banks. This was one of the main factors precipitating the banking crisis in 1995 and 1996. Paradoxically, the energy sector, with its large under-utilized capacity, is one of the sectors that could (with restructuring) become a major exporter and a source of badly needed foreign exchange to finance growth in the economy at large.

A.2 Problem Analysis

The overall economic reform of Lithuania will be impacted significantly by the decisions made on the energy sector reform. There are major budgetary (central and municipal), balance of payments, investment and environmental impacts at stake. The GOL must address the following issues: safety of Ignalina Nuclear Power Plant; inadequate energy legal and regulatory framework; uneconomic tariffs and collections; and sector restructuring and privatization.

Ignalina Nuclear Power Plant

The Safety Analysis Report identified a set of immediate steps to be taken as well as longer-term safety improvements critical for the safe operation of the plant. The G-7 Nuclear Safety Working Group and the Members of the Nuclear Safety Account are working with the GOL to identify the options. If the condition of the plant requires shutdown of the Unit #1 due to safety or the significant costly problems, it may not be economically sound to relicense it. If this occurs, or if both are closed under other various planning scenarios the balance of payments impact for electricity and alternative fuel imports for generation could approach US$300 million per annum between now and 2003. In addition, there would be significant investment requirements to rehabilitate and expand existing thermal and combined heat and power plants and improve energy efficiency to meet the need for electricity.

Legal and Regulatory Framework

The absence of comprehensive energy legislation and policy makes it difficult to make key sectoral decisions and to attract private strategic investment. The absence of adequate laws creates uncertainty about the commitment of the GOL; the absence of a regulatory body leaves key decisions, such as tariffs, subject to short-term political interests. Efforts to attract strategic investment will be suboptimal without this framework. The new Energy Price Commission can only recommend tariff changes to the GOL but this is still a significant first step.

Uneconomic Tariffs and Collections

Tariffs for electricity, heat and natural gas have historically been below economic costs. As a consequence, Lithuania suffers from inefficient energy use, unnecessarily high import costs, government budgets straining to cover energy subsidy requirements for consumers, and under funded maintenance and investment in the energy companies. The Lithuania Power Company (LPC) faces losses of $125 million in 1997 without tariff relief and efficiency improvements (district heating losses were $105 million in 1996). Intra-company debt of LPC to oil and gas companies and Ignalina exceed $200 million. Collection of payments for electricity have been unacceptably low but show signs of improvement. The worst offenders are the municipal governments and state budgetary organizations. (Recent legislation requires municipal payments in a timely fashion or withholding of central payment and the Parliament recognized formally the state's liability to LPC.)

Sector Restructuring and Privatization

The electricity/heat system remains substantially a monopoly operation with Ignalina established as a separate company. Given the conditions described above (balance of payment impact of closure of Ignalina; resulting investment requirements to meet electricity needs; tariff/collection problems puts), the GOL and utilities are in a situation where it will be difficult to provide adequate sovereign guarantees for all the investment required. Consequently private strategic investment will likely be important in meeting future needs. In addition to the legal and regulatory framework, there is a need to restructure the electric utility in a manner to facilitate private strategic investment. Some separation or autonomy for the thermal power plants and distribution companies would likely be most effective to attract required investment, modern management and technology. Presently the heat distribution companies are on a path to be transferred to the municipalities. Options on the strategy for the electricity sector are under consideration. In early 1997, Government declared that the main energy companies would be eligible for cash-based privatization, starting with Lithuanian Gas and Lithuanian Power in 1997 and 1998. This, together with the announced devolution of district heating management authority marked a major change in the Government's strategy to transform ownership and management in the energy sector

A.3 Results Framework (See box diagram LITSO15.AF3)

A.4 Performance Data Tables (LITPDT97.15)

A.5. Results Framework Narrative

1. Transition Hypothesis

One of the priority areas where USAID/Lithuania will work is on gradually reducing dependence on the unsafe components of the Ignalina Nuclear Power Plant. To achieve this requires key decisions and steps on Ignalina's future, legal/regulatory reform, and pricing and energy sector reform to meet future electricity needs in an environmentally sound manner. The USAID/Lithuania strategic objective identified is more narrowly focused than the ENI 1.5 strategic objective. This focus takes into consideration the limited resources and the actions of other donors. Consequently, USAID/Lithuania resources will be focused primarily on IR 1.5.2 "Pricing, Regulatory Reform and Restructuring Promote Investment." USAID funds in the Nuclear Safety Account and DOE funds will substantially cover the nuclear safety IR 1.5.1 "Sound Decisions on Relicensing Ignalina" and ENI regional funds will be applied to IR 1.5.3 "Enhanced Baltic Energy Cooperation."

The work focuses on the power sector and will complement other donor work already completed or underway: EU-PHARE Energy Law assistance; Danish Government support for district heating and Combined Heat and Power Plant business development; and the World Bank Structural Adjustment Loan conditionality on Energy Price Commission autonomy, collections, tariffs, restructuring and privatization.

Achieving the strategic objective over three years will mean (1) reduced risk of nuclear accidents (2) improved financial performance of the sector through rational prices and increased collections, (3) a legal and regulatory framework in place conducive to strategic investment, and (4) initiation of strategic private investment in a restructured power system.

2. Critical Assumptions

Some assumptions have been made concerning conditions that must exist or changes that must occur in order for USAID to succeed in achieving the strategic objective:

--The GOL's political commitment to energy sector reform necessary to attract private investment will continue and increase and specifically they will make timely tariff reform and sectoral restructuring decisions to attract strategic investors;

--The GOL decisions on the future of Ignalina are technically and economically sound and timely;

--The Parliament will pass a Law that provides an adequate energy regulatory framework; and

--Other donors continue their sectoral assistance and increase focus on structural reform activities.

3. Causal Linkages

The USAID/Lithuania Strategic Objective 1.5 has been focused on the US and G-7 objective of reducing the dependence of Lithuania on the Ignalina Nuclear Power Plant. To accomplish this objective, three results are critical: (1) the Government takes a decision not to operate Ignalina Unit #1 beyond 1998; (2) energy pricing and restructuring/regulatory decisions create a viable climate for investment in and operation of alternative electricity generation facilities and energy efficiency; (3) Baltic regional cooperation identifies least-cost investment opportunities for meeting Lithuania's long-term electricity needs.

Intermediate Result 1.5.1: Sound Decision on Relicensing of Ignalina Unit #1

The Government of Lithuania agreed with the Nuclear Safety Account of the EBRD in February 1994 to: (1) carry out an in-depth safety assessment and regulatory review which will also involve review by an international panel of experts; (2) prepare a detailed program for power rehabilitation, demand-side management, improvements in energy efficiency, reform of pricing and assessment of need for additional power generating capacity; (3) not extend the lifetime of either nuclear reactor beyond the time at which its fuel channels should be replaced; and (4) stop electricity generation at Ignalina Unit 1 whenever required by VATESI and in any case by June 30, 1998, unless: (I) VATESI, taking into account the recommendations of the panel of experts, agrees that continued operation of the unit would be safe and issues a new license for that purpose; (ii) the level of electricity demand justifies investing in upgrades identified through the safety analysis report; and (iii) the investments in safety upgrades would be least cost.

The safety analysis report was completed in late 1996 and concluded that there were some "intolerable" facets of the plant's systems that should be corrected during the 1997 outages. Additional priority improvements were also defined and the recommendations were applicable to both Units. The cost estimates are being refined but would appear on the order of $75 to $100 million per unit. Since Unit #1 will probably not be operable past 2000 due to the graphic swelling problem and some upgrades may take several years, the investment of $100 million in Unit #1 appears questionable. The Government has indicated its intention to fully implement the recommendations of the SAR and RSR and the plant has requested to the Price Commission a rate increase to cover the initial $11 million for immediate upgrades. The Government will seek to finance the additional improvements from next year's budget.

USAID assistance has supported NRC cooperation with VATESI on developing their role and capabilities. NRC is cooperating with the Swedes and other donors in this process. VATESI must undertake a comprehensive regulatory safety review and make a decision on relicensing. VATESI has not officially announced a target date for this decision but it is expected that they will ask for at least a one-year delay from the June 1998 date in the NSA/EBRD agreement due to approximately one-year delay in the SAR. But it must decide immediately whether to require and/or approve the inclusion of the immediate, critical fixes in Ignalina's 1997 outage plans. A quick update of the least-cost plan is underway that will evaluate the impact of earlier than planned closure and consider whether it is least-cost to spend the funds on upgrades if the Unit will only operate for a couple more years.

USAID will continue to support NRC's program to strengthen VATESI and ensure that the relicensing review is carried out in an acceptable manner. Close coordination will be essential with Swedish and other assistance efforts. The UK has recently provided a long-term advisor to VATESI who had previously been involved in the SAR. The Government is preparing a new Ignalina Law that will change its status from a municipal entity to a commercial one and enhance the oversight and transparency of its operations through the creation of a Board of Governors.

If a decision is made to close Unit #1 at Ignalina, Lithuania will be faced with the need to compensate for this generation. A Least-Cost Plan was prepared in 1996 by the Lithuanian Energy Institute will assistance from consultants financed by the UK-Know-How Fund. It concluded that Lithuania has sufficient thermal installed capacity (at the Lithuania TPP and several combined heat and power units) but use of this capacity will require additional fuel imports and entail higher generation costs. Although the prospects for energy efficiency are good, the incentives are weak given the low prices, particularly for heat, and the significant non-payments problem. The detailed feasibility work on some of the Combined heat and power plants (CHP) has not been done although a potential program for rehabilitation of the Lithuania TPP has been prepared. The Least-Cost Plan is being upgraded to include new assumptions and costs concerning Ignalina closure. The potential for private and foreign investment in municipal CHPs exists if the proper price and regulatory framework can be created.

Intermediate Result 1.5.2: Pricing, Regulatory Reform and Restructuring Promote Investment

To reduce dependency upon Ignalina will require improved pricing, an economic energy regulatory environment and restructured power system able to mobilize investment--both domestic and international strategic investors. To provide economic and environmentally sound electricity in the future, financial mobilization will be critical. Balance of payment constraints and limits on GOL borrowing capacity can be addressed by foreign strategic investment. Improved collections through distribution company reform, privatization and improved government policy will be necessary. Restructuring and privatizing will provide a framework for private investment in thermal power plant upgrades and distribution company improvements to raise collections and support improvements in end use efficiency. Tariff and other reforms through a competent independent regulatory body supported by law will be critical.

To accomplish this, the limited USAID assistance will focus on (1) creation of the regulatory organization and capacity with a significant focus on tariff reform; (2) support to the GOL in development of a restructuring implementation plan and schedule and advice on privatization policy and strategy; and (3) assistance to a model CHP and model distribution company to carry out restructuring and initiation of privatization.

Price reform is critical to this process. Prices from electricity and heat in Lithuania are subsidized and have not kept up with the 45% inflation over the past two years. The Government created by Decree an independent Energy Price Commission in November 1996 and has appointed 5 Commissioners, headed by a competent expert from the Lithuanian Energy Institute. The Price Commission is awaiting budgetary authority to hire up to 20 staff. USAID assistance to the Price Commission has resulted in the development of price adjustment methodologies for electricity, gas, and heat. These methodologies have been approved by the Ministry but have not yet been implemented.

The Price Commission is at the center of trying to balance the interests of the energy companies and those of consumers. With its current powers, it can only recommend price changes but its authority is expected to include eventually the power to determine prices. It is currently considering requests from Ignalina to raise its electricity sales price to the Lithuanian Power Company in order to pay for safety improvements as well as developing a methodology for municipal heat pricing. The country is facing large arrears and non-payments in the energy sector and USAID will work with the Price Commission and the Lithuanian Power Company on these issues through technical assistance and utility partnership programs.

The USAID program will seek to establish the Price Commission as a competent, professional body independent from political influences. A number of specific regulatory guidelines will be developed and approved, with input from consumers and other groups. Its powers may be broadened if a new electricity or energy regulatory law is passed. The EU-PHARE program is currently providing legal assistance on the energy law and certain regulatory issues and USAID will need to cooperate closely with them. USAID will continue to involve the Baltic countries in regional regulatory and pricing programs.

The potential decision by the Government, expected in late 1997, to split electricity transmission, generation, and distribution and begin privatization would create addition regulatory and pricing issues. USAID will work with the GOL to forge a consensus on restructuring and focus primarily on the transition of the thermal generation plants and distribution companies given their key role in meeting future electricity needs and improving collections. Creating the right pricing and regulatory framework is critical to mobilizing the investment needed to meet Lithuania's power needs when Ignalina is closed through expanded generation and end use efficiencies.

<u>Intermediate Result 1.5.3: Baltic Regional Energy Cooperation</u>

Each Baltic country has particular energy assets and liabilities. It has become apparent through analysis and discussions with multilateral lenders that the three countries have to take into consideration regional options to meet their energy needs and not only domestic options.

The three countries would benefit significantly by coordinating their energy requirements on a regional basis. Going beyond national considerations would improve scale economies and buffer the individual Baltic states from over-dependence on single suppliers. The Baltic Regional Energy Development Program was established by the Baltic Energy Council to carry out a cooperative program aimed at examining and promoting investments needs from a regional perspective. A Steering Committee, consisting of the utilities of the three countries and DC Baltija, the regional dispatch center, as well as USAID, World Bank and EBRD representatives has approved a program of regional least-cost investment analysis. This program seeks to develop an initial plan by the end of 1997 and to then develop institutional financing approaches to developing specific high priority projects.

The development of the regional electricity system will also be strongly influenced by the broader effort to create a Baltic Ring linking the three Baltic countries with the Nordel, Centrel, UCPTE, and Russian system. A special committee has been established under the Baltic Energy Council to participate in the feasibility work on this concept.

In addition, the EU PHARE program is planning to hire two local individuals in each of the Baltic countries and one long-term foreign project coordinator to further Baltic energy cooperation.

The USAID Baltic regional program is being funded out of regional funds and will be further defined in the ENI SO1.5 R4. The program however will be monitored from USAID Vilnius and is supportive of this SO since it is assessing the regional implications of the closure of Ignalina and identifying the least-cost investment alternatives according to different Ignalina closure scenarios.

A.6 Summary Results Review

The GOL formation of an Energy Price Commission (EPC) provided the vehicle for price reform work. The USAID consultants worked with EPC to develop electricity, gas and heat tariff methodologies. The EPC has submitted to the GOL proposed methodologies which are awaiting adoption. Electricity prices are near actual operating costs, heat prices are approximately 80 % of costs and gas prices approximately 90 % of costs. GOL dialog on a law to establish an independent regulatory body are on-going with the World Bank (and EU consultants). The GOL is in process of taking their first energy sector restructuring by transferring the heat distribution companies to 6 regional municipally-owned organizations with tariff differentiation. The World Bank through the $80 million Structural Adjustment Loan addresses further restructuring. The Lithuanian Power Company (LPC) is establishing improved energy efficiency and customer services through the assistance of USAID consultants and the USEA Utility Partnership Program.

The Government and the Regulator(VATESI) are reviewing the in depth Safety Analysis Report. The current agreement with the EBRD/Nuclear Safety Account calls for a decision on relicensing by July 1998. This date may be extended into 1999. The decision on whether to relicensing Unit#1 will depend on the DOE rechanneling study as well as the economic analysis of the costs/benefits of investing in the safety upgrades recommended by the SAR in relation to the expected life of Unit #1 assuming no rechanneling.

In January, 1997 the Baltic countries produced a preliminary draft regional least-cost plan. A significant aspect of the plan is that it is substantially the product of the utility companies (with USAID contractor input). They worked through the process needed to develop a plan. A major effort was devoted to the process which is more significant at this stage than the draft findings which indicated numerous areas where better data are needed. The draft indicates the mechanism and process are in place for an improved plan to be developed.

A.7 Forging Sustainable Progress

Achievement of the three Intermediate Results will provide a basis for sustained reform and improvement in the power sector.

Energy sector reform is expected to lead to a strong burst of private investment in the sector, but this investment will only be forthcoming if the policy and regulatory environment inspires efficient market-oriented solutions to Lithuania's energy problems. Furthermore, private investment will only be forthcoming if Government makes a credible attempt to address the safety concerns in INPP. Furthermore, an important part of the energy solution will be to broaden the focus of energy planning efforts to the Baltic region as a whole. Improving the safety and efficiency of the energy sector will, in turn, make an important contribution to the improvement of Lithuania's public financing and to ongoing attempts to forge a viable commercial financial sector, USAID other two main economic restructuring strategic objectives. Improvements in those areas, as well, will also be vital to progress in improving the safety and efficiency of Lithuania's energy sector.

A sound regulatory framework and price reform will be achieved and maintained through strengthening the existing Energy Price Commission, removing it from Government budgetary control through a fee-based revenue system, and developing it or its successor independent regulatory body into an effective organization. Passage of a law establishing the body will provide a sound legal underpinning. Through USAID regional activities, longer-term linkages will be established between the Lithuanian regulatory body and the U.S. National Association of Regulatory Utility Commissioners.

The closure of Ignalina will be sustained through the provision of alternative adequate electricity to meet the needs of Lithuania. This will be done through restructuring the sector to attract strategic investment to provide the investment capital necessary to improve and expand electricity production. The presence of strategic investors will bring a strong voice to the dialogue on economic pricing and system operation. Utility restructuring that provides greater autonomy leads to more interested organizations speaking on behalf of rationalizing electricity sector policies and practices.

The linkage of Lithuania to its neighbors for electricity will be accomplished by its increased needs for imports and the potential for more economic investment on a regional basis to meet future needs.

The World Bank presence will enhance the stability and permanence of reforms through its operations and policy conditionality in the energy sector.

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Monday, March 24, 1997

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ENI Objective 1.5
Foster economically sound and environmentally sustainable energy systems

Strategic Objective 1.5
IMPROVED SAFETY AND POLICY OF THE ENERGY SECTOR

TIMEFRAME: 3 YEARS
DEVELOPMENT PARTNERS: EU PHARE, World Bank , EBRD, Ministry of National Economy, Baltic power utilities, DC Baltia, Energy Price Commission, LE, Baltic Energy Council,NSWG, SIP, LEI

IR 1.5.1 SOUND DECISIONS ON RELICENSING IGNALINA

Timeframe:3 years

Development Partners: MNE,VATESI, LEI, INPP, EBRD, G-7 NSWG, SIP

- **IR 1.5.1.1.** VATESI completes thorough & competent regulatory review
  Timeframe: 1 year
  Development Partners: EBRD, LEI, INPP, MNEG-7, NSWG
- **IR 1.5.1.2 Lithuania meets obligations to Nuclear Safety Account**
  Timeframe: 3 years
  Development Partners: INPP, LEI, EBRD
- **IR 1.5.1.3 GOL decision based on sound economics (least cost) as well as safety**
  Timeframe: 2 years
  DevelopmentPartners: LEI, INPP, EBRD

IR 1.5.2 PRICING, REGULATORY REFORM AND RESTRUCTURING PROMOTE ENERGY INVESTMENT

Timeframe:3 years
Development Partners: MNE, EPC, LE, WB, EU Phare, EBRD

- **IR 1.5.2.1 Energy regulation becomes more independent**
  Timeframe: 1 year
  Development Partners: EU PHARE, WB, MNE, PC
- **IR1.5.2.2.** Independent regulatory commission established and staffed
  Timeframe: 2 years
  Development Partners: EU PHARE, WB, MNE, PC, LE
- **IR 1.5.2.3.** Power system restructured
  Timeframe: 3 years
  Development Partners: EU Phare, Danish government, WB, MNE, LE

IR 1.5.3 ENHANCED BALTIC ENERGY COOPERATION

Timeframe:3 years

Development Partners:LE, EBRD WB, Latvenergo, Esste Energy, DC Baltia Baltic Energy Council

- **IR 1.5.3.1.** Power investment planning capabil ities developed at member utilities
  Timeframe: 3 years
  Development. Partners: CHP, MNE, Danish gov., Baltic Energy council
- **IR 1.5.3.2** Benefits of regional power pool demonst-rated to member utilities
  Timeframe: 1.5 years
  Development Partners: Baltic power utilities,EBRD DC Baltia, Baltic Energy council
- **IR1.5.3.3.** Economic advant ages of regional projects demonstr-ated
  Timeframe: 1.5 years
  Development Partners: Baltic power utilities, EBRD DC Baltia, Baltic Energy Council
- **IR 1.5.3.4** Regulators capable to address regional issues
  Timeframe: 1.5 years
  Development Partners: Baltic power utilities, EBRD, DC Baltia, Baltic Energy Council

Abbreviations: LE-Lietuvos Energya, VATESI-Lithuanian Nuclear Inspectorate, LEI-Lithuanian Energy Institute NSWG-Nuclear Safety Working Group, SIP-Swedish International Program

TABLE 5 : PERFORMANCE DATA FOR STRATEGIC OBJECTIVE 1.5: BASELINE, TARGETS, AND ACTUAL RESULTS

LEVEL	RESULT STATEMENT	PERFORMANCE INDICATOR	INDICATOR DEFINITION AND UNIT OF MEASUREMENT	BASELINE DATA		1997		1998		1999		2000	
				YEAR	VALUE	Target	Actual	Target	Actual	Target	Actual	Target	Actual
SO 1.5	Improved Safety and Policy of the Energy Sector	Power system investment increases	Definition: Persentage of ownership of utilities by strategic investment Unit:%	1996	9% in Lithuanian Power		9% in Lithuanian Power	35% in Lithuania Power			35% in CHPs and 35% in distribut. companies		
IR 1.5.1	Sound decisions made on relicensing Ignalina	GOL decisions and Supporting Analyses prepared using proper research	Definition:Regulatory Licensing Review(RLR) and Least Cost Study (LCS) documents will be prepared Unit: Documents completed and Government Decisions made	1996	1st LCS prepared			Documents completed and Decision made					
IR 1.5.2	Pricing, regulatory reform & restructuring promote energy investment	1. New Legislation and regulations for energy sector adopted	Definition:Energy law passed Unit:yes/no	1996	Old Law in effect	New Law drafted		Law passed					
		2. Government restructures power sector into separate distribution, transmission, and generation companies	Definition: GOL splits electricity, generation and distribution and begin privatization Unit:restructuring completed	1996		District heating transfer to the Municipalities	Decision made to transfer district heating to Municipalities	restru-cturing completed					
		3. Energy prices reflect real economic costs	Definition: Electricity, heat and gas tariffs reflect costs of production Unit: % of economic costs	1996	70%	80%		90%		100%			

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LEVEL	RESULT STATEMENT	PERFORMANCE INDICATOR	INDICATOR DEFINITION AND UNIT OF MEASUREMENT	BASELINE DATA YEAR	BASELINE DATA VALUE	1997 Target	1997 Actual	1998 Target	1998 Actual	1999 Target	1999 Actual	2000 Target	2000 Actual
IR 1.5.3	Enhanced Baltic energy cooperation	Regional Energy project development planning completed	Definition: Regional agreement on project reached Unit: Yes/no (includes milestones)	1996		Regional Electricity Plan deveoped	Draft Regional plan developed	Regional Power pool Agreed to and project finance plan developed		Regional Project agreed upon			
IR 1.5.1.1.	VATESI completes thorough and competent regulatory review	Lithuanian Safety Panel Review endorses VATESI Recommendations	Definition: Internantional Peer Review of VATESI recommendations done Unit: Review done*	1996	SAR is being performed	SAR completed	SAR complted, GOL and VATESI are reviewing ithe SAR	Review done					
IR 1.5.1.2.	Lithuania meets obligations of Nuclear Safety Account	1. GOL does not undertake rechanelling	Definition: No major channel replacement. Unit is closed when gap closure occurs* Unit: yes/no	1996	SAR is being performed		SAR indicates channel gap problem						
		2. VATESI completes Regulatory Safety Review and develops recommendations on closure and/or required safety improvements for license	Definition: Review considers Safety Analysis Report and Regulatory Review* Unit: yes/no	1996	SAR is being performed			Completed					
1.5.1.3	GOL decisions based on sound economic as well as safety considerations	Economic Analyses of power and Energy Investments/Costs completed	Definition: Update of least-cost plan considering costs of Safety upgrades and options to continued operation of INPP from national and regional perspective Unit: yes/no	1996	LCP in prepa-ration	LCP prepared	The LCP is beeing updated	Analyses completed					

LEVEL	RESULT STATEMENT	PERFORMANCE INDICATOR	INDICATOR DEFINITION AND UNIT OF MEASUREMENT	BASELINE DATA									
				YEAR	VALUE	1997		1998		1999		2000	
						Target	Actual	Target	Actual	Target	Actual	Target	Actual
1.5.2.1.	Energy Regulation becomes more independent	Regulator approves rates for electricity, gas and heat	Definition: Regulator has authority to approve rates for companies Unit: yes/no	1996	Regulator recomends energy prices to GOL	Regulator recommends GOL tariff changes	Regulator recommends GOL tariff changes			June			
1.5.2.2	Independent Regulatory Commision functioning	Independent Regulatory Commision(RC) established and staffed	Definition: RC established as a Legal independent body and and permanent staff hired Unit: yes/no	1996	Rc is functioning as advisory body	RC is institutionalized	RC is institutionalized and has 5 staff memebrs	Indepen-dent RC established and has 20 permanent members					
		Electricity companies licensed	Definition: Licenses issued to companies Unit: % of total companies	1996						50%		100%	
		Electricity market established	Definition: Electricity market Rules Unit: Yes/no	1996			GOL plans to separate companies			Rules established			
1.5.2.3.	Power system restructured	Separate accountable organizations	Definition: Separate generation and distribution companies established Unit: number of companies	1996						6 in March 6 in September			
1.5.3.1	Power investment planning capabilities developed at member Utilities	Regional Integrated Resourse Plan Issued by BREP	Definition: IRP issued with updates Unit: Yes/no	1996		Plan developed	1st version prepared	November		November			
1.5.3.2.	Benefits Of Regional Power Pool Demonstrated to member Utilities	Utilities and Governments approve power pool operating Structure	Definition: Operating Agreement Unit: yes/no	1996				Approved					

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LEVEL	RESULT STATEMENT	PERFORMANCE INDICATOR	INDICATOR DEFINITION AND UNIT OF MEASUREMENT	BASELINE DATA		1997		1998		1999		2000	
				YEAR	VALUE	Target	Actual	Target	Actual	Target	Actual	Target	Actual
1.5.3.3.	Economic Adnvantages of regional projects demonstrated	Utilities develop regional finance plan	Definition: Proposed Regional Finance Plan Unit: yes/no	1996				Finance plan developed					
1.5.3.4.	Regulators capable to address regional issues	Regulatory mechanisms in place for considering of regional projects	Definition: Procedures approved by 3 countries Unit: Yes/no	1996				Approved					

COMMENTS/NOTES: *- data is subject to negotiation

Annex 3

S.O. 2.1 Baltic Regional

Sustainable Citizen Participation

to Stabilize Democracy and Market Orientation

CONCEPTUAL STRATEGIC OBJECTIVE RESULTS FRAMEWORK[1]

SO 2.1: Stabilize democracy and market orientation through increased and better informed citizen participation in political and economic decision making in the Baltic Republics.

1. Statement of Strategic Objective

The ENI objective 2.1 "Increased citizen participation in political and economic decision making in the Baltic Republics" was approved in 1996. After careful consideration of alternatives for sustaining gains achieved in the democracy and economic sectors following USAID departure from Estonia, Latvia, and Lithuania, the objective has been refined in scope to "Stabilize democracy and market orientation through increased and better informed citizen participation in political and economic decision making in the Baltic Republics."

2. Problem Analysis

The history of democracy is rife with failures of sustainability. The early 1990s saw the world's third wave of democratization, having followed widespread transitions from authoritarian regimes in the 1820s and in the period after World War I. Both of the earlier waves ended in retrenchment, wherein newly democratic nations devolved to authoritarianism which tended to spread to their neighbors.[2] Democratic breakdown characteristically occurs in countries with shallow practice in democratic habit, defined operationally as those with less than twenty years continuous experience with democratic institutions.[3]

The institutions of democracy and open markets have been substantially erected in the Baltic states, but they remain extremely fragile. Both the public and private officials who manage these institutions are universally inexperienced. Furthermore, the citizens of the region are only beginning to learn how to influence and to take direction in a democratic manner. The stability of the institutions in the Baltics is challenged by the slow recovery from economic collapse that accompanied the first stages of transition. Additional threat is posed by the reversion already taking place in neighboring Belarus.

An active role for large portions of the citizenry in governing society requires a capacity to

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[1] This results framework contains one regional activity which will be implemented through an endowment. USAID policy guidance covering endowments limits the scope of management oversight such that the detailed performance targets normally included in a results framework are inappropriate.

[2] Huntington, Samuel P. "Democracy's Third Wave," *Current*, September 1991, pp. 27-39.

[3] Dahl, Robert. *Democracy and Its Critics*, New Haven, CT: Yale University Press, 1989.

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participate, an invitation to participate, and the motivation to do so.[4] These attributes will be assured by the combination of existing institutions, other donor support, and a foundation established to achieve SO 2.1.

Table 1. Lagging Areas of Welfare Recovery

		Lithuania	Latvia	Estonia
life expectancy (years)	1990	70.5	70.4	69.6
	1995	67.2	66.0	70.1
GNP ($ / capita)	1989	6709	7416	9651
	1995	2095	4472	3620

Increased civic ownership of society: The motivation for an individual to support democracy and open market reforms derives from the perception that these reforms benefit that individual. As the recovery of personal welfare to 1989 levels lags and inequalities become ever more conspicuous, there is increasing risk that individuals will lose faith in the transition. Substantial declines in government employment have reduced the number of direct stakeholders in government support, while high unemployment levels (relative to the previous regime) have kept the benefits of private enterprise distant from some people. In Latvia and Estonia, the rejection of societal membership is explicitly recognized by the lack of citizenship for large segments of the population.

In the Baltics, public apathy and cynicism are legacies of the Soviet period. They not only dampen NGO development, but also discourage the evolution of a new generation of political leaders. There have been few private, local initiatives since the transition began largely because the public does not believe that individuals have the capability to resolve problems for the community. It is not uncommon for the electorate to return leaders to power from the former regime on the strength of their having some relevant experience, their ability to deliver minimal services, and the promise for better economic benefits without reform. Leaders with strong commitment to the reforms are in short supply as many of the most capable members of society turn away from public service. The lack of personal identification with the state manifests itself in voter apathy and non-payment of taxes, further weakening the state.

[4] Verba, Sidney, Lehman Schlozman and Henry E. Brady. *Voice and Equality: Civic Volunteerism in American Politics*, Cambridge, MA: Harvard University Press, 1995, p.1.

Table 2. Measurable Threats to Civic Ownership of Society

		Lithuania	Latvia	Estonia
government employment	1989	N/A	N/A	71.6%
	1995	N/A	N/A	42.5%
unemployment	1989	none	none	none
	1995	12.6	6.6	5.0
% residents not citizens	1996	N/A	30%	28%

More capable civil society through increased NGO activity: In an effective democracy, there exists a flow of communication and activity between NGOs and government. NGO leadership contributes organized private-sector input to government and it helps explain issues of potential interest to local citizens. Thus NGOs provide feedback both to their constituency and to government officials, potentially affecting greatly the quality of public decisions and private response. Well functioning NGOs increase the capacity of citizens to participate in decisions by lowering the threshold of knowledge, time, and expense required for participation. USAID analysis has empirically identified the importance of civil society both in generating the political impetus for appropriate reforms and in consolidating those reforms. The consolidation function is achieved in large part by holding the government accountable for its decisions.[5]

In the Baltic states, the capacity of civil society is weak in serving as a channel for information flow either from or toward the citizens. The need for this channel is critical since citizens have a limited understanding of their democratic rights, roles, and responsibilities. NGO activity is largely parochial, with interests that do not extend much beyond their confined circle of members. Networking, coalition-building, and national-level advocacy are limited to few NGOs. Municipal officials are often unaware of, or are disinterested in, the potential benefits of working with NGOs in community projects.

3. Results Framework and Narrative

3.1. Transition Hypothesis

The U.S. assistance program in the ENI region is structured on the premise that such assistance can effectively promote the transition of Central European and NIS countries from centralized, authoritarian control to nations governed on the basis of democratic and free-

[5]Hansen, Gary. *Constituencies for Reform: Strategic Approaches for Donor-Supported Civic Advocacy Programs*, PN-ABS-534, USAID/CDIE, February 1996.

market principles. As this transition goal is achieved, USAID assistance will cease, and field offices will be closed.

In 1996, Estonia graduated from U.S. economic assistance in all areas except democracy and governance. Recognizing the potential impact on sustainability of issues such as the lack of ethnic integration, assistance to NGOs continues to support public policy advocacy and appropriate legal reforms in Estonia. Latvia was originally scheduled for graduation in 1997. However, slower progress in achieving economic reform objectives in the financial sector led a decision to continue limited discrete programs during the period FY 1997-1999. Similarly, a postponement in closing out USAID's program in Lithuania, to end in FY 2000 rather than FY 1999, is being proposed. Such postponement has been deemed necessary to enable USAID to complete crucial reform efforts in key areas of the economic and energy sectors.

In pursuing the goal of democratic and economic transition, USAID faces the major challenge of ensuring the sustainability of reforms that it has helped to introduce. The remainder of USAID's presence in Latvia and Lithuania will be devoted to consolidating and deepening gains achieved in promoting free-market and democratic principles. Assistance in democracy and governance in Estonia will help sustain gains achieved to date, and will need to be continued under the proposed regional foundation. This foundation will be funded under Regional SO 2.1, which is being proposed for the Baltics to "stabilize democracy and market orientation through increased and better informed citizen participation in political and economic decision-making." Under this strategic objective, USAID envisions strengthening non-governmental organizations in each of the three Baltic states to act as catalysts for reform. By strengthening the civil society in the Baltics so that it is capable of championing the adoption and consolidation of reforms, and holding the state accountable for what it does, USAID's accomplishments in the Baltic Republics will have a greater chance of being sustained.

3.2. Critical Assumptions

Estonia, Lithuania, and Latvia will maintain their independence: Recent events highlight the fragility of the Baltic states' still recent independence. For example, several Russian presidential candidates who ran in the June 1996 elections expressed an interest in reuniting the former Soviet Union. In 1995, the Russian Parliament supported this concept by renouncing the Belovesk Accord, which formally disbanded the Soviet Union. Recent events in Belarus which moved Belarus politically closer to Russia is also cause for concern. Continuing political problems with Russia over their ethnic minority in Latvia and Estonia are a very real and continuing cause of concern. It is understandable that Baltic citizens remain wary of the potential threat from the east. The assumption that independence will continue is critical to any USAID involvement in the Baltics.

Continuation of support from other donors: USAID's programs in the Baltics are coordinated with the NGO-related programs of other donors. The scope and focus of activities to be undertaken by the foundation assume continued donor support to NGOs. In particular, donor support to the area of general NGO training (organizational development, financial

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management) is a critical assumption for achieving expected maximum results under this regional SO.

Economic growth in the Baltics continues: Continued economic growth will allow businesses and people to attain sufficient income to think beyond their immediate needs. This attitude is an important determinant for the development of a sense of volunteerism and philanthropy, both essential ingredients to a sustainable NGO sector.

The investment market is adequate for endowment earnings: Reliance on an endowment for future income requires that the investments by the fund management provide adequate returns. Planning for the foundation will make conservative assumptions regarding the likely level of nominal returns and the rates of inflation in the country where investments are made and in the Baltic states.

3.3 Causal Linkages

IR 2.1.1 Increased Civic Ownership of Society: The members of a society sense their ownership of the society when they feel they can have an effect on its decisions. Democracies offer several mechanisms for individual influence, such as personal freedoms, voting on government representatives, and referenda on state questions. However, in mature democracies, the major form of influence is through collective action in the form of NGOs. NGO advocacy skills are particularly difficult to develop in an emerging democracy because the institutional mechanisms for contact are changing and there is little shared experience on effective strategies. NGOs in the Baltics, like those in other former centrally planned states, have been slow to engage in sustained mechanisms for promoting the interests of their constituents even though there is obvious incentive to do so. Training in the techniques of advocacy, including building cooperative relationships with government and coalitions among NGOs, can stabilize and empower the sector and its participants.

Effective advocacy by an NGO builds on well informed membership and partners. Enhanced NGO communication and outreach is essential for NGOs to contribute positively to decisions. In the competition for people's attention, communication requires skillful preparation and targeted delivery. Enhancing these technical skills falls within the proven capabilities of donor institutions, like foundations.

In Latvia and Estonia, minority integration is particularly important because the failure to appropriately resolve this issue constitutes a serious threat to the stability of democracy and even to national independence. This issue extends to both the reduction of distinctions between minority members from the population at large, and the more complete inclusion of identifiable minorities into the fabric of society. With a large proportion of the population unable to vote, the fundamental strength of democracy as a shared responsibility for government actions is invalidated. Significant disenfranchisement is apparent for these minorities, such as the prevalence of inferior schools for Russian-born residents. Russia has repeatedly referred to the problems of ethnic Russians who are not citizens when negotiating international issues, such as recurrent border disputes, with Estonia and Latvia. NGO 42 activities to integrate and empower ethnic minorities, educate citizens, and create dialogue among communities is an effective means of containing, if not fully resolving, this critical threat.

IR 2.1.2 More Capable Civil Society through Increased NGO Activity: The legal and regulatory environment for NGOs differs among the three Baltic states, but each has substantial deficiencies. These include weak and conflicting legislation on NGO legal responsibilities and inadequate tax protection for contributors in all three states. NGOs are likely to be the best advocates for improvements in this environment and they might serve to inform legal changes and implementation procedures. The improvement of these factors is essential for the vigorous development of the sector and it provides a fertile training ground for NGO cooperation and activism.

Nearly all NGOs in the Baltics are nascent, with unproven capacity to secure sustainable funding. During the years of central planning, cultural and service-oriented counterparts to today's NGOs were instruments of the state. Today, NGOs continue to receive state funds. This financial support, however, has been declining and is expected to decline further. Absent a well formed concept of philanthropy, either individual or corporate, and lacking experience in fund-raising, the Baltic NGOs face an insecure institutional future. Public exposure to the benefits of NGOs, coupled with continued improvement in the Baltic economies, can be encouraged by appropriate NGO activity. Training and contact with NGO fund raising in other countries can improve NGO technical capacity for sustainable financial independence.

The quality of NGO leadership is critical to the success of NGOs both as institutions and to assure a positive impact on society. NGOs are also significant as a training ground for leaders in other parts of the state and economy. Having little experience throughout the region with private-sector organizations, there is widespread need for skills in management, office and business skills, networking, communication and related functions. Without improvements in these areas, NGOs cannot be effective advocates or service providers for their constituencies and cannot better inform public decisions. Previous donor assistance has been particularly effective in the improvement of these skills. With declining international donor activity, there is a widening gap in the need for assistance on these forms of NGO capacity.

4. Sustainability

The results framework for the Baltics demonstrates that the graduation results for all the strategic objectives except SO 2.1 will be met by the time USAID closes in Latvia and Lithuania. The expected results under SO 2.1 will take up to ten additional years to be met. Therefore an endowment is recommended as a post-presence mechanism to meet these results.

Because of the important role played by NGOs and civil society related to reforms and democratic governance, and the nascent and weak state of NGOs in the Baltic region, it is imperative to continue support in order to achieve the targets set for the NGO sector. The argument made in the results framework is that NGOs play a critical role in society as

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advocates for policy change, as a watchdog that holds the government accountable for its actions, and for the provision of basic services. Therefore, NGOs must be supported in order to sustain continuing progress in democratic and economic reforms. The nature of USAID support through the endowment should be targeted to establishing the necessary conditions for the NGO sector to become sustainable.

Factors that influence sustainability include:

- Continued economic growth: This is conducive to philanthropy and volunteerism as people are able to earn beyond their basic needs and have more leisure time.

- Supportive legal and regulatory environment: This enables NGOs to operate sustainably, e.g. be protected by law from government control and interference; raise more revenues as individuals and businesses can take a tax deduction for donated funds and as NGOs can receive a rebate on taxes for goods purchased in the local market.

- Acceptable investment market: This allows the foundation to earn income from its endowment while it develops the capacity to generate new funds.

USAID's investment in the endowment will provide assistance to local organizations that will focus on introducing and establishing critical conditions related to sustainability of NGOs. These organizations will address issues related to legal and regulatory reform regarding the creation of NGOs, their registration, taxes related to them as well as those businesses and individuals who wish to make donations to NGOs. In addition, the endowment will invest funds in the improvement of NGOs that provide training and technical assistance to other NGOs on managing an NGO, understanding laws and regulations, writing grant proposals, raising funds, analyzing policies, drafting legislation, networking and lobbying, and coalition building.

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Baltic States Regional SO 2.1

- **SO 2.1 Stabilize democracy and market orientation through increased and better informed citizens participation in political and economic decision making**
  Timeframe: 2008
  Devt. Partners: All of the below-mentioned organizations
  - **IR 2.1.1 Increased civic ownership of society**
    Timeframe: 2008
    Devt. Partners: BAFPD, Open Society Institute (NY), regional OSF affiliates, and other NGO-related groups
    - **IR 2.1.1.1 Ethnic integration**
      Timeframe: 2008
      Devt. Partners: BAFPD and other groups TBD
    - **IR 2.1.1.2 Improved NGO advocacy skills**
      Timeframe: 2008
      Devt. Partners: BAFPD and other groups TBD
    - **IR 2.1.1.3 Enhanced NGO communication and outreach**
      Timeframe: 2008
      Devt. Partners: BAFPD and other groups TBD
  - **IR 2.1.2 More capable civil society through increased NGO activism**
    Timeframe: 2008
    Devt. Partners: BAFPD, Open Society Institute (NY), regional OSF affiliates, and other NGO-related groups
    - **IR 2.1.2.1 Improved legal and regulatory environment for NGOs**
      Timeframe: 2008
      Devt. Partners: BAFPD and other groups TBD
    - **IR 2.1.2.2 NGO financial sustainability**
      Timeframe: 2008
      Devt. Partners: BAFPD and other groups TBD
    - **IR 2.1.2.3 NGO leadership quality**
      Timeframe: 2008
      Devt. Partners: BAFPD and other groups TBD

Baltic States Regional SO 2.1

SO 2.1 Stabilize democracy and market orientation through increased and better informed citizens participation in political and economic decision making

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Timeframe: 2008
Devt. Partners: BAFPD, Open Society Institute (NY), regional OSF affiliates, and other NGO-related groups

IR 2.1.2.1 Improved legal and regulatory environment for NGOs

Timeframe: 2008
Devt. Partners: BAFPD and other groups TBD

IR 2.1.2.2 NGO financial sustainability

Timeframe: 2008
Devt. Partners: BAFPD and other groups TBD

IR 2.1.2.3 NGO leadership quality

Timeframe: 2008
Devt. Partners: BAFPD and other groups TBD

Capital Markets. In 1996, Lithuania's capital markets made the transition from being an agent for financing the fiscal deficit (i.e. though treasury bill sales) to an emerging equities market. Lithuania's capital market was provided an initial boost by privatisation, investment deregulation (in insurance and leasing), and the establishment of a treasury bills market. A Securities Commission was created in 1992, a stock exchange in September 1993, the Central Securities Depository in March 1993 and a Central Bank clearing facility for securities in July 1995. There are 51 registered brokerage companies on the exchange and 12 brokerage divisions of commercial banks. Close to 2000 companies are registered with the exchange of which 350 are registered on the current list. Securities turnover has been steadily rising. As the Lithuanian stock exchange shifts from being focused on treasury bills to equities, market capitalization and liquidity are sharply rising. Monthly turnover of equities averaged 12 million litas in 1995. At the end of 1995, market capitalization was 630 million litas or 2.7 percent of GDP. By the end of December 1996, market capitalisation rose to reach 3.6 billion litas or 12.2 percent of 1996 GDP---a six-fold increase in one year. By the end of 1996, foreign investors were reported to have held approximately US$100 million in Lithuanian equities (Starkeviciute, 1997). In December 1995, the IFC released a new, Lithuania index for emerging securities. This index, set at 100 in December of 1995, rose to 260 by December of 1996.

Lithuania received its first international credit rating in 1996 (a Ba2 rating from Moodys) and in early 1997, Lithuania received its second international rating from IBCA. Government issued one-year Lithuanian state bonds (in litas) on the international market (i.e. a 200 million litas issue by Merryl Lynch at a 22 percent yield in August 1996). During 1996, the Government also received three syndicated commercial loans from consortia of western banks. In August, Vilnius Bank became the first Lithuanian company to issue global depository receipts (60 million Litas) on the Luxembourg stock exchange. Thereafter, Vilnius Bank and Nomura brokerage company launched a GDR sale for the Birzai dairy (US$6 million); and have announced that they will provide a platform for GDR sales for qualified firms in the future. The initial success of the GDR launching in Luxembourg prompted a sharp increase in investor interest in shares trading on the Vilnius exchange. It is estimated that close to 10 Lithuanian firms are due to launch GDR issues on overseas capital markets in 1997.

Table 12 : **Growth in Stock Market Capitalization**

Period	*Stock Market Capitalization (million litas)*	*Number of Issuers on the Current Trading List*
December 1993	106	44
December 1994	246	183
December 1995	630	351
September 1996	2,1670	418
January 1997	na	540

Source: Vilfima, *Securities Market of Lithuania*, 1996 and Central Depository of Lithuania.

In February 1996, the Government adopted the new Law on Public Trading and Security. This law replaced a number of temporary decrees, provides a broad range of coverage and defines more clearly the scope and responsibilities of the Securities Commission. During 1996, a new investment companies law and a capital adequacy rule for brokers was passed. The latter prompted the closure of a number of under-capitalized brokerage firms. Seven new rules on corporate disclosure were adopted; the Securities Commission doubled its staff (to 38); 97 investigations and inspections were conducted (of which 15 for cause) and a large number of capital markets training and public awareness activities were conducted throughout the year. In addition, a strategic plan for the development of the stock exchange was completed, rules for regulating investment companies were developed, capital adequacy standards were adopted for brokers, and improved corporate financial disclosure requirements were developed and implemented. Supervision skills and authorities of the SEC have been enhanced; the SEC has been more active in inspecting brokers and dealers; a training and certification program for brokers has been developed; investment company and investment fund inspection procedures have been prepared; and the accounting rules for investment companies have been revised.

Despite these improvements, rapid growth in capital markets activity is exposing certain weaknesses in the market. It is widely agreed that the software and hardware in the Stock Exchange need replacement; that brokers' back office procedures and software need upgrading; that large (and rather risky) segments of the capital market remain unregulated (commercial bank brokerage operations, margin operations); that dispute resolution remains largely untested; that corporate and public awareness of the capital markets is still rudimentary and that shareholder rights and corporate disclosure standards are modest. The stock exchange is due to be internationally audited, and part of this audit will include an examination of needed investments in trading system software and hardware. As the SEC becomes responsible for new investment funds and private pension funds, supervision and regulatory competencies of that body will need improvement. The Central Depository is, in addition to the guarantor of all transactions, the main source of market information in the country. In the future, this market information role will need to be spun-off into some form of commercial operation. In addition, contributions to the guarantee fund need to be increased, legal reform is needed to clarify investors' beneficial ownership rights, currency exposure and bankruptcy risks of the Central Depository need to be reduced, sub-custody arrangements need to be made available, procedures for transferring client portfolios from bankrupt brokerages must be established, and a major effort is needed to improve access and quality of market information (Smith and Halpern, 1996).

Elsewhere in the financial markets, 1996 witnessed the introduction of a number of new consumer banking products. Two banks began credit (debit) card operations, and several banks introduced ATM machines. Also, in December 1996, the Lithuanian Banking, Insurance and Finance Institute was established. Its objective is to provide training programs in a wide range of commercial banking and financial sector activities.

Trade and Trade Policy. In 1991 and 1993, Lithuania's terms of trade fell by close to 50 percent of GDP as Russian export prices were adjusted to world market levels (IMF 1995). Both exports and imports plunged as domestic producers adjusted to higher real import costs. Imports and exports have staged a strong recovery since 1992 due to exchange rate appreciation and steadily growing inflows of official external financing from the West. Lithuania's imports continue to be dominated by energy and mineral product purchases from Russia and other FSU republics. Exports of food, other agricultural products, minerals, textiles, manufactured goods and chemicals, have shifted increasingly to the West, with a sharp increase in trade to the EU, EFTA and North American markets.

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Annex 4

The Republic of Lithuania: the 1996 Economic Situation

Steve Tabor

Economic Management Services International

The Republic of Lithuania: the 1996 Economic Situation

Prepared for USAID
Steven R. Tabor
March 25, 1997

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LEIDEN ● THE NETHERLANDS
PHONE: 31 71 5128826 ● FAX: 31 71 5131900

I. Introduction

1996 began with the collapse of the Joint-Stock Innovation Bank and the Litimpeks bank. This prompted the removal of the Prime Minister (Adolfas Slezevicius) and the BOL Governor. When the year began, a "caretaker" government was in power and the major banks were under threat. The economy seemed poised to contract, inflation to accelerate, unemployment to skyrocket, and there was serious concern that fiscal balance would be lost.

As the year proceeded, performance exceeded expectations. Growth rebounded, inflation was relatively modest, unemployment fell sharply and despite a very difficult payments environment, the fiscal deficit was not terribly out-of-bounds. Growing demand and an investment-upsurge triggered a widening of the trade deficit, but this was of little serious concern given Lithuania's modest level of foreign debt. Throughout the financial crisis, Government managed to maintain the currency board, but more importantly, maintained some semblance of a payment's system and a fully convertible currency.

While the transition process did proceed in 1996, progress was aimed more at consolidating past reforms than deepening the process. Cash-based privatization stalled; public finances were not put on a sound footing; the social fund ran short of resources; trade protection to agriculture increased; energy industry debts accumulated; and the financial sector came out of the banking crisis more shallow and non-competitive than ever.

Furthermore, what progress did occur in the economy in 1996 was by no means broadly based. That relatively few households have "felt" any noticeable progress was reflected in a growing sense of dissatisfaction with political processes in general, and a rapid swing-to-the-right of the voters in the 1996 Parliamentary elections. The LDDP's inability to deliver on the economic front, corruption charges and perceived weaknesses towards Russia led to its loss of support and the election of the Fatherland Union (former Sajudis) and the center-right, Christian Democrats in the November elections.

II. Recent Economic Developments

Population: The Lithuanian population has fallen slightly since Independence, and long-term changes in birth and death rates, provide reason to believe that population is likely to continue to fall. In 1992, Lithuania's population stood at 3.747 million. By 1996, the population had fallen to 3.712 million, a decline of 35,000, or about 1 percent in a four year period. Rising mortality rates and falling birth rates imply that these trends will continue, adding modestly to an already high labor force dependency rate.

Economic Growth. From 1990 to 1994, GDP fell to under half the levels reached at the start of the decade[1]. The fall in output was most pronounced in 1992 and 1993 when

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It is important to note that the fall in output is actually not as pronounced as these figures would suggest. First, output in 1990 includes goods and services that were not demanded per se, but (in contrast to the product mix in 1994) were produced according to Plan dicates. Second, grey market activity have increased

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official GDP fell by 38 percent and 24 percent respectively. At purchasing power parity, official per capita GDP has fallen from about US$6700 in 1990 to US$4100 in 1995, a level that is less than half of that prevailing in Estonia and about 70 percent of that prevailing in Latvia. The main factors triggering the collapse in output include the breakdown in normal trading relations with Former Soviet Union (FSU) Republics, a sharp rise in energy and other import prices after these were liberalized, the effects of domestic price liberalization on domestic costs, and coordination losses resulting from the breakdown of central planning and the loss of traditional input suppliers and output markets for Lithuania's main products (particularly in agriculture and energy). Output began to recover in 1994, 1995 and 1996, with growth reported at 1 percent, 3 percent and 3.6 percent respectively in these three years.

The decline in GDP during 1990-1994 was more pronounced in the agriculture, transport and energy sectors than in industry or services. The share of industry increased from 18 to 23 percent while that of services increased from 20 percent to 52 percent of GDP. The pronounced shift towards services reflects both the severe under-development of these activities in the former Soviet Union and the rapid movement of (largely private) resources into these areas following small-scale privatization and deregulation. The shift of resources from low-productivity agriculture to higher productivity services and manufacturing, together with a modest recovery in exports, are the main factors responsible for the recovery in growth in the mid-1990s.

Under the auspices of the European Comparison project of 1993, Lithuania estimated a purchasing power parity exchange rate for the year 1993. By comparing a market basket of goods in Lithuania with a "similar" basket of goods in Austria, a PPP exchange rate equivalent to US$1 = $.8159 litas was calculated. In other words, for 1993, the market exchange rate was under-valued by a factor of 5.3 times at equivalent purchasing power. For that year, and at PPP exchange rates, Lithuania's GDP per capita was estimated to be the equivalent of US$3650 (Department of Statistics 1996). Some analysts have argued that Lithuania's GDP will inevitably converge on a PPP level, and therefore this level is a good indicator of actual incomes (Department of Statistics 1996). In fact, there is little reason to believe that actual incomes will in fact converge to PPP levels----many countries are low cost precisely because they are low-productivity. Furthermore, measuring living standards across countries with radically different definitions of collective goods (e.g. housing in Lithuania) makes living-standard comparisons hazardous at best.

Growth in 1996. Lithuania's economic growth performance exceeded the expectations of almost all economic and market analysts (EBRD 1996). The early predictions for 1996 were that growth would be subdued due to higher energy prices and to the adverse aftereffects of the banking crisis. In the first quarter of 1996, real GDP is reported to have declined by 10.8 percent, the highest single-quarter drop reported in three years. Since the first quarter, growth has steadily recovered, with GDP increasing by 5.9 percent in the second quarter, and annual growth estimated to reach 3.4 percent for the year as a whole.

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significantly since 1990 and is likely to offset a considerable share of the collapse in "formally recorded output". And third, statistical reporting systems have deteriorate in the wake of the breakup of the state sector. Official GDP estimates must be regarded as notional at best.

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Preliminary estimates are that GDP grew by 3.6 percent for 1996 and reached a total of 22.52 billion litas or $5.63 billion in 1996. Percapita incomes would be US$1507, which would put Lithuania squarely in the ranks of low-middle income states. The gap between Lithuanian percapita incomes and those of the poorest nations in the European Union is still almost a four-fold difference. In large part, this explains the reluctance of EU officials to promise fast-track accession.

There was no marked changes in the structure of the GDP in 1996. A somewhat larger portion was contributed by agriculture, hunting farms and forestry -- 13.2 percent. These sectors contributed 10.4 percent in the same period of 1995. Construction accounted for 7 percent of GDP, trade 20.9 percent, transport 6.1 percent and communication 2.1 percent.

For the first three quarters of 1996, 87 percent of GDP was accounted for by consumption expenditures, of which 69 percent was private consumption and 18.1 percent public consumption. Gross domestic investment was estimated at 19.4 percent of GDP, with foreign savings closing the savings-investment gap of 6.4 percent of GDP. In terms of total incomes, the first three quarters statistics show that returns to capital continue to remain high. Labor incomes (employee compensation) was 40 percent of GDP and enterprise returns (and mixed income) another 41 percent of GDP.

In the first half of 1996, total investment fell from 19 percent to 14.7 percent of GDP. In the third and fourth quarters, investment picked up, and was estimated at 18.8 percent in the third quarter of the year.

The downturn in output in the first quarter was most severe in agriculture, petroleum refining and manufacturing. Output in these sectors fell by 23 percent, 19 percent and 11 percent respectively. The downfall in output was moderated by strong growth in the electricity, gas and water supply sector (23 percent in the first quarter) due to growth in energy exports during that quarter. Pent-up demand for consumer durables has also played a strong role in the economic recovery. For example, the number of cars registered in Lithuania increased by 60,000 units in 1996.

Table 1: **GDP and Indirect Output Indicators for 1996**

Indicator	*Percent Change*
GDP	3.6 %
Mining, quarrying and manufacturing sales	1.3%
Electricity, gas and water supply	10.8%
Trade through Klaipeda National Sea Port	16.6%
Construction Activity	5.2%
Retail Trade	3.6%
Goods carried by railway	11.8%
Airport passengers	8.8%
Export (through September)	22.7%
Import (through September)	20.3%

Department of Statistics, *Economic and Social Development in Lithuania*, December 1996.

Indirect indicators suggest that the rise in GDP could be even greater than the aggregate figures suggest. In 1996, industrial sales rose by 1.3 percent. Electrical, gas and water supply sales grew by 11 percent in 1996. Industrial and manufacturing output and sales dropped-off sharply in January and February of 1996 but rebounded sharply to the end of the year.

On average, the volume of retail trade in Lithuania in 1996 increased by 6.4 percent over the 11.95 billion litas recorded in 1995. Sales were especially heavy at year-end. 1.12 billion litas worth of goods were sold in December, of which 91 percent (1.023 billion litas worth) was sold in private stores and marketplaces and 9 percent (97 million) sold in state-owned stores and consumer cooperatives. On a year-end basis, 11.7 percent more goods were sold in 1996.

Sales and freight figures suggest that economic activity was reasonably buoyant. For the year as a whole, industrial sales rose by 3 percent and milk sales rose 10 percent. Retail turnover was reported to have increased by 6 percent. Transport services grew rapidly in 1996. The volume of freight shipped by rail rose by 12 percent, river freight by 19 percent , while air-freight fell 32 percent. The amount of shipping through the Klaipeda port increased by 17 percent from 12.7 million tons in 1995 to 14.8 million tons in 1996[2]. The number of ships docking at Klaipeda rose by 12 percent, and the number of containers loaded (39,000) rose by 25 percent over 1995 levels. At the Klaipeda port, 4.2 million tons of cargo were oil products, 3.5 million tons were metals and 2.9 million tons were ro-ro cargo. Increasingly, Klaipeda is being developed as a major trans-shipment point for heavy metal products.

Export-oriented *light industry* and the energy sector emerged as leading growth sectors in 1996. In 1995, 1.6 billion litas in light industrial products was exported, while in 1996, about 2 billion litas worth of light industrial goods were exported. According to the head of the light-industry association, the majority of light industrial enterprises have restructured and have established ties with foreign investors.

The *energy* sector witnessed a strong surge in export sales in 1996. Total power generation in 1996 was 16.73 billion kW/h compared to 13.84 billion kW/h in 1995. Lietuvos Energija (the national thermal and electrical energy company) increased its production by 21 percent and exported 1.8 times more than it had in 1995. Of total generation, the Ignalina atomic power plant was responsible for 13.94 billion kW/h of this total, and the electric plant in Elektreniai, the Kaunas and Kruonys hydroelectric plants, the Vilnius, Kaunas and Mazeikiai thermal electrical plants accounted for another 2.79 billion kW/h. Labor productivity rose by 12 percent in the energy sector and power network losses fell by 20 percent. Both made a contribution to a reduction in generation and transmission costs.

In 1996, Lietuvos Energija exported 5.23 billion kW/h of electrical energy, of which 3.58 billion kW/h (69 percent) was sold to Belarus, 1.34 billion was sold Latvia and 0.31

It is reported that 3.5 millon tons of metal exports were handled by Klasco sea freight company in 1996.

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billion to Russia in repayment of outstanding debts. In 1994, Lithuania exported only .5 billion KW/h and only 2.9 billion KW/h in 1995. Domestic demand for electricity is also recovering. In 1996, Lietuvos Energija sold consumers 7.01 billion kW/h, in 1995, compared to 6.76 billion kW/h in 1994.

Agricultural production rebounded on the back of a booming grain harvest. Most of the increase in production can be attributed to good cultivation conditions, although a gradual increase in farm incomes has also led to improved access and use of chemical fertilizers. Total area planted increased by 4 percent in 1996, with sizable gains in the area allocated to vegetables (14 percent), sugar beet (28 percent) and cereals (6 percent). The total harvest is reported to have increased y 38 percent for grains, 27 percent for potatoes, 17 percent for vegetables and 15 percent for sugar beet. Yields also rebounded, rising by 31 percent for grains, 27 percent for potatoes and 4 percent for vegetables. This suggests that the input shortages and marketing difficulties that plagued the farm community during 1991-1994 are largely a thing of the past.

Livestock numbers continued to fall, with an 8 percent decline in the number of cattle, an 11 percent decline in the numbers of pigs and a 10 percent decline in the numbers of poultry. The decline in the herd numbers may be exaggerated since sales of livestock and poultry for slaughter dropped at a far lower rate (by 3 percent) and since milk sales rose by 10 percent. (Department of Statistics, 1996).

The annual grain harvest rose by 500,000 tons to reach 2.5 million tons, the best in five years. Productivity also rose by close to 20 percent thanks to favorable cultivation conditions. Wholesale sales of grains rose by 41 percent (560 thousand tons) and potatoes by 93 percent (14 thousand tons

The construction sector is largely (90%) private sector and its recovery is seen as a barometer of consumer demand. For the year, the construction industry has begun to recover, but at a very slow rate. In the near-term, construction sector activity will be closely related to progress in investments in economic infrastructure and residential rehabilitation.

Liberalization of energy prices in 1996 was expected to erode the competitiveness of Lithuania's *industrial sector*, but instead, there are signs that industrial exports continue to grow. In the first nine months of 1996, half of all industrial output was exported. Some companies have successfully restructured product lines and markets, to meet Western standards. The most rapidly developing industries are in the textiles and knitwear industry, the tanning industry, forestry and wood products industries and the chemical products industry. Machine building and electrical engineering industries continued to witness a decline in operations in 1996. But even in the electronics sector, some firms have managed to successfully reorient technology and marketing to western markets, while others have not.

Table 2: **Sales Growth in Selected Industries, 1996**

Industry	*Percent Change in Sales in 1996*
Food products & beverages	-3%
Tobacco	26.7%

Clothing and furs	22.4%
Wood and wood products	11.6 %
Refined petroleum products	11.3%
Chemicals	12.2%
Rubber and plastic	22.2%
Machinery and equipment	-22%
Electrical equipment	18.9%
Medical equipment	-39.6%
Motor vehicles	-19.9%
Furniture	-2.4%
Electricity, Gas and water supply	10.8%

Source: Department of Statistics, *Economic and Social Development in Lithuania*, December 1996.

Official GDP figures under-report actual economic activity because of significant gray-market, or unrecorded economic activity. The Economic Research Center estimates that between 40 to 50 percent of total economic activity is unrecorded. The main causes of unrecorded economic activity are tax avoidance, smuggling, unlicensed exporting and other illegal activity. If estimates of informal activity are correct, then actual GDP is approximately twice the size of GDP reported by the Government---or about US$10 billion.

In late 1995, the Free Market Institute surveyed opinion leaders to estimate the size of the shadow economy. The percent of "shadow" activity in these sectors was reported by business and government leaders to be: transportation (31 percent); processing industry (33 percent); medical care (37 percent); energy (37 percent), municipal services (43 percent) retail trade (52 percent); wholesale trade (53 percent) and real estate (59 percent). The head of one large grocery chain estimated that 60 to 70 percent of retail activity goes unreported.

Table 3: **Selected Economic Indicators, 1991-1996**

	1991	1992	1993	1994	1995	1996
Percentage Change						
GDP/NMP	-13.4	-37.7	-24.2	1.0	3.0	3.6
Consumer Prices	224.7	1,020	410.4	72.1	39.6	13.1
Real Wages	-19.9	-17.2	-45.3	20.6	5.4	6.0
Broad Money	162	351	124	64	33	-2.4
Credit to the economy	128	532	165	106	-49	-11.7
Unemployment rate (%)	0.3	1.3	4.4	3.8	6.6	6.2
Trade Balance ($ mill)	1,814	101	-294	-307	-358	-490

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Current Account (% GDP)	10.6	5.6	-9.5	-3.2	-2.5	-8.7
<u>Percentage of GDP</u>						
Government Revenue	41.4	32.1	28.5	24.6	24.0	22.5
Government Expenditure	38.7	31.3	33.4	29.3	27.0	25.7
Fiscal Balance	2.7	0.8	-3.1	-4.2	-3.4	-3.2

note: 1995 figures are preliminary and 1996 figures are estimates.

Source: IMF (1995 and 1996), Ministry of Finance, Bank of Lithuania, and Starkeviciute (1996).

Another problem with tracking GDP is the large number of private firms that, while officially registered, no longer operate. According to a survey of 8,574 newly established firms (those established since 1991), 52 percent are not operating. Of this, one-third of the firms have halted operations and the other 20 percent have suspended operations. Many of these firms were no doubt uneconomic and perhaps shouldnt have been founded in the first place. Owners of inactive firms cite inadequate operating funds, marketing and supplier problems as the reasons for halting (Department of Statistics 1996).

Privatization. In his 1997 address to the Parliment, the President declared that large-scale cash privatization had "been blocked by an open boycott of the founding ministries". This seems to accurately sum-up progress on that front in 1996, which, in retrospect, was doubly disappointing because Lithuania was in the vanguard of FSU country efforts to privatize its economy. Lithuania embarked on privatisation earlier than other Central European nations, using a decentralized system of publicly distributed investment vouchers . Between 1991 and by mid-1995, 85 percent of the 8,214 companies eligible for privatization (and just over 72 percent of their capital) were privatised. Almost all residential real estate and a large share of agricultural land holdings were privatised, the majority by conversion of investment vouchers. Three-quarters of all assets privatised were in exchange for vouchers (plus 5 percent in cash) and one-quarter for cash or foreign currency sales (dominated by the sale of shares in three large enterprises). By mid-1996, 93 percent of all investment vouchers (valued at about 9.5 billion litas) had been used for privatization. Of this, 19 percent were used for purchase of own residences, and 65 percent were used to privatize state enterprises.

While asset transfer was rapid under voucher privatisation, the process brought very little new financing or management into the enterprises and, in many instances, voucher privatization simply transferred ownership to employees or to pre-privatization management. The new law on Privatisation of State and Municipal Property, which came into effect on September 15, 1995 signals the Governments intent to pursue cash-based privatization through public share subscriptions, auctions, tenders, direct sales and capital leases. Following on the successful example of Latvia and Estonia, the Government established a privatisation agency to oversee cash-based privatization. At the time this agency was established, an estimated 50 percent of economic output is still produced by enterprises in which Government holds a majority interest. Many of these are in strategic sectors (energy, transport, communications, infrastructure, banking, health and education) although a number of large manufacturers still remain under public control.

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By the end of 1995, the government had privatized 5,706 enterprises, leaving a further 6,644 medium and large scale enterprises left to privatize. On March 19, 1996, the Lithuanian government approved a list of companies to be privatised during the second stage of privatization. This included approximately 200 companies valued at an estimated 2.9 billion Lt. On July 24, another 259 enterprises were added to the list, raising the total to 454 entities to be privatized, the total value of which was estimated at 3.74 billion litas. Actual performance fell far below expectations. During the year only 47 of these were sold. Seventeen public auctions were held in which stakes in 17 companies were sold for approximately 1.2 million litas. The National Stock Exchange held ten auctions in which shares in state companies were sold for 839,517 litas. In addition, a total of 19 entities were sold through municipal auctions, raising a total of 1,2 million litas. Taken all together, the fact that cash-privatization raised only US$1 million in 1996 indicates that the program simply didnt work.

A number of factors have been cited for the failure of the privatization effort. The first was political will. With respect to the large energy companies, concern had been raised that Russia would come to dominate the sector and exercise undue influence on the country's energy supply. The Ignalina nuclear power plant, originally part of the list of 18 major companies put up for sale, was removed from the list after a few months.

Another problem hampering privatization was that unrealistically high asset values were attached to property to be privatized. In a December 1996 meeting (ELTA December 11), the head of the Privatization Agency, Vytis Atkociunas, reported that one of the main problems was that the Government's residual share (sold in a single block) in many privatized agencies was rather small, and that when this was put up for cash sales through bids or through the Stock Exchange, the amount offered was too small to attract investor interest.

The LFMI reviewed cash-based privatization and found that excessive rights of founder ministries and municipalities, unclear objectives and institutional weaknesses in the privatization agencies, corruption and disregard for established procedures to be the main problems. The biggest constraint appeared to be the discretionary rights of founder ministries and municipalities to release assets for privatization and to select the form of privatization. Rather than relinquish control, the government agencies tended to offer small packages of shares and set unrealistic prices for privatization.

Privatization was also a source of contention during the election campaigns. The Fatherland opposition charged that the program was corrupt. Nationalistic opponents demanded that strategic industries, such as energy, remain in the public sector. Furthermore, the President acknowledged mistakes in allowing the voucher program (initiated by the Saujdis government) to play such a major role.

Investment. Gross capital formation is reported to have fallen from 34 percent of GDP in 1990 to about 20 percent of GDP in 1992-1995. A small number of lumpy projects in the energy, transport and waste water treatment subsectors, together with private investment in residential housing and small and medium-scale enterprises account for the bulk of reported capital formation. The 1995-1997 Public Sector Investment Program envisions an increase in the proportion of Government spending allocated to public investment with priority accorded to regional transport and energy projects.

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Between 1990 and 1995, Central Government capital expenditures fell from 5 percent to 3 percent of reported GDP. During this same period, cumulative foreign direct investment was US$359 million, or an annual average of under 2 percent of reported GDP. On a percapita basis, foreign direct investment levels in Lithuania are amongst the lowest of the Central European nations.

Although Lithuania appears to attach little real importance to FDI, foreign investment is considered a good barometer of the attractiveness of Lithuania's economic policy environment and an important way of ensuring that other countries have a stake in Lithuania's political independence. Despite the difficult financial environment, foreign direct investment rose moderately in 1996. According to preliminary data from the Lithuanian Investment Agency (LIA), about 150 million USD were invested in Lithuania in 1996 (Baltic News Service 20-1-97). Total foreign investment during 1990-1996 is estimated by LIA to be approximately US$510 million, with close to 30 percent of total foreign investment occurring during the past year. The upsurge in FDI during 1996 would bring per capita FDI levels up to US$135---still well below levels reached in central European countries in recent years.

Foreign companies that made early investments in Lithuania continued to expand operations. The ten largest foreign investors reported that they had increased their investments from US$106 million to US$246 million. In 1996, the largest foreign investor was the Lancaster Steel Co. Inc., which invested 26.55 million USD in the Klaipedos Nafta company. Motorola, the country's largest foreign investor, increased its investments in Lithuania's Omnitel company by US$20.4 million in 1996 for a total of US$40 million investment. While passive foreign investment is not known with any certainty, Lithuanian stock brokers estimate that about US$100 million in foreign investment has been made in the stock exchange during 1995 and 1996.

While foreign investment levels in Lithuania are disappointing, it is important to note that FDI inflows for all of Eastern Europe (including Russia) were only US$13 billion in 1995, less than the amount that flowed into one east-Asian economy (Malaysia) in that year (Business Eastern Europe 1996). FDI inflows into Eastern Europe are rising rapidly, with inflows in 1995 twice as large as in 1994, but it is only three countries, Hungary, Poland and the Czech Republic, that dominate FDI flows into the region.

Table 4 : **Cumulative Foreign Direct Investment into Lithuania (US$ millions)**

Year	*Cumulative Foreign Direct Investment*
1991	8
1992	19
1993	149
1994	310
1995	359
1996	500

Source: Lithuanian Department of Statistics and, for 1996, Lithuanian Investment Agency

Table 5: Foreign Investment by countries and numbers of joint ventures

Group of countries	Share of total j.v.'s and f.c.e.'s in Lithuania 1991-95 (%)	Share of total foreign capital 1991-95 (%)	Share of total foreign capital 1996 (through 6 May)
EU	34.8	62.2	65.5
CIS	31.2	5.9	0.8
Country	**Number of j.v.'s and f.c.e.'s established between January 1991 and May 1996**	**Number of j.v.'s and f.c.e.'s established in 1995**	**Number of j.v.'s and f.c.e.'s established in 1996 (through 6 May)**
Russia	1046	70	11
Germany	847	138	31
Poland	660	63	11
USA	343	62	11
Ukraine	230	15	2
Sweden	139	28	14
Great Britain	142	36	5

Source: LIA, Country Information, May 1996

Investment laws were eased to attract more inward investment in 1996. In June, a constitutional amendment was passed which allows purchases of non-agricultural land by nationals of OECD countries. The modification of this law (done in a way to avoid opening-up the land market to Russian investors) eased a constraint to Lithuania's ascension to the EU and removed another regulatory hurdle to foreign direct investment.

Small businesses have been the foundation of economic revival, particularly in the services sector. A number of "start your own business" programs have been established and the new Government has attached a high degree of importance to providing financing for this sector. Still, the SMEs suffer from a high failure rate (50 percent of firms established since 1991 are inactive) and chronic shortages of working and investment capital. Small enterprises are developing strongly in other parts of the former Soviet Union---the ability to provide a conducive environment for this class of enterprise will have a major influence on the economy's ability to generate employment and reduce dependence on oversized industries[3].

The number of small businesses operating in Russia - mainly in trade, catering, industry, and construction - reached about 810,000 last year, ITAR-TASS and Izvestiya reported on 22 January. Investment in small businesses last year reached 28.2 trillion rubles, or 8% of total investment in the economy. Small businesses accounted for 10%-12% of GDP. This share is expected to increase to 30% by 2000. Small businesses created 1 million new jobs and now employ more than 14 million people.

Three free economic zones (Siauliai, Klaipeda and Kaunas) were authorized in 1996 in an effort to inspire greater foreign investment. The Free Economic Zone in Siauliai is the most advanced—a management group (Siauliu Skrydis) was selected and the firm plans to develop 125 hectares of the FEZ area. Imports into the FEZs would be duty free. For five years after registration of a FEZ, companies will pay 80 percent less profit tax and 50 percent less profit tax during the subsequent five years.

On the tax side, amendments were made to remove the requirement that foreign capital had to be equivalent to 30 percent of a company's capital to receive a three year profit tax break. Under the August 1996 legislation, those companies making more than a 2 million dollar foreign investment are eligible for a three year exemption from profit taxes and a 50 percent concession on their profit tax for the next three years.

In 1996, fair-competition laws were invoked for the first time. In November, the Philip Morris Lietuva company was fined 342,590 litas for price fixing and restricting sales to exclusive distributors, in violation of Lithuanian competition legislation (ELTA, November 8, 1996).

Major infrastructure investment projects underway in Lithuania include the construction of the Butinge oil terminal (est. cost US$270 million), the upgrading of the Mazeikiai oil refinery and the Ignalina power plant, the construction of the Via Baltica highway, upgrading of the national railway lines and the expansion of the Klaipeda sea-port facilities. New projects in 1996 included an IBRD US$10 million loan to finance energy saving and habitat development, an IBRD, EBRD and EU Road Repair and Reconstruction project (US$60 million project) a US$5 million loan from the Danish government to modernize Lithuanian Railroad company's signal and telecommunications systems, a 40 million ECU loan from the European Investment Bank to restructure and modernize the railroads; a US$18 million Klaipeda geothermal power plant (EBRD/ Danish/EU-Phare), a US$6.2 million Siauliai environmental protection project, a US$30 million agriculture development project (IBRD), and a US$5 million Vilnius heat pipe (Denmark) project.

Of the different projects, the investment in the Klaipeda port is expected to pay rich returns in future years. A terminal for "sand-like" freight is being built to export products of the Kedainiai and Jonava chemical plants. A cement terminal (with a capacity of about 1 million tons of cement) is under construction and oil and container terminals are being built. The reconstruction of the oil terminal should allow a significant increase in oil exports, starting in 1997. The Government has approvd a US$250 million investment program for the Klaipeda port between 1996 and 2000. That program should allow the port to double its capacity and develop a specialized pier at Belga for loading liquid fertilizers, for developing the container terminal quay and for joining the future container quay and an improved ro-ro terminal in one unit.

Employment. Of a total population of 3.7 million, 51 percent are in the labor force. With privatisation (and the start-up of new private businesses), the labor force has shifted from being 70 percent in the public sector in 1991 to 34 percent in the public sector by mid-1995. By mid-1996, two-thirds of all employment was in the private sector.

Total employment has fallen from 1.85 million in 1990 to 1.67 million in 1994 due

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to a decline in the labor force participation rate[4]. About one-fifth of the labor force was reported to be self-employed in 1994, compared to practically no self-employment in 1990. Following land reform, agricultural employment increased initially to 29 percent of total employment, but has fallen back to 22 percent of estimated employment in 1995.

Agricultural employment rose again to 24.8 percent of total employment in 1996. In mid-1996, the trade sector accounted for 12.3 percent of total employment, transport and storage for 4.5 percent, public administration for 4 percent, education for 8.6 percent, health care for 6.4 percent and other services 6.9 percent.

The Lithuanian labor force is characterized by relatively high levels of labor force participation (77 percent of those of working age), and by a high level of skills. It is estimated that 44 percent of the work force have a higher or specialized secondary education.

Unemployment in 1994 was officially estimated at 1.5 percent, the lowest amongst the Baltic countries. But official unemployment was defined in such a way that did not take into consideration short-term work and enforced leave. When Lithuania revised its methods of accounting for unemployment, and defined it to encompass those seeking employment through a labor bureau, the number of registered unemployed increased sharply (see below). According to the Labor exchange[5], official unemployment increased from 4.4 percent in 1993 to 6.1 percent in 1995. In 1996, the official unemployment rate has fallen steadily from 8.1 percent in the first quarter to 7.4 percent in the second quarter and 6.6 percent in the third quarter. In December, official unemployment fell to the lowest level in the year---6.2 percent. At the end of 1996, there were 109,400 registered unemployed persons, a decline of 18,000 over the numbers registered as unemployed in 1995. The decline in unemployment has come largely as a result of a continued decline in (mainly female) labor market participation. A total of 25,900 persons were receiving unemployment compensation payments at the end of the year.

Official unemployment is far higher in secondary towns, cities and rural areas. Many of these are "one-factory towns" which have witnessed sharp cutbacks in the main employers. The highest rates of official unemployment in 1996 were registered in the Southeast, South and Southwest regions in places such as Druskininkiai (13.9 percent); Taurage (12.7 percent) and Svencionys (12.4 percent), Salcininkai and Jonava (each 11.2 percent). While employment conditions are more buoyant in the major cities, difficulties in the housing market, and skills mismatch impede the shift of labor from surplus to deficit parts of the country (UNDP 1996).

Official labor exchange figures probably underestimate the severity of unemployment because of enforced leaves in industrial enterprises and hidden unemployment in the agricultural sector. Furthermore, compensation paid to the

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As is the case in all FSU republics, Lithuania had a high rate of labor force participation, particularly among women, at independence. Part of the fall in participation rates reflects a voluntary withdrawl from the labor market. Other factors that explain falling participation rates include a rise in the share of pensioners and discouraged job-seekers in the work force.

The Labor exchange defines the number of unemployed as those persons of working-age having no paid job or business but prepared to accept employment or start a business.

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unemployed is tied to the Minimum Living Standard (MLS) which, at 90 litas per month (US$23) until December of 1996, provided little incentive to register for unemployment benefits[6]. For 1996, the minimum unemployment benefit was US$23 per month and the maximum was US$46 per month, and benefits were capped at 6 months (over an individuals last 12 month period).

The Department of Statistics conducts a labor force survey each quarter. Their surveys find that unemployment was in fact 11.6 percent in the first quarter and 11.8 percent in the second quarter of 1996 could be classified as unemployed. According to their survey, close to 765,000 persons, out of the adult population of 2.8 million are inactive, or not seeking work. Two-thirds of those classified as "inactive" were women, reflecting earlier retirement ages for women and the fact that female labor participation has declines since Independence. The Statistics Department survey finds that just under 317,000 persons are unemployed (those seeking and ready to start a job). That survey found that total employment was 1.7 million, with 45 percent employed in services, 25 percent in agriculture and 30 percent in industry.

Wages. From 1991-1993, wages were tied to food prices. As food prices increased faster than inflation, wages rose in real terms. When real food prices fell in 1992, real wages declined by nearly 50 percent. In mid-1993, voluntary wage guidelines were adopted and government influence in wage setting was limited to establishing a minimum wage.

The average after-tax monthly salary in Lithuania in November, 1996 was 174 USD. In Latvia, the average salary was 213 USD and in Estonia 246 USD (third quarter figure). Only in Lithuania did salaries decline in November. The average retirement pension in Lithuania in the third quarter of 1996 was 49 USD. In Latvia that figure was 71 USD and in Estonia it was 81 USD. At the end of 1996, however, Lithuania had the highest minimum wage in the Baltic countries. The minimum monthly salary in Lithuania in November was $75 while in Latvia it was $69 and in Estonia $56 USD.

Since the abolition of wage guidelines, wage differences have emerged amongst different occupations. The highest average wages are recorded in the more skill-intensive, financial and energy sectors. The lowest wages, by contrast, have been recorded in agriculture and in the hotel and restaurant industry, and in the wholesale and retail trade.

Real wages increased modestly in 1994, fell sharply through the first three-quarters of 1995 and increased by close to 18 percent in the last quarter of that year. In US dollar terms, real wages more than doubled during 1994 to 1996[7]. Wage growth moderated in 1996, with average wages rising by 6 percent. In 1996, it appears that a link is being

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It should be noted, however, that the Lithuanian employment office has a relatively good record in obtaining jobs for those registered as unemployed. In 1996, the unemployment offices found jobs for 48,600 persons, or about 40 percent of those registered.

Real reported wages remain low by standards of other low-middle income nations. The minimum monthly wage in January 1996 was 210 litas (US$52.5) and the average monthly salary was 653 litas (US$163). On these grounds, the IMF has argued that there remains significant scope for wage increases (in US dollar terms). However, a number of reports find a large share of wages paid unofficially, to avoid taxes. Accordingly, the prevailing average wage is likely to be well in excess of that which is reported.

forged between real wage growth and productivity, an important sign of progress in the labor market.

Table 6: Average Wage Development in 1994-1996

Date	USD/month	Percent Change
1996		
November	173.1	-1.75
October	176.2	2.1
September	172.47	2.2
III quarter	170.98	5.01
II quarter	162.82	3.32
I quarter	157.58	5.28
average annual		
1995		
IV quarter	149.68	12.68
III quarter	132.83	7.23
II quarter	123.87	13.2
I quarter	109.42	4.71
average annual	128.95	41.0
1994		
IV quarter	104.5	12.76
III quarter	92.67	6.55
II quarter	86.97	6.5
I quarter	81.66	
average annual	91.45	

Source: Department of Statistics, Monthly Bulletin (various issues), Vilnius.

In the public sector, average real wages have been relatively stable from 1993 through the end of 1996, while those in the private sector have tended to trend upwards. From October 1991 to January 1993, real wages in the public sector fell by close to two-thirds, as a result of rapid inflation. Thereafter, real wages in the public sector increased modestly through the end of 1996, but are still less than half the levels reached in October 1991 (Department of Statistics, 1996).

In 1996, the minimum wage was raised twice, from January it was 210 litas and from September to 300 litas. The base pension was set well below the minimum wage, starting the year at 90 litas per month and finishing at 100 per month (with the increase in December). The average pension in 1996 was just about as high as the minimum wage, at 213 litas per month in December. Given that approximately 20 percent of the population received pensions, and another 10-20 percent were either unemployed or in unskilled jobs, this would suggest that close to forty of the adult population had an average monthly cash wage in 1996 in the range of about US$50 per month. While Government defined the minimum standard of living to be 100 litas per month (increased from 90 litas in November 1996), it is widely understood that the MSL bears little relation to the minimum cash salary required to meet basic needs (UNDP, 1996).

Table 7: **Average Wages by Sectors, December 1996**

Sector	*Average Net Wage and Salary (litas)*
Agriculture	328
Industry	599
Mining and Quarrying	602
Manufacturing	598
Electricity, gas and water supply	895
Wholesale and retail trade	446
Banking and Finance	1228
Real Estate	603
Senior Civil Service	872
Education Sector	464
Transport, storage and communication	686
Health Sector	434

Source: Department of Statistics, *Information: Wages and Salaries*, 24 January 1997.

Public Finance. As in other transition economies, Lithuania experienced a rapid fall in Government revenues, from 44 percent of GDP in 1990 to 22 percent of GDP in 1996. The fall in actual collections is even more acute when one considers that close to half of total economic activity is unreported. This means that the effective tax rate is closer to 12 to 14 percent of actual prevailing GDP. This has two major implications. First, the tax system inspires evasion and avoidance and fails to capture a significant amount of revenue. Second, this has resulted in a sharp imbalance between the revenue necessary for Government to provide collective goods and services and the resources actually at its disposal. A discussion of options for broadening the tax base in Lithuania is included in Appendix 1.

During the first three months of 1996, revenue collections were 20 percent below targets, threatening to collapse the budget. As collections fell, the tax burden shifted more from capital (company taxes and VAT) to labor (e.g. income taxes).

The Government has maintained a prudent fiscal stance throughout 1992-1996 despite the severe fall in revenues. The fiscal balance moved into a small surplus in 1991 and 1992 as Government attempted to reduce domestic absorption and hence choke-off inflation. Between 1993 and 1996, the fiscal stance eased, with a deficit in the range of 3 to 4 percent of GDP, financed equally by domestic (Treasury bill) and foreign borrowing.

The 1996 Budget set a revenue target of 4.84 billion litas and an expenditure target of 5.5 billion litas. Revenues were slated to reach 24 percent of GDP (for the national budget) while preliminary end-year figures suggest that actual national revenues were 22.5 percent of GDP.

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The deficit of 655 million litas was forecast at 1.8 percent of GDP, just below the 2 percent target agreed to with the IMF. The actual outcome appears to be a deficit about twice the target. In 1996, planned expenditures for social welfare (79 percent), health (42 percent) and education (37 percent) were sharply increased, but Government was unable to fully meet these commitments.

With the collapse of two of the largest private commercial banks, many corporate accounts were frozen and companies could not pay their taxes or wage bills. By August, uncollected tax arrears amounted to 200 million litas. With confidence in the currency flagging, investor demand for Treasury bills began to wane. As of May 1996, government revenues were 181 million litas below target. The Government budget was then revised downwards to accommodate lower revenue outcomes. Excise duties on petroleum products and alcohol were sharply increased in mid-year and a 5 percent cut was made in spending on state administration and on all government institutions except for defense, education, health and culture. For the year, transport and communications received only 50 percent of their budget allocation, healthcare 90 percent, education 85 percent and public housing 94 percent. In early July, Parliament approved expenditure cuts of 293 million litas.

Despite, the liquidity crisis, and the freezing of Government accounts in distressed banks, preliminary data of the Lithuanian state tax inspection, suggests that the national budget collected approximately 6.664 billion litas last year or 95 percent of planned revenues. The main reasons given for poor budget revenue performance was the failure to abolish VAT exemptions, which were annulled only on January 1,1997. In addition, excise tax hikes on alcoholic drinks, tobacco and oil products were imposed six months later than originally planned. Of this, the state budget collection 4.599 billion, or 95 percent of the 4.860 billion planned. The two largest sources of revenue were the VAT and personal income tax. VAT revenues amounted to 2.286 billion litas of which 249.4 million came from VAT on petroleum products and 85.8 million came from alcohol excise taxes. Personal income tax amounted to 2.894 billion litas of total revenues. Of this, 571.8 million litas was paid into the national budget, with the remainder provided to the Municipalities. Corporate income tax contributions to the national and state budgets were 590.7 and 369.3 million litas respectively. This included 513 million litas in profit taxes from joint-stock and closed joint-stock companies. Fully state-owned firms contributed 22.6 and 22.2 million litas respectively in profit taxes to the national and state budgets. The Banks contributed 22.6 and 19.5 million litas to the national and state budgets. In addition, a total of 832.3 million litas in excise taxes was collected.

Tax reform. Some progress was made in tax reform during 1996. A new personal tax law and enterprise tax law were formulated and approved by Government. The enterprise tax was reviewed by the Seimas in early 1997 and was sent back to the Government for final review. As of early 1997, the Seimas has apparently refused to examine the revised personal income tax because of the provisions pertaining to wealth disclosure. These laws provide for a more clear and complete definition of income, reduce the number of personal tax rates to 2, eliminate a number of earlier tax exemptions and equate the top marginal rates of personal and enterprise tax at 29 percent. [8]

During 1996, a new and simplified customs declaration system (based on a general declaration) was developed, streamlining the paperwork required and easing customs automation. New VAT documentation was developed, with improved invoice and receipt vouchers being used to help counter VAT-avoidance. Government passed a law requiring all merchants to use cash registers. As of January 1, 1997, new VAT registration numbers were assigned in an effort to reduce VAT evasion. Preferential VAT rates, which had been provided in agriculture and energy were removed at the end of the year. In August 1996, excise duties for gasoline were increased by 40 percent, for tobacco by 50 percent and for alcoholic beverages by 20 percent. To combat evasion, as of July 1996, companies must report to the tax authorities any cash payments exceeding 10,000 litas per day.

In 1996, the STI was reorganized along functional lines. This has apparantly created some confusion, led to an initial loss of revenues in Kaunas, and has caused some difficulties in linking audit and inspection functions. A tax police was established with this service reporting to the Ministry of the Interior. The tax police was created as a body separate from the STI, in an effort to provide a separate layer of checks-and-balances to the revenue services. In theory, cases will be turned over to the tax police if they are not resolved within two weeks by the STI. But with this separation, prosecution of fraud cases is likely to be very difficult and this does open many opportunities for abuse. One of the reasons for the buildup of tax arrears and penalties is that STI tax administrators receive part of the fines as additional compensation. This appears to have inspired a preference for levying fines than collecting direct taxes. In 1997, the newly appointed director of the STI director acknowledged this problem and recommended that this practice be eliminated (Lietvuvos Rytas, 1-27-1997).

To help reduce the snow-balling stock of back tax arrears, In 1996, the Government passed a law which enabled companies to exchange enterprise assets for tax arrears. As of January 1, 1996, enterprises owed a total of 1.128 billion litas to the budget, of which 617 million was in fines (in 1995, the overall debt to the budget was 780 million litas of which 486 million litas was in fines). Lithuanian companies were given until December 1, 1996 to exchange shares or assets to Government in exchange for back tax arrears. About 200 enterprises have reduced their debts to Government of about 500 million litas through such transactions.

Another measure that was taken in 1996 to reduce the overhang of inter-- government arrears was the decision by Parliament that the debts to the State Energy Companies in 1994, 1995 and up to October 1, 1996 would be assumed by Government, up to a total of 776 million litas. In practice, this meant that the Government would assume the repayment requirements stemming from the foreign debts of the energy

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Elgin (1996) notes that there are still significant problems in the tax code. The natural persons law lists 25 types of tax-free income; the business income tax law permits 100 percent deduction for long-term investments and provides for the possibility of depreciating assets as well. Elgin suggests that the MOF take the lead in tax policy reform, that debate within government be conducted on policy options (not law drafts), that implementation timelines be developed before new laws are implemented and that assistance be provided on revenue forecasting.

companies. In the 1997 Budget, the Government has not yet incorporated this law of Parliament, and discussions about its feasibility and possible implementation mechanisms are still underway.

The 1997 National Budget (excluding social welfare payments) calls for total expenditures of 6.72 billion litas, revenues of 6.02 billion litas and a deficit targeted at 698 million litas (or 3 percent of forecast GDP). VAT is forecast to account for 57 percent of total revenues; excise duties another 21 percent; and corporate taxes for 9 percent. In total expenditures, defense and security were allocated 15 percent of total expenditures, education for 12 percent, state administration for 8 percent, social care (over and above that funded directly to SODRA), agriculture and health each another 8 percent, and about 6 percent for transfers to municipalities. Improved revenue administration (combating smuggling, removing VAT exemptions and improved collection of VAT and other indirect taxes) is expected to add 13 percent to total revenues. The defense budget is to increase by close to 100 percent as Lithuania tries to bring its armed forces closer to NATO standards.[9] The 1997 Budget also signals an attempt to reduce the numbers of civil servants by between 10 and 30 percent; to hire more qualified people in Government; and to improve salaries for the more-qualified civil servants. The expected budgetary impact of civil service reductions is forecast to be modest, because compensation for dismissed government officials is capped at 4 months of total salary.

Table 8: **Summary of Central Government Finance**
(Share of Reported GDP)

	1990	1991	1992	1993	1994	1995	1996p*
Total Revenue	43.7	41.4	32.1	28.4	24.6	24.0	23.7
Tax Revenue	35.6	39.9	31.1	26.4	23.9	23.7	23.1
Income and profits	15.5	12.0	11.0	10.3	7.8	7.1	7.6
Payroll tax	4.6	10.2	8.2	6.3	6.7	6.1	6.6
VAT/GET/Excise	14.7	13.1	10.8	8.0	7.1	8.7	9.2
Expenditures & Net Lending	49.1	36.6	31.4	33.3	29.3	27.0	31.2
Capital expenditure	4.7	4.7	2.6	5.5	2.6	1.8	2.0
Current expenditure	44.4	31.9	28.8	24.6	23.6	22.0	26.0
Wages and salaries	na	na	na	5.6	6.6	7.1	5.7
Household Transfers	na	na	na	9.1	8.2	7.4	3.6
Subsidies	14.0	5.5	2.1	1.3	1.3	0.8	1.1
Other	na	na	na	8.6	7.4	6.4	7.8
Financial Balance	-5.4	4.8	0.8	2.4	-1.5	-1.5	-5.2
Net Lending	na	2.1	-0.1	5.5	2.6	1.8	2.0
Fiscal Balance	-5.4	2.7	0.8	-3.1	-4.2	-3.4	-3.2
Nominal Reported GDP	.13	.382	3.2	12.2	22.2	31.9	37.6

Pilferage and sale of weapons and explosive devices by military leaders to the criminal underworld led the former defense minister, Linkevicius to order a complete inventory of army supplies to discover what was missing in mid-1996.

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(billion litas at current prices)

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a/ note that shares are defined relative to reported GDP. If "gray market" activity is as much as half of actual GDP, then such shares should be divided in two to obtain an accurate estimate of the size and distribution of public revenues and expenditures.

*/ note that the 1996 figures are preliminary and reflect November 1996 government expectations.

Source: IMF (1995 and 1996) and Ministry of Finance preliminary 1996 estimates.

Social Fund. Both revenues and expenditures on the State Social Insurance Fund (SODRA) have been on an upward trend since 1993 due to an increase in the numbers of pensioners and unemployed. SODRA expenditures were 6.9 percent of GDP in 1993 and rose to 8.9 percent of GDP in 1995. Total national, municipal and state social insurance budgets amounted to 13.7 percent of GDP in 1996 (4.4 billion litas). Close to three-quarters of SODRA outlays were for pension payments, although the share allocated to sickness and maternity insurance rose sharply in the first two quarters of 1996 (from 7.6 percent of outlays to 10.2 percent) as benefit levels were increased.

The average old-age pension rose from 168 litas to 213 litas per annum in 1996 (US$54). This is close to one-third of what is estimated to be the minimum subsistence level, leading to persistent complaints about inadeqate old-age support. At the same time, individuals are eligible for more than one pension (old-age and disability and widowhood and scientific service); there is no means-testing or poverty-targetting of state pensions; and there is but a narrow gap between minimum and maximum state pensions.

The social fund has been under considerable pressure as the share of pensioners, relative to the total labor force has increased, and as the numbers of unemployed and disabled persons have risen. Social welfare contributions are financed by a 31 percent payroll tax, with 1 percent paid by the employee. Avoidance of social fund contributions is widespread, and as a result, the social fund (SODRA) must borrow from the Budget to meet its obligations. This has, in practice, kept pensions at a very low levels. In 1996, the Social Fund ran a deficit of 97 million litas (3.5 percent of spending) and payments of 64.7 million litas to the employment fund were delayed in the last quarter of the year. If existing trends persist, the World Bank (1997) forecasts that SODRA will be operating at a deficit of 3.5 to 6 percent of total spending. It is forecast that in two years, there will be more persons receiving pensions than paying into the system. Furthermore, privatization of large enterprises will increase the opportunities for social fund avoidance and evasion.

On November 1, 1996, the SODRA minimum pension was raised by 10 litas to 110 litas. Following the increase in the minimal living standard (MLS) to 100 litas, family allowances were raised to 600 litas on birth and 75 litas per month until the child is three years of age.

During 1996, Government began to implement the pension reform program that was defined a year earlier. Under this program, the official retirement age is to be gradually increased until it reaches 65 years of age (in 2005). In the future, Government has announced that pension payments will not be fully indexed to inflation, employees and employers will share the social fund contributions, control functions will be coordinated with the State Tax Inspectorate and SODRA's administrative costs will be reduced.

Quasi-fiscal spending and tax arrears. Faced with revenue shortfalls, Government has increasingly resorted to quasi-fiscal spending (building up arrears and directing commercial credit) to meet public expenditure objectives. Large quasi-fiscal government spending operations have contributed to the financial problems in the banking sector, to trade fractions with Russia (over natural gas imports), damaged the financial status of the state enterprises and threaten the solvency of the pension fund. A variety of mechanisms have been used to reduce arrears, including freezing and forgiveness of past tax arrears, exchange of arrears for enterprise shares and intensified collection efforts.

Energy arrears continued to be a major concern in 1996. As of January 1997, the debts of Lietuvos Energija to Ignalina Power Plant passed the 500 million litas mark, throwing into question the ability of that plant to operate in a secure, commercial manner (BNS, Jan 16, 1997). In 1996, the Energy Regulatory Commission reviewed utility tariffs and proposed that Government increase these by a total of about 40 percent. Instead, Government took the decision to increase these by 25 percent. The Energy Regulatory Commission was asked to estimate the losses to the State Electricity Company from providing electricity below cost. They estimated that, in 1994, 1995 and prior to October 1996, the total loss to the Energy sector due to repressed tariff setting was 776 million litas. Government then agreed to assume this amount of the debts of the Energy sector. As of early 1997, the implementation mechanism for this had yet to be established, but it appears that Government will assume the foreign debts (up to 776 million litas) of the energy companies.

Inflation. Considerable progress was made in combating inflation in 1996. The average (mid-year to mid-year) inflation rate fell to 410 percent in 1993, 72 percent in 1994 and 40 percent in 1995. Factors which contributed to high rates of inflation included price liberalization (1991-1992), increases in real wages, exchange rate devaluation and elimination of the large monetary overhang. Anti-inflationary measures in 1993 and early 1994 included tight monetary and incomes policy. Since April 1994, adoption of a currency board arrangement has limited growth in the money supply, and helped restrain imported inflation. In 1994 and 1995, monetary expansion (fueled through capital inflows) above levels warranted with falling output, increases in energy prices and seasonal shortages of agricultural products also added to inflationary pressures. Other factors that have contributed to inflation include growing inter-enterprise borrowing and imported inflation from Russia and Germany (due to the appreciation of the Ruble and DM relative to the Litas). For 1994, the annual rate of consumer price inflation was 45 percent and for 1995 it was 36 percent.

At the beginning of 1996, Government set an inflation objective of 15 percent, which was widely dismissed as unobtainable (Economist Intelligence Unit, 1996). Year-to-year inflation fell to 13.1 percent, despite a 25 percent average increase in utility tariffs earlier in the year. For the first time in nearly five years, monthly inflation was brought to near-zero in August of 1996. The largest price increases in 1996 were registered for transport and communications (17 percent) housing, fuel and energy (14.4 percent) and food products (13.7 percent). Prices of alcoholic drinks and tobacco rose by 7.7 percent; health care by 9.9 percent; clothing and footwear by 12.4 percent; and leisure and cultural services by 10.4 percent.

Factors contributing to the slowdown in price growth in 1996 included the demonitization that took place in the aftermath of the banking crisis and fiscal restraint in the face of weak revenue performance. More generally, the IMF (1996) reports that inflation in Lithuania (post currency board)is closely linked to the restructuring of relative commodity prices ---in other words, the greatest price increases have been registered in administrative prices and in those subsectors whose prices were far out of line with norms in other European nations.

Monetary and Exchange Rate Policy. · In 1992, the shortage of Rubles forced Lithuania to introduce its own currency. In October, 1992, the talonas was introduced as a transitional coupon. It was easily forged and depreciated rapidly. After the Talonas stabilized, the Litas, Lithuania's permanent currency was introduced in July 1993. In August 1993, the Litas became the sole legal tender.

On April 1, 1994, a currency board system was established (under the Litas Stability Law). Under this arrangement, the Litas was pegged to the US dollar at a fixed exchange rate of 4 to 1. The Litas was backed by 5.8 tons of gold (held by Western banks prior to W.W.II) and by $200 million of hard-currency reserves, the majority of which was borrowed from the IMF. All Litas in circulation are fully backed by official foreign exchange and gold reserves and are freely convertible. Under the currency board arrangement, the central bank is bound by a money-creation rule that limits growth in base money to the growth in official foreign exchange reserves. Accordingly, the scope for government deficit financing through money creation is restricted by the nation's ability to accumulate official reserves. This, in turn, is influenced by developments in trade and capital flows. Conversely, international developments (in trade and capital movements) have an immediate effect on both the money supply and public finance.

Table 9 : **Consumer and producer price indices in Lithuania 1994-1996**

Year/month	Consumer prices ()			Producer prices ()	
	Monthly	As of beginning of the year	Yearly	Monthly	Yearly
1996			13.1		
XII	0.9				
XI					
X	0.1	10.8	18.2		
IX	0.3	10.7	22.3	4.5	19.0
VIII	0.0	10.4	24.3	0.3	18.0

VII	0.1	10.4	24.9	0.7	21.3
VI	0.4	10.3	28.1	0.1	21.7
V	0.3	9.8	28.8	-0.5	21.8
IV	1.3	9.5	31.4	0.2	19.7
III	2.3	8.1	31.6	1.2	13.8
II	2.4	5.7	30.4	1.0	12.2
I	3.2	3.2	32.4	1.6	16.5
1995					
XII	2.7	35.7	35.7	1.3	20.6
XI	4.3	32.0	37.2	4.4	26.5
X	3.2	26.5	36.3	3.0	26.3
IX	2.0	22.6	35.7	3.5	28.2
VIII	0.4	20.2	36.1	3.1	23.5
VII	2.7	19.7	38.5	1.0	23.4
VI	1.0	16.6	37.7	0.2	23.5
V	2.2	15.4	39.3	-2.3	20.0
IV	1.4	12.9	44.9	-4.7	30.3
III	1.4	11.3	45.1	-0.2	39.4
II	3.9	9.8	47.8	4.9	42.7
I	5.7	5.7	46.4	5.2	40.8
1994					
XII	3.8	45.1	45.1	6.3	33.8
XI	3.6	39.6	48.4	4.2	33.0
X	2.8	34.8	53.1	4.5	31.7
IX	2.3	31.3	59.8	-0.3	31.8
VIII	2.2	28.2	62.8	3.0	35.6
VII	2.1	25.4	60.7	1.1	34.5
VI	2.1	22.8	61.9	-2.7	31.3
V	6.3	20.3	68.4	6.2	37.2
IV	1.6	13.2	78.5	1.9	50.3

Source: Department of Statistics (1996), *Economic Bulletin*, Vilnius.

The currency board arrangement was introduced to provide Lithuania with a nominal anchor that could break the spiral of devaluation, wage increases, expansionary fiscal policy, monetary growth and cost-plus inflation. Towards this end, it has enjoyed a considerable measure of success. Persistently high rates of domestic inflation vis-à-vis Lithuania's trading partners have, however, caused the Litas to appreciate by nearly 100 percent in real terms since 1994. The degree to which this dampens the competitiveness of the export sectors (crucial to recovery in a small nation) was a source of growing

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concern in the 1996 elections. Other concerns relate to the effectiveness of linking money supply growth to official reserve accumulation in an uncertain trade and capital markets environment.

Since the introduction of the currency board, overall growth in the money supply has slowed, but has been highly volatile due to confidence-related foreign exchange movements. Foreign exchange outflows occurred following rumors of devaluation in late 1994 and early 1995. Thereafter, through December 1995, large foreign exchange inflows resumed causing growth in broad money to increase by 32 percent by mid-1995. Following the moratorium placed on the operations of two commercial banks in December 1995, foreign exchange outflows again resumed, but began to be reversed in February 1996.

The credibility of the currency board hinges on the public's belief that Government will back all high-powered money with foreign exchange reserves, and will not engage in "inflationary" lending to Government or the banking system. While not prohibited under the currency board arrangement, Government eased commercial bank reserve requirements for the Agricultural Bank in December 1994 and in the same month, pledged Lithuania's foreign exchange reserves for a loan from a German bank. Devaluation rumors, in late 1994 and again in late 1995, were not met by prompt public denial from the currency board; and again, in mid-1996, the currency board became a topic of political contention in the national elections. As Camard (1996) notes, the use of discretionary monetary policy during 1994-1996 combined with lackluster official support for the Currency Board acts to undermine its credibility, and in so doing, raises the costs associated with operating such an arrangement.

1996 witnessed a number of debates about the future of the Currency Board and about Lithuania's monetary management stance, in general. During the fall elections, the Currency Board (and more generally the appreciation of the Litas) was claimed to be responsible for a widening trade deficit. BOL pronouncements gave credence to the notion of limited official support for the currency board arrangement. In early 1997, the BOL announced that it would continue to maintain the currency board through September 1997; thereafter it would peg the currency to the dollar and, as inflation eased and fiscal balance improved, it would then consider a peg to the EURO. The BOL has also indicated that it was considering introducing repurchase agreement to reinvigorate the inter-bank market, foster growth of a secondary market in treasury bills and to attempt to smooth interest rates.

The Bank of Lithuania undertook an effort to reduce its staff and reorganize its operations in 1996. Institutional strengthening in the BOL is required, especially as its scope and authorities are to be expanded. The margin for error in monetary policy in Lithuania is very small due to the fact that the country has an extremely shallow, and cash-dominated financial system, that official reserves are hardly sufficient to sustain a major shock (much less a speculative assault on the currency), that the nation operates near the limits of its external creditworthiness, and that the autonomy of the central bank from Government is limited. That currency devaluation is perceived as a means of meaningfully enhancing competitiveness makes little empirical sense (when imports of raw materials and capital goods are close to half of GDP). Finally, given the nation's recent history of recapitalizing distressed banks and the limited independence of the Bank of Lithuania, there is the danger that proposed Government repurchase operations could become a mechanism for either transferring liquidity to unsound financial institutions or for accumulating government debt. The downside risks of abandoning the currency board have inspired a number of observers to suggest that Lithuania should continue to follow its long-standing tradition of commitment to a fixed exchange rate (Grennes 19996). Ensuring that the BOL has clear and consistent monetary policy objectives[10], creating meaningful autonomy between the BOL and Government and strengthening BOLs surveillance and analytic capability are high priorities.

Interest Rates. Interest rates in Lithuania remain well above international interest rates, although rates have come down sharply after the introduction of the currency board. Average interest rates on commercial loans peaked at 131 percent per annum in the second quarter of 1993 and fell to about 25 percent per annum in early 1996. Deposit rates (for litas financing) have fallen from 61 to 10 percent during the same period. Spreads between lending and deposit rates were very high until the last quarter of 1996, and by the end of the year, were relatively narrow. In general, interest rates have tended to lag inflation and, on the deposit side, were negative in real terms.

After the banking crisis, interest rates on Treasury bills rose from 15-20 percent per annum in real terms in October/November to 25-30 percent by mid-December and climbed through February. Treasury bill rates peaked at close to forty percent in nominal terms in the last week of February of 1996. Rates then fell sharply through July, edged up again in the end of July and early August, and then fell to close to 10 percent by the end of September 1996. By the end of December, treasury bill auction rates fell below 10 percent for the first time in five years.

Banking and Financial Markets. The banking sector is weak and public confidence in the banks has reached new lows. Government liberalized private banking in 1992 and 1993. Just under half of the equity in the large state banks (Savings, Agriculture and Commercial) was sold to the private sector to inject new equity into the Banks, despite the absence of modern banking standards (Fleming 1996). By mid-1994, 28 commercial banks were registered in Lithuania. By mid-1995, nine (smaller) banks were under administration, liquidation or were declared bankrupt. In December 1995, two commercial banks (Innovation and Litimpex) were placed under administration and deposits were frozen. Public outcry at the banking scandal led to the resignation of the Prime Minister, Central Bank Governor and several other senior officials, and prompted the introduction of a Government deposit guarantee scheme for (the non-State) commercial banks. The three state banks (Agriculture, State Commercial Bank, and the State Savings Bank) account for just over half of all bank assets and are all reported to have serious portfolio problems.

Causes of the Bank Crisis. There were many different reasons for the banking crisis. The downward pressures on bank income that resulted after the currency board was introduced, the drying up of the lucrative Russian metal trade, and political pressures by

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Given the main characteristics of Lithuanias financial markets (very thin markets, low and erratic money multiplier, low elasticity of money demand to interest rates, a near-binding external credit constraint, a few months of import cover in reserves, several distressed institutions, weak fiscal controls and limited central bank autonomy), it will be difficult for the BOL to maintain the credibility of its exchange rate stance and broaden its policy scope to include secondary, financial market-development targets.

Government on the Agriculture bank to make loans to distressed farmers and for the Innovation bank to lend to weak state energy companies all had an adverse effect on the commercial banks balance sheets. Other reasons for the weak position of the commercial banks include: fraud, connected lending, political lending (directed uneconomic credits), initial under-capitalization, inadequate prudential standards[11], weak bank supervision, inadequate provisioning for doubtful loans, weak management systems and the high risks associated with lending in a unpredictable, deflationary environment (Fleming, 1996). Castello-Branco, Kammer and Psalida (1996) note that the roots of the banking problems stem back to the weak internal and external controls exerted on the banks and on the enterprises during the Soviet times. They find that low barriers to entry (20 new banks established quickly after independence and peaking at 28 banks by 1994 in Lithuania), the limited independence of the banks from the major firms, limited capacity to account for, supervise or sanction poor performance, and the accumulation of bad loans was at the core of the banking problems, not only in Lithuania but throughout the Baltic. Ross (Baltic Review, 1996) attributed the banking crisis to: a) the large role of the Government, directly in the Banks, and indirectly through government-owned companies that were either the principle owners of commercial banks or the largest depositors/borrowers of private banks; b) the use of quasi-fiscal expenditures (e.g. not repaying energy debts) which put energy borrowers in arrears to the banks; and c) the unequal deposit insurance coverage and capital adequacy requirements for state and private banks which inspired private banks to engage in riskier operations.

The Banking crisis caused an immediate upsurge in capital flight. BOL foreign reserves fell sharply in January and February 1996 and then recovered and grew strongly through August 1996. In August, BOL reserves stood at US$852 million. By the end of the year, official reserves declined to reach $834 million, a 3 percent increase over the level reached at the end of 1995.

The December 1995 crisis caused the interbank market to come to a near-halt. For the first ten months of the year, the Lithuanian interbank loan market floundered. Finally, in December 1996, interbank lending reached 77.5 million litas, a 5.5 fold increase over Novembers levels. Compared to December 1995, however, the interbank market in December 1996 was about half as large. For the year as a whole, the average monthly volume of interbank loans was 25.4 million litas.

The Banking crisis significantly slowed down growth in the money supply. By the end of 1996, broad money in Lithuania was approximately at the same level as it was in September of 1995. The banking crisis caused depositors to shift their assets towards cash and more liquid demand deposits. M1 as a share of broad money rose from 54 percent of broad money to 68 percent in September 1996, before falling back slightly to 65 percent by the end of the year. The higher cash to total financial assets ratio indicates a fall in the level of popular confidence in the banking system.

Major shifts in the financial markets took place as financial assets shifted to what investors perceived to be more "secure" banks during the year. Of the State Banks, the

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The rapid increase in capital requirements for the commercial banks in 1994 caused many banks to become technically insolvement.

Taupomasis [Savings] Bank grew by 25 percent, while the Zemes Ukio [Agriculture] Bank grew by 10 percent. At the same time, the Lithuanian State Commercial Bank shrunk by 33 percent. The Vilnius Bank emerged as the largest commercial bank in Lithuania. Total deposits at the Vilnius Bank grew threefold, from 214 million to 639 million litas, with residents' deposits growing by 2.3 times, from 43 million to 102 million litas. During 1996, the Vilnius Bank's loan portfolio increased by 78 percent, from 229 million to 409 million litas.

Table 10 : **Selected Monetary Indicators**

	Official Reserves (billion Lt)	Broad Money (billion Lt)	Ratio of M1 to M2 (%)	Average Interest Rate on Deposits (litas) (%)	Average Interest Rate on Loans (litas) (%)
March 1995	2.6	4.9	54	20.2	29.1
June 1995	2.4	5.4	55	21.5	27.4
Sept. 1995	2.9	5.7	57	20.3	26.5
Dec. 1995	2.6	5.2	61	16.8	23.9
1996					
January	2.9	5.3	61	16.8	25.0
February	2.7	5.0	60	16.6	20.5
march	2.8	5.0	61	16.9	24.2
April	2.8	5.0	62	15.1	22.7
May	2.9	5.1	63	15.4	22.9
June	2.9	5.1	64	13.7	20.4
July	3.2	5.1	66	14.0	24.3
August	3.4	5.3	67	13.1	23.0
September	3.4	5.4	68	12.6	20.4
October	3.4	5.2	65	11.7	21.6
November	3.2	5.3	65	10.4	17.8
December	3.3	5.6	65	11.0	16.0

Source: Bank of Lithuania, *Monthly Bulletin*, December 1996.

The banking crisis in 1996 was triggered in December of the year before. Operations at the Joint-Stock Innovation Bank and the Litimpeks bank were suspended on December 20 and 22, 1995 respectively. The suspension was embarrassing to the Government because the BOL and the Finance Ministry had asserted that Lithuania's commercial banks were more stringently controlled than Latvia's and therefore problems wouldn't occur, and because the Prime Minister had withdrawn his private savings a few days prior to the suspension.

Between 1992 and 1995, six banks lost their licenses and two were merged; by mid-1996, 16 banks were either suspended or facing bankruptcy procedures. During 1996, the banking license of Ekspres Bank was revoked and criminal charges were brought against three bankers for fraud, violation of foreign currency rules and embezzlement. On September 19, the BOL revoked the license of the Kooperacija Bank which was then liquidated in November. In September, the Vakaru Bank initiated bankruptcy proceedings. Vakaru was the 11th and largest bank to file for bankruptcy. In total, for 1996, there were 11 banks operating in Lithuania, while at the end of 1993, there were 26 banks in operation. Problem assets of banks ["bad loans"] comprised 20 percent of all holdings and amounted to 1.34 billion litas. By the end of December 1996, 16 banks were declared to be bankrupt, liquidated or problematic..

In July, the Lithuanian State Commercial Bank (LVKB) was suspended after it failed to meet official capital adequacy limits. The state holds 51 percent of LVKB. Rather than permit another run on deposits, a rescue plan included a sharp depreciation in LVKB's shares, a recapitalisation loan of US$37.5 million and a liquidity loan of US$164 million to be financed by short-term bonds. Of the 208 million litas in bad loans of the LVKB, approximately half are related to the activities of the (suspect) EBSW financial-industrial group.

The Lithuanian Government's response to the banking contrast was in sharp contrast to that in Latvia or Estonia. Rather than let poorly managed banks fail, the Lithuanian authorities initial response was to provide support, especially during the summer of 1995, through liquidity injections into the Aura Bank and the Vakaru Bank. After the December 1995 crisis, Parliament passes a number of emergency pieces of legislation, including the creation of a limited deposit insurance scheme and, under the law entitled "On Measures to maintain the Liquidity of Commercial Banks" Government was provided the right to guarantee up to 300 million litas in interbank loans and was required to lift the moratorium on Innovation Bank and Litimpeks Bank no later than February 1, 1996.[12] During January 1995, the Government developed a bank restructuring plan together with the World Bank and IMF. This plan envisaged the full recapitalization and renationalization of the three State-owned banks, the merger and nationalization of the Innovation Bank, Litimpex Bank, and Vakuru Bank and liquidation of Aura Bank.

Under the recapitalisation agreement reached with the IMF/World Bank, the government will be able to issue up to one billion litas in securities to redeem the non-performing loans of banks with assets in excess of 400 million litas. The bad loans will be administered by the Property Bank (Turto Bankas), a debt-collection institution created out of the failed Aurabankas. This bank was established in August 1996 and provided a share capital of 83 million litas. The Bank aims to assume about 600 loans and other assets from 3 commercial banks and Aurabankas, amounting to about 1 billion litas. It is expected that the resolution of the bad loans will require around ten years to complete. A 30 percent recovery target has been set. In the future, the Property Bank would also inherit the distressed portfolio of the State banks and the other commercial banks that fail. The initial transfer of "bad loans" to the Property Bank has been behind schedule[13]. In part

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The Litimpeks Bank was allowed to resume operations in foreign exchange, with new accounts, on February 26, 1996.

Establishing a competitive "salaries" system in the Property Bank has also been a problem. The "problem" bank faces a hostile collection environment but is obliged, by law, to pay salaries below that prevailing in the banks that are under administration. Efforts were being made in early 1997 to augment the Property Bank salaries.

this is due to the fact that, in a majority of cases, problems of "connected lending" (between bank managers, industry heads and government) are at the core of the problem. A great number of economic crime cases have been identified in this process and one of the challenges for the new Government will be to address these cases.

New Regulatory Safeguards. A deposit insurance law was passed, after the crisis, with Government insuring compensation up to 80 percent of total deposits to a maximum of 5,000 litas. Deposit insurance is to be funded through a mandatory compensation fund from all banks.

A November 2 amendment to the commercial bank laws enlarged the authority of the Central Bank over the country's commercial bank operations. As a result of that amendment, the Central Bank has the authority to remove commercial bank's board members or administrative directors, as well as to suspend the powers of board members. In addition, fines were sharply increased (to between 10,000 and 50,000 litas) for commercial banks that provide incorrect information to the BOL.

Weaknesses in bank supervision were one of the factors contributing to the banking crisis. The first round of on-site inspections took place during 1994-1996 and involved 19 banks. Results from this supervision confirmed that few banks were sound, some illiquid and several insolvent. Bank supervision skills have considerably improved, and the BOL has insisted that Bank's accounts must be in accordance with IAS by 1997 and that the Banks must meet all prudential regulations by that time. Bank financial statements for calendar 1996 must be published in accordance with IAS standards in 1997. IAS standards differ from Lithuanian standards in the accounting for bad debt reserves and in the classification of real estate in the Bank's balance sheets. Since real estate (valued under Lithuanian accounting standards in a continually appreciating "optimistic" fashion) constitutes a significant part of many Bank's assets, the switchover to IAS could produce some balance-sheet surprises.

The Banking crisis inspired Government to improve Bank supervision standards. Since July 1, 1995, the minimum capital requirement was increased to ECU 1.9 million but was not applied to the State Banks. The minimum capital requirement was raised to ECU 3.8 million on January 1, 1997 and will be raised to ECU 5.0 million on January 1, 1998. In addition, Banks are required to meet a capital adequacy ratio of 10 percent of risk weighted assets, based on Lithuanian accounting standards through 1996, and Intentional Accounting Standards thereafter.[14] Connected lending may not exceed 10 percent of a Bank's capital and maximum lending to one borrower may not exceed 30 percent of a bank's capital. The maximum open positions in foreign currencies may not exceed 20 percent, except for US dollars and finally, the ratio of liquid assets to liabilities may not be less than 30 percent. As of November 1996, only seven of the 13 licensed banks were meeting all of the BOL banking norms. Those banks meeting the norms included the Vilnius Bank, Tauro Bank, Snoras Bank, Hermis Bank, and the Siauliu Bank.

IAS and Lithuanian Accounting Standards differ in their treatment of loans which are not fully deductible nor can be written off against the core capital of the bank. Also, the two differ in their treatment of bank real estate and other property which may appreciate in value under Lithuanian Accounting standard and which is subject to depreciation under IAS.

To further improve transparency, the BOL has ordered the country's commercial banks to publish annual reports, providing detailed accounts of their previous year's banking activities. The balance sheets and profit/loss statement, together with the results of an independent auditor, are to be published no later than May of the next calendar year. As of May 1996, only three of the country's banks met all the statutory requirements for the first quarter of 1996.

During 1996, the Government removed and replaced the council and most members of the management board of the State Commercial Bank and the Agriculture Bank. Under EU support, a Dutch commercial bank was brought in to help improve management systems in the Agriculture Bank. Throughout 1996, the Savings Bank continued to be distressed---in early 1997, a 50 million litas liquidity injections into the Savings Bank was being contemplated. Government has agreed to develop a plan for privatizing the state-owned banks by the end of the first quarter of 1997. As these Banks have accumulated weak portfolios, and are under-capitalized, poorly managed, and with a range of uneconomic operations, it will be difficult for Government to privatize them and to maintain the levels of services that these institutions provide.

Under the guidance of the interior ministry, a special commission was established to check the investigations of commercial bank cases. The main aim of the commission is to investigate the reasons impeding progress on commercial bank crime investigations and to enhance cooperation of the police and investigators in tracing lost deposits (ELTA 1-10-97).

The banking crisis has also inspired Government to "partially" deregulate access to Lithuania's banking sector. Foreign investor's have bought controlling shares in the Hermes and Vilnius banks stock. Nomura's 33 percent stake in Ukio bank was sold in January 1997 to a range of foreign investment funds. A Polish Bank, Kredyt Bank S.A. was granted permission in November 1996 to open a branch office in Lithuania. The Houisabank of Estonia has also announced its plans to enter Lithuania's banking sector.

Broader implications of the banking crisis. Although the banking crisis has had far-reaching effects on the regulations and participants in the banking sector, because of the very low level of financial intermediation, the failure of even very large banks has had a negligible effect on incomes and enterprise employment. The IMF (Branco et. al., 1996) report a number of indicators of the "shallowness" of Lithuania's financial markets. Broad money to GDP fell to 12 percent (compared to 75 percent in the OECD) in early 1996 currency held by the public was just over 4 percent of GDP (indicating that most transactions were in currencies other than litas), currency as a share of M2 rose from 33 percent in mid-1995 to 43 percent in early 1996 (effectively holding down the money multiplier), deposits fell to just over 10 percent of GDP and total credit plummeted to just over 8 percent of GDP (as banks shifted their assets to treasury bills) compared to 50 percent of GDP in most eastern and central European countries and over 100 percent in the major industrial nations. The IMF analysts also note that banking sector remains highly segmented since the commercial banks are able to mobilize funds through large enterprise deposits and external funds, and have little incentive to raise high-cost small deposits. As a result, more than half of all household deposits continue to be held at the Savings Bank.

While the banking crisis exposed a number of weaknesses in financial markets, the fact that its impact on the real sectors was relatively modest also signaled that:

- the great majority of financial market activity in Lithuania takes place on the curb, or informal market (through inter-enterprise lending);
- that enterprise and household confidence in the banking system is very low;
- that the lack of clarity in commercial bank regulations and in the development strategy for the banks (particularly over the issue of whether specialized or universal banks would be preferred) has made it difficult to supervise banks (some are commercial banks, some are quasi-investment banks); and
- the distress in the government banks, most notably in the State Commercial Bank and in the Agriculture Bank, has yet to be fully addressed.

In the early part of 1996, the commercial bank profits stemmed primarily from investing enterprise and government deposits (in large part) into low-risk government treasury bills[15]. In fact, total domestic lending by the commercial banks was 4 billion litas, compared to total-assets of 6.8 billion litas. As treasury bill yields fell, and as the interest rate spreads on domestic loans narrowed, a number of the commercial banks have shifted their assets into capital market activity. While capital market operations have been profitable for the Banks in late 1996 and early 1997, the volatility and largely unsupervised risks of the Bank's own-account activity in Lithuania's capital markets are a source of concern.

Table 11: **Key Published Indicators of Commercial Banks** (December 1996)

Bank	Share Capital (million litas)	Assets (million litas)	Loans (million litas)
Ukio Bank	42	223	147
Vilnius Bank	102	938	409
Innovation Bank	-	226	354
Tauro Bank	36	238	137
Litimpeks Bank	41	217	129
Vakaru Bank	3.5	124	149
Hermis Bank	67	542	218
Siauliu Bank	20	74	43
Snoras Bank	20	565	121
Ancorobank	21	49	30
Agriculture Bank	128	1396	1084
Savings Bank	40	1185	505
State Commercial Bank	165	857	617
Total	762	6,792	4123

Source: Bank of Lithuania (1996), *Monthly Bulletin*, December.

Some commentators have noted that the commercial banking system served largely as a mechanism for indirect financing of the fiscal deficit.

Capital Markets. In 1996, Lithuania's capital markets made the transition from being an agent for financing the fiscal deficit (i.e. though treasury bill sales) to an emerging equities market. Lithuania's capital market was provided an initial boost by privatisation, investment deregulation (in insurance and leasing), and the establishment of a treasury bills market. A Securities Commission was created in 1992, a stock exchange in September 1993, the Central Securities Depository in March 1993 and a Central Bank clearing facility for securities in July 1995. There are 51 registered brokerage companies on the exchange and 12 brokerage divisions of commercial banks. Close to 2000 companies are registered with the exchange of which 350 are registered on the current list. Securities turnover has been steadily rising. As the Lithuanian stock exchange shifts from being focused on treasury bills to equities, market capitalization and liquidity are sharply rising. Monthly turnover of equities averaged 12 million litas in 1995. At the end of 1995, market capitalization was 630 million litas or 2.7 percent of GDP. By the end of December 1996, market capitalisation rose to reach 3.6 billion litas or 12.2 percent of 1996 GDP---a six-fold increase in one year. By the end of 1996, foreign investors were reported to have held approximately US$100 million in Lithuanian equities (Starkeviciute, 1997). In December 1995, the IFC released a new, Lithuania index for emerging securities. This index, set at 100 in December of 1995, rose to 260 by December of 1996.

Lithuania received its first international credit rating in 1996 (a Ba2 rating from Moodys) and in early 1997, Lithuania received its second international rating from IBCA. Government issued one-year Lithuanian state bonds (in litas) on the international market (i.e. a 200 million litas issue by Merryl Lynch at a 22 percent yield in August 1996). During 1996, the Government also received three syndicated commercial loans from consortia of western banks. In August, Vilnius Bank became the first Lithuanian company to issue global depository receipts (60 million Litas) on the Luxembourg stock exchange. Thereafter, Vilnius Bank and Nomura brokerage company launched a GDR sale for the Birzai dairy (US$6 million), and have announced that they will provide a platform for GDR sales for qualified firms in the future. The initial success of the GDR launching in Luxembourg prompted a sharp increase in investor interest in shares trading on the Vilnius exchange. It is estimated that close to 10 Lithuanian firms are due to launch GDR issues on overseas capital markets in 1997.

Table 12 : **Growth in Stock Market Capitalization**

Period	*Stock Market Capitalization (million litas)*	*Number of Issuers on the Current Trading List*
December 1993	106	44
December 1994	246	183
December 1995	630	351
September 1996	2,1670	418
January 1997	na	540

Source: Vilfima, *Securities Market of Lithuania*, 1996 and Central Depository of Lithuania.

In February 1996, the Government adopted the new Law on Public Trading and Security. This law replaced a number of temporary decrees, provides a broad range of coverage and defines more clearly the scope and responsibilities of the Securities Commission. During 1996, a new investment companies law and a capital adequacy rule

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for brokers was passed. The latter prompted the closure of a number of under-capitalized brokerage firms. Seven new rules on corporate disclosure were adopted; the Securities Commission doubled its staff (to 38); 97 investigations and inspections were conducted (of which 15 for cause) and a large number of capital markets training and public awareness activities were conducted throughout the year. In addition, a strategic plan for the development of the stock exchange was completed, rules for regulating investment companies were developed, capital adequacy standards were adopted for brokers, and improved corporate financial disclosure requirements were developed and implemented. Supervision skills and authorities of the SEC have been enhanced; the SEC has been more active in inspecting brokers and dealers; a training and certification program for brokers has been developed; investment company and investment fund inspection procedures have been prepared; and the accounting rules for investment companies have been revised.

Despite these improvements, rapid growth in capital markets activity is exposing certain weaknesses in the market. It is widely agreed that the software and hardware in the Stock Exchange need replacement; that brokers' back office procedures and software need upgrading; that large (and rather risky) segments of the capital market remain unregulated (commercial bank brokerage operations, margin operations); that dispute resolution remains largely untested; that corporate and public awareness of the capital markets is still rudimentary and that shareholder rights and corporate disclosure standards are modest. The stock exchange is due to be internationally audited, and part of this audit will include an examination of needed investments in trading system software and hardware. As the SEC becomes responsible for new investment funds and private pension funds, supervision and regulatory competencies of that body will need improvement. The Central Depository is, in addition to the guarantor of all transactions, the main source of market information in the country. In the future, this market information role will need to be spun-off into some form of commercial operation. In addition, contributions to the guarantee fund need to be increased, legal reform is needed to clarify investor's beneficial ownership rights, currency exposure and bankruptcy risks of the Central Depository need to be reduced, sub-custody arrangements need to be made available, procedures for transferring client portfolios from bankrupt brokerages must be established, and a major effort is needed to improve access and quality of market information (Smith and Halpern, 1996).

Elsewhere in the financial markets, 1996 witnessed the introduction of a number of new consumer banking products. Two banks began credit (debit) card operations, and several banks introduced ATM machines. Also, in December 1996, the Lithuanian Banking, Insurance and Finance Institute was established. Its objective is to provide training programs in a wide range of commercial banking and financial sector activities.

Trade and Trade Policy. In 1991 and 1993, Lithuania's terms of trade fell by close to 50 percent of GDP as Russian export prices were adjusted to world market levels (IMF 1995). Both exports and imports plunged as domestic producers adjusted to higher real import costs. Imports and exports have staged a strong recovery since 1992 due to exchange rate appreciation and steadily growing inflows of official external financing from the West. Lithuania's imports continue to be dominated by energy and mineral product purchases from Russia and other FSU republics. Exports of food, other agricultural products, minerals, textiles, manufactured goods and chemicals, have shifted increasingly to the West, with a sharp increase in trade to the EU, EFTA and North American markets.

Recorded trade has fallen as a share of total economic activity, reflecting an increase in domestic services and an increase in the domestic market orientation of the agriculture sector.

Table 13: Foreign Trade, 1992-1995 (in percentage shares)

	Export			Import		
	1993	1994	1995	1993	1994	1995
Total (in mln. LTL)	**8707**	**8077**	**10790**	**9798**	**9355**	**12038**
EU	16.9	25.8	36.3	18.7	26.4	41.5
EFTA	3.5	5.3	3.2	4.7	7.8	2.9
CIS	57.1	46.7	42.4	67.5	50.2	37.6
Estonia	2.5	2.5	2.2	0.8	1.6	2.0
Latvia	7.3	8.4	7.1	1.5	2.7	3.6
Other	12.7	11.3	8.8	6.8	11.3	12.4

Source: LIA, Country Information, May 1996.

Lithuania's trade balance shifted from a surplus of US$100 million in 1992 to a deficit in subsequent years, peaking at US$440 million in 1996. The current account deficit peaked at 5 percent of GDP in 1993 before falling to an estimated 2.5 percent of GDP in 1995 and then rising to close to 7 percent in 1996. The current account deficit has been financed equally by inward investment (mainly passive investment in treasury bills) and by official borrowing. The nation's foreign debt has reached a relatively modest 15 percent of GDP, although debt service rose from less than 2 percent of the nation's exports to the West in 1993 to 6 percent of exports to the West in 1995.

Compared to 1995, imports have increased by 20.3 % while exports grew by 22.8 %. Russia, Germany, Belarus, Latvia, Ukraine and United Kingdom were the largest Lithuanian trade partners during the first three quarters of this year. The largest importers were Russia (29.9 percent of the total Lithuanian exports), Germany (15.3%), Poland (4.3%), Italy (3.6%), Ukraine and Denmark (3.5 percent each), Finland (3.4%), Sweden (2.9%), United States (2.3%), Japan (1.2%) and South Korea (1.6%). The largest Lithuanian import items were mineral products (crude oil and natural gas) accounting for 19.9 percent of the total imports, machinery and equipment's, electric goods (15.8%), chemical products (9.5%) and textiles goods (7.9%). About half of Lithuania's imports were from the European Union countries and 46 percent were from the CIS countries (mainly fuel). Lithuania's largest exports were textiles (15.5%), mineral products (14.8%), chemical goods (11.4%) and machinery (11%).

Trade figures from Western partner countries suggest that Lithuania's exports are significantly under-reported. Import figures for Lithuanian product exports into OECD nations are 40 percent above reported exports from Lithuania, while import figures to

Lithuania are within 10 percent of those reported by exporters to Lithuania (IMF 1995). Weaknesses in customs' control, under-invoicing of exports and unrecorded trade appears to account for this discrepancy. If exports are, in fact, significantly under-reported, then capital flight would also be well in excess of that reported in the balance of payments.

Free trade agreements came into force between Lithuania and Norway (1992), Switzerland (1993), Latvia and Estonia (1994), the European Union (1995) and the Ukraine (1995). Free trade agreements have been signed between Lithuania and Poland, the EFTA countries, the Czech Republic (1996), Slovenia (1996) and the other Baltic states (on agricultural products). Negotiations on a free trade agreement with Hungary also started in 1996. Improved relations with Poland, and the development of a cooperation agreement to develop the Warsaw-Kaunas railroad line are some of the key measures aimed at improving the trade flow between those two countries. Under the auspices the EU's Crete Corridor Supervision Committee, Lithuania and Poland have agreed to upgrade the quality of the railway track and to resolve border issues. The two countries aim to increase freight shipped across the border from 100,000 tons to 800,000 tons by the year 2000.

Tariff rates are uneven across sectors; main agricultural products remain subject to both tariff and non-tariff protection; and customs' controls and trade administration are unevenly applied. Corruption in the Customs Department is said to be rampant, and the border with Belarussia is essentially unregulated. A number of cases of alcohol and tobacco smuggling resulted in arrests in 1996, although black-market trade in these goods is generally thought to be widespread.

Lithuania has entered into several free trade agreements and bilateral trade agreements during 1991-1995, with the result being that tariffs and trade restrictions vary markedly by source market. Import duties on agricultural products were increased on April 15, 1996. Customs duties for milk and meat products, eggs, sugar and potatoes were increased to between 15 and 70 percent. Duties on imported sugar were raised from 35 to 70 percent, but these duties would not apply to EU countries.

Transparency of trade regulations increased significantly in 1996. A new Customs Code, based on the EU model was promulgated in 1996. Within the code, valuation is specific, signaling the phase-out of industry-specific minimum and check-prices for traded products. An inquiry point has been established in Lithuania for trade information; phytosanitary and sanitary regulations have been improved; and broader access to trade regulations and trade information has been provided via internet and other means. In 1995, modern border crossing points were established at the Kybartai road border and the Kena railway. In 1996 additional border crossing points were established at Kybartai and Kena. The Customs' Service is also in the process of introducing an automated system for customs data and management, and is hoping that automation will reduce opportunities for smuggling, fraud and inaccurate reporting (Darginavicius, 1996). Still, the fact remains that the country's 600 kilometer border with Belarus is largely unguarded, and that smuggling is rampant through that corridor into the country.

Lithuania moved closer to WTO accession in 1996. Working party meetings were held in November 1995, and again in March and October of 1996. Initial bilateral contacts were made with working party members on market access issues. The WTO accession process has helped Lithuania's government focus on gaps in its trade regulations, on the difficult areas of agricultural trade policy reform and customs controls and procedures. The process of WTO accession has also prompted Lithuania to clarify laws and regulations governing access to its market in services; protection of intellectual property rights and policies on government procurement. The next steps in WTO accession may be difficult, as demands are being placed on Lithuania to open its services markets, reduce agricultural tariffs, lower subsidies, modify customs transit charges and provide evidence that the country can enforce IPRs (patents, trademarks, copyrights). Providing MFN treatment to WTO members would help Lithuania achieve greater uniformity in its external trade relations, Government is aiming to achieve WTO accession by the end of 1997.

On the trade policy front, external pressures are guiding Lithuania in three distinct directions. First, in an immediate effort to safeguard and expand market access, the nation is actively negotiating and entering into free (or more accurately preferential) trade accords with its most immediate trading partners. Second, to prepare for European integration, the country is attempting to fashion a customs and tariff policy that, structurally and operationally, if not in the degree of protection accorded to weaker sectors, is similar to that of a fortress-Europe. And third, under the guise of WTO integration, Lithuania is being encouraged to liberalize market access, provide more equal treatment to all trading parties, upgrade its enforcement and surveillance capabilities and to making binding commitments to reduce trade distortions.

Despite the nations attempts to negotiate free trade zones, for certain products, Lithuania is already beginning to experience market access problems. In January, Russia raised its import duties on Lithuanian goods. In October, the EU imposed tariffs , ranging from 12 to 13.4 percent, on Lithuanian textile and knitwear products.

External Debt. At Independence, Lithuania rejected any claims to the official debts of the former Soviet Union. External borrowing in 1996 reached US$981 million, about half of which was for different investment projects. Since 1991, close to one-third of all foreign loans to Lithuania have been used to finance imports of Lietuvos Energija. Lithuanias biggest creditors were the IMF (US$328 million), the World Bank (US$125 million), the European Union (US$125 million), Nomura Intl. (US$110 million), Morgan Securities (US$108 million), EBRD ($88 million) and the Japanese EXIM Bank (US$80 million). Lithuanias total foreign debt increased by US$360.4 million in 1996 (or 1.4 billion litas) to reach 4.8 billion litas, or 15.8 percent of GDP. The Finance Ministry forecasts that Lithuania will receive between US$185 to US$210 million in new foreign loans in 1997. Because Lithuania exceded its target of 1.1 billion litas in external borrowing in 1996, the new Prime Minister has requested that a review be made of all external borrowing activity.

Energy Sector Developments. Lithuanias energy sector was designed as a major source of electricity for the former Soviet Union. With the break-up of the FSU, the gap between potential energy supply and demand has widened. Total energy production fell from 18.6 million tons of oil equivalent in 1989 to 8.5 million tons in 1994. Energy producers are plagued by excess capacity, high transmission losses in the delivery of home heating, incomplete metering of final and intermediate users, tariff levels set below operating costs and the build-up of energy payment arrears. In January 1996, energy payment arrears were estimated at approximately 300 million Litas for electricity and district heating, 150 million Litas for domestic gas and US$50 million to Russia for gas imports. Close to three-quarters of the overdue payments are from "budgetary entities" (Government and State Owned Enterprises). Payments discipline has been encouraged through cut-offs and rationing of energy.

Within the energy sector, petroleum imports and oil exploration have been opened to private sector participation. All other activities have remained under Government control (approximately 10 percent of the equity of Government companies in power, gas and oil refining are held by the private sector). Strategies have been developed for least cost planning to evaluate future energy prospects in the event that the Ignalina Nuclear Power Plant (INPP) is decommissioned. With the support of the G-7 nations, US$30 million has been provided to strengthen safety equipment and procedures at INPP. Future energy investment plans accord high priority to completing the Baltic Ring, connecting transmission lines to Poland and upgrading existing gas pipelines.

Outstanding debts, threats of higher prices and periodic delivery stoppages characterized the stormy relations between Gazprom, Russia's gas company and Lietuvos Dujos Co, Lithuania's gas supplier. In February and March, gas deliveries to Lithuania were reduced from 12 million until 3 million cubic meters per day because of the country's outstanding debt of US$45 million to Gazprom. In April, a debt rescheduling agreement was reached, which also included partial payment in kind (e.g. payment through construction services at Gazprom headquarters). In October and November, deliveries were again reduced until Lithuania was able to arrange payment on outstanding Gazprom obligations. At the end of the year, US$20 million of emergency financing was arranged from the Union Bank of Switzerland for Lietuvos Dujos Co. and all old debts to Gazprom were paid, along with payments for gas purchased in November. On December 8, 1996, Gazprom concluded an agreement to supply gas in 1997 and promised to maintain stable prices. Under the current agreement, if Lithuania does not pay for 1997's gas by April 1, 1997, then gas supplies will again be cut off. Meeting these payment commitments remains difficult, for as of December 5, 1996 the energy sector still owed Lietuvos Dujos US$18.7 million.

In mid-year, leading energy specialists drafted the Energy Pricing Methodology, which was approved by the State Control Commission of Prices for Energy Resources and Energy Activities (SCC). Based on the recommendations from the Ministry of Social Affairs, and the Energy Pricing Commission, in August of 1996, thermal energy prices were increased by an average of 25 percent, although an earlier agreement by Government and IMF would have seen a rate hike of 40 percent to cover production costs. The Ministry of Energy had forecast that an increase of 40 percent would be required to eliminate energy subsidies. Higher prices, combined with more vigorous enforcement of electricity collections, helped to reduce outstanding debts to energy concerns. In November 1996, the SCC was provided the status of an independent regulatory entity, with its own budget and core staff. As of early 1997, the SCC is still in the process of being established.

Some progress has been made in reducing consumer debts to the energy complex, although the stock of outstanding debts still remains high. Debt to Latvijas Gaze has decreased by 4.4 million litas to 422.6 million over the past year, while indebtedness to Lietuvos Energija dropped by 66 million list, or 37 percent. As of January 1, consumers owed Lietuvos Energija a total of 100.5 million litas. At the beginning of January 1996 they had a total debt of 246.5 million litas. On the other hand, the debt from Lietuvos

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Energija Co. to Ignalina Nuclear Power Plant increased over the past year to total about 400 million litas. The 1997 Budget included provisions to the effect that, when energy debts of municipalities to LPC exceed 30 days worth of billing, the Government will pay the excess to LPC out of budgetary transfers to the municipalities. This provision does not apply to debts to Lithuanian Gas and, in the Budget, is capped at Lt.100 million.

In an effort to improve operating efficiency in the domestic energy industry, the Government announced that it would transfer the responsibility for district heating to the municipalities by July 1997. Furthermore, the electricity generation and transmission business of LPC is to be unbundled, allowing for more efficient management in each of those areas. IAS (International Accounting Standards) will be used for the first time in an external audit of the LPC and Lithuanian Gas for 1996, an LPC Manaement Performance Audit is planned and international rules for competitive procurement have been adopted by the main companies.

In September 1996, Parliament confirmed the establishment of the Lietuvos Nafta national oil company. The company is created out of the merger of four of the nation's six largest oil industry companies—the Mazeikiu Nafta oil refinery, the Butinges Nafta oil terminal, Lietuvos Kuras fuel company and the Birzu Naftotiekis oil pipeline. Combining these companies under one umbrella was done to enhance prospects for obtaining foreign investment and loans to modernize the oil industry.

Lithuania's prospects for expanding refinery services and exports improved with the progress made in identifying contractors for the Butinge oil terminal. This terminal would be connected by a 94 kilometer underground pipeline from the Mazeikiai oil refinery to Butinge and construction of a pipeline and pier about 10 kilometers off shore. Flour Daniel, of the USA and Preussag Anlagenbau of Germany have been selected to undertake the construction. This project has, however, raised environmental concerns and protests in Latvia (as the pipeline is some 2 kilometers from the Latvian border).

In addition to friction caused by the Butinge oil terminal, 1996 witnessed heated discussions with Latvia over the distribution of offshore oil exploration rights. In October 1995, Latvia signed an oil exploration agreement with Amoco and OPAB. The Government of Lithuania strongly protested the agreement, although it stated that it would only come into effect when the two countries determine their sea borders. Heated negotiations over the sea border, and over possible division of offshore oil revenues, dominated relations between Lithuania and Latvia for most of 1996. Disputes over the division of possible offshore oil deposits near the Kaliningrad Oblast have also hindered the conclusion of a sea border agreement between Lithuania and Russia.

Other key energy sector developments in 1996 included the joint venture, founded by Mazeikiu Nafta and the French Elf company to produce jet fuel in Lithuania. Production of A1 jet fuel will be sold to all airlines operating in Lithuania.

The Butinge oil terminal, being built close to the shore of Latvia, has been a source of friction between the two countries. In August, Latvia's environmental minister described the terminal as unnecessary and accused Lithuania of violating the 1974 Helsinki accord on protection of the Baltic sea. Lithuania has countered that Latvia's concerns stem primarily from potential competition that Butinge could bring to the oil terminal operations at Latvia's Ventspils port.

Ignalina Nuclear Power plant (INPP) operated at 53 percent of capacity in 1996, employed 5,100 persons and generated 12.7 billion KWh of electricity. A total of 9 unanticipated stoppages were reported during the year (compared to 4 since 1990), of which only two were for planned repairs. A large number of repairs, leakages and faults in turbines were reported during 1996. According to representatives of INPP, radiation levels in the area were unaffected. To enhance safety, a draft law on nuclear safety was prepared, ensuring that Lithuania's nuclear energy facility meets international safety standards and preventing the sale of nuclear fuel and waste for armament development. Also in 1996, INPP received a US$10 million loan to be used to modernize the first reactor block. While considerable progress has been made in upgrading monitoring and safety analysis conditions, a Nuclear Safety Account report, completed in late 1996, has identified a number of serious design flaws in INPP, and has recommended consideration be given to decommissioning both INPP reactors ahead of schedule. The most important issues identified in the report are the ability of the shutdown function to be initiated and completed irrespective of any single failure, and the integrity of the reactor coolant system.

Healthcare. Health indicators in Lithuania have deteriorated since Independence due to falling incomes, rising alcoholism and crime rates, and the lack of financing, medicine and supplies for the country's healthcare system. Life expectancy, especially for men, has been steadily falling (from 67 years in 1989 to 63.6 years in 1995). Deaths due to infectious diseases rose from 9 per 1000 persons in 1990 to 16 per thousand in 1995. Children's health is rapidly deteriorating---a 1994 survey found that only 49 percent of all children under 15 years of age were classified as healthy (UNDP 1996). Alarming rises in cancer, tuberculoses and syphilis have been reported (UNDP 1996). Morbidity and mortality rates are far higher in rural than in urban areas. There has also been a rapid jump in suicide levels from 800 per year in 1990 to 1800 per year in 1994. Alcoholism is on the rise, with the number of deaths resulting from alcoholic poisoning increasing from around 600 in 1990 to just under 1800 in 1994 (UNDP, 1996). It was estimated that about 52,000 Lithuanians were classified as chronic alcoholics in 1995 (Department of Statistics, 1996).

The Law on the Health system, adopted in 1994, envisages that 5 percent of GDP should be spent on healthcare (the 1994 budget was 4.4 percent of GDP), the creation of a National Health Board, a copayment system and competitive health insurance providers. The new health insurance law, which was to come into effect at the end of 1996, was postponed until July 1997, and the likelihood of implementation at that time has already been thrown into question. In 1996, the Health Ministry faced budget cutbacks and introduced a one litas fee for visits to hospitals and polyclinics, a 5 litas per night fee for hospital stays, and halted provision of expensive services, such as heart transplants. Despite deteriorating health conditions, fewer and fewer Lithuanians make use of the state healthcare system. In 1990, there were 35,400 visits to public physicians. By 1995, there were a total of 26,400 recorded visits to public physicians (Department of Statistics, 1996). The marked decline in visits to Government physicians has been attributed, in part, to the development of private health facilities.

Even prior to the fall in demand, Lithuania's public healthcare system suffers from severe over-capacity. In 1996, there were 1,800 health care institutions, employing more than 14,000 doctors and 40,000 total staff. On a per capita basis, Lithuania has twice as many doctors as in an average OECD nation. Reducing staffing, institutions and numbers of hospital beds to an affordable level is a major challenge in the years to come. And although over-capacity is a problem, the health education system continues to increase the number of doctors that graduate from the Universities (due in part to competition between the Kaunas and Vilnius Universities). In 1990, the annual outturn of doctors was 496. This increased (and peaked) at 684 in 1994 and was 655 in 1995 (Department of Statistics, 1996).

The rising price of pharmaceutical products has become a major concern. In 1996, medicine prices rose by 6 percent in real terms. In the annual address to Parliment, the President called on Government to stimulate the development of a local pharmaceutical industry.

A number of new health-sector laws were passed in 1996. This included the Laws on Patients Rights and Compensation for Health Damages, Health Care Institutions, Health Insurance, Medical Practices, Stomatologic Care Assistance, Control and Prophylactics of Contagious Disease, Application of Economic Measures for Violations of the Legal Acts on Public Health Care, Human Blood Donorship, and the Donorship and Transplantation of Human Tissue and Organs. A major task in 1997 will be the drafting of implementation guidelines and regulations.

Education. Lithuania's education system has faced three key challenges since Independence. The first has been to retool its curricula to the needs of a modern, market economy. The second has been to retain staff and maintain facilities and standards in the light of the economic downturn and falling Government support. The third has been to accommodate the reemergence of the private sector as a provider of education services. The combination of rising enrollment levels (since 1993) and the loss of teachers to the private sector has created a shortage of qualified teachers in the education system. Training programs for teachers have increased and Government has introduced fees for higher education.

Hygiene standards of the schools have plummeted---about 49 percent of general schools do not meet acceptable hygiene standards (UNDP 1996). Some progress has been made in redirecting Lithuania's educational curriculum to meet western norms, although Lithuania's higher education system remains more "closed" to foreign involvement. Reflecting budget realities, the number of workshops and laboratories has fallen, physical education activities are sharply reduced, and the number of children able to afford school lunches has fallen rapidly.

Reflecting demographic trends, long-term enrollment in Lithuania's education system has fallen from 794,000 pupils in 1975 to a low of 633,000 in 1993. Since 1993 enrollment has climbed to 665,000 pupils as more students remain in school due to the difficult job market. With the fall in demand for unskilled labor and agricultural technicians, the demand for higher education and training in service-sector specializations (economics, business, law) has increased. Some 37 "high fee" private schools have been licensed by the Ministry of Education and Science. Private schools are located in the larger cities and reportedly find a ready market amongst Lithuania's elite (UNDP 1996).

Maintaining quality in the education system promises to be difficult---the UNDP reports that one-quarter of the teachers in 1994 were classified as unqualified. Goverment estimates that there is still a shortage of 1,500 specialist teachers, particularly in the language area. Putting the education system on a sound financial footing is the second major challenge, and with subsidies pervasive in all aspects of post-secondary and tertiary education, this promises to be a major challenge as well.

Agriculture. The break-up of the former Soviet Union led to the breakdown of export markets for meat and dairy products and for the import of animal feed. Price liberalization and land reform contributed to a situation in which the agriculture sector came to be dominated by small farmers. Since 1991, agricultural output has declined by 55 percent and agricultural exports by 50 percent. Livestock numbers are down fifty percent since 1991. Agro-input use fell sharply between 1991 and 1995 but has shown signs of recovery in 1996.

Privatization of the rural agro-enterprises (*bendrove*) was based primarily on voucher sales. As of 1996, the Government still owned 115 agro-enterprises and it is planned that, by the end of 1997, Government will hold only 8 percent of the shares in these companies (with 47 percent for farmers and 45 percent for employees). Many of these enterprises are effectively owned by their workers (since farmers have little management voice), and almost all lack capital, effective management and appropriate marketing and farmer outreach skills. Competition from private (small-scale) agro-processors, together with the steep decline in farm output has led to a sharp fall in capacity utilization in the agro-processing sector as a whole.

Land reform efforts began in 1989 and accelerated in 1991 with the adoption of a restitution program and voucher-privatization. Approximately 420,000 land restitution claims were filed of which approximately 50,000 have been settled.

The number of farms peaked at 4,300 in 1992 but have consolidated significantly since as small, nonviable farms have been closed. As of 1995, there were a total of 2,340 farms. As farms have consolidated, the average size of a farm has increased to around 450 hectares in 1995. Close to 60 percent of total arable land is now farmed by the private sector, about half of which is in small (subsistence oriented) plots of one to two hectares. About 30 percent of all land is in private farms which average 25 hectares and which by law may not exceed 85 hectares. Just under 40 percent of all agriculture land is held by rural agro-processing companies for eventual restitution or privatization. The break-up of large farms under land reform has shifted agricultures orientation towards subsistence farming and has created a need for small-farmer oriented extension and research efforts.

Prior to 1991, agricultural output and input prices were both seriously under-valued. Price liberalization has resulted in a far sharper increase in agricultural input prices than in agricultural output prices (see figure 1 in the statistical annex). Between 1991 and 1994, agricultural input prices increased twelve-fold while agricultural output prices rose by four times. The combination of a cost-price squeeze on the sector, together with the rising numbers of small farmers reentering agriculture after receiving land restitution, inspired Government to use trade barriers, direct subsidies and targeted credit to enhance agricultural incentives.

In the face of declining output, Government has raised agricultural tariffs on 8 major agricultural products (meats, poultry, dairy, sugar, potatoes) and, in the Agriculture Law of December 1994, introduced a provision for threshold import prices to be defined as a minimum import price set by the Government. Direct subsidies are paid to producers in the form of below-market interest rate loans (which are then not recovered) from the State Agriculture Bank[16]. Budgetary transfers to the farm community have fallen as public expenditures as a whole have come under pressure. Aggregate subsidy expenditures in agriculture are reported to have been cut by close to 20 percent in 1996. Starting in 1995, Government has increasingly resorted to trade protection and debt forgiveness to bolster producer incomes.

The Lithuanian meat sector---the anchor of the agricultural sector---has been plagued by over-capacity, high costs and an inability to meet western quality standards. Most of the meat factories reported losses in 1996 (ELTA 3-1-97). Meat factories purchased 155,000 tons of cattle, pigs and poultry in 1996, of which only 11,000 tons was exported, almost all of which to Eastern markets. Meat producers have outstanding debts to producers of 4.3 million litas. To assist the flagging meat industry, the Government has left the 1996 cattle purchase price and subsidies (1000 litas per ton) in place and has doubled the pig purchase subsidies from 200 litas to 400 litas per ton.

Some progress has been registered in establishing a commercially viable dairy sector. Milk production shows signs of increase, two of Lithuania's dairies have attracted investment finance on international capital markets, dairy quality regulation has been improved, and modifications to the Government's milk pricing formula have been made. There is micro-level evidence of productivity gains, and the Government has agreed to privatize a number of veterinary station and feed testing laboratories.

Some parts of the agriculture sector have emerged as competitive, while others have not (Stuikys 1995). In 1996, reported yields for grain crops and potatoes (the largest users of agricultural land) were at levels similar to those in western Europe. Milk powder exports are now Lithuania's largest agricultural export to the West, and are reported to meet international standards. Certain dairies, such as Rokiskio Suris, have established a reputation for exports of high-quality cheese and other dairy products. Certain breweries, such as Utenos beer, have already found a niche in western markets. Furthermore, lower quality meats and dairy products continue to expand sales in Russia. Other industries, such as sugar and flax, face continued losses and growing dependence on government subsidies. In the case of flax, government subsidies in 1996 accounted for 60 percent of the purchase price, and processor arrears to farmers are large.

The OECD (Centre for Cooperation with the Economies in Transition) has calculated producer and consumer subsidy equivalents for agricultural products in Lithuania. They find that producer subsidies, in 1995, were highest for pork, sugar and poultry, and that consumer subsidies were relatively large for milk, beef and veal. Overall, the average producer subsidy was equivalent (in 1995) to 13 percent of agricultural output and that consumers were indirectly taxed by 13 percent of the value of agricultural output to

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Direct subsidies account for more than half of public expenditures in agriculture.

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finance agricultural support. Consumer and producer subsidy measures are just one snapshot indicator of protection and do not capture all of the implications of Government trade intervention. Still, compared to protection levels prevailing in the EU (1995 consumer subsidy of -34 percent and a 49 percent producer subsidy), Lithuania's agricultural protection must be regarded as relatively modest. That incomes are low in agriculture; that the price adjustments have involved sharp and adverse terms-of-trade; and that adjustment costs in the sector are high are amongst the different reasons for the Government's interventions. Inefficient use of land, under-fertilization rates, low incomes in the small farm sector and a lack of modern farm machinery are all cited as key structural constraints.

While the aggregate level of distortion appears relatively modest (particularly compared to European levels of protection), the intra-sectoral distortions may have negative effects on investment allocation (e.g. too many resources flowing to the too heavily protected sectors) that are quite large over time. The IMF has found (IMF, 1996) that agricultural tariff unification and reduction to a 20 percent flat rate would benefit consumers, would reduce agricultural output, employment and incomes and would discourage production in highly protected commodities (e.g. sugarbeet). The IMF estimates (based on a rather odd methodology) that the one-off static income gains from agricultural tariff reduction to be on the order of 120 million litas or about 4 percent of GDP[17]. With food comprising a high share of the consumption expenditures of the average non-agricultural Lithuanian household, the degree to which price protection for agriculture has a positive distributional effect is ambiguous. For certain commodities (the sugar industry), the cost of protection relative to the employment created in the sector is very small indeed.

Environmental Policy. Falling output, the rise of the service sector and the decline in industrial and agricultural activity have, paradoxically, sparked a modest improvement in Lithuania's environmental indicators. Government investment in the environmental area has focused on improving municipal water quality, sparked by the interest of Scandinavian countries in reducing pollution in the Baltic sea.

In the past few years, Lithuania has been developing an environmental policy framework that relies on charges and other market mechanisms to discourage hazardous practices. In 1996, the schedule of pollution charges was revised, an environmental investment fund was launched and a pilot project developed that involved the use of tradable emission rights (together with the Panevezys water authority). The Law on Pollution Charges is based on a polluter-pays principle. If this approach is adopted, then fees and fines will provide an estimated US$2-4 million per annum to the Environmental Investment Fund (plus 60 percent to Municipal pollution funds) which, in turn, will provide loans aimed at financing pollution reduction costs. By way of demonstrations, environmental standards in a number of factories (Akmenes Cementas, Vilkas Tannery) have also been improved through the design of retrofitting and retooling projects.

The Funds calculations ignore inter-commodity market and general equilibrium effects, and are therefore only very rough approximations of the changes in producer and consumer welfare. The Fund also ignores the adjustment costs to price changes in the farm sector (e.g. commodity substitution costs) and the eventual costs to compensate the farm community for income loss (through unemployment payments). As a result, the one-off benefit from agricultural tariff production is likely to be much smaller.

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Ambient pollution continues to remain a problem in Lithuania, and with 70 percent of emissions from vehicles, there is a need to encourage less pollution-intensive transportation. Addressing mobile source pollution, developing a system of product charges for solid waste, revising the system of penalties for pollution permit violations, and developing new methodologies for damage valuation are some of the reforms underway in the Ministry of Environment in early 1997.

Social Safety Net. Lithuania had one of the highest standards of living in the former Soviet Union. With the sharp fall in GDP, living standards have deteriorated. Poverty has intensified most amongst pensioners, the rural population and those receiving the minimum wage. There is evidence of an alarming rise in the rate of suicides and alcoholism, and a measurable fall in life expectancy. Public expenditures on healthcare and education have fallen sharply in real terms and, although the serious shortage of health supplies and pharmaceutical products witnessed in 1991/1992 has largely been overcome, social services are in a state of severe decline.

Lithuania's social insurance expenditures (old-age, disability, widower allowances and non-contributory social and state pensions, unemployment, maternity and sickness allowances) have lagged inflation. Prior to catch-up pension awards in 1995 and growing enterprise payment arrears to SoDra, the system was financially balanced. Cash flow deficits in SoDra (the extra-budgetary social insurance fund established in 1991) began to occur in 1995, leading to payment delays and benefit-arrears. The social welfare burden presently adds 31 percent to the wage bill and, under current demographic trends, would have to rise to close to 45 percent of the wage bill to meet future demands. In 1995, a total of 20 percent of the population (870,000 persons) were entitled to state pensions (Department of Statistics 1996). The base pension, in 1995, was increased in steps from 75 litas per month to 90 litas per month and the average pension was only 120 litas per month (US$30). In 1996, the average old age pension was 172 ($43) litas per month, and the average disability pension was 165 litas per month ($41). The ratio of old-age pensions to average net salaries and wages was about 40 percent for most of 1995 and 1996. In 1994, 38 percent of all pensioners were working to supplement their incomes (Department of Statistics, 1996).

The 1995 Social Welfare Reform includes an increase in the retirement age (by 6 months per year until retirement age reaches 65 or both men and women), narrowing of coverage for unemployment and sickness benefits, improved administration of SoDra, establishment of private pensions, a shift of healthcare expenditures to the budget, and both lower pensions and better linking of pension payments to incomes. Under the new pension law, there will be a basic pension, set by the Government, which will be related to the level of prices and the minimum standard of living (MSL). The supplementary component will be set by the State Social Insurance Fund Council, based on the current average wage (during the past three employed years) from which pension insurance contributions are made. In examining the Pension Reform, the IMF raises concerns that the existing system is not sustainable in the medium- to long-run. They advise that the pension burden be shared more equally between the employer and the employee and that consideration be given to establishing a fully privately-funded tier of supplementary pension coverage (IMF 1996). In 1997, the new Government was giving serious consideration to the establishment of private pensions.

The actual extent of poverty in Lithuania is not known with any certainty. Polls of consumers estimate that some 80 percent of Lithuanians are living at or below the poverty level. Applying the EU definition of poverty (those with less than 40 percent of the average income) only 18 percent can be classified as impoverished. In the third quarter of 1996, it was reported that the average Lithuanian family had about 329 litas of income per person to spend each month, but that to meet "necessary requirements", the average requirement was almost twice as much, or 614 litas.

One indirect indicator of poverty is nutrition levels. Food consumption standards are on the decline, with percapita consumption of meats falling from 89 kilograms per capita in 1990 to 52 kilograms per capita in 1995; vegetable consumption from 83 kilograms per capita in 1991 to 65 kilos per capita in 1995; and fish products from 19 kilograms per capita in 1991 to 10 kilograms per capita in 1995 (Department of Statistics 1996). Two-thirds of the domestic budget (about US$1 per person per day) went to food. Another 20 percent went on housing costs, suggesting that most people have little discretionary income at all.

Income inequality has widened sharply since Independence. The EIU (1996) reports that percapita incomes of those in the top income decile in 1995 were 14 times higher than those in the bottom decile, compared to a difference of 8 times in 1992. A Department of Statistics survey in 1996 showed that the income gap between the top and the lowest decile was 13 times.. The Baltic Surveys estimates that a small wealthy minority of around 10,000 persons control a significant share of the country's productive assets.

Social Satisfaction. Although the economy is in its third year of (albeit modest and unequal) recovery, the level of popular "satisfaction" is not terribly high. In October 1996, a survey conducted by the Baltic Research company found that eight out of ten adult Lithuanians report that living standards are deteriorating. The department of statistics reported that, in November 1996, that half of the Lithuanian population consider their living conditions as satisfactory and that about one-fifth of the population reported difficulty meeting their public utility bills. Despite the difficult living conditions, there are still signs that Lithuanian citizens approve of the market economy. According to the Baltic Research company survey, 79 percent of the population still approve of a market economy and 45 percent of the population say that progress in creating a market economy is too slow. Another 24 percent of the respondents say that progress is taking place too quickly. The survey finds that the young and the educated are the strongest supporters of a market economy.

Commercial Law: Slow progress continued to be made in developing Lithuania's commercial law infrastructure in 1996. Major areas of commercial legislation were revised in 1996, most of which were aimed at correcting deficiencies in earlier laws or regulations, and to address critical gaps in the legal infrastructure. Major accomplishments included passage of a new Securities Law, a law on Registry of Immovable Property and the Law on Arbitration. Steady progress has been made in improving the skills and reputation of the judiciary, through a variety of training and outreach programs[18]. A draft pension law has also been prepared, and is under review by Government. In the areas of collateral law and leasing law, committees have been established to prepare the laws, but progress has been limited.

The focus on legal reform has firmly shifted to matters of EU integration, with the establishment of a Ministry for EU Affairs, the creation of ten working groups on EU legal harmonization and provision of external EU-PHARE supported legal assistance in these areas. The task of reviewing and modifying laws and statues to bring those into compliance with EU legal directives is a major one, and is made more difficult by gaps and inconsistencies in Lithuania's legal infrastructure.

A growing backlog of disputes, the high cost of court-based adjudication, lack of confidence in the courts and a strong desire for confidentiality in the business community has inspired the creation of a number of alternative dispute resolution mechanisms. In April 1996, a draft law on arbitration was passed and in June 1996, an arbitration tribunal was founded by the Lithuanian Lawyers Association. In connection with the International Chamber of Commerce (ICC), the Vilnius Institution of Arbitration was founded in 1996. In a remarkable show of cooperation, the ICC-Lithuania, the Association of Commercial Banks, the Chamber of Industry, Trade and Crafts and the Association of Industrialists---representing almost all of the country's businesses--established this arbitration body. Putting arbitration to work will require further immediate improvements in the law, its enforcement, and in the training and certification of mediators and arbitrators. But with strong business backing, progress is moving quickly in this area (Vetter and Welch, 1997).

Law and Order. Widening income inequalities, growing "hidden" unemployment, increased awareness of and opportunities for economic crime, and the growing visibility of mafia-related activity have resulted in a deterioration in the law and order environment in Lithuania. In 1996, the Lithuanian police reported 68,053 crimes which was 11.9 percent more than was reported in 1995. Half of all the criminals are under the age of 24, suggesting that respect for law and order is weakest in this group. Of all crimes reported, a total of 30 percent were characterized as "grave" crimes. While the number of grave crimes is growing, and is already about 30-40 percent higher than in the Czech republic or Hungary (where there are 43 and 33 serious crimes reported per thousand persons), the serious crime rate is still lower than in Canada (109/10,000 persons), the USA (265/10,000), the UK (96/10,000) and other large European countries.

Theft is the most common crime (66 percent) and 40 percent of all reported crimes were resolved. Car theft is becoming more common, with the number of vehicle thefts rising from 3,338 in 1995 to 6,060 in 1996. Mafia activities are reported to be of growing importance in Lithuania, and have direct links to the Mafia's in Russia and the NIS (Handelsman 1995). The 60 bombings in 1995 prompted Government to declare that possession of explosives was illegal and punishable by up to five years in jail. The new

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CEELI has developed and conducted workshops on a Uniform Commercial Code, negotiation, franchising, contract law, international contracts, arbitration, joint ventures and securities law. The Commercial Law Center continues to provide ongoing training to hundreds of regulators and private attorneys, and with the support of the UNDP, a Judiciary Training Center has been launched to provide ongoing training to Lithuania's judges.

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government has been elected on a strong anti-crime platform and has declared 1997 to be a year of "war on the mafia" (ELTA, January 15, 1997).

Perhaps the most alarming criminal development in 1996 is the apparent upsurge in theft of nuclear materials. Police detained six persons attempting to sell 100 kilograms of radioactive material on 10 February 1996 in Visaginas, where the Ignalina Nuclear Power plant is located. In April, police arrested two persons trying to sell 10 kg of caesium-133 in Kaunas and in May, 13 kg of radioactive uranium was seized in Klaipeda.

Economic Outlook. A number of agencies have made forecasts of the 1997 and 1998 economic situation. Table 14 below presents a comparison of GDP and inflation forecasts for 1997. While it is not surprising that the new Government's growth forecasts are the highest and their inflation forecasts are the lowest, the wide range of expected growth outcomes is of interest. Economic growth in 1997 is forecast to range from 2 to 8 percent, in real terms. That growth in 1996 has exceeded expectations, in the wake of the banking crisis, has provided many analysts with reason to believe that 1997 and the few years thereafter will see the start of a rebound in economic performance.

For 1997, analysts perceive that the growth recovery will be led by increased utilization of existing capacity, by growing light-industrial exports, by transshipment activity, and by investment and output increase in the energy sector. The late-1996 recovery in consumer demand is expected to spill forward into 1997 and trigger an upturn in wholesale and retail related activity. Investments in ports, the oil platform, the trans-baltica roadway and upgrading the railway are expected to provide a boost to the highly depressed construction industry. Establishment of free trade zones, the relaxation of restrictions on foreign ownership of land, and development of a world trade center are expected to provide a boost to foreign direct investment. The late 1996, early 1997 boom in capital markets together with accelerated implementation of large-scale enterprise privatization, should sharply boost passive foreign direct investment. Agriculture and heavy industry are the sectors in which performance is the most difficult to predict, but in both sectors, there are a number of leading enterprises that have already restructured operations and are rapidly expanding operations to serve western markets.

Recovery of growth in Russia and eastern Europe should also exert a strong pull on output and employment in Lithuania. Growth in Russia is forecast by OECD to increase to 2 percent in 1997 and 5 percent in 1998. Output is expected to grow by around 5 percent in Poland, 2 percent in Belarus and by more than 10 percent in Georgia (EBRD 1996). The rebound in growth in the region should increase demand for Lithuanian exports, primarily from transshipment-related services and the energy complex, but also from agriculture and light manufacturing.

It is worth noting that accurate measures of GDP in 1997 and the years thereafter will be difficult to obtain. The pervasiveness of the "shadow economy" implies that GDP measures are highly sensitive to what is treated, or declared, as an official enterprise and what escapes the net. Second, as more large, strategic enterprises are privatized, it is reasonable to expect that the quality of their reporting to the Statistics Department will decline. Third, the progressive replacement of "command economy" goods and services with goods and services produced to western standards means that quality improvement is not fully reflected in output and value-added estimates. The consequence of this is that

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economic activity indicators, such as transport volumes, energy demand, and retail turnover may provide a more accurate indicator of overall growth than national GDP estimates.

For 1997, Government sources predict that inflation will be about 15 percent. Outside analysts are less confident that inflation can be held at such levels, but few foresee inflation much in excess of 20 percent for the year. Under current monetary arrangements, there is relatively little that the Government can do to hold inflation below 15-20 percent. The removal of VAT exemptions from food and petroleum products has caused consumer price inflation to rise to 3.4 percent in January. The 10 percent increase in minimum wages and pensions planned for February will add to wage-push pressures. External demands to bring utility prices to levels at which production costs are covered (requiring about a 20-30 percent price hike) may also result in cost-push pressures. Presuming that the exchange rate stays fixed to a modestly appreciating US dollar, prospects for buoyant growth in exports, foreign investment and external assistance will fuel growth in the money supply. This, together with the gradual convergence between Lithuania's tradable prices and those in western markets will exert an upward pull on product prices.

The Government is forecasting that the trade balance in 1997 will narrow, from 3.7 billion litas in 1996 to 3.4 billion in 1997. Foreign direct investment is expected to pick-up and reach US$450 million over the year. The bulk of the capital investment would be from domestic sources, with gross capital investment targeted to rise from 4 billion to 5.2 billion litas in 1997. Whether the growth momentum and Government's policy framework is sufficient to inspire such rapid growth in investment remains uncertain.

Table 14: **GDP and Inflation forecasts for 1997**

Forecast Source	*GDP Growth*	*Inflation Rate*
Prime Ministers Office (1996)	**7-8%**	**<15**
Ministry of Economy (1996)	**3.7**	**15**
Ministry of Foreign Affairs (1996)	**4.0**	**16**
IMF (1996)	**6.0**	**15**
EBRD (August 1996)	**4.0**	**24**
European Union (May 1996)	**2.5**	**19**
Plan Econ (Aug 1996)	**6.6**	**24**
EIU (Nov 1996)	**2.0**	**23**
Starkeviciute (1997)	**5.0**	**12**

Source: EBRD (1996), EIU (1996), European Union (1996), ELTA (1996), Starkeviciute (1996) and Ministry of Foreign Affairs (1996).

III. Implications of Recent Economic Performance for the USAID Assistance Program

In 1996, the first tentative signs of stabilization have been achieved, growth is rebounding more quickly than anticipated, official unemployment is below target, and the financial sector is showing some signs of consolidation and recovery. Taken all together, this implies that:

- some of the crisis-management pressure (to fight inflation, to reverse a sinking economy, to salvage a distressed banking sector) is off;

- the agenda for Government shifts from one of stabilizing the financial system to one of stimulating investment to underpin export-oriented, sustained growth; and

- as Lithuania shifts from being perceived as an unstable global trouble-spot, with high inflation and failing banks, to a bounce-back economy, overseas investors will pump larger and larger sums into the stock exchange and will lend the country money to retool its antiquated industries and infrastructure. Managing the macroeconomy in a period of rapid growth in capital inflows can be far more difficult than managing financial markets in an era of tight external credit constraints.

Low-inflation and a "sound" financial sector are very "fragile" and could easily be destabilized once again. While there is much that can be done to boost growth and restore aggregate demand, the Government runs the risk of destabilizing the economy through an overly expansionary fiscal stance. There are already signs that it will be difficult to restrain the new Government's spending and tax giveaway impulses. At the same time, prices have still not fully adjusted to "medium-term" equilibrium levels, and as utility tariffs need to rise about another 30 percent to cover costs and as the Government seems intent to raise wages, pensions and other transfers, bursts of cost-push and demand-pull inflation appear likely.

Most of the "easy" transition reforms have been done, leaving the hardest transition reforms for last. Some of the difficult transition reforms left on the Government's plate include: privatizing the large scale enterprises (in a socially cohesive fashion); broadening the tax base, rationalizing healthcare financing, eliminating inefficiency in the energy sector; deepening and enhancing competition in the financial markets, stimulating private savings and efficient investment; rebuilding an affordable social safety net; and bolstering the institutions charged to deliver law and order and to protect well-established property rights. These are all difficult and complex tasks.

Very few of these will be "win-win" reforms. The fact that there will be many losers in this process is not terribly good news for a Government keen on mobilizing popular support in the runup to the end-1997 Presidential elections. Broadening the tax-base will mean that Lithuania's many hidden-economy operators will no longer be hidden. Raising energy tariffs will hit enterprises and consumers directly. Decentralizing district heating will adversely effect (in some instances) municipal finance. Privatizing "strategic" enterprises will take cash-cows away from big, vocal Ministries. Deepening the financial markets means that somehow the banking sector will need to be less of a club and more of a competitive market. Enforcing law-and-order should be generally popular, but the share of the population that benefits from weak enforcement of the laws (e.g. those who consumer smuggled goods) is rather high.

The Government has declared that it wishes to offset painful adjustments by raising

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salaries, offering credit to SMEs and the farm sector, providing tax breaks for foreign investors and lower taxes to the enterprise sector in general. Where the revenues will come from to finance these tax-breaks and transfers remains somewhat uncertain, particularly when much is being bet on revenues from cash-privatization (which were trivial in 1996) and better enforcement of existing taxes (just after past tax arrears were largely forgiven).

The biggest risk facing Lithuania is not one of policy error but one of policy and institutional complacency. The fact that the economy is recovering gives national leaders reason to believe that the policy and regulatory framework is "not too bad". But in fact, Lithuania's growth and economic recovery is built on an economic structure that is both highly distorted and extremely vulnerable. Enterprises have become accustomed to sub-cost energy prices; households have become accustomed to avoiding/evading taxes; the formal financial system does little more than clear payments (and only that for the enterprises); the third of the population in agriculture subsists off of government subsidies and price distortions; inequality is widening and poverty a growing problem; government continues to own and operate most large assets/enterprises without binding budget constraints; and the fallout from the banking collapse threatens to expose a web of connected lending problems that criss-cross the top-tiers of enterprise, banking and public sector.

For USAID, the immediate challenge is to keep the pressure on, and to encourage Government to, if anything, accelerate the pace of transition reforms. Since many of these reforms are complex and will have adverse effects, USAID should continue to assist Government in identifying the options and consequences of different reform strategies and policies.

USAID should also be careful not to reinforce a sense of complacency or premature optimism within Government----with many of the most difficult policy and institutional reforms still to come, it is far too early to declare victory on the transition front. USAID should also recognize that, with the resumption of growth, the Government's attention has shifted to "intervening" to stimulate specific sectors (or even enterprises). In this area, USAID technical support can assist in "damage control" by ensuring that Government is well aware of the limitations of such interventions and the risks that it is taking by pursuing such policies.

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V. ANNEX 1: Broadening the Tax Base: Winners, Wealth and Revenue Fairness in Transition

Introduction

Broadening the tax base has emerged as a major transition issue in Lithuania (Elgin 1996). The Lithuanian tax system is characterized by a high degree of evasion and avoidance, a large number of tax exemptions and holidays, relatively high nominal rates of personal and social taxation, and an accumulation of arrears and penalties by a large share of the tax payers. Government has made numerous attempts to enhance enforcement and improve collections during the past two years. While some success has been registered in this area, the most notable result is the buildup of penalties and tax-arrears that have then had to be written-down (or exchanged for assets).

A narrowly-based direct tax system violates both of the major tenants of revenue-mobilization policy--horizontal and vertical equity. Horizontal equity calls for equal treatment of people with equal incomes. In the Lithuanian case, individuals with equal incomes (be they farmers or factory workers) are likely to face radically different effective tax burdens, because of the difference in tax treatment for different sources of income. A narrowly based tax system also violates the principles of vertical equity (e.g. that progressive taxation should be related to either the ability to pay or the proportion of benefits derived from public goods). Typically, with a narrow tax base, it is the wealthy firms and households (e.g. those who consume more public goods and have a greater ability to pay) that proportionately bear the lowest tax burdens.

A large "hidden" or underground economy (UGE) is one of the consequences of a "punitive" tax system. If the tax system is narrowly based, then relatively high rates are levied on those who do bear the tax burden. The incentives to avoid or evade taxes will rise in proportion to the burden imposed by the tax system, by the probability of detection and sanctions and by the perceived "fairness" of the tax burden (Ahsan 1995). The more narrowly-based the taxed system is, the higher the burden will be on those who are within the tax net (to compensate for the revenues lost to those outside the base), and with widespread avoidance and evasion, the risks of sanctions diminish and the perceptions of tax-fairness erode.

The amount of economic activity that is considered to be "gray market" in Lithuania is not known with any certainty but is variously estimated at between 15 percent (Department of Statistics 1995) and 45-50 percent of total output. In late 1995, the Free Market Institute surveyed opinion leaders to estimate the size of the shadow economy. The percent of "shadow" activity in these sectors was transportation (31 percent); processing industry (33 percent); medical care (37 percent); energy (37 percent), municipal services (43 percent) retain trade (52 percent); wholesale trade (53 percent) and real estate (59 percent). The head of one large grocery chain estimates that 60 to 70 percent of retail activity goes unreported. The Ministry of Social Welfare estimates that more than half of all employees do not report wages accurately and pay the correct withholding tax. The IMF (1996) has gone so far as to suggest that individuals and enterprises choose to "drop out" of the tax net when they form small or medium-scale enterprises. As Lithuania implements its second stage of cash-based privatization, there is a concern that during this process a growing share of what are now "visible" enterprises will opt to become "hidden" economic activity.

Causality between a narrowly-based tax system and an underground economy runs both ways. The narrower the base, the greater the burden for those in the "formal economy", and the greater the incentive to join the "hidden economy". The greater the share of economic activity in the "hidden economy", the narrower the potential tax base. The persistence of a narrowly-based tax system can quickly degenerate to the point at which Government intensifies collections from a smaller number of visible economic activities, inspiring more and more enterprises "opt-out" of the tax system and join the hidden economy.

With a narrow tax base, the burden of public expenditures falls excessively on a narrow segment of the population. In Lithuania, the direct tax burden is estimated to be the heaviest on civil servants and the large parastatal enterprises---not because of the high incomes of either group, but more because of their limited ability to shelter income or otherwise avoid tax. Foreign investors, typically leery of gray market activity, are another segment of the population that may bear a heavy share of the direct tax burden. In the Lithuanian case, foreign investors have been granted tax holidays which essentially allow them to compete on a near-equal footing with those in the hidden economy.

With a narrow base, tax rates have to remain high in order to meet revenue targets. The higher the rates and the more pervasive the avoidance and evasion, the more enterprise profitability hinges on "tax management" and less on competitiveness, technology or entrepreneurship. Different factors of production earn different rewards, depending primarily on their tax management abilities. This distorts resources allocation---for resources flow not necessarily to efficient or competitive sectors, but to those enterprises/sectors that are good evaders/avoiders. Over time, the cumulative effect of allocating resources to inefficient or non-competitive sectors can have serious adverse economic consequences (Ahsan, 1996).

That it inspires "hidden economy activity" and distorts resource allocation are the two most serious economic disadvantages of a narrowly-based direct tax system. Other disadvantages include:

- a narrowly-based direct tax system discourages legitimate investment and employment creation;
- the high returns that can be obtained from "opting-out" of the direct tax net provide an environment conducive to rent seeking and malpractice within Government. The potential returns to lobbying for special tax treatment are high as is the potential for abuse in enforcing confiscatory taxes;
- revenue shortfalls inspire ad-hoc moves to collect more taxes from the already small group of complying firms and households;
- necessary social outlays may be under-funded (for example pensions) due to the inability of Government to mobilize sufficient revenue; and
- respect for law-and-order, in general, diminishes when tax evasion is common;

During transition, a narrow tax base slows down the pace of enterprise restructuring (by discouraging legitimate investment), distorts the enterprise incentives environment (by inspiring resource flows to tax evaders/avoiders), weakens the potential for good governance (by creating many opportunities for rent-seeking), exacerbates income inequity, contributes to under-funding of necessary public goods and erodes the social consensus underpinning reform. Erosion of the social consensus in support of reforms results when a wide sweep of the population believes that the tax system is "unfair" and "inequitable" or that success in the market economy comes from avoiding rather than complying with the rules of the game.

A final, important implication of a narrow tax-base is that it tends to erode popular interest in ensuring that Government expenditures are efficient and effective. To put it quite simply, when a large segment of the economy do not bear the tax burden (or bear it indirectly in the form of the inflation tax), then they tend to have less interest in scrutinizing public expenditures and lobbying Government to improve expenditure controls and management.

While the benefits of a broad-based tax system are relatively obvious, it is difficult in practice to transform a narrowly-based tax system into a broadly based one. Since 1991, the Lithuanian tax base has shifted from its heavy reliance on enterprise profits to VAT and excise duties (i.e. a consumption base). VAT and excise duties together constitute more than 60 percent of total collections.

While taxes on consumption are a reasonably good proxy for income from the low and middle income earners, they are not a terribly good proxy for the incomes of the rich---hence, horizontal equity suffers. Furthermore, as there are limits to the levels at which consumption taxes can be applied (e.g. negative yields to consumption tax rate increases), such taxes alone may not provide sufficient government revenues.

A number of important reforms have been taken over the past year to broaden the tax base of the Lithuanian tax system. These could be generally classified under the headings of tax rate reduction, tax simplification and enhanced enforcement. Some of these measures include:

- concessionary VAT rates have been eliminated for a number of goods (food and petrol products) starting January 1, 1997;

- a new personal income tax law and enterprise income tax law were developed and approved by Government in 1996 (but still to be ratified by Seimas in 1997). These laws provide for a clearer definition of income, reduce the number of exemptions and unifies rates for corporate and household income tax. The number of tax bands is reduced to two, which yields a far less progressive tax system but one which is (possibly) less likely to inspire high-income taxpayers to opt-out of the tax net;

- a state tax police was established in 1996; customs posts were computerized; new and improved VAT forms were issued; excise tax stickers were issued; and specific attempts were made to combat smuggling in tobacco and alcohol.

Further reforms are needed. Elgin (1996) urges Government to reduce the employers share of the SODRA tax and base employees benefits on each year of employment, rather than merely the last 3 years; to institute a broad-based tax system with low rates, that encourages long-term capital investment, economic growth and job formation; to establish a fair tax structure quickly and freeze it; and to build upon progress already made in tax administration, most notably by using penalties far more judiciously.

There are a number of general approaches to broadening the tax base, such as:

- a reduction in high, progressive rates in the direct tax system;
- elimination of tax expenditures of all kinds (preferential treatment, holidays, concessions and tax incentives) to broaden the base and to limit scope for tax lobbying
- improved legal clarification of taxable bases (income, profits, turnover);
- simplification of compliance procedures; and
- improved administration to inspire a culture of compliance;

There are two other ways in which the Lithuanian tax base could possibly be broadened which have not, to date, apparently received as much attention. These are 1) the use of presumptive taxes; and 2) wealth taxation.

Presumptive taxation. Application of presumptive taxes have a long history, most notably in agriculture, where record-keeping practices are not well established and where a great deal of income may be in-kind rather than in cash. In a presumptive tax system, Government makes an estimate of average income and expenses for a given type of activity (usually through surveys) and levies (a presumptive) level of tax on individuals or enterprises engaged in such an activity. Agricultural income, income of enterprises in the informal sector and self-employment income are the primary targets for presumptive taxation.
In several countries (Colombia, Brazil), Government issues "tax stamps" which are purchased by traders, merchants or other small businesses, with the amount charged based on an apriori estimate of the income earned in that particular sector.

For presumptive taxes, a conservatively estimated tax rate, and the possibility for the taxpayer to establish a lower assessment, may ease enforcement (Musgrave 1989). In certain countries, presumptive income taxation is based on gross turnover (Mexico) while in others it is based on consumption indicators (Turkey). Although voluntary compliance has been a main feature of the Lithuanian tax system, many tax systems blend voluntary and presumptive taxation.

Wealth. Income inequality has widened sharply since Independence. The EIU (1996) reports that percapita incomes of those in the top income decile in 1995 were 14 times higher than those in the bottom decile, compared to a difference of 8 times in 1992. The Baltic Surveys estimates that a small wealthy minority of around 10,000 persons control a significant share of the country's productive assets. While relatively little is known about the distribution of wealth with any certainty, the reasons that it is likely to be concentrated include:

- private savings at Independence were very low, and the relatively small population able to employ insider-knowledge (e.g. buying firms at undervalued rates) or to mobilize relatively small amounts of savings were able to accumulate considerable holdings;
- the industrial base, at Independence was dominated by a number of relatively large firms and factories---in other words, wealth was distributed in a number of large, lumpy

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packages; and

- a number of "Winner-Take-All" professions have emerged following the breakup of the former Soviet Union, such professions typically exhibit a high concentration of income and wealth.

A great number of legitimate and illegitimate "winner take all" occupations that have emerged following Independence. In a "winner take all" market, the returns to labor are proportional not to one's individual effort or output, but to achieving the top position within a given organizations (Frank and Cook, 1995). Or in other words, pay is related not to performance, but to rank. In the Mafia, for example, the rewards paid to the heads of the organization are reported to be exponentially greater than the returns paid to the average foot soldier (Handelsman 1995). In Lithuania's commercial banks, the amount of compensation paid to bank directors (of failing banks) are about 10 times that of senior Cabinet Ministers (and drew the ire of the President in his 1996 address on the State of the Economy). What is important to note is that the "winner-take-all" labor markets are becoming increasingly common in market economies and that the proliferation of such markets has important implications for the design of non-distortionary tax systems.

Wealth Taxation. In a country with a highly concentrated distribution of both wealth and income, wealth may be a better measure of taxable capacity than either income or consumption. In fact, taxing wealth can be viewed as taxing the capacity to receive capital income (Musgrave, 1989). If, for example, the returns on capital are 10 percent, and the tax rate on income is 20 percent, then an individual with US$1 million in income would be indifferent between paying a 2 percent wealth tax (e.g. US$20,000) or paying a 20 percent tax on interest earned (e.g. 20% of US$100,000).

There are three main arguments against using wealth as a tax base, none of which appear to be completely valid for Lithuania. The first is that taxing wealth is unnecessary because income taxes will capture the "returns to wealth". Clearly, a narrowly-based tax system is already proof that this is not the case. Furthermore, exemptions provided for interest income exclude a large share of financial wealth from the tax base.

The second argument against taxing wealth is that this discourages capital accumulation and encourages consumption. In other words, that individuals would have an incentive to consume instead of accumulate. This latter argument hinges very much on the point on the wealth-spectrum that is the target. For very wealthy households, biophysical limits to consumption of non-durables has probably already been reached. Furthermore, in "winner-take-all" markets, the rewards are so great for those that are in the "top positions" that the presence or absence of a wealth tax wouldn't discourage competition to become the leader in those job groups (e.g. a wealth tax will not inspire the leader of a Mafia group to fold-up his organization).

The third argument against taxing wealth is that the reports on wealth could easily fall into the wrong hands, and lead to criminalisation of legitimate enterprises. This last argument could be made equally for income as for wealth, and given that the latter is more difficult to disguise than the former, it would be difficult to imagine that any system of direct taxation would be possible. In fact, if wealth information is well-recorded, this may lead to the creation of a strong pressure group for confidentiality and integrity within the revenue service.

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The advantages of a wealth tax, for Lithuania, are as follows:

•wealth is highly concentrated in Lithuania;
•returns from wealth (property, capital) constitute a high share of the income of the upper income groups;
•wealth is more visible, or administratively easier to define and record, than are income flows; and
•taxing wealth would be a reasonable proxy for taxing the income and consumption of the highest income classes (those who apparently have had the most success in avoidance and evasion);
•if applied at the top-tier of the wealth-holders, the disincentives to capital accumulation would be minimized.

A number of European countries (France, Netherlands, Germany) levy a tax on the wealth of "wealthy" individuals. This is justified in part on equity considerations and in part because large stocks of wealth provide these individuals with a dissaving capacity that wouldnt be available to other households. Many countries tax wealth as it is passed between generations. Estate and other forms of bequest taxation are the most common form of wealth tax in all of the EU countries[19].

Lithuania has a very limited system of wealth declaration and a limited range of property taxes. In 1995 and 1996, Lithuanian politicians, state officials, board members of Central Bank of Lithuania, heads of Lithuanian commercial banks and major enterprises are to declare their 1996 income and assets acquired during the last year[20]. Starting in 1998, all Lithuanian citizens are to declare their income and assets. Under this law, Lithuanians are to include into their declarations real estate, land, transport vehicles, fire-arms, potentially dangerous equipment, civil airplanes, art pieces and jewelry priced at more than 2,000 litas. Lithuanian citizens should also declare financial income, shares, mortgage bills, credit and other valuable securities, the value of each amounting to more than 2,000 litas.

As a start has been made at assembling the necessary wealth-information, a wealth tax could be used as a proxy for the incomes of the "top tier" of Lithuania's income spectrum. There are a number of ways in which this could be accomplished, but some possible design criteria might include:

- target the "high-wealth" individuals by establishing a reasonably high threshhold level (below which point distortions to capital accumulation may be important);
- use self-assessment of all forms of wealth, either in Lithuania or abroad (enterprises, land, financial assets, residences, other durables). Accurate valuation of these assets can be encouraged (as in Switzerland) by providing the option for the Government to purchase such assets from the taxpayer at some multiple (say 110 percent) of the value reported;
- establish sanctions that would involve some form of confiscation of unreported wealth;

Numerous strategies for avoiding these taxes have also evolved in the EU.

In1996, the Lithuanian state tax inspection received 30,137 declarations on revenues and assets acquired in 1995. 24,366 individuals declared acquired assets, 4,115 of them purchases of vehicles.

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- set a wealth tax rate that would be equivalent to the rate that would accrue if the returns-to-capital were taxed as equivalent enterprise or household income; and
- allow an offsetting credit for other enterprise profit or income taxes paid in Lithuania.

But is it worth going to the effort of putting in place a wealth tax in Lithuania? While such a tax could improve the fairness of the system, what might its yield be? GDP at the beginning of this year was officially reported at US$5.6 billion. Taking into account "hidden" economic activity, actual GDP could easily be as high as US$10 billion. The share of capital in national income (proxied by enterprise income/profits to total income) is running at close to 50 percent and we can conservatively estimate that the real return to capital in Lithuania is pretty high, at least 15 % (or in other words 5 to 6 percent higher than equivalent dollar returns in the US or other mature economies). This would imply that productive wealth in Lithuania is (e.g. an 15% return on wealth yields between 3.75 and 6 billion in income) on the order of 25 to 40 billion US dollars. If we were to accept the lower estimate of wealth (at US$25 billion), then this "stock of wealth" would generate approximately US$3.75 billion in income per annum. If this were taxed at 29 percent income rates, it would yield US$1 billion in revenues (or 13 percent of GDP). An equivalent tax rate on wealth (with total wealth valued conservatively at US$25 billion), would be 4 percent to generate the same level of earnings. If we exclude half of the wealth from the base (assuming an appropriate cut-off point) and imagine instead a rate of 2 percent (e.g. equivalent to an effective income rate of 14.5 percent), then the tax yield would still be equivalent to 3.3 percent of GDP without the wealth of those in the "hidden economy" being reported and potentially as much as double this amount if hidden wealth is captured. Of course, more detailed calculations would be needed to identify the appropriate base, likely deductions and actual yields. Preliminary calculations suggest that the yield could, however, be significant.

Conclusions:

Broadening the tax base is essential to Lithuania's economic transition. The tax base has become narrow, undermining revenue mobilization efforts and undermining both the efficiency and equity effects of the tax system. The narrowing tax base has inspired "hidden" market activity, reduced the horizontal and vertical equity of the tax system, and undermined the public's confidence in the fairness and integrity of Government.

A number of efforts have been made to broaden Lithuania's tax system. The composition of taxes has shifted from enterprise income to consumption, the latter a reasonably proxy for low and middle-income incomes. VAT exemptions have been reduced and recent direct tax reform efforts have aimed at simplification, rate reduction and rate unification. But still, large segments of the population are outside the direct tax net, most notably the wealthiest households. For some hard-to-reach households, such as agricultural producers and small-scale traders, a system of presumptive income taxation may help to (equitably and efficiently) broaden the tax base. For the top tier of the income spectrum, a wealth tax may be a more practical and equitable means of taxing income. Preliminary calculations suggest that the tax base and revenue yield from a well-crafted wealth tax could be quite substantial.

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I. ANNEX 2: **Post-Stabilization Macroeconomic Dynamics: the Savings Gap, Debt and Growth**

The macroeconomic policy environment for Lithuania is rapidly changing from one of stabilization (at almost all costs) to one of providing a conducive environment to sustained, private sector led growth. While the transition process is far from complete, considerable progress has been made, and progress on the stabilization front exceeds expectations.

Stabilization is by no means assured. Many of the factors which contributed to lower inflation in 1996, such as the decline in the money supply after the banking collapse, the below-target increase in energy tariffs, and the forgiveness of tax arrears, are undesirable and are unlikely to be repeated. But still, there is evidence that Government is committed to maintaining reasonably low rates of inflation and that economic activity is recovering, albeit in a patchy fashion.

As the macroeconomic agenda shifts from "stabilization" to "growth", both the targets, objectives and possible choice of instruments available to Government are likely to change in a number of ways. First, fiscal policy becomes more an instrument of securing growth and employment generation, and less an instrument for demand-management. Second, monetary policy continues to remain oriented to maintaining low rates of inflation, but whether this is accomplished by using an exchange rate anchor, or through an exchange rate anchor together with a more active liquidity management stance, is a matter of policy choice. And third, the deepening of financial markets becomes an important objective, of both fiscal and monetary policy. The macroeconomic environment changes, most notably in the sense that the constraints to external borrowing that Lithuania faces are eased-----to put the matter quite simply, a *growing, low-inflation, private sector oriented entrepot nation* is a far better credit risk than a *sinking, transition economy*. How Lithuania manages its external borrowing, in the years to come, will have important implications for the pace of economic recovery and for the long-term sustainability of its public finances.

The discussion of possible macroeconomic policy, by Lithuania's leaders and economic ministers, is marked by inconsistency. High growth, fiscal balance, falling inflation, balanced trade and a reduced debt burden are laudable objectives, but are they consistent with the country's savings-investment gap? This note aims to cast the debate on macroeconomic policy during transition in the context of known, national accounting relationships.

We start with the simple savings-investment balance:

$$-(Tg-Cg-Ig) = (Sp-Ip) + (M-X) \qquad (1)$$

where the left side of equation one is the fiscal deficit, in which Tg is government revenue, Cg is government consumption and Ig is government investment. The right side of equation one is the private sector's saving-investment gap (Sp is private savings and Ip is private investment) and the foreign balance (M is imports and X is exports). The larger the

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gap between savings and investment, the larger the trade gap will be---and the larger the required inflow of foreign savings or foreign borrowing to close the gap.

The figures in Table 1 below provide an indication of the size of the savings-investment gap in Lithuania, and the role of the public sector's financial balance in that gap. The figures in this table are IMF estimates. These differ from those presented in the Government's national accounts (Department of Statistics, Main Macroeconomic Indicators, 1996) mainly in the treatment of stock changes in gross domestic investment, which are large and erratic in the Government's accounts. What these figures suggest, however, is that domestic savings are in the range of 14-15 percent while gross capital formation is in the range of 18-19 percent. The savings-investment gap was 9 percent of GDP in 1993 and 4 percent of GDP in 1994 and 1995 respectively.

Savings rates tend to fall during the transition process, most notably because Government's ability to capture savings and channel these into public investment diminishes and because private consumption expenditures increase to offset falling output and incomes. To sustain high rates of investment and growth, gross domestic savings will have to rise (EBRD 1996). It is worth noting that in high-growth trading economies, it is quite normal to have gross domestic savings that are twice as high a share of GDP as those in Lithuania. For example, gross domestic savings in Malaysia were 35 percent of GDP in 1994; 48 percent of GDP in Singapore; 33 percent of GDP in Hong Kong; and even reached 29 percent of GDP in the Czech Republic.

Appendix Table 1: **Savings-Investment Gap in Lithuania, 1992-1995**
(percent of current GDP)

Indicator	*1992*	*1993*	*1994*	*1995*
Domestic Demand	98	109	104	104
Consumption	80	86	85	86
Domestic Savings of which:	20	14	15	14
public	3.4	0.1	-1.2	-0.3
private	16.6	13.9	16.2	14.3
Gross Capital Formation	18	23	19	18
Foreign Balance	2	-9	-4	-4

note: government savings defined as government investment plus the government budget balance.

Source: IMF (1996), *Lithuania: Recent Economic Developments*, Washington DC.

To support higher growth, Lithuania will need both higher rates of saving and higher rates of gross capital formation. In the short-term, private savings may be limited by the sharp fall in incomes during 1991-1995, the large share of the population living near the poverty line and the shallowness and fragility of the financial markets. The savings potential of the enterprise sector may be limited by the demands for restructuring, the overhang of overdue maintenance and the accumulation of a variety of payment arrears.

In the near-term, the Government can encourage growth in private savings by improving both the supply and demand of private savings opportunities. An example of the former would be the creation of private pension programs. An example of the latter would be the development of sound, commercial banks offering positive rates of returns on private deposits. There is also considerable scope to increase public savings, through an improved revenue mobilization effort, by increasing the share of public investment (and net transfers to the private sector for investment) in total public expenditures and by increasing external borrowing for investment purposes.

But how much more savings and investment would be needed to drive growth in Lithuania to a target of, for example, 5 percent growth? Let us imagine that the incremental capital-output ratio (ICOR) in Lithuania is around 5. That would imply that Lithuania does not use capital as efficiently as an Asian Tiger economy, but is more efficient than a mature European economy. Although growth hinges on many other factors in addition to investment, we could assume that to restore economic growth to 5 percent per annum, gross capital formation (less say 2-3 percent of GDP for depreciation) on the order of 30 percent of GDP would be required. Domestic savings, at 14 percent of GDP are well below what would be required to meet this investment target. Raising public and private savings to close this gap will take some time, suggesting that the economy will continue to require significant inflows of foreign savings to meet the domestic savings-investment gap.

Foreign savings to Lithuania will come in two forms---as foreign direct investment and as foreign borrowing. FDI has been modest to date, with inflows yet to exceed 1 percent of GDP. Most of the savings-investment gap has been closed through external borrowing, with external debt levels increasing from US$281 million in 1992 to US$757 million in 1995 and more than US$1.1 billion in 1996. Although external debt has grown at a rapid rate, overall debt levels are relatively modest—15 percent of GDP in 1996. Furthermore, debt service remains well below danger levels (at 2.7 percent of exports in 1995).

Because of the existing savings-investment gap, and because of the probability that the savings-investment gap will widen as growth resumes, external borrowing is likely to continue to grow. Managing growth in external borrowing, so as not to jeopardize creditworthiness, overheat the economy or dampen competitiveness requires astute macroeconomic management. Does growth in external borrowing imply that the Lithuanian government should run ever-increasing fiscal deficits? The answer to this question is---not necessarily.

For a country that is not constrained by external limits on resource availability (e.g. is operating below the external credit ceiling), then the sustainable level of external debt will depend on the tradeoffs between domestic inflation, the budget deficit, the current account deficit, growth and the real interest rate[21]. The dynamics of the public debt can be described by the following equations for the change in the debt-to-GDP ratio (Hemming and Mackenzie, 1991):

See Van Wijnbergen et. al. (1992) and Morisset (1991) for interesting applications of the debt dynamic equations in dynamic models of financial portfolio choice, fiscal policy, growth and external debt.

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$$db = (r - g)\ b + p - s \quad \text{(internal balance and debt)} \qquad (2)$$

$$db = (r - g)\ b + nicad + e^{*}b \quad \text{(external balance and debt)} \qquad (3)$$

and $s = (\Pi + g) / v$

where db is the change in the debt-to-GDP ratio, r is the real interest rate, g is the rate of growth of real GDP, b is the stock of gross external debt, p is the primary (i.e. non-interest) fiscal deficit relative to GDP, nicad is the non-interest current account deficit relative to GDP, e^{*} is the rate of change of the real exchange rate and s is the seignorage revenue available to government. Seignorage is the change in the stock of high-powered money to GDP which is increasing in the rate of inflation (Π) and growth (g) but decreasing in proportion to the velocity of base money.

In the long-run, if the (r-g) term is positive, then the country is borrowing to service its debt and the growth and debt accumulation process will be inherently unstable. This is the first important macroeconomic debt rule for Government. If the real cost of borrowing is more than the rate of economic growth, then debt accumulation is unstable---in such an environment, the rate of debt accumulation should be reduced and every effort made to enhance the efficiency of domestic investment[22].

In the past few years, Lithuania's effective cost of borrowing abroad (the r) has been deceptively low (at about 0.1 percent) because of the concessionary nature of the loans and because of the grace period built into multilateral borrowing. As the grace periods of foreign loans expire, and as the country's dependence on commercial sources of financing increase, the effective cost of borrowing will rise.

Given an inflation and growth outlook, and Lithuania's record of relatively low velocity of broad money, we can estimate seignorage revenues. If medium-term inflation is targeted at 7 percent, growth at 5 percent, and velocity remains steady at 1.4 (see IMF, 1995), then seignorage would amount to about 8 percent of GDP. This would be relatively large and reflects, more than anything else, the fact that money velocity is low despite moderate rates of inflation.

Large seignorage revenues will reduce pressures to expand external borrowing (as Government can resort to the inflation tax rather than borrow to meet the deficit). Using equations 2 and 3 above, the fact that seignorage revenues are likely to be on the order of 6-8 percent of GDP would imply:

- even with a small primary deficit (3-4 percent of GDP) the foreign debt could fall by as much as 3-4 percent of GDP (relative to its original stock);
- If the debt stock to GDP was held constant, and seignorage revenues continued to be in the range of 6-8 percent of GDP, then a primary deficit of as much as 5-6 percent of GDP would be consistent with a 7 percent inflation outcome;

Government borrowing during 1992-1995 was used primarily to smooth consumption and finance restructuring investment. The gestation lag of restructuring investment would imply that the aggregate impact would become more evident in the next 2-3 years.

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- even if the exchange rate continued to appreciate at, say 5 percent per annum (e.g. the same rate as inflation differentials), then the (non-interest) current account deficit would still increase to about 7-8 percent of GDP;

What then would be the macroeconomic consequences of a savings-investment gap on the order of 10 percent of GDP? In turn-around central European economies, it has not been uncommon for such gaps to appear for a short period of time. Using equation (3), we can see that the effect that this will have on public sector debt accumulation depend primarily on the rate of appreciation of the real exchange rate. If the real exchange rate appreciates at, for example, 5 percent per annum, and the non-interest current account deficit is approximately 10 percent of GDP (to close the savings-investment gap), then foreign borrowing will be on the order of 5 percent of GDP. If Government actively manages the exchange rate to prevent a real appreciation, then foreign borrowing will rise that much faster (e.g. the savings-investment gap will be equal to the absolute change in the share of foreign debt to GDP). With a relatively wide savings-investment gap, if Government acts to offset the appreciation of the real exchange rate, then public sector debt accumulation will increase at a rapid rate.

Annex 5

Emerging Opportunities for Supporting Economic Policy Reform

The New Government's Program

Steve Tabor

Economic Management Services International

Emerging Opportunities for Supporting Economic Policy Reform: the New Government's Program

Prepared for USAID
Steven R. Tabor
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I. Introduction

In its seven years of Independence, Lithuania has experienced eight changes of Government[1]. Frequent changes in Government reflect a swing of political thinking from right to left, the tendency for personality politics to prevail and the vulnerability of political consensus to episodes of economic mismanagement. Although national governments in independent Lithuania tend to be short-lived, the 1996 October and November elections provided a surprisingly strong vote of no-confidence in the Lithuanian Democratic Labour Party (LDLP), which had been in power for four years and passed the mantle of leadership to the Center-Right coalition of the Conservatives and the Christian Democrats.

In the first round of voting in the Lithuanian parliamentary elections on October 20, the Conservative party, led by Vytautas Landsbergis gained 32 seats in the 140 seat Parliament with 29.7% of the popular vote. The LDLP received 9.7% of the votes, in third place behind the center-right Christian Democrats. Both parties received 11 seats in the Parliament. The Centrist Union garnered fourth place with 8.3% of the vote and again took nine seats. The Social Democratic Party received 6.7% of the vote and seven seats. All other parties received less than 5% of the vote. In fact, close to one-third of the voters cast their ballots for 19 parties that received less than the 5 percent of the votes needed to meet the threshold requirement of "block" Parliamentary representation (Vareikis 1997). This latter development inspired calls for election law reform to improve representation of the smaller parties.

In the second round of Parliamentary elections on 10 November, the Homeland Union (Conservatives) and their ally (the Christian Democratic Party) won the majority of the vote. The Conservatives won 70 of the 141 seats In Parliament and the Christian Democrats won 16 seats[2]. Together it means that a coalition of the Conservatives and Christian Democrats will have a strong majority in the parliament. The Homeland Party and the Christian Democrats achieved a larger victory than either party had anticipated, according to political analysts (Vareikis 1996). Support for the Christian Democrats (9.9 percent of the votes compared to 17.7 percent in local elections a year earlier) made them the weak-partners in the coalition.

The 7th government was in power for 9 months; the 6th for 35 months; the 5th for 3 months, the 4th for four months, the 3rd (prior Vagnorius government) for 19 months; the 2nd for 3 days; and the 1st for 10 months.

The election results were as follows: the Homeland Union (Conservatives) won 70 seats, the Lithuanian Democratic Labor Party won 12 seats, the Christian Democratic Union 1 seat, the Center Movement of Lithuania 13 seats, the Lithuanian Democratic Party 2 seats, the Lithuanian Christian Democratic Party 16 seats, the Lithuanian Social Democratic Party 12 seats, the Lithuanian National Union 1 seat, the Union of Political Prisoners and Deportees 1 seat, the Lithuanian Poles Electoral Action 1 seat, the Lithuanian Liberal Union 1 seat, the Lithuanian Womens Party 1 seat, the Lithuanian Nationalist Party "Young Lithuania" 1 seat, the Lithuanian Farmers Party 1 seat and the 4 seats for independent candidates.

While the Conservatives and the Christian Democrats won a resounding share of the total votes, this does not necessarily mean that they enjoy widespread popular support. It would be more correct to interpret the election outcome as a vote of no-confidence in the LDDP. The number of people voting for the Conservatives in 1992 and 1996 was about the same. Furthermore, voter turnout in the elections was low, at about 52 percent of eligible voters, suggesting growing apathy and dissatisfaction with political processes in general.

Political participation by smaller parties is also on the rise. Fourteen parties had representatives elected to Parliament, and the LDDP (previous government) lost heavily. New parties represented in Parliament include the Liberal Party, the Womenś Party and the National Party "Young Lithuania".

Commentators noted that party "personalities" continued to be more important in the elections than party programs, and that the main factor underlying the shift in power was the inability of the previous Government to deliver broad-based economic progress (OMRI, 1996). The Conservative party has promised to turn-around economic performance, to introduce more honesty and transparency in government practice, to stimulate exports and to actively privatize the poorly performing energy companies. Political scientists suggest that it was both personalities as well as the focus on turning around the economy that won the party its strong popular support (Burgess, 1996).

The newly elected Parliament is noted for its high percentage of highly educated members, by a dwindling number of lawyer-members (down to five) and also by the limited participation of younger politicians. 89 percent of the new Parliamentarians have a University of other higher education degree and 9 percent have vocational training. Only 3 percent of the new Parliamentarians are under the age of 31 while 53 percent are between the ages of 31 and 50, 28 percent between the ages of 50 and 60 and 14 percent over 60 years of age.

Following Mr. Vytautas Landsbergisś (chairman of the Homeland Union Party) election as Speaker of the Seimas, the Parliment selected Mr. Gediminas Vagnorius as the Prime Minister. The Conservative and Christian Democratic party then invited the Centre Union to participate (but not to join) in the new Government. Representatives of the Centre Union were provided the portfolios for Environmental Protection and the Building and Urban Ministries. Gediminas Vagnorius held the Prime Ministerś post from January 1991 to July 1992.

Of the 17 ministerial posts, 11 are controlled by the Conservatives, three by the Christian Democrats and two by Centrist Union members. The posts of Ministers of energy and forestry were not filled as these Ministries were to be eliminated. In addition, the ministry of economics will be reorganized as the national economy ministry--assuming some of the responsibilities of the previous Economy Ministry, Ministry of Energy and Ministry of Trade and Industry. In addition, a new Ministry of European Affairs was developed, and will have some new responsibilities with regards to European Integration and assume some of the responsibilities from the Ministry of Trade and Industry, and from the Ministry of Foreign Affairs.

On December 4th , the Prime Minister appointed seventeen ministers including: Environment - Imantas Lazdinis, Economy - Vincas Babilius, Defense - Ceslovas Stankevicius, Culture - Saulius Saltenis, Industry and Trade (European Integration) - Laima Andrikiene, Communications and Informatics - Rimantas Pleikys, Social Care and Labour - Irena Degutiene, Construction and Urban Development - Algis Caplikas, Transport - Algis Zvaliauskas, Health - Juozas Galdikas, Education and Science - Zigmas Zinkevicius, Justice - Vytautas Pakalniskis, Foreign Affairs - Algirdas Saudargas, Management Reforms and Municipalities - Kestutis Skrebys, Interior - Vidmantas Ziemelis, and Agriculture - Vytautas Knasys (see appendix one for a profile of the new Cabinet).

The appointment of the 28 year old Rolandas Matiliauskas as Finance Minister was viewed as a surprise by the popular media. According to Deputy Parliament Speaker, Andrius Kubilius (Baltic Times, December 5, 1996), the appointment of Matiliauskas was viewed as an asset in that he "can make some difficult decisions, not thinking what will be the consequences for his personal career, which is sometimes difficult for the older politicians". Matiliauskas has not had an easy start at the Finance Minister's post. In January of 1997, he was queried over the receipt and non-repayment of a commercial bank loan at sub-market rates. He then submitted his resignation. An investigation followed and on 4 February 1997, the Government announced that his resignation had been accepted. On February 19, Algirdas Semeta was appointed to the post of Finance Minister. Previously he had served in the Lithuanian National Stock Exchange Commission.

II. The New Government's Program

The Conservatives and the Christian Democrats were elected on platforms that were very much pro-European/NATO integration, pro-growth and pro-private investment. Rule of law was emphasized by both parties. Both parties place a strong emphasis on Lithuania becoming a member of the European Union and the NATO security alliance. Both parties called for measures to tackle corruption and an unresponsive civil service. The Conservative party called for tough law and order measures to tackle rising lawlessness and Mafia activity, while the Christian Democrats called for a wide set of measures designed to encourage a shift from "nomenclatura capitalism to a western European economy". In their campaign, both parties emphasized the need for broad based economic recovery in order to stimulate employment and restore aggregate demand. Fiscal balance and the use of foreign borrowing for investment was stressed by both parties. Poverty alleviation was accorded a relatively higher priority by the Christian Democrats than by the Conservatives, but both parties perceived the need to establish a meaningful pension system (see Appendix 2 for a summary of the political platforms of these two parties).

While the ruling parties were elected on a pro-growth platform, there are certain elements of that platform that call into question the authorities' grasp of market economics. Both parties called for the Central Bank to expand its authorities, and the Conservative Party, in particular, called for active exchange rate management (presumably devaluation) to spur exports. The Conservatives seem to believe that Lithuania has some scope for active exchange rate management and that imports are either unnecessary or uneconomic (or just plain bad). The Conservative party platform is divided between the need to open-up

provided the possibility to extend short-term loans to banks and to participate in the securities market. The Currency Board shall be gradually phased out and classical monetary and financial instruments shall be implemented no earlier than 1998. Export development programs would be introduced along with the capital investment program to help maintain the balance of payments. Inflation in 1997 will be below 15 percent, in 1998 at 10 percent and in 1999 about 7 percent. In terms of competition measures: Import duties would be reduced, and the anti-monopoly measures of the Agency of Prices and Consumer Protection Rights will be increased. As wages rise, subsidized prices will be eliminated by mid-1998.

Foreign Policy: Early admission to NATO and the European Union are the top objectives. Improving Baltic cooperation, forging better relations with Poland, and enhancing Lithuania's foreign image are high priorities. An Office for Expert Examinations of Legal Acts and Legal Assistance (the Law Office) would be established to ensure that legal drafts conform to EU requirements; and to accede to the European network system of transport.

Legal System Reform. Government plans to buttress rule of law by evaluating the present status of all legal acts (all laws adopted under the Soviet regime shall be null and void as of 31 December 1998); the Government shall establish a national law system (finalize a new criminal code, administrative code, labor code, civil code and commercial code); shall reform legal institutions; modernize legal practices, foster legal consciousness and defend the right of all citizens to have equal recourse to the legal system. Fighting organized crime and corruption shall be accomplished by deregulation (to reduce opportunities), by "disrupting" criminal groups and by promoting public discussion and transparent government. Penalties for economic crimes will be made more severe; the Ministry of Interior and Police Force will be reorganized in accordance with the requirements of the European Charter of Policemen; the management of the police will be decentralized and their service conditions improved; a special unit will be established to fight organized crime and corruption; a Court of Jury shall be established to prosecute organized crime and other complex cases; and an ethical code will be established for Judges.

Tax Regulation and Administration: Total taxes shall be "capped" at 50%. VAT shall be reduced to 15 percent; income tax rates reduced to 28-30% and then personal income tax abolished for 10 years; technology purchases will be tax exempt; and enterprise late-payments and penalties accumulated to 1-1-1996 will be written-off. The government will modify the income tax to allow tax loss carryforwards for 3 years; raise the property tax rate from 1 to 1.5 percent; eliminate the bonus system in tax payment collection; raise non-taxable income up to the MSL level; combat smuggling; earmark property taxes to local governments (starting from 1998); make tax administration more focused on public awareness; keep tax laws unchanged for some time; and allow a 2 percent payment of income taxes to registered charities and churches.

Banking: Commercial bank regulations are to be further tightened; creditors will have priority rights to pledged collateral in a bankruptcy case; large banks (and foreign banks) will be encouraged to establish more branches; the deposit insurance law will be modified to increase contributions; the banks must regulate their salaries; the BOL shall introduce international accounting standards, improve bad loan assessment and loan recovery; and Government will tighten embezzlement laws.

Business Environment: One-time licensing (using stamp taxes) will be used to regulate business entry. Cash payments in business will be discouraged. The State Assistance Fund, for small and medium-sized businesses will be formed and supplemented annually. This will give soft-loans and credit guarantees to small businesses. Foreign loans, distributed through the Banks, would aim at nurturing small and medium-sized business. Tourism would be promoted. The Investment Agency would have an expanded mandate. A mortgage system would be established; foreign loans will be used for investment; foreign investment restrictions would be lifted; tax-exempt private pension funds will be established in 1998; free trade and transport zones in Siauliai and Klaipeda will be implemented; and a leasing law adopted. Shareholder rights in enterprises shall receive increased protection.

Tender Privatization. All further privatization will be by public purchase share transactions or open tender sales. An inventory of state property will be taken; the privatization law shall be amended to focus on the price obtained (instead of other criteria); enterprises to be privatized will be transferred to the (to be established) State Property and Savings Compensation Fund, and parts of the proceeds will be used to compensate deposits lost through hyperinflation under the Soviets. Electric power, electricity transmission, airport runways and other social infrastructure will not be privatized. Past debts incurred by enterprises and by distressed banks, as well as the integrity of the past privatizations will be reviewed.

Export Promotion. A long-term plan will be developed and the Export Promotion Agency strengthened; an Export Insurance Agency will be established; an export support fund will be used to insure against political risk; and special export subsidies would be provided for agricultural products;

Anti-Corruption. Public procurement will be through tender at market price; licensing requirements will be reduced; senior enforcement officials will be well-paid; official pensions and insurance will be forfeited in case of administrative dismissals; legal liabilities of officials would be clarified and individual recourse to administrative courts improved;

Energy. The energy sector will be demonopolized and decentralized. Energy privatization will be promoted. District heating will be decentralized gradually. Power tariffs will be reviewed periodically and prices changed according to inflation or the price of imported fuel; the State Control Commission of Power Prices and Energy activities shall be empowered to coordinate prices and tariffs; a power production strategy will be developed; safety of Ignalina gradually improved; a national energy strategy developed and harmonized with the needs of the other Baltic states; power savings

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will be promoted; payment rules for power debts will be enforced and energy supplies suspended for non-payment; energy sector management would be reformed to become more market oriented; a variety of raw material imports would be used to maintain competitive power markets and compensation for heating costs would be provided to the very poor.

Industry and Trade. Anti-dumping measures would be enacted; European phytosanitary standards would be put in place; environmental projects would get government and "monopoly industry" funding and preference in such projects would be accorded to Lithuanian firms; at least 50 percent of foreign loans will go to manufacturing firms; dividends and interest shall not be subject to the enterprise tax; and financial and legal conditions will be improved to enable enterprises to borrow working capital.

Agriculture: Soft loans (from the Agriculture Support Fund) will be provided to farmers to construct buildings and buy equipment; state guarantees shall be provided for procurement and export of key products; more favorable quotas and WTO treatment shall be negotiated; producer prices will be supported; land reform will be accelerated and land restitution procedures simplified; a land market will be created; foreign investment in agriculture will be explored; costs of land plot surveys will be reduced; subsidizes for elite seeds and pure-bred livestock continued; farmers organizations assisted; anti-monopoly laws enforced in agricultural markets; rural social infrastructure (flats, clinics, disadvantaged care) expanded; and the qualification training system of agricultural specialists will be improved;

Transport: The overall aim is to integrate Lithuania's transport system into the Baltic region and the EU infrastructure. The Government will privatize public entities providing commercial transport; use government resources to introduce multi-mode transport technology and general infrastructure and harmonize transport laws with EU legal and technical standards. The railway infrastructure will be separated from the carrier and considerable upgrading of the lines will be done. A European gauge standard railway from Poland to Kaunas will be built, and a shuttle railway service from Mukran-Klaipeda-Moscow will be developed. Road transport will focus on the first phase of the Via Baltica project; the Klaipeda-Vilnius trunk route will be reinforced; the first phase of the development of the Klaipeda sea port infrastructure will be completed (by year 2000); and civil aviation will be integrated into the EU aviation transport market.

Social Security. State Social Security laws will be revised; the number of groups with exceptional guarantees will be reduced; the MSL will be increased and then kept in line with inflation; the minimum wage would then rise; problems associated with pensions and benefits for exiles and political prisoners will be resolved; civil insurance, including obligatory insurance, will be developed; social information will be improved; citizens' responsibility for social insurance will increase; supplementary pensions would be developed; independent insurance funds would be created; farmers and self-employed would be brought into the social insurance net; family support levels for low-income families (including free school food to low income children) would increase; youth retraining efforts will be revamped; social services will be decentralized; benefits to the disabled will rise and facilities for the disabled vastly improved; legal protection of childrenś rights shall be extended; and repatriation and compensation of exiles, political prisoners and their families shall be clarified and improved;

Employment: An active labor market policy will be adopted; unemployment insurance benefits maintained; labor markets and training institutes will be improved; legal employment will be promoted; trade unions and employer organizations will be encouraged; work safety standards will be improved and harmonized with EU standards; the State Labor Inspectorate will be strengthened; wage setting shall be mainly by bilateral contracting; and secondary teachers and employees in health, education, art and culture shall receive higher wages.

Healthcare. Healthcare will be increasingly decentralized and further reorganized; contracting systems will be used for front-line services; the health insurance system will finance approved second-tier and third-tier services; primary health care investment priority will be accorded to the rural areas; as income taxes are reduced, an additional individual insurance tax (by 1998) will be paid; Lithuania will produce 10 percent of its medicines by the year 2000; approved drug lists will be updated; and special programs for prevention and treatment of addiction and STDs will be implemented.

Communications. Telecoms modernization, EU integration, expanded telephone access will be promoted; a new Law on Information Technology developed; privatizing the state telecoms company, using information technology to link-up various information bases in government and easing telecoms administration are all priorities;

Education. Electronic media shall be used; all children till 16 years of age and disabled children shall have secondary schooling; teacherś conditions shall be significantly improved; school computerization shall be accelerated; the nationś scientific potential will be redirected more towards national needs; teacher-student ratios will be gradually regulated; and tax incentives will be provided for investment in science and education.

Public Administration. Eliminating and reorganizing the Ministry of Economy, Ministry of Energy, Ministry of Forestry, and Ministry of Trade and Industry is anticipated. A Ministry of National Economy and Ministry of the European Affairs will be established. Public information systems will be improved; more accurate residentś registers will be collected; a system of "real personal liability" for civil servants decisions will be adopted; more public awareness promoted; the laws on Territorial Administrative Units and their Boundaries, and the Law on Administration of the Countries shall be revised to promote clear specification of responsibilities and to promote transfer of responsibilities to counties; the law on self-government will be revised; long-term stable sources of municipal funding will be developed; the European Charter of Local Governments shall be adopted; municipalities will have the legislative authority to carry out social care functions, primary health care, police services, and local infrastructure supervision; a law on borrowing for municipal

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infrastructure will be developed; immovable property will be provided to municipalities; the competence and authority of the municipal officer and chief executive will be more clearly defined; elections of chief executives will be encouraged; popular anti-crime initiatives will be supported; the Law on Public Administration will be developed; public service ethics codes will be prepared; and the civil servants law will be revised.

III. Early Changes in Public Policy Under the New Government

In the first quarter of 1997, the new Government has begun to implement the initiatives it has proposed, although most progress has been in the form of policy announcements and administrative reorganization rather than changes in actual policy. A great number of populist measures have been adopted, although many of these have yet to stand the test of fiscal reality or parliamentary scrutiny. In certain key areas (such as the management of the exchange rate) Government has quickly revised its policy position (or at least stopped public discussion) after an initial adverse reaction to its pronouncements. Some of the key early reforms include:

Administrative Reform: One of the new Government's first steps was to announce the consolidation of three large economic ministries (Energy, Trade and Industry and Economy) into a Ministry of National Economy. The consolidation of the three has taken several months, and during that process, Government has announced that the staff of the merged-Ministry will become approximately one-third the size of the three previous Ministries. The merging of the three Ministries has triggered a sense of policy paralysis at the technocrat level, as existing officials were unsure what posts would be retained. This merger has taken longer than expected, and as of the start of February 1997, was still incomplete.

The creation of a Ministry for European Affairs, headed by the new Government's most senior western-trained economist, has opened the issue of jurisdiction over economic reform matters. In theory, almost any aspect of Government policy is related to Lithuania's eventual integration into Europe. In the early months of the new Government, the transfer of authorities to the new Ministry has triggered a "struggle for turf", particularly amongst those Ministries that had previously dealt with foreign trade matters. As of February 1997, the Ministry of European Affairs had been provided authority to supervise the Lithuanian Investment Agency, the Privatization Authority and appeared to be taking the lead on export and trade promotion issues.

1997 Budget: The new Government has announced that it will continue to maintain a prudent fiscal stance. The fiscal deficit would increase by 65 million litai in 1997 (to 700 million litas) but the deficit will only be run to repay existing public debts. The fiscal deficit is estimated at about 3 percent of GDP for 1997 and is forecast to fall in 1998.

The 1997 Budget includes a number of measures aimed at securing popular support for the new Government. After raising family allowances on December 1, the 1997 Budget targets an extra 10 million and 29 million litai to raise the salaries of employees of cultural and scientific institutions. Those who have an academic degree will have their salaries raised by 40 to 50 percent. The government will also increase salaries for employees of budgetary institutions, as well as pensions, student grants and other social payments. To support this increase, an extra 380 million litai will be earmarked in the budget. The administration has also proposed allocating an extra 40 million litai to provide free meals at schools for children from poor families. This last measure is aimed at encouraging more children to attend school. From February 1, base pensions will increase by 10 percent (to 121 litai/month) while the minimal subsistence level (MSL) will be raised to 110 litai. Minimum wages, at 90 litai per month, are to be increased from March 1.

By the same token, the Government has agreed to a number of prudent fiscal management policies in its 1997 budget and in its undertakings with the IMF.
In its letter of development policy to the IMF, the Government has agreed to cap the overall growth in the state wage bill at 8 to 9 percent in 1997, to establish the Health Insurance Fund as a self-financed entity and to insulate the budget from the financing demands of bank recapitalization and the deposit compensation fund.

Extra expenditure pressures are likely to arise from the structural under-funding of SODRA obligations. Early indications in 1997 are that revenues have been less than expected in January of 1997. The State Social Insurance Fund (SODRA) has been forced to borrow money from Vilnius Bank and the State Savings Bank to meet its pension and unemployment compensation payment obligations in the early part of the year.

Tax reform: The new Government has announced that the value added tax (VAT) is to be reduced from 18 percent to 15 percent; that there will be no taxes on profits, interest and dividends that are reinvested; and that the property tax will be raised from 1 percent to 1.5 percent. VAT exemptions on agricultural and energy products were removed on January 1. The increase in the VAT rates from 9 to 18 percent in agriculture and the application of VAT to refined petroleum products is expected to lead to (one time) cost-plus pressures for food and fuel. Elimination of the VAT exemptions had been agreed upon with the IMF and is expected to add Lt.500 million to 1997 revenues. The Department of Statistics has predicted that January inflation may reach 4.3 percent because of the flow-through effects from the VAT. Tax administration is also to be tightened and sanctions for tax evasion are to be increased. The reorganization of customs and excise is forecast to add 150 million litai in revenues for 1997. Excise duties on alcohol products were increased in January of 1997 and a working group was established, on February 5, to oversee the activities producing, importing or trading in alcohol.

On February 13, 1997, the Parliment ammended the Law on Tax Administration which provides for very high fines for "intentional" tax evasion. The law, which has been widely criticized for the discretionary authority that it provides to the state tax inspectorate, distinguishes between unintential under-payment and intentional evasion. For the latter, a fine of 25 percent of a company's yearly turnover, but not less that 50,000 litas, is mandated for tax evasion. Government has agreed with the IMF that it will raise excise taxes by 15-20 percent on tobacco

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and alcohol by April 1, 1997 and that by the end of September, excises will be applied uniformly on domestically produced and imported items. it has also agreed to institute bankruptcy proceedings against the largest tax delinquint enterprises, to improve VAT invoicing and to make appropriate personnel changes in the customs and tax administration units.

Exchange Rate Management: During the election campaign, Prime Minister Vagnorius express concerns about the adverse economic consequences of the litas§ real appreciation. The real effective exchange rate has doubled between 1994 and 1996 due to higher inflation in Lithuania than in its trading partners. The trade deficit has also grown and external debt has increased rapidly. During the initial aftermath of the elections, Vagnorius called for the abolition of the currency board. This was then softened to a gradual elimination of the currency board and the replacement of the litas-US dollar link with a litas-US dollar-German mark link. The BOL Chairman has commented that the litas will be eventually be pegged to the ECU, after low rates of inflation have been secured for a few years. The new Finance Minister Semeta, has described the exchange rate peg as inflexible, but has also described Lithuania§ monetarty policy as far-sighted. He has indicated his support to a gradual delinking of the litas to the US dollar. Also, in February 1997, Siemans§ announced that the "hard currency" was one of the main factors undermining the viability of their export operation in Lithuania. Siemans announced that it would review the situation for two years and then decide whether or not they would remain in the country.

In the Government§ letter of development policy to the IMF, it stated that there would be a three stage monetary reform process during 1997-99. In 1997, the currency board would be maintained, but gradually repurchase operations would be introduced (and capped at Lt.60 million). In 1998, the Litas Stability Law would be ammended to broaden the asset base to be used to back the currency. In the third stage, the peg concept would be revised in order to broaden the currency mix.

Banking: Government has signaled that it will reorganize the problem state banks and continue the commercial bank restructuring initiated in 1996. In January, the Innovation Bank took the first steps to pass on its non-performing assets to the Turto Bankas (Property Bank), a sign that the new Government is committed to following the bank restructuring agreements of the last administration. Implementation of those agreements are behind schedule, and whether or not the Government will accelerate implementation remains to be seen. In many respects, the actual collection of overdue obligations by the Property Bank appears to have stalled. There are also signs that the Government is trying to identify who should bear responsibility for the banking crisis. A new commission has been established to investigate commercial banking crimes.

On February 27th, the Government decided to liquidate the Joint-Stock Innovation Bank, which was once the country§ largest commercial bank. The Government also announced that depositors in the Innovation Bank would be repaid US$1000 this year and that it would take five years to fulfill all its repayment obligations. The Government also announced, in February of 1997, that the State Commercial Bank would be privatized by the end of 1997. Both the liquidation of the Innovation Bank and the announcement of the SCB's privatization signal Government's committment to follow through bank sector reform obligations that had been undertaken by the previous government.

Trade Policies: The Government has accorded a high priority to expanding Lithuania's free trade area and on negotiations on membership in the WTO and the Central European Free Trade Association. The new cabinet has also declared that a high priority will be given to settling border disputes with neighboring states, especially Poland. There are already signs that relations with Poland are improving. In the first months after election, Government secured Poland's support for an early entry of Lithuania into NATO and the EU. On the home front, the Government indicated that it would pursue problems related to non-competitive practices. The Nesta company, a producer of stainless steel building materials and the Zujunai Gravel Pit were fined for forming a cartel to set prices and restrict supply for non-rusting building materials. Nesta was fined sixty thousand litas and Zujunai Gravel 15,000 litas.

Early indications are that the new Government will continue to favor trade protection for the agriculture sector. The Government has reported that it will seek to renegotiate the agreement reached earlier with the IMF to reduce import duties to a maximum of 20 percent. This would mainly affect the agriculture sector which, despite tariff and subsidy increases in 1995, shows little signs of sustained recovery. Government has announced that 1996 cattle purchase prices and subsidies (about 1000 litai per ton) will remain in place and that pig subsidies will be increased from 200 to 400 litai per ton. After VAT exemptions were removed, the Government increased subsidies for wheat and bread products to hold retail prices of those good steady. The Government has also announced that it would subsidize meat product exports. Also, a "gas-for-meat" swap deal was organized by Government to reduce the debt obligations of Lithuanian gas. The Prime Minister also announced, on February 10, that subsidies of 10 to 25 percent could be paid for Lithuanian food exports to Russia.

Privatization: When in the opposition, the Conservative party expressed its disagreement with the Government's plans to privatize about 200 enterprises in March of 1996. At that time, it was argued that this would be a threat to Lithuania's strategic interest. During the elections, Conservative Leader and Prime Minister Gediminas Vagnories has stressed his commitment to privatize key energy companies such as the Butinge oil terminal, the Mazeikiai oil refinery and the Lithuanian oil company. The new Government has argued that privatization is to be done in a transparent fashion (through more flotation through the stock exchange) and that all of the companies that were not sold in 1996 will be on the privatization list for 1997. It has been announced that stakes in some of the larger transportation companies, such as 30 percent of Lithuanian railways, will also be

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sold in 1997[3]. In total, an estimated 832 companies are on the privatization list for 1997, valued at approximately 3.7 billion litai. As this far exceeds all of the assets in Lithuania's financial markets, it is clear that a strong foreign investment response will be needed to make cash-based privatization a success. Privatization in the last months of 1996 and the first months of 1997 has gotten off to a very slow start, with Government failing to find any investors willing to meet the price it set for the Republic Theater. Whether Government will "let go" of public assets, at a price that legitimate investors are willing to pay, is still an open question. In February, Government announced that AB Lietuvos Dujos would distribute 66 million new shares of capital, raising the private stake in the company from 9% to 24%. On 26 February, Minister Andrikiene announced that tenders for Lietuvos Telekomas (the phone company) would be opened in March. International investors would be invited to take part in this tender.

To secure popular support for privatization, the Government announced in March 1997 that it would establish a deposit compensation fund to repay individuals for lost Russian Ruble deposits. This is to be financed by the proceeds from cash-based privatization. Compensation is to be limited to Lt.6,000 per eligible citizen and payments will be made first to the elderly (in December 1997). A deposit compensation fund is to be established and has been provided authority to borrow in advance of receiving privatization revenues. It is estimated that the deposit compensation exercise will cost the Government close to 4 billion litas. This program has raised a certain amount of alarm for it: a) appears to pre-spend the "hoped-for" privatization revenues; b) earmarks those revenues to consumption rather than investment; c) doesn't link compensation to common notions of asset ownership (e.g. employee rights).

Sectoral Reforms: Government wishes to restructure the energy sector, introduce medical insurance and establish a system of supplementary old age pension insurance. Initial discussions have been held on the possibility of reducing the civil service by 30 percent, to competitively recruit senior Government staff, and to provide attractive salaries for senior specialists in Government. Government has reaffirmed its commitment to the IMF to reduce energy arrears, and has promised to reduce consumer debts to the energy complex to 100 million Litai by March of 1997. While an increase of about twenty percent in gas and electricity prices had been proposed for 1997, the new Government has declared that it will not raise energy prices until incomes and living standards improve. The Government did officially appoint the five members of the Energy Pricing Commission on February 10, with Dr. Vidmantas Jankauskas, of the Energetics Institute, as its head.

Law and Order: Reducing crime was an important election campaign promise. Prime Minister Vagnorius claimed, in December 1996, that the budget is losing 1 billion Litai of revenues due to smuggling. He has called for modernizing customs posts to eliminate the "human factor" in regulating inter-border goods transit. The initial budget submitted by the

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Although the Government has announced that 30 percent of the railway would be sold, the Ministry of Transportation has subsequently announced that it would require 18 months to prepare the company for partial privatization.

new Government called for a 187 percent increase in public expenditures on defense. Furthermore, all government law enforcement agencies (customs, police, prosecutors office and tax inspectorate) would be subject to supervision by oversight agencies. On January 16, the new Government declared "war" on organized crime. It will attempt to "cut off" criminals access to illegal money, augment the criminal code to handle Mafia-related issues and create a new department in the MIA to combat smuggling and drug trafficking (ELTA, 1-16-1997). Two new crime prevention institutions are being formed to spearhead the fight against organized crime. The national crime prevention council (NCPC) will focus on administrative issues and the special investigation board (SIB) will address organized crime and corruption. The NCPC was formed by the Justice Institute and the SIB has been formed as an agency of the Ministry of Interior. SIB investigators have special terms and conditions, including health and social insurance for themselves and their family, and monthly salaries of approximately US$1,250. .

Economic Forecasts: The Government was elected on a platform of turning around the economy. Shortly after elections, the Government issued ambitious targets for economic performance. The new Government forecasts that average earnings will rise to 960 lts. in 1998, 1150 lts. in 1999, and 1320 ts. in 2000; that average pensions will rise from 330 litas in 1998 to 400 litas in 1999 to 460 litas in 2000; and that GDP will grow in real terms by 5 percent in 1997, 8 percent in 1998 and 6-7 percent in 1999-2000.

Market Reaction to the New Government.

The initial reaction of the business community to the new Government has been guarded but positive. Interest rates have continued to decline, and demand for Lithuanian Government treasury bills remains strong. On January 14, yields on six month treasury bills fell below 10 percent, a psychologically important threshold in a market that has been subject to inflation and exchange rate uncertainties. The stock market, after a Christmas/New Year's lull has experienced sharp growth in prices and liquidity in the first month of the year. More generally, Lithuanian financial market analysts expect that the Government will continue the necessary economic reforms and that macroeconomic policies will continue to secure price stability and external competitiveness. Investment analysts expect significant progress on cash-based privatization this year (VILFIMA, 1997). One influential analyst has declared that: "it is expected that after four years of sluggish market-led changes implemented by the LDDP's (former communists) Governments, the new Government will speed up and complete the transformation of Lithuania's economy to the market economy" (Stankeviciute, 1997).

Some outside economists are worried that Government will loose control over the exchange rate. The London-based Economist Intelligence Unit (January 1997) predicted that the exchange rate would be delinked from the dollar at the end of 1997 and would quickly devalue by 50 percent. If these views gain popular acceptance, than pressure on the exchange rate could be severe.

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There are also worries that the Government will pursue a "populist" agenda, and not take the difficult decisions needed to reform the energy complex and deal with the economic crimes within the banking system. There are also concerns that the abolition of the currency board will lead to temporary "exchange rate volatility" and that investors will "wait and see" if currency convertibility is maintained and if stability of the litas is (in fact) secured. Finally, the investment community is concerned that the Government's economic management team (in the core economic ministries) is widely perceived as "weak" and "political" at the same time. This introduces elements of uncertainty.

On the political front, there are concerns that December 1997 will be a national Presidential election and that election-related pressures may drive economic policy. The Government has declared an economic program that promises to "give something to everyone", but, besides a basic commitment to "medium-term" fiscal balance, doesn't declare how all of this is to be paid for. Political analysts suggests that the Government believes that using "new financial instruments" (domestic bonds, bills, promissory notes) there will be a way of paying for everything. The problem with this, of course, is that the cost of such largesse will one day have to be repaid. More specifically, an inability to maintain and enforce consensus on difficult policy reforms could forestall progress in key areas (banking crimes, energy pricing, large-scale privatization).

IV. Opportunities for Supporting Economic Policy Reform and Necessary Changes in the USAID program

On the face of it, the program of the new Government is fully consistent with the initiatives that USAID has identified in its strategy for external assistance. Government aims to improve tax policy, promote private investment, speed-up the cash privatization process, improve banking policy, reform the energy complex, put fiscal policy on a sound footing, enhance the nation's integration in the global trading arena and address problems of unemployment, corruption, organized crime and the rural poor. That a Government committed to a liberal economic system and democratic pluralism has been elected is, unto itself, a major plus for the USAID program. Having common general goals and objectives is a step in the right direction, but this doesn't necessarily imply that the USAID program will become immediately more effective.

Build Competence During the Long Transition. The first hundred days of the new Government appear to be marked by a rather lengthy and uncertain transition process. The creation of a super-Ministry for the National Economy and a European Integration Ministry may prove sensible in the long-run, but this has created a great deal of uncertainty over just who will be responsible for what aspects of economic policy. For some USAID project implementors (and their Government counterparts) this uncertainty is frustrating, but while it has slowed-up the pace of change, it has by no means brought Government to a halt. At present, it is difficult to forecast when the Ministry of National Economy and Ministry of European Integration will reach a stable set of responsibilities, authorities and staffing. In the interim, it appears wise for USAID projects in these areas (e.g. trade, energy, investment promotion) to use this opportunity to strengthen ties with mid-level technocrats and to build the analytic foundations (ie. data bases, policy analysis tools, briefing papers) for improved future policy dialogue. In those parts of Government where many senior officials have been replaced (STI, Customs and the Ministry of Finance), a gradual process of reviewing progress under past cooperation and modifying work plans in light of the priorities of new senior officials may be needed. Governments need to identify a new Finance Minister (as of early February) and the distinct possibility that a new Minister of Finance could bring in a new group of deputies and other senior officials means that a certain amount of flexibility will be required in activities located in that Ministry as well. But the "scope of work" of the Finance Ministry is likely to remain much the same (in contrast to the Ministry of Economy and Ministry of European Integration) and progress can be made at the mid-level technocrat level in building the information, skills and experience necessary to guide changes in public finance.

Be Aware that this is an Election Year. The first round of the Presidential elections are slated for December 1997 and municipal elections will be starting on March 20, 1997. If a second round of Presidential voting is required, that would most likely be held in January 1998. Following the Presidential elections, a new Government can be formed. It is possible (but unlikely) that the new President could demand new Parlimentary elections. The fact that municipal elections are onging, and that the Presidential elections are only 11 months away gives political analysts reason to think that the new Conservative government will want to demonstrate quick and positive results in its economic program. But at the same time, the new Government will be reluctant to take decisions that have a high social cost (e.g. raising utility prices, closing bankrupt state banks)[4]. Some analysts suggest that there is already a split within the conservative party, and that this fractionalization will make it difficult to achieve the political concensus needed to guide major transition reforms.

Build Upon Positive Momentum in "Stable" Ministries: There are only a rather small number of areas within Government (Bank of Lithuania, the Energy Complex) where leadership after the elections has remained largely unchanged. In these areas, it is possible to build upon past success and carry forward planned initiatives reasonably quickly. The areas of central banking and energy regulation are all experiencing rapidly growing demand for new policies, regulations and information technology investments because of enlarged authorities (for the Bank of Lithuania) and impending cash privatization (energy complex).

As an example of this, the new Parliment apparantly rejected the personal income tax law which was submitted by Government to it in November 1996, on the grounds that if it was passed, too many people would then have to pay tax.

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In these areas, it may be appropriate to re-examine the scope of USAID assistance to determine if, within the bounds of the defined strategic objectives, additional training, advice or other external assistance support would be merited.

Even in the core Ministries, there are still risks of policy reversal. In the Bank of Lithuania, for example, the Prime Minister has made it clear that the BOL is not yet "implementing" the Government's program. There is discussion within Government of "slowly" changing the leadership of the BOL and trying to refocus that organization to follow a "political" exchange rate stance, and providing "political" liquidity support to favored banks and enterprises. USAID, and its contractors, will need to be mindful of these risks, to try and educate (as best as possible) policy makers against unsound decisions, but at the same time, to be prepared for unfavorable contingencies.

Competence Gaps. Several commentators have noted that the new Government appears to lack a "competent core" of senior officials in a number of areas. In Parliament, for example, the number of lawyers has fallen to five, which is rather small given the "law making" brief of this body. The limited supply of competent leaders, combined with the fact that the ruling coalition has been out of office for several years, may simply mean that it will take the new leaders longer to learn the ropes of managing Lithuania's government. USAID could utilize its development assistance to help close the competency and leadership gap. A "low-key" seminar series on economic policy for Seimas members has been proposed. Exposing new cabinet members to their counterparts in the US, or providing US-based leadership training, would be other ways of helping to bridge this gap. Efforts to expose new Government leaders to regional and US experience in their sectors, to enhance Seimas competence in economic management and to provide targeted leadership training for new senior leaders in the US are initiatives that merit consideration.

Retain Focus. Early pronouncements from the new Government, in areas such as export promotion and agricultural support, suggest that there may be a strongly interventionist streak in the new Cabinet. USAID, and its various advisors, should be very cautious before providing support or guidance in these new areas of "market guiding" reforms. Such measures will likely be opposed by the IFIs but may find some support amongst certain European assistance providers. It would be counter-productive for USAID to become embroiled in such activities, and will be important to retain the Agency's focus on achieving the objectives it has set out to accomplish in its strategic plan.

Build Ties With New Super-Ministries. New ties will be needed between USAID and the newly created Ministries of National Economy and European Affairs. A process of generally introducing the USAID program to the new leaders of these Ministries has already been launched. It probably will be necessary to repeat this process at the middle layers of these Ministries when staffing decisions in those Ministries have been taken. It would be important to be responsive to the needs expressed by the new leaders of these Ministries, but to be cautious to do so within the areas already defined as strategic objectives for USAID. As the new Ministries will have responsibilities for many areas that fall outside of USAID's immediate objectives (such as cash based privatization, energy sector public investment), the Agency should be cautious before responding to requests in green-field areas.

Carefully Monitor Sector Policy Developments. The new Government has promised to accomplish a great deal very quickly. If this is done, then public policies and institutional arrangements in economic restructuring will be subject to considerable change over the next year. New opportunities may emerge (and then close) very quickly. Tracking these developments should be a prime topic for each SO group.

Plan for Contingencies. There is a risk that the administrative changes in key Government Ministries will take longer than anticipated and that the lack of competent officials may hinder the pace of economic restructuring. This, combined with the fact that the economic transition challenges facing Government have become more complex and costly, may mean that the program witnesses a slowdown in the pace of change. If this occurs, it would be appropriate to review portfolio priorities. In such cases, resources should be concentrated on those areas where progress is likely and there will be a need to disengage from areas where there is movement.

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Appendix 1: **Background of the Ministers Appointed on November 4, 1996**
ELTA News Service

Environment Protection Minister Imantas Lazdinis, age 52, is a forestry engineer, and a Dr. Sci. (Nature Sciences). From 1990 he was a deputy director of the Dzukija National Park and from the beginning of 1996, its director.

Economy Minister Vincas Kestutis Babilius, age 59, is an engineer. He has worked at Vilnius Electric Metering Machine Factory as its chief engineer and director. In 1995, he became its director general. He is the vice-president of the Lithuanian Confederation of Industrialists.

Finance Minister Rolandas Matiliauskas, age 28, was trained in book-keeping and economics. In 1991-1993 he was employed at the Finance Ministry as a deputy head of the currency and securities department. From 1993 to 1995 he worked for Kredito Bankas, and from March of 1995 he was the chief financial officer of Interfarma, a joint Lithuanian-German company. Mr. Matiliauskas resigned from his post as Finance Minister in February 1997. His replacement is Algirdas Gediminas Semeta, age 34. Mr. Semeta had served as chairman of the Lithuanian National Securities Commission since 1992.

Defense Minister Ceslovas Vytautas Stankevicius is 59 years of age. For thirty years, he worked at the Urban Construction Design Institute. From 1974 to 1994, he was a chief engineer in that institute. In 1990, he was elected to the Supreme Council for the Restoration of the Seimas. He is a signatory of the March 11 Independence Act. In 1990-1992 Stankevicius was a deputy chairman of the parliament. In 1992 he received the rank of ambassador for special missions.

Culture Minister Saulius Saltenis, age 51, is a playwright. From 1994 he was an editor-in-chief of the Lietuvos Aidas daily. Saltenis was a signatory to the March 11, 1991 Independence Act.

Industry and Trade Minister (European Integration) Laima Liucija Andrikiene, age 38 is an economist-mathematician. She has worked in various research institutions and was trained in Great Britain. Andrikiene was a signatory of the March 11 Independence Act. She is a former Seimas (Lithuanian parliament) member.

Communication and Informatics Minister Rimantas Pleikys, age 39, is a journalist. In 1989 he founded M-1, the first independent radio station in Lithuania, and then a second one, Radiocentras in 1990. Pleikys was editor-in-chief of these stations. In 1995 he headed the Kaunas Plius TV branch in Vilnius.

Social Care and Labour Minister Irena Degutiene, age 47, is a physician. For 20 years, she has worked at Vilnius University Red Cross Hospital, in a variety of posts. From 1994, Degutiene was the Secretary of Health.

Construction and Urbanistics Minister Algis Caplikas, age 34, is a construction engineer. Mr. Caplikas has worked for several different construction enterprises. In 1995, Mr. Caplikas was elected a member of Vilnius municipality council and board, and chaired the committee for municipal services.

Health Minister Juozas Galdikas, age 38, is a physician. In 1983 he started working at the Vilnius University Heart and Blood-Vessel Surgery Clinics. He is a surgeon of the first category. Galdikas was trained in Bern, Switzerland, Czech Republic, Germany, and the USA. From May 1995, Galdikas has headed the Vilnius municipal health, sanitary and hygiene department.

Transport Minister Algis Zvaliauskas, age 41, is a construction engineer. In 1979-1981 he worked as a construction superintendent in Marijampole and in 1991-1993 he was a director of a private enterprise. In 1993 he worked as the chief engineer at the economy department of the municipality. In 1993, Mr. Zvaliauskas was elected to be the mayor of Marijampole town, and later, in 1995, he was re-elected for the second term as mayor.

Education and Science Minister Zigmas Zinkevicius, age 71, is a member of the Lithuanian Academy of Sciences. For many years he headed the department of Lithuanian language and literature at the Vilnius University and is now the director of the Lithuanian Language Institute. Zinkevicius has published more than 20 books, including a six-volume History of Lithuanian Language. He has published about 500 scientific articles in Lithuania and abroad. Zinkevicius has been elected as an honorary member of the Latvian Science Academy, the Lithuanian Catholic Science Academy, the Swedish Royal Humanities Academy and the Norwegian Science Academy.

Justice Minister Vytautas Pakalniskis, age 52, is a lawyer. He has lectured at Vilnius University and was a vice-dean of Law Faculty. In 1989-1991 he was employed at the legal department of the Supreme Council. On January 23, 1991, he was appointed to the post of deputy prime minister and from March 23, 1991, finance minister. After a change of the Cabinet in 1992, he worked for a private investment agency.

Foreign Minister Algirdas Saudargas, age 48, is a biophysicist. He has worked at the Institute of Mathematics and Cybernetics, the Agriculture Academy and other research institutions. In 1990, Saudargas was elected to the Supreme Council for the Restoration of the Seimas. He is a signatory of the March 11 Independence Act. From March of 1990 to December of 1992, he was the foreign minister. Saudargas also was a former Seimas member.

Management Reforms and Municipalities Minister Kestutis Skrebys, age 31, is an engineer. Before 1992 he was employed at the Kaunas Polytechnical Institute in Panevezys. He held this post until the autumn election to the Seimas of the same year.

Interior Minister Vidmantas Ziemelis, age 46, is a lawyer. After graduation from Vilnius University, he worked as a legal adviser. From 1984 to 1990 he was a prosecutor at the department of general supervision of the Lithuanian Prosecutor's Office. In February of 1990, he was elected to the Supreme Council for the Restoration of the Seimas. He is a signatory of the March 11 Independence Act. In 1992 he became a Seimas member and has worked at the state and legal committee.

Agriculture Minister Vytautas Petras Knasys, age 59, is an agronomist. Before 1965 he worked at the Vytenai horticulture experimental station. He later headed the Smaliskes experimental station which was transformed into the Vezaiciai branch of the Agriculture Institute. In 1989 he was appointed agriculture minister of the last Soviet government. After restoration of independence, he became a minister in the first Cabinet. He is one of founders of the Agrarian Sajudis and UN Lithuanian Association. Recently he worked at the Valstieciu Laikrastis daily. In 1996, he was elected to the new Seimas.

Appendix Two: Excerpts from the Election Program of the Lithuanian Conservatives and the Christian Democratic Party

The following text is provided by Kaunus University, School of Public Administration, 1996 Election Project, Internet.

Excerpts from the election program of Homeland Union/ Lithuanian Conservatives

(1) THE CONSERVATIVES OF LITHUANIA: OUR PRINCIPLES:

The state should be concerned not with the interests of the bureaucracy, but of the individual who participates freely and creatively in the economic, political and cultural life.

Therefore, the four principles that support the whole program of the Conservatives of Lithuania are these:

1. Independence

The aim of the Homeland Union is to ensure the citizens' right of free choice and to prevent the bureaucratic power structures from restricting the lawful activity of the citizens.

2. Private ownership

The possibility for each citizen and family to accumulate and hand their property down to the following generations ensures stability of the society and the economy.

3. Equal opportunities

Lithuania's success can be guaranteed by equal legal and economic conditions for the initiative of able-bodied people of any age. The role of the state is to encourage the creation of new jobs, competition, export and market aggregate demand without distorting market relations.

4. The rule of law (a legal state)

Just laws which do not contradict common sense, just like moral principles are the heart of the tradition of a state, therefore, compliance with laws is essential for the survival of the state. Following the philosophy of Conservatism, the Homeland Union places the rule of law above personal and corporate interests.

(2) LITHUANIA IN THE EUROPEAN UNION

Integration into the European Union and NATO is a priority goal of Lithuania.

Relations with the European Union and NATO

The sought after Lithuania's membership in the European Union and NATO should become the main guarantors of security and economic development of the country. [...] Upon the opening of a possibility of direct Lithuanian- NATO negotiations, it should be utilized as best as possible by displaying Lithuania's genuine activity as of a reliable partner.

The accession to the European Union strengthens national economy- opens the way for cheaper Lithuanian goods to the Western market, encourages the creation of new jobs, guarantees security for foreign capital investments, speeds up the growth of welfare.

Relations with neighbors

The Baltic states. [...]One of our goals should be the implementation of the principles of a customs union and a common market, as well as the creation of a defense union if approved by NATO and WEU.

Russia. Lithuania is interested in maintaining with Russia relations of goodwill and equal rights.

For the sake of Russia's democratization, protection of human rights and Russia's rapprochement with Europe, we urge to cease without delay the war with Chechnia; we support peaceful democratic processes and aspirations for independence in the Ukraine, Moldova, Belarus and the Caucasus.

Lithuania shall seek that in interstate relations Russia fully abolished discriminatory economic measures and complied with the signed agreements.

Poland. The development of mutual political and economic relations with Poland will remain among the priorities of our state in international security, as well as co-operation in air space control and establishment of a joint battalion.

Lithuania's relations with the United States of America and the Lithuanian Diaspora. [...] Regular relations with the US Congress and Administration, with an obligatory involvement of the US Lithuanian community and other organizations of Lithuanian Americans, must be a particularly important sphere of foreign policy of the Homeland Union.

(3) LITHUANIA'S NEW WAY

Other democratic states and international organizations can help us, however, we ourselves have to change our country.

The goals of the Homeland Union and ways to achieve them:

1. To achieve a strict legal order:

a) to replace the laws that encourage corruption by those that would support economic crime;

c) to apply tax and any other laws to all in an indiscriminate manner,...

f) to pass an anti- Mafia law...

2. To change methods of state administration:

a) to reform the activities of ministries and other state and self- government institutions and personnel management in line with the principles of administration of market economy and democratic society;

3. To revive a solvent demand (buying power) in the market by preserving the same level of inflation, and to seek revival of enterprises- so that they receive orders and income

4. To support local goods and services and encourage their export

5. To apply financial incentives for creation of new jobs and capital investments into production

6. To attract foreign capital:

c) to amend the law on Foreign Investments and simplify the bureaucratic registration procedure of foreign capital (ventures) and increase investment security guarantees;

g) to accelerate the formation of Siauliai, Kaunas and Klaipeda free trade and transport zones;

7. To stop inflation:

a) to restore and establish by law the functions of the Central bank of Lithuania;

d) to balance the state budget;

8. To protect private property shareholders and stop intentional bankruptcies of enterprises and banks

9. To renew and develop privatisation by tender- an open sale of enterprises and their block of shares:

g) to broaden commercial privatisation, excluding the (Ignalina- A.K.) Nuclear Power Plant, railway, oil and gas pipelines, power transmission lines, airports (takeoff and landing strips) and certain other monopolistic objects of production and social infrastructure that are of vital importance in the country;

10. To guarantee reliability of the banking system:

a) to create legal and economic conditions for big and reliable foreign banks to open their branch offices in Lithuania, so that they could take over certain structures of state and commercial banks that are going to bankrupt;

11. To adjust taxes:

b) having expanded the basis of taxation, to reduce the VAT to 15 per cent , and later to 13 per cent;

e) not to tax the procured modern technology;

12. To ensure a real wage and pensions, and minimal social guarantees

13. To introduce an additional (individual) pension insurance

14. To introduce medical insurance

15. To support the country's agriculture and the farmers

16. To support education, culture and science as the principal investment into Lithuania's future, to restore the prestige of the intelligentsia

17. To develop property and social insurance,

18. To eliminate political antagonism among the people, reduce social tension:

a) to distinguish clearly all those who perpetrated genocide and the criminal former KGB and GRU employees and collaborators who committed crimes, from the former informers and agents who were forced to collaborate with special agencies through blackmail and threats but who did not commit crimes and ceased their activities after March 11, 1990;

19. To evaluate contribution in the struggles against the occupation

20. To strengthen national security and defense:

c) to implement the principles of unconditional and total national defense;

k) to establish by law a provision whereby in the coming four years the national defense system would receive no less than 5- 6 per cent of the state budget;

LITHUANIA'S SUCCESS is:

- an economy without inflation, a macroeconomic guarantee of stable and reliable prices;

- an economy for export and not a market for import. Export is promoted by an appropriate monetary policy carried out by the Bank of Lithuania. In a fair competition support is given to small- and medium- scale business and not to the "friends' business";

- citizens who have a job and can earn sufficiently. There will be no production without demand;

- unified, simplified and reduced tax burden on production and other business;

- banks that are reliable and are able to compete in the Lithuanian market with foreign banks;

- strict management of the state- owned property and its profitable privatisation according to well publicized tender regulations;

- the police with the people and not in their offices. The better community takes care of its own safety, the smaller the police force it will need. A strict legal order in all spheres and an unconditional respect for law. The court and the police are well "supplied" with conscience and are protected from influence of criminals;

- a personal responsibility of civil servants for their decisions and a broad programme of "Clean Hands" aimed at eliminating possibilities of corrupt interests in government institutions;

- economic, legal and social assistance for the restoration of family;

- education as the foundation on which modern Lithuania is being built which is able to adjust to the present- day requirements of Europe. Conditions for young people enabling them to establish in life, and care for senior citizens ensuring them a tranquil and well-provided for retirement which they earned by a conscientious work;

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- care for and respect to all those fought against the occupation regime and suffered from it;

- a man who discarded revenge and envy towards those who on the other side of the "barricade" or who became rich by a conscientious work;

-a self-confident Lithuania with its unique culture in the European Union.

Election program of Lithuanian Christian Democratic Party: A summary

I. GENERAL PRINCIPLES

The basic values of Christian Democracy include personality, freedom and responsibility, natural equality, justice and solidarity.

Relations with the Church

We are united into a secular political community to whom the Church is a moral authority. Our values and actions are based on social doctrine of the Christian Church.

Lithuania in Europe

We understand that Lithuania is an integral part of Western Christian civilization. We see Lithuania as non- isolated, but within a freely uniting Europe, developing its unique way of life and culture.

II. OUR GOALS AND STRATEGY

Features of current situation: economic and social crisis and its causes

In 1992 the nomenclatura came back to power and fortified itself in the institutions of economic management, judicial system and many other governmental structures as well as in the banks. [...] This phenomenon we call nomenclatura capitalism.

From nomenclatura capitalism to European social market economy

Lithuania's integration into community of European nations is main direction of our policy.

Christian Democratic Party stresses the following goals of social policy:

- to stop poverty and to establish conditions for people to secure appropriate living standards on the basis of honest work;

- to guarantee minimal living standards for socially disadvantageous individuals;

- to restrain organized crime, corruption and situation of unpunishment;

- to reduce alcoholism and other social defects.

III. OUR ATTITUDES AND ACTIONS

1. Evaluation of state's wealth

2. System of state administration

Structural reform of government will be implemented on the basis of the experience of European countries.

It should include:

- a decrease in the total number of ministries;

- decentralization of state administration through transfer of some functions in environmental protection, civil defense, education, social insurance, health care as well as implementation of regional programs of development to local authorities.

3. Self- government

Local government should be developed according to the following directions:

- to approve by Seimas decision a long- term model of taxes for local government, to decrease dependence of local budgets from the central government;

- to increase the role of Association of Municipalities in a decision- making body of local self- government.

4. Law and order

- to resolutely carry out reform of law and justice

5. Development of Economy

Main directions of economy's development:

* integration to the EU economy;

* growth of competitiveness of economy and Lithuania's export;

* reform of rights and responsibilities of state in the regulation of economy;

* rational policy of state budget.

5.2. Expansion of competitive economy

* medium- and small- scale business will dominate in rational and balanced structure of Lithuania's economy;

* development of small- scale business is a basic condition for people' employment, and increasing free initiative.

5.4. State's budget policy

- all taxes and tariffs must be set only by law and not by decision of the Cabinet;

- to abolish protectionist and discriminative tax privileges for foreign investors;

- to increase real incomes of low- paid persons by changing income tax tariffs.

6. Monetary, banking and crediting policy

- consistently strengthen Lithuania's Central Bank;

- to give priority in the use of foreign loans for restructuring the economy, modernization and expansion of production;

- to stimulate and support Western investments into Lithuania's banking system;

- to introduce by law compulsory insurance of savings;

7. Development of rural areas

8. Energetics

9. Social policy

- to implement an active policy aimed at preserving jobs, to stop rising unemployment;

- to support the creation of new jobs by providing some tax privileges for employers;

10. To provide help for family and care for children

11. Problems of youth

12. Health care

13. Ethnic policy

14. Education, science and culture

15. Natural environment

16. Overcoming consequences of the [Soviet] occupation

17. National security

- Lithuania's security is an indispensable part of uniting Europe's security;

- equal guarantees of Lithuania's security will be created only if Lithuania become a full member of European and Transatlantic institutions, e.g. the European Union, the Western European Union, and North Atlantic Treaty Organization (NATO);

- preparedness for total defense of citizens and state will be an additional factor to discourage potential aggressors and will reinforce national security.

We are determined and ready to serve for Lithuania. Together with thousands of our supporters we believe in the need of Christian Democracy for Lithuania.

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Annex 6

Foundation for Participatory Democracy Concept Paper

(to be submitted)