LITHUANIA

Highlights

- **A recovery in private investment has supported GDP growth.** Private consumption has grown robustly too in the past year, as a tightening labour market has contributed to real wage increases, while the export sector is also performing well.
- **Tax and pension reforms have been launched.** The tax reform introduces new progressivity along with increased tax exemptions for incomes under a certain threshold. The pension reform fully separates the state-backed pension system from the second-pillar voluntary private system, while at the same time strengthening the latter. Both reforms will take effect in January 2019.
- **Lithuania has joined the OECD.** The accession process took five years and was concluded in July 2018. Lithuania will benefit from the exchange of policy experience with other OECD members, which ultimately should positively shape policy decisions in the country.

Key priorities for 2019

- **Enhancing labour supply is critical to offset demographic pressures and to increase potential growth.** The new, modern labour code, which entered into force in July 2017, should be accompanied by additional employment-enhancing measures, such as a reduced tax wedge, lower costs of childcare and a reformed immigration policy to attract more highly skilled labour.
- **A successful implementation of the tax reform may reduce the shadow economy.** It will be important to ensure that the income tax reform, which will come into effect in January 2019, reduces the tax burden for those living on the lowest income, as this sector is often operating in the shadow economy.
- **Improving energy efficiency should be continued.** The greatest financing needs have been identified in the energy efficiency sector. According to the Public Investment Development Agency (VIPA), such needs can reach €1 billion until 2023.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	3.5	2.0	2.4	4.1	3.4
Inflation (average)	0.2	-0.7	0.7	3.7	2.7
Government balance/GDP	-0.6	-0.2	0.3	0.5	0.7
Current account balance/GDP	3.2	-2.3	-0.8	0.9	0.4
Net FDI/GDP [neg. sign = inflows]	0.0	-1.9	-0.4	-1.3	-1.0
External debt/GDP	69.9	75.7	85.2	82.5	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	40.5	41.3	42.7	41.1	n.a.

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Macroeconomic performance

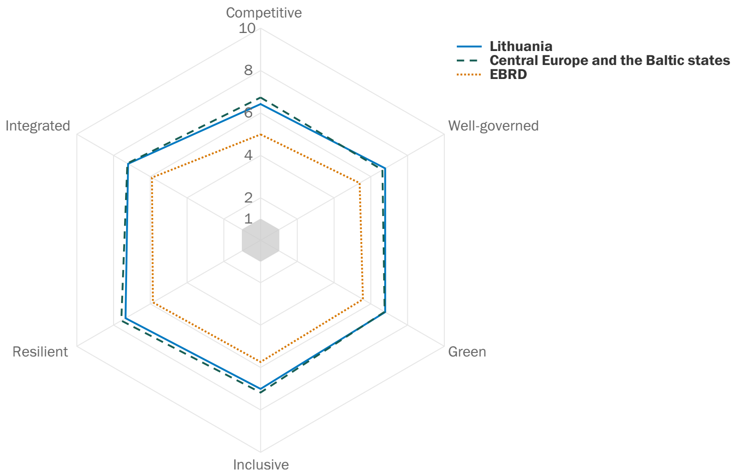
GDP growth has been fuelled by strong private consumption and a recovery in investment. Real GDP growth reached 4.1 per cent in 2017, followed by 3.8 per cent growth year-on-year in the first half of 2018. Robust private consumption has been accompanied by a strong pick-up in investment (by about 8.0 per cent), which is expected to improve further, in line with the accelerated absorption of EU funds. Exports also showed a robust recovery, although their positive effect on GDP has been largely offset by an investment-led strong rise in imports.

The labour market has tightened further. The current employment rate is among the highest in central Europe and the Baltic states, at 76.8 per cent in the first quarter of 2018, while the unemployment rates continue to fall, reaching an historic low of 6.8 per cent in June 2018. Long-term unemployment has dropped to only 2.4 per cent. Nevertheless, in absolute numbers employment is expected to fall during the next few years, in line with the fall in the working-age population.

The general government balance remains in surplus. In 2017, Lithuania managed to register a budget surplus for the second year in a row, reaching 0.5 per cent of GDP last year. The improved tax collection, underpinned by strong economic performance and robust consumption, mitigated the costs associated with the labour market and pension reforms. Public debt remains on a downward path, dropping to below 40 per cent of GDP by the end of 2017. The recently introduced pension system reforms will likely improve long-term fiscal sustainability, in particular through introducing an automatic indexation system.

GDP growth will likely moderate gradually. Strong wage growth and a further tightening of the labour market will continue supporting strong private consumption. GDP growth is forecast to reach 3.4 per cent in 2018, before it decelerates to 2.8 per cent in 2019. Nevertheless, the expected weakening in external demand from Lithuania's major trading partners, amid an investment-led surge in imports, will result in a negative trade balance, and thus will weigh on GDP growth in the forecast horizon. The shrinking working-age population is expected to hurt businesses increasingly, which in turn may defer investment decisions, as the lack of skilled labour may not be easily replaced by machines. In contrast, the accelerated utilisation of EU funds will likely propel a rise in public investment.

Assessment of transition qualities (1-10)



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Major structural reform developments

Lithuania has joined the OECD. In July 2018 the agreement was ratified by the French government and concluded an accession process that lasted five years. Lithuania will benefit from the exchange of policy experience with the other 35 members and draw on the OECD's expertise, which ultimately should positively shape the policy decisions in the country.

Tax reform is advancing. In July 2018, the President signed into law tax amendments, including to personal income taxation and social security contributions. The reform consolidates labour-related taxes on the employee side by introducing two personal income tax rates. Incomes below €107,000, calculated as the average monthly wage multiplied by 120, will be taxed at 20 per cent and incomes higher than that will be taxed at 27 per cent. Other measures include an increase in the tax-exempt threshold and a significant cut in social security. These changes will likely reduce Lithuania's tax wedge, which is substantially above the OECD average (37 versus 28 per cent). A reduction of the tax wedge was one of the OECD's recommendations, on the occasion of Lithuania's accession, to make low-skilled workers more attractive to employers.

Pension reforms have been adopted. Along with the tax reform (described above), the government has adopted reforms to the pension system. According to the amended law, the state social insurance fund (Sodra) will stop making transfers to the second pillar pension system. At the same time, Sodra will become the sole payer of pension annuities. In addition, employees younger than 40 years will be automatically enrolled to the second pillar, with the right to opt out during the first three years. Under the second pillar scheme, employees will transfer 3.0 per cent of their salary to a private pension fund, which will be complemented by a 1.5 per cent transfer from the state. Pension fund fees will be reduced from 1.0 to 0.5 per cent of the average annual value of funds. The law will enter into force in January 2019. While the second pillar will be strengthened, it remains unclear if the reform will generate sufficient replacement rates in the future.

Lithuania has issued its first green bonds. In May 2018, the government issued a €100 million sovereign green bond, the first country to do so among the Baltic states. The net proceeds from that placement were on-lent to VIPA, the Public Investment Development Agency, and will be used exclusively to improve the energy efficiency of multi-apartment buildings throughout the country. According to VIPA's *ex ante* assessment, the financial needs in the energy efficiency sector until 2023 amount to €1 billion, of which about 30 per cent could be covered by VIPA and the remaining part by the private sector.

The new energy strategy aims to achieve complete energy independence. An updated National Energy Independence Strategy was adopted by the parliament in June 2018. It foresees a gradual increase of power produced locally, reaching 35 per cent in 2020, 70 per cent in 2030 and 100 per cent in 2050. Renewables are expected to become the key source of energy in all sectors, starting from a share of 30 per cent in 2020, then 45 per cent in 2030 and 80 per cent in 2050. Natural gas imports are expected only by 2050, supplied by the Klaipeda liquefied natural gas terminal and, from 2021, the gas pipeline interconnection between Lithuania and Poland (GIPL), which is currently under construction. Also, the strategy stipulates the full integration of Lithuania's energy system with the continental European system by 2025.

The state-owned railway monopoly is being split up. In February 2018, the government approved the transport ministry's proposal to divide the Lietuvos Gelezinkeliai (Lithuanian Railways) into three separate entities managing the country's railway infrastructure, passenger transport and infrastructure. The three companies are expected to remain 100 per cent state-owned but such a model will likely allow more efficient management and transparency. According to the EU's Fourth Railway Package, infrastructure and rail operators should be managed separately.