This Overview is extracted from the 2020 Economic Survey of Lithuania. The Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

This document, as well as any data and any map included herein, are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

OECD Economic Surveys: Lithuania© OECD 2020

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgement of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to rights@oecd.org. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at info@copyright.com or the Centre français d’exploitation du droit de copie (CFC) at contact@cfcopies.com.tatus of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.
Executive summary
The covid crisis hit a buoyant economy

The strong pre-COVID-19 economy boosted rapid convergence towards the OECD average incomes. An investment-friendly business climate helped attract foreign direct investment and integration in global-value chains.

Figure 1. Lithuania is converging rapidly

GDP per capita, difference to OECD upper half

Source: OECD Economic Outlook database.

The recovery will be uncertain. The COVID-19 recession was comparatively mild, and the economy is recovering. The government swiftly set up a programme supporting households and firms, representing almost 10% of GDP, and plans new investments to support long-term growth. The economy is expected to contract by 2% in 2020 and to rebound by 2.7% in 2021, and unemployment will rise to around 9%, yet protracted disruptions in world trade would be harmful for the outlook.

Poverty is high, especially among the unemployed, less educated, single parents and older people. The tax-benefit system is not very redistributive and its size below the OECD average. The government should increase social support while keeping work incentives.

Regional disparities are increasing. Investment in peripheral regions is low and labour mobility towards economically strong areas insufficient. Productivity differences between core and peripheral regions are rising. The government should continue investing in rural areas while facilitating migration to more prosperous areas.

Table 1. The economy is projected to rebound

<table>
<thead>
<tr>
<th></th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP at market prices</td>
<td>4.3</td>
<td>-2.0</td>
<td>2.7</td>
</tr>
<tr>
<td>Private consumption</td>
<td>3.4</td>
<td>-3.2</td>
<td>2.8</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>6.2</td>
<td>-6.6</td>
<td>3.8</td>
</tr>
<tr>
<td>Exports</td>
<td>9.5</td>
<td>-4.7</td>
<td>3.7</td>
</tr>
<tr>
<td>Imports</td>
<td>6.3</td>
<td>-6.9</td>
<td>5.5</td>
</tr>
<tr>
<td>Consumer price index</td>
<td>2.2</td>
<td>1.2</td>
<td>1.5</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>6.3</td>
<td>8.8</td>
<td>8.1</td>
</tr>
<tr>
<td>Government financial balance (% of GDP)</td>
<td>0.3</td>
<td>-8.9</td>
<td>-5.4</td>
</tr>
<tr>
<td>Current account (% of GDP)</td>
<td>3.5</td>
<td>5.2</td>
<td>3.9</td>
</tr>
</tbody>
</table>

Source: OECD Economic Outlook 108 database (provisional).

Growth should be greener. CO2 emissions are below OECD average and declining, but mortality from exposure to fine particles is the highest in the OECD. Transport and energy are the main sources of emissions. Environmental taxation is low. The government set up a programme to co-fund private climate investment and wants to reach carbon neutrality by 2050. The government should also introduce a CO2 tax.
Fiscal and financial policies are sound

Sound fiscal policy over the past years has created fiscal space to help the economy in the current crisis.

Fiscal policy is expansionary. The constitutional fiscal law of 2015 provides for tight surveillance. In 2019 the budget was in a small surplus. To help households and firms to weather the COVID-19 crisis, the government plans additional tax and spending measures totalling 10% of GDP. As a result, the balance is expected to turn sharply negative in 2020. Once fiscal positions have recovered, the government should simplify the fiscal framework and set a long-term debt target.

The COVID-19 crisis affects credit. About 40% of the corporate sector was affected by containment measures, exacerbating funding challenges especially for small firms. Non-performing loans in the banking sector declined markedly, and frequent use of macro-prudential regulation helped strengthen financial stability. The government eased financial conditions following the COVID-19 crisis and should continue to do so.

Reforming state-owned enterprises could boost the recovery

Wages grew faster than productivity over the past few years, reducing competitiveness while boosting lower incomes. Reforming state-owned enterprises could help raise productivity.

State-owned enterprises are oversized. The scope of state-owned enterprise (SOE) belongs to the largest in the OECD. Governance has improved over the past two years following the adoption of the 2018 “SOE Reorganisation and Optimization Plan”, but remains weak against OECD standards. Only half of the SOEs reach their targets. A clearer strategy defining the rationale for public ownership is needed, and SOEs should be subject to same regulations and market constraints as private companies.

Municipal SOEs pose a particular challenge. Around 250 municipal enterprises are active across 40 sectors, ranging from energy supply, waste treatment to local public transport, with few limits set on their scope. Municipal SOEs often compete with private providers and cross-subsidise corporate activities with revenues from publicly supported ones, distorting competition. The government should strengthen the regulatory framework for municipal enterprises, by establishing a level playing field between public and private providers.
Education should foster strong and relevant skills

Strong and relevant skills could help accelerate the recovery and reduce inequality across regions and income groups. The education infrastructure should better adapt to higher skill needs and shrinking student numbers.

Performance of primary and lower secondary education is weak. Spending on infrastructure is excessive, reflecting high spending on overly small schools. School performance lacks systematic oversight. Recent reforms were rather shy, mainly involving an increase in teacher salaries. The government should merge small schools and strengthen quality oversight.

Vocational education fails to provide relevant skills. The school network often lacks scale and specialisation. Firm-based learning (apprenticeships), introduced in 2016, still attracts few students. Reform should improve VET, including apprenticeships, thereby strengthening links to the labour market.

Tertiary education is fragmented. Recent attempts to consolidate the university network failed or did not bring the expected results. Funding provides few incentives to improve quality. The government should encourage universities to specialise in fewer areas. More rigorous quality assessment and a funding reform could also help improve quality.
## MAIN FINDINGS

### Policies to support the recovery
- The COVID-19 crisis has affected economic activity and household incomes, exacerbating funding challenges for the corporate sector.
- Continue providing temporary support to households and firms, while helping to reallocate resources to viable firms.

### Financial and fiscal policies
- The asymmetric fiscal rule (two-regime rule), relying on potential output, causes frequent revisions to fiscal planning.
- Simplify the fiscal framework and establish a long-term debt target.
- Public investment is low.
- Increase public investment against rigorous cost-benefit analysis.

### Structural policies
- The scope of state-owned enterprises is large and governance lags behind OECD standards.
- Strengthen the governance of state-owned enterprises further. Sell to private investors if no compelling reasons for public ownership exist.

### Green growth policies
- The economy’s carbon imprint is considerable, while environmental taxation is below the OECD average.
- Introduce a carbon tax in sectors not covered by the European emission trading system, and reimburse at least partially the proceeds to households and firms.
- Fossil fuel subsidies belong to the highest in the OECD.
- Remove environmentally damaging fuel subsidies.

### Reducing poverty and social disparities
- Social spending is comparatively low and the provision of cash benefits and social services is not closely linked to the needs of vulnerable groups.
- Further increase the level of minimum-income benefits, while maintaining work incentives.
- Increase gradually social assistance pensions, while strengthening means-testing.
- Better tailor the provision of social benefits and services to individuals’ needs.
- The long-term care services do not effectively reach the elderly population.
- Move to an integrated model of long-term care provision, with a focus on home-care for the elderly.
- Access to early childhood education and care is not ensured for all children.
- Continue the expansion of early childhood education and care, with a special emphasis on children from disadvantaged background and rural areas.
- Activation policies need to strengthen to facilitate labour market integration of those out of work with high poverty rates.
- Increase spending in active labour market programmes, upon a close monitoring of their outcomes and a focus on training programmes.

### Fostering regional growth
- PISA scores are weak, especially in small rural schools.
- Improve educational outcomes by reforming the school network and by strengthening supervision.
- Vocational education and training is little developed, contributing to skills mismatch especially in rural areas.
- Foster and improve vocational education and training, and strengthen firm-based learning (apprenticeships).
- The housing rental market is very small, discouraging mobility.
- Revise rental legislation by clarifying the rights of tenants and landlords.
- Policy coordination between municipalities is weak, driving cost and reducing public service quality.
- Implement functional regions as planned and provide them with power to coordinate investment and public services across municipalities.
Key policy insights
Introduction

Lithuania has gone through a comparatively mild COVID-19 crisis so far. The number of victims remained low thanks to effective containment measures and a well-functioning health system. The lockdown was rather short and lenient. The economy dived less than in almost any other European country and seems to recover fast. Some sectors suffered more such as manufacturing and transport, given still weak export markets and the country’s role as a transport hub between Eastern and Western Europe. A surge of new infections and the reintroduction of travel restrictions since end-August dents the outlook further. Before the pandemic, the economy showed a strong performance and was rapidly converging towards the OECD upper half, driven by rapid export and investment growth supported by several key policy initiatives. With income prospects brightening up further, net migration turned positive for the first time since renewed independence (Figure 1.1; Box 1.1).

The government swiftly provided emergency funds for the health care system as well as financial and fiscal support to households and firms with the aim to preserve incomes and jobs, representing around 10% of annual GDP. In May the government extended support, in particular short-term work schemes and additional unemployment benefits, until the end of the year. The central bank’s liquidity assistance programme helped maintain financial stability. Support is now being gradually wound down, giving way to more targeted programmes. To stimulate supply and long-term growth after the crisis, the government is stepping up a multi-annual investment programme covering education, innovation and research, digital transformation, infrastructure and a climate and energy action plan, amounting to another 4.5% of GDP and with a focus on balanced development across Lithuania’s regions. A sound macroeconomic framework and a business-friendly climate is supporting these policies.

Figure 1.1. Lithuania is converging rapidly, and migration flows have turned positive

Source: OECD Economic Outlook 107 database; and Statistics Lithuania.

StatLink 2  https://doi.org/10.1787/888934184947
Box 1.1. The government's key policy initiatives

The government has followed up on the “new social model” reforms of 2016-18, which thoroughly revamped labour markets, pensions and taxation. Key new initiatives until summer 2020 include:

- The adoption of new insolvency legislation, which makes the framework from one of the most restrictive and burdensome to one of the most open and balanced of the OECD.
- An increase in income taxation for high-income earners and a reduction of social security contributions, bringing higher tax progressivity, and additional tax deductibility for payments into pension funds. A one-off tax amnesty and the introduction of tax deductibility of personal services aims at fighting tax evasion better.
- A reform of the innovation system to raise productivity and competitiveness, which strengthens the digital transformation of the industry, helps develop a start-up ecosystem, and provides additional support for selected sectoral activities. The support system was streamlined and additional R&D tax incentives are granted.
- A change in the funding of general education, giving more weight to class size, student needs and test scores. Salaries of teachers at all levels were increased, teacher education improved and the quality of vocational education and training schools strengthened.
- Gradual deregulation of electricity prices and the creation of a gas exchange market.

In the health sector, the salaries of medical staff were considerably increased and service quality – e.g. shorter waiting times – improved, although the planned reorganisation of small municipal hospitals, as recommended in the last Survey, continued only slowly.

Source: (OECD, 2018[1]), (Government of Lithuania, 2019[2]), questionnaire responses

However, the COVID-19 crisis laid bare some weaknesses of Lithuania’s economy, in particular the uneven distribution of prosperity across people and places. Income inequality and poverty rates are among the highest in the OECD, although wealth inequality is comparatively low because of a high homeownership rate (Figure 1.2). Despite recent reforms that made the benefit system more effective especially for families and taxation more progressive, and despite a recent decline, the share of poor households remains elevated. The elderly, disabled, lone parents, the less educated and unemployed, are among the most vulnerable groups, facing poverty rates well above the overall population. Regional differences in income, productivity and unemployment are among the highest in the OECD despite the small size of the country, and they continue to rise. Growth is concentrated in a few urban agglomerations and resorts along the Baltic coast, while many rural and more peripheral areas stagnate, with emigration often the only way to escape poverty. Other areas where Lithuania fares below OECD average is general life satisfaction, housing quality, and the level of skills and education.

Against this background, the Survey sends the following key messages:

- Maintain resilient and sustainable growth, by improving skills, strengthening the regulatory framework, and moving towards a low-carbon economy.
- Reduce poverty, by ensuring adequate income support for the needy and high quality social services, while helping the transition out of poverty and into the labour market.
- Foster regional convergence, by strengthening regional institutions and fostering mobility of people towards economically stronger regions.
Recent developments and short-term prospects

The economy held up well during the pandemic-related crisis, yet risks to recovery remain

The outbreak of the COVID-19 pandemic has affected the course of the economy but the impact has been comparatively mild (Figure 1.3). Containment measures, heightened uncertainty and deteriorating external environment triggered a decline in activity in the second quarter of 2020. Service sectors, especially tourism, felt the impact of the crisis most. The dip was short-lived, however. Retail sales and consumer confidence rebounded fast once the confinement measures started to be eased in mid-April and industrial confidence has improved from the spring’s slump. The deceleration in export growth has also slowed. The resurgence of the pandemic and the introduction of new measures appear to have an impact on economic activity according to some high frequency indicators, such as mobility data. Investment is supported by public spending but also faces headwinds from the still weak domestic and external demand. Headline inflation receded as oil prices fell.

After a comparatively mild contraction of 2% in 2020, economic activity is projected to return to a positive growth in 2021. While the economy seems to be on the path of recovery and confidence has rebounded from its lows in early 2020, uncertainty remains high and export markets weak. Policy measures (Box 1.2) and the implementation of EU-funded projects and the multi-annual public investment project will provide support to activity. GDP is expected to grow by 2.7% in 2021 (Table 1.1).
Figure 1.3. The pandemic had a relative mild impact on the economy

A. Real GDP
Y-o-y % changes

B. GDP components
Y-o-y % changes, volume

C. Confidence and retail sales

D. Economic activity has dipped in some sectors
Search intensity index, January 2018 = 100

E. Consumer price index
Y-o-y % changes

F. Interest rates
%

Note: Panel D: most recent observations are for 20 October 2020. Online search categories encompass various keywords and are harmonised across languages. Results show a three-week moving average of search intensity indexed to January 2018. Panel F shows the annualised agreed rate on loans of less than, or equal to, 1 million euros to non-financial corporations (excluding revolving loans and overdrafts, convenience and extended credit card debt).

Source: OECD Economic Outlook 107 database; OECD Main Economic Indicators; and Google Trends data and OECD calculations.

https://doi.org/10.1787/888934184985

OECD ECONOMIC SURVEYS: LITHUANIA 2020 © OECD 2020
Box 1.2. The government introduced a broad stimulus package in response to the crisis

The government announced an overall package of EUR 5 billion (10% of GDP) on 16 March 2020, equally split between fiscal and financial support. The fiscal initiative entails funds for the health care system and emergency management, as well as measures to preserve jobs and incomes, maintain business liquidity and stimulate the economy. The initiative includes short-time work schemes and support for non-standard workers (Chapter 2). Other measures were loan and tax payment deferrals, soft loans to eligible small firms and temporary rental subsidies to businesses. To help the economy recover, special attention is given to the acceleration of investment programmes, including co-financing of private climate investment. Additional fiscal measures of around 2% of GDP were approved in May 2020 to support businesses and households after the end of confinement. The central bank lowered its counter cyclical capital buffer in March 2020 and is also taking a more flexible approach regarding some capital and liquidity requirements imposed on banks (discussed below), in addition to the ECB’s accommodative monetary policies. To help the recovery and ensure robust growth over the longer-term, the government is stepping up a multi-annual investment programme (DNA Plan for the Future) that aims to create the conditions for a qualitative transformation of the economy. The investment package covers the areas education, innovation and research, digital transformation, infrastructure and climate and energy, with expenditure on new investment amounting to 4.5% of GDP.

Source: Ministry of Finance and Ministry of Labour and Social Security.

Projections are subject to substantial uncertainty and risks. Return to normal is closely related to economic developments in Lithuania’s trading partners, given high export dependence, as well as to domestic demand which could be affected by high unemployment. The economy may further confront unforeseen events, including protracted disruptions in world trade that would be particularly harmful for the outlook (Table 1.2).
Table 1.1. Macroeconomic indicators and projections

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current prices</strong></td>
<td>EUR billion</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP at market prices</td>
<td>38.9</td>
<td>4.3</td>
<td>3.9</td>
<td>4.3</td>
<td>-2.0</td>
<td>2.7</td>
</tr>
<tr>
<td>Private consumption</td>
<td>24.5</td>
<td>3.5</td>
<td>3.7</td>
<td>3.4</td>
<td>-3.2</td>
<td>2.8</td>
</tr>
<tr>
<td>Government consumption</td>
<td>6.6</td>
<td>-0.3</td>
<td>0.2</td>
<td>0.1</td>
<td>5.9</td>
<td>4.7</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>7.7</td>
<td>8.9</td>
<td>10.0</td>
<td>6.2</td>
<td>-6.6</td>
<td>3.8</td>
</tr>
<tr>
<td>Final domestic demand</td>
<td>38.9</td>
<td>3.9</td>
<td>4.4</td>
<td>3.4</td>
<td>-2.4</td>
<td>3.4</td>
</tr>
<tr>
<td>Stockbuilding1</td>
<td>-0.3</td>
<td>-1.3</td>
<td>-1.1</td>
<td>-1.5</td>
<td>-0.9</td>
<td>0.2</td>
</tr>
<tr>
<td>Total domestic demand</td>
<td>38.6</td>
<td>2.6</td>
<td>3.3</td>
<td>2.0</td>
<td>-3.4</td>
<td>3.8</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>26.3</td>
<td>13.5</td>
<td>6.8</td>
<td>9.5</td>
<td>-4.7</td>
<td>3.7</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>26.0</td>
<td>11.1</td>
<td>6.0</td>
<td>6.3</td>
<td>-6.9</td>
<td>5.5</td>
</tr>
<tr>
<td>Net exports3</td>
<td>0.3</td>
<td>1.7</td>
<td>0.7</td>
<td>2.5</td>
<td>1.4</td>
<td>-0.9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Other indicators (growth rates, unless specified)</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Potential GDP</td>
<td></td>
<td>2.4</td>
<td>3.0</td>
<td>3.0</td>
<td>2.8</td>
<td>2.8</td>
</tr>
<tr>
<td>Output gap2</td>
<td></td>
<td>-0.6</td>
<td>0.4</td>
<td>1.6</td>
<td>-3.0</td>
<td>-3.1</td>
</tr>
<tr>
<td>Employment</td>
<td></td>
<td>-0.5</td>
<td>1.5</td>
<td>0.3</td>
<td>-2.1</td>
<td>0.4</td>
</tr>
<tr>
<td>Unemployment rate (% of labour force)</td>
<td></td>
<td>7.1</td>
<td>6.1</td>
<td>6.3</td>
<td>8.8</td>
<td>8.1</td>
</tr>
<tr>
<td>GDP deflator</td>
<td></td>
<td>4.2</td>
<td>3.5</td>
<td>2.8</td>
<td>1.1</td>
<td>1.5</td>
</tr>
<tr>
<td>Harmonised index of consumer price index</td>
<td></td>
<td>3.7</td>
<td>2.5</td>
<td>2.2</td>
<td>1.2</td>
<td>1.5</td>
</tr>
<tr>
<td>Harmonised index of core inflation</td>
<td></td>
<td>2.6</td>
<td>1.9</td>
<td>2.3</td>
<td>2.7</td>
<td>1.6</td>
</tr>
<tr>
<td>Household saving ratio, net (% of disposable income)</td>
<td></td>
<td>-3.7</td>
<td>-3.6</td>
<td>0.6</td>
<td>6.9</td>
<td>5.6</td>
</tr>
<tr>
<td>Current account balance (% of GDP)</td>
<td></td>
<td>0.6</td>
<td>0.2</td>
<td>3.5</td>
<td>5.2</td>
<td>3.9</td>
</tr>
<tr>
<td>General government financial balance (% of GDP)</td>
<td></td>
<td>0.5</td>
<td>0.6</td>
<td>0.3</td>
<td>-8.9</td>
<td>-5.4</td>
</tr>
<tr>
<td>Underlying government financial balance2</td>
<td></td>
<td>0.6</td>
<td>0.5</td>
<td>-0.3</td>
<td>-7.7</td>
<td>-4.2</td>
</tr>
<tr>
<td>Underlying government primary financial balance2</td>
<td></td>
<td>1.7</td>
<td>1.3</td>
<td>0.5</td>
<td>-6.8</td>
<td>-3.4</td>
</tr>
<tr>
<td>General government gross debt (% of GDP)</td>
<td></td>
<td>47.0</td>
<td>40.7</td>
<td>44.5</td>
<td>53.6</td>
<td>58.1</td>
</tr>
<tr>
<td>General government debt, Maastricht definition (% of GDP)</td>
<td></td>
<td>39.1</td>
<td>33.7</td>
<td>35.9</td>
<td>45.0</td>
<td>49.5</td>
</tr>
<tr>
<td>Three-month money market rate, average</td>
<td></td>
<td>-0.3</td>
<td>-0.3</td>
<td>-0.4</td>
<td>-0.4</td>
<td>-0.5</td>
</tr>
<tr>
<td>Ten-year government bond yield, average</td>
<td></td>
<td>0.3</td>
<td>0.3</td>
<td>0.3</td>
<td>0.2</td>
<td>0.2</td>
</tr>
</tbody>
</table>

1. Contributions to changes in real GDP, actual amount in the first column.
2. As a percentage of potential GDP.
3. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 108 database (provisional).

Table 1.2. Events that could entail major changes to the outlook

<table>
<thead>
<tr>
<th>Shock</th>
<th>Potential impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Protracted disruptions in world trade</td>
<td>Prolonged weakness in external demand and disruptions in supply chain, and geopolitical events in and around Europe, especially related to Russia and Belarus, would curb exports and weaken confidence and investment</td>
</tr>
<tr>
<td>Financial market turbulence</td>
<td>An increase in non-performing loans and a sharp correction in housing markets could cause financial duress. Turbulences in the Nordic banking system could put Lithuania’s banking sector under pressure</td>
</tr>
<tr>
<td>Prolonged period of pandemic</td>
<td>A more protracted pandemic period would compound health and economic risks, given the interconnectedness of economies</td>
</tr>
</tbody>
</table>

The labour market, which showed signs of overheating before the crisis, was severely hit (Figure 1.4). Registered unemployment increased by 2.4 percentage points between mid-March (beginning of the quarantine) and end-April. The rise might have been sharper without short-time work schemes (Box 1.2). Net international migration became positive in 2019 due to the favourable situation in Lithuania, changes in migration policy, and probably Brexit (Bank of Lithuania, 2019[3]) (Figure 1.1). It slowed in April, however,
affected by mobility restrictions and a decline in labour demand. Unemployment is projected to decline but remain above the pre-crisis level in 2021, given hysteresis effects. Large skills mismatch and labour shortages, especially of highly qualified workers, may also slow the adjustment of the labour market, even though improving migration trends and larger labour market slack reduce pressures.

**Figure 1.4. The labour market was strong before the crisis**

![Labour force indicators](image1)

A. Labour force indicators

<table>
<thead>
<tr>
<th>%, population aged 15-64</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labour force participation rate</td>
</tr>
<tr>
<td>100</td>
</tr>
</tbody>
</table>

B. Registered unemployment and job placements

Index, Jan 2019 = 100, 3-month moving avg.

<table>
<thead>
<tr>
<th>Registered unemployed</th>
<th>Permanent job placements</th>
</tr>
</thead>
<tbody>
<tr>
<td>180</td>
<td>160</td>
</tr>
</tbody>
</table>

C. Type of skill mismatch

% of employed aged 15-64, 2016

- Overqualification
- Underqualification


Wages were growing rapidly before the pandemic (Figure 1.5). Minimum wages increased by almost 2.5 times between 2009 and 2019, bringing the ratio of the minimum to the median wage close to OECD average. The COVID-19 crisis is expected to reduce wage pressure due to increased unemployment and weak consumer demand. Recent wage data for the accommodation sector and food service activities and real estate sectors show a considerable slowdown in wage growth in the first quarter 2020 (Ministry of Finance, 2020[4]). Wage developments need to be closely watched to ensure that vulnerable groups are not affected disproportionally by the crisis. At the same time, competitiveness needs to be maintained. High wage growth did not bear, so far, on export performance, but relative unit labour costs have been...
trending up. Against this background, in-work benefits would be a more appropriate tool than increases in minimum wages, to tackle poverty issues (Chapter 2).

**Figure 1.5. Wages grew fast in recent years**

Note: Panel A: real minimum wage data are PPP-adjusted.
Source: OECD Earnings database; OECD Economic Outlook 107 database; and Eurostat.

External positions appear sustainable with total foreign debt less than 70% of GDP at end-2019 and the net international investment position on an improving trend (IMF, 2019[5]) (Figure 1.6). The current account became positive in 2017, with the surplus increasing to over 4% of GDP in 2019 driven by strong exports of services, particularly transport. The balance remained in surplus in the first half of 2020. Before the COVID-19 crisis foreign direct investment (FDI) trends were encouraging, with the number of greenfield projects increasing by 25% in 2018 compared to the previous year. The inward FDI stock, however, remains low in international comparison given that many projects in recent years concerned shared services centres, which require little capital expenditure and hence do not contribute much to FDI stock. The crisis raises additional risks, as business confidence and appetite for investment have weakened.
Improving the business environment to attract FDI remains important. More FDI would help foster knowledge transfer and increase productivity which is essential for fast convergence.

Figure 1.6. External positions appear sound

Trade openness is high, but exports have relied on low-medium technology and resource-intensive goods, and on less-knowledge-intensive services such as transportation (Figure 1.7). The export structure has not changed much over the last decade, with the domestic value-added content of total exports having stabilised at around 60%, according to official estimates. Lithuanian exports have been mostly low-complexity goods. The share of exports of more complex goods (mostly machinery, equipment and vehicles) remains relative small, with low and medium complexity goods accounting for the largest share (Bank of Lithuania, 2019[3]), and some recent export indicators point to new dynamism in integration to global value chains. Progress towards rising complexity of exports could help deepen integration in global value chains, boosting productivity. The National Progress Plan for 2021-2030 aims to promote exports of higher added value products, including high-tech goods and knowledge-intensive services.
The financial system appears solid, but the COVID-19 crisis poses challenges

The crisis affects credit developments

The COVID-19 outbreak is exposing vulnerabilities mostly in the corporate sector. Credit to households has been expanding robustly before the crisis, reflecting a rapid growth in housing loans, while business lending continued to contract (Figure 1.8). The financial leverage of domestic businesses increased, however, driven by funding from alternative sources such as trade credits and loans extended by other firms (Bank of Lithuania, 2020[6]). Corporate debt amounted to around 40% of GDP in 2019. The containment measures put in place at the onset of the crisis have affected firms through losses in revenue. Approximately 40% of the corporate sector have been directly affected by the lockdown, according to official estimates (Bank of Lithuania, 2020[6]). This, coupled with considerable uncertainty about the economic outlook, has resulted in a slower pace of expansion of credit to the non-financial corporate sector, especially for small firms, and exacerbated pre-existing funding challenges. The close financial links among firms in Lithuania, following increased non-bank funding by the corporate sector, aggravate the
pressures. Although the housing market froze after the onset of the crisis in late March, the growth of household lending remains solid (Figure 1.8). Still house prices remained stable.

Figure 1.8. Credit and housing indicators were robust before the crisis

![Graphs showing credit and housing indicators before the crisis](image)

Note: Panel B: the housing affordability index is calculated by dividing the average annuity housing loan instalment by average net wage.
Source: OECD Housing Price database; European Central Bank; and Bank of Lithuania.

The banking sector appears well prepared to cope with the crisis but vigilance is needed

Over the years, Lithuanian banks have increasingly relied on deposits for funding, and asset quality has been improving (IMF, 2019[5]) (Figure 1.9). The marked decline in NPLs over the past decade or so mirrors the improvements in credit quality and buoyant economic conditions. Financial stability has been strengthened since the 2009 global crisis through greater use of macro-prudential regulations, including through the establishment of buffers for countercyclical capital requirements and important domestic institutions which are readjusted on a periodical basis, as well as requirements based on loan-to-value ratios, debt-service-to-income ratios, loan maturity indicators for borrowers (OECD, 2018[7]).
Since the onset of the crisis several measures have been taken to shore up the credit market. The central bank lowered its counter-cyclical capital buffer from 1% to 0% in March 2020 and is also taking a more flexible approach regarding some capital and liquidity requirements imposed on banks (Box 1.3). Solvent financial institutions facing temporary liquidity problems can apply to the Bank of Lithuania for emergency liquidity assistance. These initiatives add to the ECB’s accommodative monetary policies. As in other countries, support measures have included a variety of loan and mortgage payment forbearance (OECD, 2020[8]). Going forward, financial conditions should remain accommodative and support the recovery, continuing to provide temporary liquidity support to viable firms.
**Box 1.3. Financial measures to counter the effects of the crisis**

The key measures taken by the Bank of Lithuania to shore up credit in response to the crisis include:

- **Macro-prudential measures:** The countercyclical capital buffer was lowered from 1% to 0% as of 1 April 2020, and the end-date of the phase-in period for O-SII capital buffers was postponed by one year.

- **Micro-prudential measures:** Credit institutions are encouraged to review dividend policies and abstain from paying dividends in 2020, and a more flexible approach is taken in terms of some capital (e.g. Pillar 2 guidance, combined buffer requirement, composition of Pillar 2 requirement) and liquidity requirements, as well as requirements for NPL strategies imposed on directly supervised credit institutions.

- **Monetary policy measures:** A number of policy measures adopted by the Eurosystem have been implemented, including an increase in government bond purchases and some easing of collateral eligibility for use in monetary policy operations. In addition, on 30 March 2020 Parliament amended the Law on the Bank of Lithuania, enabling the central bank to grant emergency liquidity loans not only to credit institutions but also to other financial institutions experiencing liquidity problems.

- **Other measures** include deferrals of mortgage loan payments for up to one year, and leasing and consumer loans for up to half a year (deferrals apply to the principal only, not interest payments). In addition, voluntary agreements were reached on deferrals of corporate loans repayments for up to 6 months, without changing contract terms and interest rates.

Source: Bank of Lithuania

The COVID-19 crisis can affect financial stability. Non-financial corporations facing liquidity problems may become insolvent, putting pressure on banks through an increase in non-performing loans. Households also may find it difficult to honour their obligations due to income losses, with consumer loans raising particular risks for creditors. The Bank of Lithuania estimates that, under a baseline scenario, around 80 000 households would lose their regular income source due to the COVID-19 shock, undermining the value of around 19% of consumer and other non-housing loans (Bank of Lithuania, 2020[6]). A sharp adjustment in the housing market could put borrowers and lenders under duress. Housing markets are holding up, but the commercial real estate segment is facing the strains caused by the crisis. Should these pressures continue, real estate developers will be under strain, posing risks for banks, given that commercial property loans accounted for around 60% of the total portfolio of bank loans to non-financial corporations (Bank of Lithuania, 2020[6]).

The banking sector is highly concentrated and dominated by foreign-owned banks. The three largest banks operating in Lithuania account for over 80% of the market and are controlled by foreign-owned institutions. The authorities assess that a possible correction of imbalances in the Nordic countries, which may accelerate due to the COVID-19 crisis, can pose risks to the Lithuanian banking sector, even though the significance of the direct exposure channel (net funding from parent banks) has decreased (Bank of Lithuania, 2020[6]). Steps to strengthen the Baltic-Nordic co-operation agreement on cross-border financial stability and crisis management, including the joint financial crisis management exercise conducted in 2019, have enhanced resilience (IMF, 2019[5]). Moreover, as highlighted in the previous Survey (OECD, 2018[7]), the concentration in the banking sector makes the financial system dependent on a few large market players. In its 2019 assessment, the Bank of Lithuania identified three systemically important institutions and set additional capital buffers to them.

The Fintech industry is rapidly developing due in part to regulatory reform, including remote Fintech licensing with a fast-track process and the introduction of a regulatory sandbox in 2018. The latter allows
market participants to test financial innovations in a real environment for a limited time. Participants must submit a testing plan to the central bank that needs to meet specific requirements. Lithuania has currently 210 Fintech companies, making it a regional Fintech hub, with the sector employing more than 3 400 specialists (Invest Lithuania, 2020[9]). The development of Fintech can promote financial deepening and competition among financial service providers in areas such as payments and loans, especially among the underserved population. It also poses challenges, however, particularly related to money laundering, financing of terrorism and cyber-security risk. These challenges are addressed through enhanced cooperation and exchange of information in risk management between the government and financial institutions, and capacity building.

Anti-money laundering and counter-terrorist financing (AML/CTF) efforts were also stepped up. Lithuania has improved its framework for anti-money laundering and counter-terrorist financing in recent years, including by explicitly criminalising the financing and support of terrorism and extending the list of activities punishable as money laundering. The 2018 mutual evaluation report by the committee of experts (MONEYVAL) stressed the need for further policy action recommending that Lithuania strengthen existing law enforcement strategies, continue targeting more complex and sophisticated types of money laundering, and extend financial investigations. A comprehensive action plan to address the identified deficiencies approved in 2019, with the central bank already enhancing its AML/CFT supervision. Moreover, the National AML/CFT Risk Assessment has recently been updated, in response to the 2018 MONEYVAL review. Ensuring sufficient resourcing and expertise across all involved agencies is crucial.

In June 2020, the Parliament authorised the government to launch the procedures for the establishment of a National Development Institution that will rely on the pooled competence of three existing institutions: the state-owned credit guarantee agency (INVEGA), the Public Investment Development Agency and the Agricultural Loan Guarantee Fund. A rationale for the National Development Institution is to ensure credit for SMEs. In 2019, 60% of loan applications submitted by small enterprises were rejected, compared to 12% in the EU on average (Bank of Lithuania, 2020[6]). This may be explained by a number of factors including increasing expectations for a price correction in the Lithuanian real estate markets that made banks more cautious to lending to SMEs, the rise in banking sector’s concentration in the recent years constraining credit supply to the corporate sector and the relatively high degree of banks’ risk aversion. Beyond supporting small innovative companies, the new institution aims to ensure financing for long-term investments that benefit the wider economy and provide sufficient credit during economic slowdowns. Cross-country experience suggests that national development banks can play an active role in crises (IMF, 2020[10]), while also contributing to the development of key new sectors, such as sustainable energy (Ocampo and Griffith-Jones, 2019[11]). Public banks entail risks, however, including from explicit or implicit government guarantees, from taking up bad loans, and from slowing the development of private finance. Appropriate design is essential, especially strong governance, rigorous assessment of projects, and close monitoring of outcomes.

**Sound fiscal policy created fiscal space to deal with the crisis**

Lithuania has sufficient fiscal space to deal with the COVID-19 crisis. Fiscal positions were sound after a bumpy consolidation period following the economic crisis of 2009 and the implementation of the constitutional fiscal law in 2015 (Figure 1.10). At the end of 2019 the budget was in a small surplus. The fiscal stance was slightly expansionary, partly due to an unexpected change in accounting in the pension system. The government had initially planned further consolidation, yet given additional spending and lower tax revenue following the COVID-19 pandemic, the balance is expected to turn sharply negative in 2020 (-11% of GDP) and then improve to around -6% in 2021 (Box 1.2).
Gross public debt, which stood at 41% of GDP at the end of 2019, is expected to rise sharply. Bold policy steps will be required to maintain fiscal space (Figure 1.11). For debt to stabilise, the structural balance has to decline from -5.5% in 2020 to -0.5% in 2022, which is a sharp consolidation. In addition to overcome the current shock, policy should help address future crises. As a small open economy, Lithuania is highly vulnerable to external shocks and the authorities estimate fiscal buffers needed to cushion them at 5% to 10% of GDP. For that reason, the government should agree on a long-term numerical debt target and establish a credible debt reduction path once the recovery is well on its way, by prioritising reforms that help both reduce deficits and increase effectiveness of spending and taxation.

The fiscal framework has proved flexible during the covid-19 crisis, yet some simplification could make it more predictable and easier to follow going forward. Frequent revisions to potential output and the output gap, which underlie the fiscal rule, make the budget a moving target. The asymmetry of the rule compounds uncertainty. The rule requires the budget to move towards a 0% structural balance when the output gap is positive while not exceeding the medium term objective (currently minus 1% of GDP) if the output gap is negative. Against this background, small changes to potential output when it is close to actual output could imply budget revisions of up to 1% of GDP. The government should simplify the fiscal framework and establish the same numerical rule for both negative and positive output gaps. Iceland established such a rule in 2016, including correction paths if outcomes deviate from the rule.

The Fiscal Council or Budget Policy Monitoring Department, established in 2015 jointly with the constitutional budget law, continues to monitor compliance with fiscal rules, prepares opinions and submits them to Parliament following a "comply or explain" principle. The Council also started to assess medium and long-term fiscal forecasts and sustainability. Somewhat unusual, the Council is one of three independent institutions within the National Audit Office. The OECD published an assessment of the Council, concluding that it benefitted from the strong leadership and support of the Auditor General, yet lacks a clear public identity and visibility, and operational independence (OECD, 2019[12]). Improving operational independence could strengthen visibility and impact of the Council. The Council has started to publish macroeconomic forecasts and other fiscal data, as recommended by the OECD, but should also publish methodological details in technical notes and working papers.
Figure 1.11. Debt would rise to unsustainable levels if growth slows and deficits remain high

Debt scenarios under different assumptions

Note: The projections are based on the OECD Economic Outlook No. 107 until 2021, single-hit scenario. From then on, long-term GDP growth is assumed 2.5% for scenarios 1 and 2 and 1.25% for scenario 3. The implicit interest rate on public debt is assumed at 1%. Inflation will remain at the target (2.5%). The scenarios assume a gradual improvement of the structural balance until the structural deficit reaches respectively -0.5%, -1% and -2%. Declining pension spending from around 6% in 2020 to less than 5% of GDP in 2060, as assumed by government following the 2017 pension reforms, is not reflected. Other ageing costs are not taken into account.

Source: OECD Economic Outlook 107 database.

Table 1.3. Fiscal overview

Main fiscal aggregates 2009 and 2018 percent of GDP

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross financial liabilities</td>
<td>34.1</td>
<td>41.8</td>
</tr>
<tr>
<td>Net financial liabilities</td>
<td>2.9</td>
<td>14.8</td>
</tr>
<tr>
<td>Budget balance</td>
<td>-9.1</td>
<td>0.6</td>
</tr>
<tr>
<td>Total revenue</td>
<td>35.8</td>
<td>34.6</td>
</tr>
<tr>
<td>Tax on individual income</td>
<td>4.1</td>
<td>4.1</td>
</tr>
<tr>
<td>Tax on corporate income</td>
<td>1.8</td>
<td>1.5</td>
</tr>
<tr>
<td>Taxes on property</td>
<td>0.3</td>
<td>0.3</td>
</tr>
<tr>
<td>Taxes on sales and services</td>
<td>11.3</td>
<td>11.3</td>
</tr>
<tr>
<td>Other Taxes</td>
<td>0.4</td>
<td>0.3</td>
</tr>
<tr>
<td>Social contributions</td>
<td>12.6</td>
<td>12.7</td>
</tr>
<tr>
<td>Other revenue</td>
<td>5.2</td>
<td>4.4</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>44.9</td>
<td>34.0</td>
</tr>
<tr>
<td>Social protection</td>
<td>16.4</td>
<td>12.1</td>
</tr>
<tr>
<td>General public services</td>
<td>4.4</td>
<td>3.5</td>
</tr>
<tr>
<td>Health</td>
<td>6.7</td>
<td>5.9</td>
</tr>
<tr>
<td>Education</td>
<td>7.2</td>
<td>4.6</td>
</tr>
<tr>
<td>Economic affairs</td>
<td>3.9</td>
<td>3.0</td>
</tr>
<tr>
<td>Other expenditure</td>
<td>6.2</td>
<td>5.0</td>
</tr>
</tbody>
</table>

Source: OECD National Accounts database; and OECD Global Revenue Statistics.
Public investment should be maintained

Government spending accounts for around 33% of GDP, which is below the OECD average (Table 1.3). Spending increased considerably over the past two years, particularly following wage increases in the education and health sectors. Spending quality – i.e. the composition of spending across policy areas - remains favourable for inclusive growth, with the share of spending on education slightly above OECD averages, spending on pensions and subsidies below average, and social spending raising rapidly, especially on child and family benefits.

Public investment remains relatively low however, running counter to the needs of a catching-up economy (Figure 1.12). Investment concerns mainly transport, digital infrastructure, education and health care. Most investment projects benefit from European Union cohesion funds with a matching rate of 85%. The European Union plans to reduce the matching rate to 40% for wealthier regions, although several new instruments (Recovery and Resilience Facility, REACT-EU and others) could partially make up for lower co-funding. Given the importance of modernising the infrastructure, of increasing long-term growth and stimulating crisis-hit demand in the short term, the government should at least maintain the level of investment and improve investment quality by carrying out rigorous cost-benefit analysis for individual projects.

Figure 1.12. Public investment is relatively low

Public investment, % of GDP, 2018 or latest year

The pension system has undergone significant amendments (Box 1.1). A thorough pension reform in the wake of the “New Social Model” strengthened capital-based pension funds, linked benefits to economy-wide wage growth and increased minimum pensions. The retirement age, currently increasing by 2 months every year, helps weather the fiscal implications of ageing for the coming years. Funding of the basic pension shifted from the social security fund towards the general budget, broadening the funding base. Minimum pensions remain low however (Figure 1.13). The government plans to raise minimum pension entitlements above nominal GDP growth, in line with a newly defined basket of minimum consumption needs, which is welcome. To maintain sustainability and adequacy, the government should establish an automatic link between the retirement age and life expectancy, once retirement age has reached 65 years for both men and women.
Figure 1.13. Pension adequacy could improve

Net pension replacement rate, male, average wage, 2018

Note: The net replacement rate is defined as the individual net pension entitlement divided by net pre-retirement earnings, taking account of personal income taxes and social security contributions paid by workers and pensioners.

StatLink  
https://doi.org/10.1787/888934185175

Taxation relies too much on labour

Rebalancing taxation could help the economy recover from the covid-19 shock and make it more inclusive and resilient. With less than 30% of GDP, the overall tax burden is below the OECD average of 34% (Table 1.3). Consumption taxes and social security contributions are high, while income and property are taxed rather lightly. Moreover, frequent piecemeal revisions to the tax code reduce confidence of firms and households in tax policy. Against this background, the government should put taxation on a sustainable and inclusive basis.

- **Income tax and social security contributions**: The authorities continued to shift taxation from social security contributions (SSC) to the personal income tax, in a welcome attempt to broaden the tax base and to make taxation more progressive. Two brackets of 20% and 32% replaced the flat income tax rate of 15%, while SSC were lowered. As a result, overall labour taxation declined by 1.55%. Employer and employee SSC were merged to be borne by employees alone, with a corresponding increase in gross salaries.

- **Business taxes**: the government broadened tax incentives to make corporate income taxation more innovation-friendly, including a patent box – i.e. tax-favouring income from commercialising patents - and alternative business financing models such as collective investment undertakings. Moreover, agriculture no longer benefits from reduced business tax rates, making taxation less distorting.

- **Property taxes**: Lithuania remains among the OECD countries with the lowest share of property tax revenue in GDP at around 0.4%, despite separate land and building taxes and despite a progressive scale for the buildings tax. In 2020, the threshold when the building tax kicks in was reduced from EUR 220 000 to 150 000, which is still high. Moreover, municipalities often set low land tax rates and partially or fully exempt the building tax, further reducing tax revenues. Against this background, the government should broaden the land tax base and incentivise municipalities to raise more property tax revenue (see also chapter 3).
Environmental and “sin” taxes remain low. Lithuania has no carbon tax, which should be levied at around 30 EUR/ton at least to reflect damage of emissions (OECD, 2019[13]). Gasoline taxes were increased in 2020 but remain low in international comparison, and Lithuania was one of the last countries to introduce a car tax in 2020. Environmental taxes, including the landfill tax, will increase significantly in 2021 following an amendment of the pollution tax law. All environmental taxes are earmarked to fund environmental projects. Excise taxes on tobacco were increased in 2019 and further increases are planned.

The fiscal recommendations of this Survey would have an overall negative impact on the budget balance (Box 1.4).

### Box 1.4. Quantifying fiscal policy recommendations

The following estimates roughly quantify the fiscal impact of selected recommendations within a 5-10 year horizon, using simple and illustrative policy changes. The reported effects do not include behavioral responses.

#### Table 1.4. Illustrative fiscal impact of recommended reforms

<table>
<thead>
<tr>
<th>Policy Measure</th>
<th>Impact on the fiscal balance, % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Deficit-increasing recommendations</strong></td>
<td></td>
</tr>
<tr>
<td>Maintain public investment</td>
<td>Maintain the share of public investment in GDP despite a potential decline in EU funds</td>
</tr>
<tr>
<td>Increase minimum-income benefits</td>
<td>Increase the level of state-supported income from 50% to 57% of the amount of minimum consumption needs</td>
</tr>
<tr>
<td>Increase spending on childcare</td>
<td>Increase public spending on childcare from 0.1% of GDP to 0.3% of GDP (OECD average)</td>
</tr>
<tr>
<td>Increase spending on activation policies</td>
<td>Increase expenditure per unemployed from 7% to 10.2% of GDP per capita</td>
</tr>
<tr>
<td><strong>Deficit-reducing recommendations</strong></td>
<td></td>
</tr>
<tr>
<td>Increase property taxation</td>
<td>Increase property taxation from 0.4% of GDP to the OECD average of 1.2%</td>
</tr>
<tr>
<td>Levy a CO₂ tax</td>
<td>Increase carbon taxes to 30 Euro/ton, corresponding to the lower bound of estimated damage of emissions</td>
</tr>
<tr>
<td>Consolidate the school network</td>
<td>Merge schools until each has at least 200 pupils</td>
</tr>
<tr>
<td><strong>Total fiscal impact</strong></td>
<td>0.4</td>
</tr>
</tbody>
</table>

Note: Activation spending calculation based on OECD public spending on labour markets indicators.

### The fiscal framework is centralised

Lithuania’s fiscal framework is highly centralised and local governments face tight fiscal rules, limiting local incentives and capacity to invest. Municipalities have little own tax revenue and rely on transfers from the central government to cover responsibilities in education, health care and social welfare. The local fiscal rule requires municipal budgets to be nominally balanced every year, except for the largest cities with a structural balance rule. European co-funding might decline over the next few years. Against this
background access to own-source revenue, such as property taxation and development fees, should be strengthened. A multi-annual municipal fiscal rule or a rule that exempts investment (“Golden Rule”) might also help increase investment while maintaining the sustainability of the public finances.

Table 1.5. Past OECD recommendations on financial and fiscal stability for inclusive growth

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Action taken</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduce social security contributions, especially for low-income workers, while ensuring benefits and deficit targets, including through broadening the tax base.</td>
<td>Two new income tax brackets of 20% and 32% replace the former flat tax rate of 15%. Social security contribution rates were reduced and capped for high-income earners</td>
</tr>
<tr>
<td>Assess spending efficiency by carrying out regular spending reviews.</td>
<td>Spending review has started in the education and health care ministries</td>
</tr>
<tr>
<td>Set a debt target and establish a credible frontloaded path to reach it.</td>
<td>Preparatory work ongoing</td>
</tr>
<tr>
<td>Actively use macro-prudential measures once imbalances threaten to emerge.</td>
<td>Rules have been made more flexible following the covid-19 pandemic</td>
</tr>
</tbody>
</table>

Structural reform could accelerate the recovery and boost productivity

_The regulatory framework is well-prepared for post-covid-19 challenges_

The regulatory framework is business-friendly and the regulatory burden below OECD averages (Figure 1.14). Trade in services is less restricted than in most other OECD countries, although restrictions remain in legal services, air transport services and motion pictures. Reforms over the past two years – in addition to those mentioned in (Table 1.6) - include a gradual deregulation of electricity prices; the creation of a gas exchange market; simplifications in the tax and social security system; as well as stricter disclosure requirements to protect minority investors. Regulatory impact analysis has become compulsory for all new legislation with an economic impact. The regulatory framework provides firms with the necessary flexibility to adapt to post-COVID-19 challenges, such as to help them reposition workers, change production patterns or move to new sectors.

The competition framework has improved, especially in the network industries. A change to the competition law in 2019 allows the authorities to remunerate whistle-blowers who provide information about anti-competitive behaviour. The government created an electricity and gas exchange to foster multilateral trading. In 2019 the state railway company was split into three separate companies responsible for infrastructure, freight and passenger transport, although the reform remains relatively modest as all three entities remain state-owned. Unlike in most other Northern, Central and Eastern European countries, there are no private providers in the rail market, and the regulatory body is considered weak (European Commission, 2019[14]). Against this background, access of private providers, especially in the rail sector, should be facilitated further.
State-owned enterprises could be a drag on the economy

State owned enterprises (SOE) are widespread, and their governance remains weak against OECD standards despite recent improvements (Figure 1.15). The strength of SOE governance is positively associated with efficiency of the firm and the economy (Égert and Wanner, 2016[15]; Bourlès et al., 2010[16]). The “SOE Reorganisation and Optimization Plan” from end 2018 clarifies the ownership strategy and sets out goals and timelines for streamlining SOEs’ legal and corporate forms and for reducing the number of SOEs. The government privatised five (5) SOEs in 2018-2019. The corporate function of SOEs was strengthened, with more than 60% of board members now being professionals rather than public servants. However, only half of SOEs reached their financial objectives in 2018. A clear strategy that defines the rationale for public ownership is lacking. Against this background, the government should continue to subject SOEs to the same laws, regulations and market constraints as private companies, and if no compelling reasons persist to maintain public ownership, sell them (OECD, 2015[17]).

SOEs owned by municipalities also pose a challenge. Around 250 municipal enterprises are active across 40 sectors, from energy supply to waste treatment and local public transport (Lithuanian Free Market Institute, 2019[18]). While a few rules limit the power of municipalities to set up a local SOE, including prior

Source: OECD Product Market Regulation Indicators; and OECD Services Trade Restrictiveness Index database.

https://doi.org/10.1787/888934185194

OECD ECONOMIC SURVEYS: LITHUANIA 2020 © OECD 2020
agreement of the Competition Council, existing undertakings are not assessed even if they violate the rules (National Audit Office, 2017[19]). Against this background, municipal SOEs have proliferated, often competing with private providers. Some SOEs cross-subsidise corporate activities with revenues from publicly supported activities, distorting competition (Lithuania Free Market Institute, 2018[20]). While services heavy in infrastructure such as water or heat supply or sewage may be appropriately provided by a public monopoly, private providers can - and do - compete for public transport, waste management or catering services. The government should establish a level playing field between municipal and private providers, and submit all municipal SOEs to a ruling of the Competition Council.

Figure 1.15. State-owned enterprises weave through the economy

Note: 2013 and 2018 PMR vintages are not directly comparable: the 2013 figure should be interpreted for countries' relative standing to each other and not to their 2018 score.
Source: OECD Product Market Regulation Indicators.

The new insolvency framework will help address covid-19 challenges

The government thoroughly overhauled the insolvency regime in 2020, accelerating timely initiation and resolution of personal and corporate insolvency proceedings and increasing returns for creditors. The new regime is well designed to address the challenges of economic change after the covid-19 crisis, namely to restructure viable firms, unwind non-viable ones, move capital to their most productive use and foster
continued technological diffusion (Figure 1.16). In particular, the new regime encourages the parties to look for dialogue and out-of-court solutions; provides business with more options for restructuring rather than exit; speeds up court procedures; improves accountability of insolvency administrators; and establishes new supervision rules implying stronger self-regulation. The reform changed Lithuania’s insolvency framework to become one of the potentially most effective of the OECD (Adalet McGowan and Andrews, 2018[21]).

Figure 1.16. After thorough reform, Lithuania boasts an effective insolvency framework

Restrictiveness of insolvency frameworks, Index from 0 (less stringent) to 6 (more stringent), 2016

Note: The figure shows values for 2016, except Lithuania for which the pre-reform 2016 and post-reform 2020 values are shown.

StatLink https://doi.org/10.1787/888934185232

Performance of education is weak

A lack of strong and relevant skills slows Lithuania’s growth potential. While the government tried to minimise the impact of the covid-19 crisis on education and training to avoid hysteresis, e.g. by ordering a relatively mild school lockdown, long-term challenges persist. These include high skills mismatch, a lack of digital skills, and large urban-rural disparities in access to quality education and in student performance. The education infrastructure adapts only slowly to shrinking student numbers and higher skill needs.

Performance of primary and lower secondary education is weak, with Lithuania having one of the lowest PISA scores of the region (Figure 1.17 Panel A). While spending on education is comparatively low, spending on infrastructure is excessive, reflecting high spending on an extensive network of small schools, failing to reach scale and network effects (see also chapter 3). (Figure 1.17 Panel B). Salaries hardly rise with teachers’ skills or performance, and school performance lacks systematic oversight (Shewbridge et al., 2016[22]). Recent reforms were rather shy, essentially involving an increase in teacher salaries.

Upper-secondary education leans strongly towards the general curriculum, while students shun vocational education and training (VET) as it often fails to provide relevant skills (National Audit Office, 2016[23]). The school network often lacks scale and specialisation. Collaboration between VET schools and firms is scarce, weakening the link between education and labour market needs. The 2017 reform, aimed at rising quality of VET, helped modernise infrastructure and brought more modular and flexible training opportunities to the curriculum. Apprenticeships, introduced in 2016, still attract few students. Reform
should focus on raising the share of VET in upper secondary education, especially by raising the number of apprenticeships, and strengthen links to the labour market.

Tertiary education again is fragmented, and studies are not always in line with labour market needs, although quality is improving (IMD, 2019[24]). With 19 public universities and 22 colleges, Lithuania’s tertiary institutions struggle to reach scale, and overlap and duplication of study areas is rife (OECD, 2017[25]). Recent attempts to consolidate the university network failed or did not bring the expected results. Universities are largely funded on per-student basis (student voucher), providing few incentives to improve quality. To reach critical mass, the government should close some universities and encourage others to specialise in fewer curriculae. Relating funds to graduates’ success on the labour market, as in some Nordic countries, and rigorous quality assessment, could also help improve relevance of tertiary education.

**Figure 1.17. Education performance is weak, although the system is well endowed with teachers**

Enhancing innovation performance

Lithuania has strengthened its international innovation position over the past decade but has not yet caught up with the EU average (Figure 1.18). Recent efforts aim to improve the funding and governance of the innovation system, as part of a comprehensive reform of the system aiming to boost productivity and competitiveness (Box 1.1). A new law in 2018 defines the areas of technology and innovation and
establishes the principles and mechanisms for supporting such activities. Moreover, the government plans to establish in 2021 the Innovation Promotion Fund, aiming to ensure effective financing of R&D and innovation activities and contribute to their development. The Fund will also make it easier for innovative businesses to obtain funds. This is appropriate, given that public funding for R&D is low in international comparison. Measures to improve the co-ordination and effectiveness of innovation policy, are also in the right direction. These include, in particular, the creation of the Science, Technology and Innovation Council in 2019, chaired by the Prime Minister with broad representation of stakeholders. Moreover, business and innovation support agencies are to be consolidated under a unified agency by end-2021 that will provide financial services for small firms, including for innovation. This should help to reduce fragmentation and overlap.

Figure 1.18. Innovation performance can be strengthened further

A. European Innovation Scoreboard
Summary innovation index, EU in 2012 = 100, 2019

B. R&D expenditure by source of funds
% of GDP

C. Global Innovation Index
Collaboration with universities score, 2020

D. Global Innovation Index
Knowledge absorption score, 2020

Note: Panel C: Results show the average answer to the survey question: "In your country, to what extent do people collaborate and share ideas in between companies and universities/research institutions?" Panel D: The knowledge absorption index is a composite indicator that measures how good economies are at absorbing and diffusing knowledge. It is based on the following indicators: intellectual property payments as a percentage of total trade; high-tech net imports as a percentage of total imports; imports of communication, computer and information services as a percentage of total trade; net inflows of foreign direct investment as a percentage of GDP and the percentage of research talent in business. Source: European Commission European Innovation Scoreboard 2020; OECD Research and Development Statistics database; Eurostat; and Global Innovation Index 2020.

StatLink: https://doi.org/10.1787/888934185270
Reforms since 2018 further aimed to strengthen the collaboration between research and businesses on innovation, to foster knowledge transfer (OECD, 2015[26]). Business-research collaboration remains limited, with low mobility between the two sectors, that can explain to a large extent the low absorption capacity of firms in Lithuania (Figure 1.18) (Maggs and Hathawa, 2016[27]). Measures include innovation vouchers, support of technical feasibility studies at early stages of R&D projects, support to SMEs for the recruitment of researchers, and the establishment of science and technology parks for start-ups attached to a university. In addition, a new funding formula for universities and research institutions was introduced taking into account science-business collaboration, as well as the activities related to international R&D programmes. This is a positive step, and in line with international experience (OECD, 2018[7]). The effectiveness of the new measures needs to be monitored regularly.

Box 1.5. Quantification of structural reforms

Selected reforms proposed in the Survey are quantified in the table below, using simple and illustrative policy changes. Other reforms, including in the area of skills or public spending, are not quantifiable under available information or the complexity of the policy design. Some estimates rely on empirical relationships between past structural reforms and productivity, employment and investment, assuming swift and full implementation, and they do not reflect particular institutional settings in Lithuania. The estimates are hence illustrative, and results should be taken with caution.

Table 1.6. Potential impact of structural reforms on per capita GDP

<table>
<thead>
<tr>
<th>Policy</th>
<th>Measure</th>
<th>10 year effect, %</th>
<th>Long-run effect, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public ownership</td>
<td>Privatise state-owned enterprises to reach the average OECD public ownership level</td>
<td>1.4</td>
<td>3.6</td>
</tr>
<tr>
<td>Public integrity</td>
<td>Improve control of corruption by 0.5 indicator points to reach EU average</td>
<td>1.3</td>
<td>3.3</td>
</tr>
<tr>
<td>Retirement age</td>
<td>Link retirement age to life expectancy or</td>
<td>1.2</td>
<td>2.6</td>
</tr>
<tr>
<td>Property taxes</td>
<td>Raise property taxes from 0.5% to 0.7% of GDP, keeping overall taxation stable</td>
<td>1.8</td>
<td>3.7</td>
</tr>
<tr>
<td>Business R&amp;D spending</td>
<td>Increase R&amp;D business spending from 0.3% to 0.7% of GDP (half of OECD ratio)</td>
<td>0.6</td>
<td>1.5</td>
</tr>
<tr>
<td>Increase spending on activation</td>
<td>Increase expenditure per unemployed from 7 % to 10.2 % of GDP per capita</td>
<td>0.8</td>
<td>1.6</td>
</tr>
</tbody>
</table>

Note: The following recommendations are included in the fiscal quantification (Box 2), but their impact on GDP cannot be quantified: maintain public investment, levy a CO2 tax, consolidate the school network, spending on activation

Source: OECD calculations based on (Égert and Gal, 2017[28]) and (Cournède et al., 2018[29])

Public integrity should be improved

Indicators of control and perceived risks of corruption suggest Lithuania performs below the OECD average, and some scores worsened recently (Figure 1.19). Sectors where corruption practices seem to endure include health care - especially illicit payments to physicians, insufficient control of lobbying and close ties between public institutions and private companies -, and public procurement. 15% of Lithuanian firms consider corruption in the country a problem, less than in 2015 (28%) and the EU28 average but more than some Nordic countries (Eurobarometer, 2019[30]).

Policy measures to prevent, detect and report foreign bribery have been impressive though. The OECD Working Group on Bribery concluded that Lithuania implemented fully or partially 26 out of 27 recommendations (OECD, 2019[31]). In particular, the country amended the law on Money Laundering and
Terrorist Financing to include all types of monetary transactions, and the Financial Crime Investigation Service updated the list of suspicious monetary transactions and operations. An amendment to the Law on Financial Statement planned for spring 2021 will require large public and private entities to provide information on anti-corruption and bribery matters. The credit support agency “Invega” requests that credit beneficiaries agree to a set of integrity measures and the repayment of guarantees if it discovers bribes or other forms of corruption. There were no new foreign bribery cases in 2019.

Some unfinished business remains. The Anti-Bribery Working Group concluded that procurement agencies do not have sufficient access to the list of firms and people convicted for corruption. More generally, the informal sector in Lithuania is a source of corruption and anti-integrity behavior. The shadow economy shrank in 2019 after four consecutive years of expansion, mainly because of declining “envelope wages”, yet remains above 18% of GDP (Stockholm School of Economics in Riga, 2020[32]). Lithuania’s National Anti-Corruption Programme 2015-2025 addresses public integrity in eight critical areas; among them public procurement; political finance; public construction supervision and waste management. Public integrity should remain a guiding principle in the government’s anti-corruption efforts.

Over the past two years, the government implemented several reforms in the area of state-owned enterprises, innovation, education and active labour market support, in line with recommendations in the last Survey (Table 1.7).

Figure 1.19. Some perceive corruption to be considerable

Note: “Control of corruption” is an indicator developed by the Varieties of Democracy Project. Panel B shows a point estimate and the margin of error. In Panel D, Best (OECD) and Worst (OECD) refer to the scores of the best and worst performing OECD member countries.

Source: Panel A: Transparency International; Panels B & C: World Bank Worldwide Governance Indicators; Panel D: Varieties of Democracy Institute; University of Gothenburg; and University of Notre Dame.

StatLink  
https://doi.org/10.1787/888934185289
Table 1.7. Past OECD recommendations on fostering productivity and inclusiveness

<table>
<thead>
<tr>
<th>Recommendations</th>
<th>Action taken</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strengthen the monitoring capacity of the Governance Coordination Centre (GCC), building on the recent increase in its budget.</td>
<td>GCC’s functions were expanded in 2018 and the obligation to prepare annual aggregated reports on the activities of municipally owned enterprises was established. Moreover, ownership entities are obliged to coordinate the Letters of Expectations of the SOE (entailing state’s expectations) with the GCC.</td>
</tr>
<tr>
<td>Simplify criteria for starting bankruptcy procedures and establish more favourable conditions for restructuring.</td>
<td>The new insolvency framework of 2019 accelerates initiation and resolution of insolvency proceedings and facilitates restructuring.</td>
</tr>
<tr>
<td>Continue the implementation of the institutional reform of innovation policy by improving co-ordination, and consolidate agencies and support programmes where overlaps exist.</td>
<td>The Science, Technology and Innovation Council was launched in 2019. Business and innovation support agencies will be consolidated under a unified agency by end-2021.</td>
</tr>
<tr>
<td>Give more weight on collaborative research when allocating funds to public research institutions.</td>
<td>A new funding formula for research institutions was introduced taking into account science-business collaboration and international R&amp;D programmes.</td>
</tr>
<tr>
<td>Strengthen work-based learning, including by linking the length of apprenticeships to the level of acquired competencies.</td>
<td>No action taken.</td>
</tr>
<tr>
<td>Provide differentiated awards for tertiary courses with skills closely linked to labour market needs.</td>
<td>Since 2020, special grants are provided for students who choose programs that provide skills in demand, such as teacher training programmes.</td>
</tr>
<tr>
<td>Continue with overall reform of education at all levels system addressing skill mismatch.</td>
<td>Vocation education and training curricula have been made more flexible.</td>
</tr>
<tr>
<td>Further increase the level of social assistance, while ensuring strong work incentives.</td>
<td>The state-supported income was considerably increased and indexed. A universal-child benefit was introduced in 2018 and the income disregard raised. In-work benefits were strengthened.</td>
</tr>
<tr>
<td>Increase investment in active labour market programmes upon a close monitoring of their outcomes.</td>
<td>No action taken.</td>
</tr>
</tbody>
</table>

Greening the economy

Lithuania’s environmental performance has improved since the mid-2000s, but more needs to be done to improve sustainability and reach the government’s ambitious targets (Figure 1.20) Greenhouse gas emissions (GHG) declined over the past decade, reflecting some decoupling of emissions from economic growth, yet per capita emission increased due to population decline. Lithuania has the highest welfare cost from exposure to fine particles (PM2.5) in the OECD. Transport and energy are the main sources of emissions with 28% and 27% respectively, followed by agriculture with 22% and industry with 18% of total emissions. The large share of transport emissions will require a deep restructuring if the 2030 targets are to be met.

The use of renewables has climbed rapidly over the past 10 years, led by wind power and biomass burning for heat and electricity. Though biomass burning has contributed to energy independence and diversification, it is also a major contributor to GHGs and air pollution. The National Energy Independence Strategy sets ambitious renewable energy development goals such as at least 80% renewable energy in final consumption and 100% renewable electricity by 2050. As such, the strategy should focus on the development of cleaner renewable energy, such as wind, solar and geothermal, despite headwinds from low fossil fuel prices. Lithuania has continued to reduce energy intensity in recent years and is currently slightly below the OECD average, yet energy efficiency is a concern, particularly in the housing sector where almost 30% of owners report difficulties to keep their house warm. On the other hand, there was much improvement in waste management practices, with a significant reduction of landfills.

Pricing of environmentally damaging activities is low. Carbon is not taxed, except in sectors subject to the European Union emission trading system. Lithuania has one of the lowest excise duties on motor fuel,
petrol and diesel in the OECD, and has one of the largest ‘diesel differentials’, the gap in the price of diesel versus gasoline. It also provides among the highest subsidies to fossil fuels. Against this background, there is scope for increasing fossil fuel taxes and removing subsidies, in particular as energy prices have declined recently. Such a policy shift would achieve both reductions in emissions and pollution and generate additional revenues that could help reduce social security contributions or fund green jobs and innovation. Recent policy actions have moved in this direction. In July 2020 Lithuania joined most other OECD countries in introducing a tax for private passenger vehicles which, moreover, is differentiated along emissions. In 2021 tax rates for most taxes on pollutants will increase considerably. In addition, the parliament is currently debating the long-term National Climate Change Management strategy, which sets a net-zero carbon emission target by 2050.

The COVID-19 crisis presents both challenges and opportunities for environmental policy reform. Efforts to strengthen the recovery should be aligned with necessary action to limit the risks faced from climate change, pollution and biodiversity loss. The Lithuanian fiscal stimulus package approved in March has accelerated some investment programmes with an environmental goal, such as the Climate Change Programme and the multi-apartment building renovation programme to improve energy efficiency.

**Figure 1.20. Lithuania needs to become greener**

<table>
<thead>
<tr>
<th>Chart Description</th>
<th>Year</th>
<th>Data Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. CO₂ intensity</td>
<td>2000-2018</td>
<td>OECD Green Growth Indicators</td>
</tr>
<tr>
<td>B. Energy intensity</td>
<td>2000-2018</td>
<td>OECD Green Growth Indicators</td>
</tr>
<tr>
<td>C. Renewable energy share</td>
<td>2000-2018</td>
<td>OECD Green Growth Indicators</td>
</tr>
<tr>
<td>D. Exposure to PM2.5</td>
<td>2000-2018</td>
<td>OECD Green Growth Indicators</td>
</tr>
<tr>
<td>E. Municipal waste treatment</td>
<td>2017 or latest year</td>
<td>OECD Green Growth Indicators</td>
</tr>
<tr>
<td>F. Environment-related taxes</td>
<td>% of GDP</td>
<td>OECD Green Growth Indicators</td>
</tr>
</tbody>
</table>

Note: Gross Domestic Product (GDP) in constant PPP-adjusted 2010 USD. Panel A: Included are CO₂ emissions from combustion of coal, oil, natural gas and other fuels. Source: OECD Green Growth Indicators.

StatLink: https://doi.org/10.1787/888934185308
### MAIN FINDINGS

<table>
<thead>
<tr>
<th>Policies to support the recovery</th>
<th>RECOMMENDATIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>The COVID-19 crisis has affected economic activity and household incomes, exacerbating funding challenges for the corporate sector.</td>
<td>Continue providing temporary support to households and firms, while helping to reallocate resources to viable firms.</td>
</tr>
</tbody>
</table>

### Financial and fiscal policies

<table>
<thead>
<tr>
<th>The asymmetric fiscal rule (two-regime rule), relying on potential output, causes frequent revisions to fiscal planning.</th>
<th>Simplify the fiscal framework and establish a long-term debt target.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public investment is low.</td>
<td>Increase public investment against rigorous cost-benefit analysis.</td>
</tr>
<tr>
<td>The fiscal council lacks public identity and visibility.</td>
<td>Increase operational independence of the fiscal council.</td>
</tr>
<tr>
<td>The government plans to set up a National Development Institution, to ensure sufficient financing of small innovative firms.</td>
<td>Ensure appropriate design for the planned public National Development Institution.</td>
</tr>
</tbody>
</table>

### Structural policies

<table>
<thead>
<tr>
<th>The scope of state-owned enterprises is large and governance lags behind OECD standards.</th>
<th>Strengthen the governance of state-owned enterprises further. Sell to private investors if no compelling reasons for public ownership exist.</th>
</tr>
</thead>
<tbody>
<tr>
<td>There are no private providers in the rail transport market.</td>
<td>Facilitate access of private providers to the rail network.</td>
</tr>
<tr>
<td>Innovation performance remains comparatively low.</td>
<td>Improve the governance of the innovation system by strengthening co-ordination and by consolidating agencies.</td>
</tr>
</tbody>
</table>

### Green growth policies

<table>
<thead>
<tr>
<th>The economy’s carbon imprint is considerable, while environmental taxation is below the OECD average.</th>
<th>Introduce a carbon tax in sectors not covered by the European emission trading system, and reimburse at least partially the proceeds to households and firms.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fossil fuel subsidies belong to the highest in the OECD.</td>
<td>Remove environmentally damaging fuel subsidies.</td>
</tr>
</tbody>
</table>

Note: Key recommendations are in bold and can be found again at the end of the executive summary.

### References


Eurobarometer (2019), *Businesses’ attitudes towards corruption in the EU*.


[14]
[15]
[16]
[17]
[18]
[19]
[20]
[21]
[22]
[23]
[24]
[25]
[26]
[27]
[28]
[29]
[30]

IMD (2019), IMD World Talent Ranking.


Lithuanian Free Market Institute (2019), Kiek Savivaldybiu Valdomu Imoniu Veikia Pagristai (How Many Municipally Managed Companies Are Reasonable?).


