The Impact of EU membership on the Lithuanian budget

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1. Introduction

One of the main challenges for the European Union (EU) in the near future will be enlargement. Ten Central and East European countries (CEEC) are expect to join the EU in 2004. Both sides - the EU as well as the candidate countries - are estimating the benefits and costs of future membership. The most visible benefit for new member states will be financial assistance from the EU budget. The EU budget affects the budgets of member states mainly through:

- the contributions that each member state pays into it,
- the funds which most countries receive from Structural and Cohesion funds
- the direct payments and compensation for agriculture.

However, the impact for new member states will be much greater as all countries will have to adopt and implement new budget policies in order to avoid budgetary crises and to maintain financial discipline during the early years of EU membership.

Lithuania as well as other Laeken[1] group countries successfully concluded negotiations at the end of 2002 with a view to accede to the Union in 2004. However, the most difficult negotiation chapters for Lithuania remained open until the Copenhagen European Summit. Particular attention was being paid to the financial aspects of the negotiations. In Lithuania's agenda the main questions were related to:

- the direct subsidy payments for farmers, structural support for agriculture,
- Lithuania's contributions to the EU budget,
- structural assistance from Structural and Cohesion funds,
- financing the closure of the Ignalina Nuclear Power Plant (Ignalina NPP).

The focus lies on the impact these considerations will have on Lithuanian budget policy and how the financial flows to and from the EU budget will change Lithuania's budget expenditure policy. This paper aims to address these questions, with the presumption that the main impact of EU membership on Lithuanian budget policy will involve the financial flows to and from the EU budget. It will therefore analyse only the financial side of the membership, i.e. the financial flows to the Lithuania State budget and Lithuania's contributions to the EU budget. The paper is based on the final results of negotiations (Copenhagen financial package) and draws on the European Commission's proposed financial framework for enlargement, the EU Commission's Paper on the methodological aspects related to the calculation of the net budgetary balances approved by the Brussels European Council (24-25 October 2002) and the EU Common Position on Financial and Budgetary Provisions for the Accession Conference with Lithuania (8 November 2002). All calculations are based on EU Commission forecasts but 2004 estimates are prorated since it is likely that EU enlargement will take place on 1 May, rather than 1 January, 2004.

[1] The European Council held in Laeken towards the end of 2001 reaffirmed the EU's commitment to enlargement of the EU to include 5 Central Eastern European states, three Baltic States, Malta and Cyprus from 2004.

1.1 Financing EU enlargement

At the Copenhagen European Council in 1993, the member states accepted the principle of an eastward enlargement of the Union. Helen Wallace has argued that 'like all previous enlargements, this would alter the existing budgetary bargains and necessitate considerable changes in the policy *acquis*'.[2] Thus the accession of so many more relatively poor states might be expected to generate pressures for more redistribution of structural funds and a larger budget. The budgetary costs of future enlargements had therefore provided the context for the negotiations on the Financial Framework 2000-2006 finalised at the Berlin European Council in March 1999. The net contributors to the EU budget in the EU-15 were therefore concerned not just with the outlook up to 2006, but also with future financing arrangements once the CEEC became members.[3] It is a concern they have maintained until the present day.

Agenda 2000, prepared ahead of the Berlin Council, provided provisions for the costs of pre-accession aid and enlargement to be kept within the tight limits envisaged for the overall EU budget. However, the candidate countries had little chance to influence the internal EU debate on its future financing. They have had to accept 'the broad parameters of what is being offered until they become members and are in a position to influence the internal debate'.[4]

At each of the previous enlargements, all new member states have benefited from transitional periods on their financial obligations towards the EU budget. Arrangements agreed in the past were based each time on the specific context of the accession of the new member states. Although the nature of the transitional measures was different, the achieved result has remained the same, namely to either ensure that countries destined to be net recipients of the EU budget did not temporarily find themselves in the position of net contributors, or that countries destined to be net contributors were not temporarily overburdened[5].

Transitional measures agreed at previous enlargements have been on the revenue side (i.e. percentage reductions to the GNP or VAT resources) of the EU budget as in all enlargements until 1986, or through lump sum compensations on the expenditure side of the EU budget as in the last enlargement. According to the European Commission, the measures agreed on the revenue side are generally less than transparent and in some cases complicated to implement. However, the 1995 enlargement showed that measures agreed on the expenditure side of the EU budget in the form of lump-sum compensations constituted a far simpler approach to such arrangements with substantially increased transparency and predictability.[6]

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[2] Wallace, H. (2001), *Policy-Making in the European Union,* Oxford University Press, 2001. 4th ed. p. 225.

[3] Ibid, p. 225.

[4] Ibid, p. 238.

[5] European Commission (2002), *Draft Common Position. Chapter 29: Financial and budgetary Provisions: Lithuania*. DG Enlargement. 29.05.2002. p.4

[6] European Commission (2002), D*raft Common Position. Chapter 29: Financial and budgetary Provisions: Lithuania*. DG Enlargement. 29.05.2002. p.4

1.2 Financial proposals for candidate countries

On 30 January 2002 the European Commission proposed a financial framework for the financing of the EU enlargement. The framework indicated three major areas - the Common Agriculture Policy (CAP), Regional policy and Budget - where enlargement will have the biggest financial consequences. The proposal refers to the ten candidates that could join the EU in 2004: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. The Brussels European Council of 24-25 October 2002 approved a methodology of calculations of contributions to the EU budget and financial flows from the EU budget proposed by the European Commission in September 2002. The final financial package of EU enlargement was approved at the Copenhagen Summit of 12-13 December 2002.

According to the European Commission in its proposal of 30 January 2002,[7] 'since enlargement will not take place until 2004 and could include up to ten new member states, the Berlin scenario has to be adjusted'. However, the Berlin financial framework cannot be changed in this way since multi-annual financial packages require unanimity in the Council. Besides, the opening of this question was never discussed within the EU because of the high political sensitivity of the issue. The final results of negotiations showed that Berlin scenario ceilings were respected and the financial package of EU enlargement is within it.

The European Commission[8] wanted to preserve the *Agenda 2000* budgetary ceilings and envisaged annual amounts for the period 2002-2006 increasing from €6450 million to €16780 million on the basis of a scenario for an enlargement in 2002 with six new member states. Moreover, the amounts foreseen for enlargement in 2002 and 2003 (€15480 million) were not available since they cannot be transferred to later years in view of the annual nature of the *Financial Perspective* ceiling. This means that there was not much scope for negotiations with the ten candidate countries once the member states had struck a compromise on the financial issues.

During the period of 2004-2006 the total amount of commitment appropriations foreseen in the Commission's proposed Financial Framework (30 January 2002) was €40160 million. The EU has foreseen only €13400 million for the new member states in 2005, and €15966 million in 2006. The total cost of enlargement in the first year (2004) was expected to be €10794 million. The proposed total amount during the period of 2004-2006 is below the ceiling of €42590 million (in commitment appropriations), earmarked for enlargement by *Agenda 2000*. Moreover, the Commission's Paper on the methodological aspects of the calculation of the net budgetary balances (approved by the Brussels European Council of 24-25 October 2002) proposed €37645 million (in commitment appropriations) as the total amount for the enlargement. This amount is €2515 million below that proposed by the Commission in the Financial Framework announced in January 2002 and €4945

[7] European Commission (2002), *Communication from the Commission. Information Note: Common Financial framework 2004-2006 for the Accession Negotiations*, SEC (2002) 102 final. Brussels. 30.1.2002. pp.1-10
[8] ibid, pp.1-10

million below the ceiling proposed in *Agenda 2000*. The final Copenhagen financial package is €37467 million (in commitment appropriations) that is €5123 million below the ceiling foreseen in *Agenda 2000*. The difference is even greater in payments appropriations: the last amount foreseen for enlargement in payment appropriations is €12791 million below the ceiling in the Berlin scenario.

TABLE 1 FINANCIAL FRAMEWORK FOR ENLARGEMENT 2004-2006

€ million

	2004	**2005**	**2006**	**TOTAL**
Commitment appropriations (Berlin 1999 scenario)	11 610	14 200	16 780	**42 590**
Payment appropriations (Berlin 1999 scenario)	8 890	11 440	14 220	**34 550**
Commitment appropriations (Financial Framework, January 2002)	10 794	13 400	15 966	**40 160**
Payment appropriations (Financial Framework, January 2002)	5 686	10 493	11 840	**28 019**
Commitment appropriations (Brussels European Council)	10 080	12 601	14 964	**37 645**
Payment appropriations (Brussels European Council)	4 920	7 016	9 649	**21 585**
Commitment appropriations (Copenhagen package)	9 927	12 640	14 901	**37 468**
Payment appropriations (Copenhagen package)	3 709	8 163	9 887	**21 759**

Source: European Commission, DG Budget, 2002.

On the basis of the final financial framework, new member states will receive payments increasing from €4903 million in 2004 to €10171 million in 2006. However, at the same time the contribution rules for the new member states to the EU budget will be implemented from the beginning of accession and new member states will have to contribute fully to the EU budget, representing more than €5000 million per year (excluding year 2004 when contributions are adjusted on a *pro rata* basis) and €14745 million during the period of 2004-2006. Bearing in mind that EU enlargement will cost around €25145 million and that part of these costs (€14745 million, or €197 per head) will be met by the new member states, EU enlargement for current member states will cost only €10400 million or €30 per head.

Moreover, the new member states, upon accession, may legitimately expect their net balance vis-à-vis the Union, which is currently positive due to pre-accession aid and no contributions to the EU Budget, not to deteriorate. Temporary budgetary compensations in the form of lump sum, degressive and temporary payments on the expenditure side of the EU budget[9] were approved in the final Copenhagen package. However, any annual payments for temporary budgetary compensation for the years 2004-2006 will remain within the margins left under Berlin ceilings for commitments and payment appropriations for enlargement. Moreover, these compensations will not be available for all new member states. According to the approved calculation method, these temporary budgetary compensations could be granted for 2004-2006 and only in cases where the estimates show that the candidate country could find itself in a net budgetary position which is worse than the year prior to accession when it was a beneficiary of pre-accession financial support. In the final stage of negotiations, the Danish Presidency proposed cash flow lump sum compensations for all candidate countries in 2004. The Copenhagen package showed that during the period of 2004-

[9] European Commission (2002), *European Union Common Position. Chapter 29: Financial and Budgetary Provisions*. Conference on Accession to the European Union: Lithuania. CONF-LT45/02. Brussels. 8 November 2002.

2006 lump sum compensations should be granted only to four candidate countries (Cyprus, the Czech Republic, Slovenia and Malta). However, the others will not receive lump sum compensations because of their positive net budgetary position during the period of 2004-2006 in comparison to 2003 despite, as we shall see shortly, the negative impact such receipts will have on budget management.

In the Financial Framework proposed in January 2002 the margin (in commitment appropriations) available as contribution to budgetary and cash flow compensation payments was €1119 million (see Table 3). The Brussels Financial Framework allowed for the lump sum compensations of €1652 million. In the final Copenhagen package €3386 million are earmarked for these compensations. However, there are a number of considerations which influence these estimates. Moreover, the approved budgetary and cash flow compensations are below the margins under the Berlin ceiling available for compensatory measures (see Table 2 and Table 4).

Table 2 MARGINS UNDER THE BERLIN CEILING FOR COMMITMENTS AND PAYMENTS BEFORE COMPENSATORY MEASURES

€ million

	2004	**2005**	**2006**	**TOTAL**
Commitment appropriations (Financial Framework, January 2002)	816	800	814	**2 430**
Payment appropriations (Financial Framework, January 2002)	3 204	947	2 380	**6 531**
Commitment appropriations (Brussels European Council)	1 530	1 599	1 816	**4 945**
Payment appropriations (Brussels European Council)	3 970	4 424	4 571	**9 385**
Commitment appropriations (Copenhagen package)	1 683	1 560	1 879	**5 122**
Payment appropriations (Copenhagen package)	5 181	3 277	4 333	**12 791**

Source: European Commission, DG Budget, 2002.

Table 3 BUDGETARY AND CASH FLOW COMPENSATIONS

€ million

	2004	**2005**	**2006**	**TOTAL**
Commitment and payment appropriations (Financial Framework, January 2002)	855	141	123	**1 119**
Commitment and payment appropriations (Brussels European Council)	976	453	223	**1 652**
Commitment and payment appropriations (Copenhagen package)	1 273	1 173	940	**3 386**

Source: European Commission, DG Budget, 2002.

Table 4 MARGINS UNDER THE BERLIN CEILING FOR COMMITMENTS AND PAYMENTS AFTER COMPENSATORY MEASURES

€ million

	2004	**2005**	**2006**	**TOTAL**
Commitment appropriations (Financial Framework, January 2002)	-39	659	691	**1 311**
Payment appropriations (Financial Framework, January 2002)	2 349	806	2 257	**3 312**
Commitment appropriations (Brussels European Council)	554	1 146	1 593	**3 293**
Payment appropriations (Brussels European Council)	2 994	3 971	4 348	**11 313**
Commitment appropriations (Copenhagen package)	410	387	939	**1 736**
Payment appropriations (Copenhagen package)	3 908	2 104	3 393	**9 405**

Source: European Commission, DG Budget, 2002.

In the Berlin 1999 scenario (*Financial Perspective 2000-2006)* the assumptions underlying the calculations for 2002-2006 did not include any expenditure for direct payments in favour of farmers in the new member states. That changed in 2002. The Commission still considered that 'immediate full integration into the system of direct payments would not give the right incentives to farmers in the new member states to engage in, or continue, the necessary restructuring'.[10] Nevertheless, the Commission proposed that direct payments should be introduced in the new member states starting from 25 per cent in 2004, 30 per cent in 2005 and 35 per cent in 2006 of the EU-15 level. Moreover, in the final stage of negotiations it was approved for candidate countries to top up EU direct payments to 55 per cent of the EU-15 direct payments level in 2004, 60 per cent in 2005 and 65 per cent in 2006. The topping-up to 40 per cent of the EU level can be financed partly from allocations foreseen for rural development. For this purpose 25 per cent of commitment appropriations can be used in 2004, 20 per cent in 2005 and 15 per cent in 2006. However, any further topping-up can only be financed from the national budget.

Furthermore, in the Copenhagen Summit the increased funds for rural development as the more appropriate way of restructuring agriculture was approved. Together with other measures an increased EU co-financing rate of 80 per cent for the rural development measure was approved, financed by the EAGGF 'Guarantee Section'.[11] Generally, expenditure of €1570 million in 2004, €1715 million in 2005 and €1825 million in 2006 for rural development is foreseen.

For regional aid the Copenhagen package approved the Commission's proposed three-year transition period (i.e. by 2007) to reach the full possible level of 4 per cent of GDP, as proposed in the Berlin Council Conclusions. According to the financial proposal, the proportion of the structural funds which can be used as Cohesion Funds could be increased to one third compared to 18 per cent for the current four member

[10] European Commission (2002), *Communication from the Commission. Information Note: Common Financial framework 2004-2006 for the Accession Negotiations*, SEC (2002) 102 final. Brussels. 30.1.2002. p.3
[11] ibid, p.5

state beneficiaries.[12] Nevertheless, the new members would get much less regional aid per head than the current members.

The Commission's proposed financial support for certain specific issues was approved by the Copenhagen Summit as well. The Commission proposed financial support of €375 million in commitment appropriations under the nuclear safety post-accession program for Lithuania and Slovakia.

In summary, the key elements of the final financial framework for the EU enlargement are as follows:

- Berlin Financial Framework 2000-2006 ceilings respected;
- any budgetary lump sum compensation will be degressive and temporary payments on the expenditure side of the EU budget;
- temporary budgetary compensation will be available as appropriate in case the estimates show that a country will find itself in a net budgetary position which is worse than the year prior to accession as a beneficiary of pre-accession funds;
- clear distinctions are made between the candidate countries which will receive the budgetary compensations (the Czech Republic, Cyprus, Slovenia and Malta) and candidate countries (Hungary, Slovakia, Poland, Lithuania, Latvia and Estonia) which will have a positive net budgetary position in the first years of accession;
- in the calculations of net budgetary position only the financial flows to and from the country are taken into account, i.e. net budgetary position is estimated as the difference in any given year between on the one hand the estimated own resources payable by the country to the EU budget on the basis of full application of the *acquis* and on the other hand the sum of the estimated expenditure paid from the various EU spending programmes;
- EU structural assistance capped at 4 per cent of GDP and estimated absorption rates of EU financial support suggested;
- compensatory payments under the CAP will be 25 per cent in 2004, 30 per cent in 2005 and 35 per cent in 2006 of EU-15 levels, there is a possibility to top-up these payment to 55, 60 and 65 per cent of EU-15 level but only if funded from already committed rural development monies or from national resources;
- the EU approved calculations methodology only partially took into account the structural budgetary imbalances arising from EU membership and as a result cash flow lump sum compensations were proposed;
- all risks are transferred to the new member states as there is no option for *ex post* adjustment based on the real absorption rates during the first years of EU membership.

[12] European Commission (2002), *Communication from the Commission. Information Note: Common Financial framework 2004-2006 for the Accession Negotiations*, SEC (2002) 102 final. Brussels. 30.1.2002. p.3 , pp.1-10

2. The impact on Lithuania's budget

The impact of EU membership on Lithuanian budget policy should be discussed bearing in mind a number of points. First, the main factors which will affect Lithuania's budget are financial flows to Lithuania's budget and Lithuania's contributions to the EU budget. Second, there is clear distinction between the impact on the budget in the short- and long-term perspectives. This distinction derives from two factors: firstly, EU enlargement is likely to take place in 2004 when the current *Financial Perspective for 2000-2006* will still be in operation and all political decisions as regards the financing the EU enlargement were made in Berlin Council 1999. Secondly, new member states will take part in the preparation of the new *Financial Perspective for 2007-2013*, which will begin in 2004-2005. Any decisions will be thus made in the light of potential new political coalitions, i.e. a group of countries promoting the agricultural sector, or Cohesion countries with new member states promoting structural assistance. The forthcoming CAP reform, structural funds reform and the possible own resources reform will also have an impact on the new *Financial Perspective*. Thus, the new *Financial Perspective* might result in a new financial framework which could affect one or another sector more severely than before.

In the short-term there are several main factors, which will have a direct impact on Lithuanian budget policy:

- Lithuania's contributions to the EU budget and its ability to pay these contributions;
- financial flows from the EU budget, i.e. the EU structural assistance from Structural and Cohesion funds
- compensatory payments under the CAP and financing of top-up;
- Lithuania's obligation to co-finance or at least fund in advance these EU budget expenditures
- financing of the closure of the Ignalina NPP.

2.1 Lithuania's contributions to the EU budget

In the European Commission's Communication on Common Financial Framework 2004-2006 for the Accession Negotiations it was foreseen 'that the own resources decision is fully applied by the new member states from the first year of accession'.[13] However, Lithuania has requested a transitional period for the gradual increase of its contribution to the EU budget. With respect to this request the Commission proposed 'that temporary budgetary compensation (lump sum payments) inside the Berlin framework be available as appropriate if the estimates show that Lithuania would find itself in a net budgetary position worse than the year before accession as a beneficiary

[13] European Commission (2002), *Communication from the Commission. Information Note: Common Financial framework 2004-2006 for the Accession Negotiations*, SEC (2002) 102 final. Brussels. 30.1.2002. pp.1-10

of pre-accession funds'.[14] However, the calculations presented in the Commission's paper suggest that during the first year of accession Lithuania will have a positive net budgetary position in comparison to 2003 and thus would not qualify for lump sum compensation. At the Copenhagen Summit these provisions were approved.

Starting from the first day of accession Lithuania will pay full contributions to the EU budget in the form of own resources - traditional own resources (customs duties, agricultural levies, sugar levies), VAT-payments and GNP payments. The contributions to the EU budget will be paid quarterly at rates fixed in advance. Over the period 2004-2006 Lithuania's contributions to the EU budget will be €510 million or €147 per head. For Lithuania will also be applicable the rules according to which there is possibility that Lithuania could be invited by the Commission to bring forward by one or two months in the first quarter of the financial year the entry of one-twelfth or a fraction of one-twelfth of the amounts in the budget for VAT resources and/or the GNP-based resource. In this case, Lithuania will need to find additional resources in the beginning of financial year (excluding 2004). Moreover, in case Lithuania's contributions to the EU budget will be delayed, these late payments to the EU budget will give rise to the payment of interest, which will be covered from the national budget as well.

TABLE 5 LITHUANIA'S CONTRIBUTIONS TO THE EU BUDGET

€ million

	2004	**2005**	**2006**
Traditional own resources	22	33	33
VAT resource	14	21	22
GNP resource	78	120	123
UK rebate	10	16	17
Total own resources	**124**	**191**	**196**

Source: Copenhagen financial package, 2002.

Even if the contributions are made monthly for the Lithuanian budget these will have a considerable impact on the budget's expenditure. In 2004, gross contributions to the EU budget will be €124 million or 3½ per cent of the State budget expenditure.

From the first years of accession, Lithuania is also assumed to contribute to the UK rebate. Thus in 2004 the contribution to 2003 UK budget rebate will be €10 million, despite Lithuania not being a member of the EU in 2003. The methodological derogation for candidate countries was not made and new member states will pay contribution to the UK rebate starting from the year 2004.

According to the Commission's explanations, the estimated net position of Lithuania was defined as the difference in any given year between the estimated total contributions (i.e. own resources) payable by Lithuania to the EU budget and the sum

[14] European Commission (2002), *Draft Common Position. Chapter 29: Financial and budgetary Provisions: Lithuania.* DG Enlargement. 29.05.2002. p.5

of the estimated expenditure paid from the EU budget to Lithuania.[15] The expenditure was estimated as the total amount of payments from the EU budget on agricultural market expenditure, direct payments, structural actions including rural development, internal policies and pre-accession aid (on-going payments based on earlier commitments). Administration expenditure was not included in the total amount of expenditure. Estimations on both commitments and payments approach suggest that the Lithuanian contribution to the EU budget will be less than receipts in 2004.

TABLE 6 FINANCIAL FLOWS TO AND FROM THE LITHUANIAN BUDGET

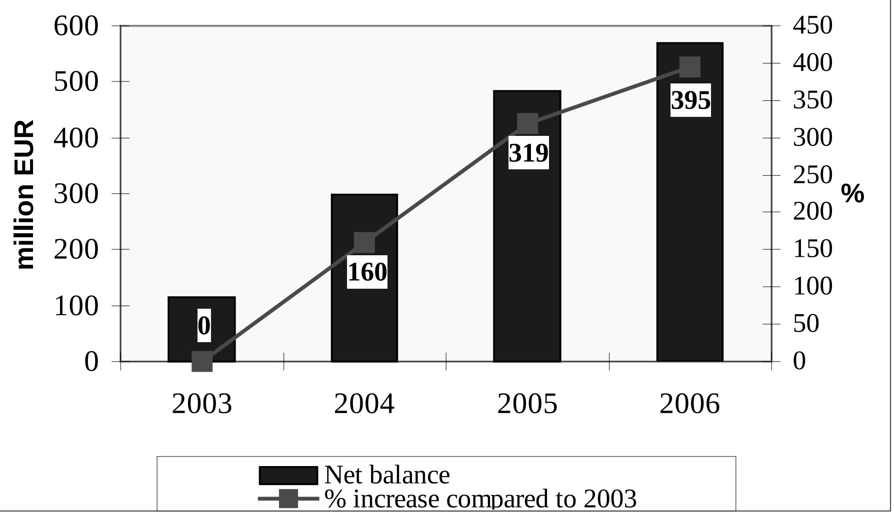
€ million

	2004	**2005**	**2006**	**TOTAL**
Contributions to the EU budget	124	191	196	510
Payments from the EU budget: including cash flow compensation	423 35	674 6	766 6	1863 47
Total net balance	**423**	**674**	**766**	**1863**
Pre-accession aid in 2003	115	115	115	115
Change vs. 2003	**299**	**483**	**570**	**1353**
Net balance in % of GNI (0.75 % in 2003)	1.82	2.83	3.21	-

Source: Copenhagen financial package, 2002. DG Budget, 2002.

Estimates show that Lithuania's net balance will increase by more than 100 per cent annually during the period of 2004-2006 (see Figure 1). This rate is the highest among all candidate countries.

Figure 1 Change of Lithuania's Net Balance (2004-2006)



Source: Copenhagen financial package, 2002.

[15] European Commission (2002), D*raft Common Position. Chapter 29: Financial and budgetary Provisions: Lithuania*. DG Enlargement. 29.05.2002. p.4

2.2 Structural assistance and co-financing issues

EU membership will change the amount and sources of financial assistance for Lithuania. Pre-accession funds ISPA and SAPARD will be transformed to Cohesion fund and EAGGF respectively. The PHARE fund will be ended in 2003, however, part of PHARE funds (in payment appropriations) along with other pre-accession funds will reach Lithuania after accession in cases such as projects started in 2003 which could be implemented until 2006. According to the European Commission's estimates, allocations of the EU structural actions for Lithuania 2004-2006 will reach around €1366 million (in commitment appropriations). Besides this, €302 million will be allocated from the pre-accession aid programmes, around €92 million will be allocated for existing policies, €136 million for the Schengen system, €285 million for nuclear safety and €26 million for institutional building.

This constitutes 5.4 per cent of the total Structural Funds resources allocated for Structural operations to the new member states for assistance under Objective 1 and 6.15-8.17 per cent of the total Cohesion Fund resources allocated in the new member states for Cohesion Fund assistance. Lithuania could also receive an indicative share of 5.2 per cent of the resources allocated to Structural Funds assistance in the new member states for the Community initiative INTERREG and an indicative share of 3.5 per cent of the resources allocated in the new member states for the Community initiative EQUAL. This would constitute around €19.9 million and €10.5 million respectively. Calculations showed that financial assistance for structural actions per year could be approximately €455 million (commitment appropriations) or €131 per head.

Lithuania will be eligible for financial assistance of Structural Funds under Objective 1. The main criteria for this is that the level of GDP per head in Lithuania is less (35 per cent) than 75 per cent of the Community average. Objective 1 draws on funds from the European Regional Development Fund (ERDF), European Social Fund (ESF), Guidance Section of the European Agricultural Guidance (EAGGF Guidance Section), and the Financial Instrument for Fisheries Guidance (FIFG). The aims of these funds will actually determine the sectors which receive financial support. The main sectors benefiting from the EU structural support will be transport, communication technologies, energy, the environment, agriculture and rural development (see Table 7). Social policy, education and health care will only partially benefit from EU structural support.

The Cohesion Fund finances projects designed to improve the environment and develop transport infrastructure if Lithuania's per head GNP is below 90 per cent of the Community average. There has to be an appropriate funding balance between transport infrastructure projects and environment projects, i.e. the funds will be split 50-50 between these two categories. This means that transport and environment sectors could receive around €271 million each during the period of 2004-2006.

Additionally, all three pre-accession funds (PHARE, ISPA and SAPARD) will affect financial flows to the Lithuanian budget during the period 2004-2006. For example, the last programming year for PHARE funds will be 2003, however, the contracting period is two years (until 2005) and implementation period 3 years (until 2006). This leads to the conclusion that part of the pre-accession aid for the period 2001-2003 will be used after accession as well. It means that part of the co-financing funds will still go to these projects.

TABLE 7 FINANCIAL SUPPORT FOR STRUCTURAL ACTIONS 2004-2006

FUNDS	€ million		SECTORS
Cohesion Fund	543	271	Transport
		271	Environment
Structural Funds			
ERDF	792	521	Energy
			Transport
			Environment
			Social, health and education infrastructure
			Industry and SMEs
			Tourism
			Information society
ESF		147	Education
			Employment measures
EAGGF		113	Rural development
			Agriculture
FIFG		11	Fishery
INTERREG	19.9		Regional development and cross-border co-operation
EQUAL	10.5		Social policy
Total	**1366**		

Source: Ministry of Finance of the Republic of Lithuania, 2002.

While the EU financial support will bring much needed investment for the development and growth of the Lithuanian economy, the rule that this assistance is supplementary to national financing and must be co-financed means that the economic benefits of membership cannot be realised unless significant additional co-financing is provided from the Lithuanian budget.[16]

The payments appropriations estimated as a percentage of commitment appropriations are the main indicator for co-financing needs. The calculation of co-financing needs is based on the Commission's proposed absorption rates (see Table 8), which in most cases are still over-optimistic.

In 2004 Lithuania will have to provide approximately €98 million for the co-financing of EU structural support. The co-financing of the Structural and Cohesion Funds will amount to around €52 million, the rest, €46 million, will be provided for co-financing of pre-accession aid and rural development. In 2005 and 2006 this sum will be around €170 million and €197 million respectively. During the period of 2004-2006 the

[16] European Committee of the Government of the Republic of Lithuania, *Draft Additional Information to the Position Paper on Chapter 29 'Financial and Budgetary Provisions'. November 2002.*

additional co-financing which needs to be raised by the Lithuanian state will amount to around €278 million.

TABLE 8 THE ABSORPTION RATES OF THE EU STRUCTURAL ASSISTANCE

%

	2004	2005	2006	2007	2008	2009
	n	**n+1**	**n+2**	**n+3**	**n+4**	**n+5**
PHARE	5	20	25	30	20	
ISPA	3	18	22	22	22	13
SAPARD	0	50	50			
Structural Funds*	2	41	63	63	63	
Cohesion Fund	3	21	22	22	22	10
Rural development*	23.3	45	31.7			
Direct payments	0	25	30			
Internal policies	36	25	20			

**preliminary rates after reduction of rates (in 2004 reduction from 3% to 2% of structural funds and from 35% to 23.3% for rural development).*

Source: Commission's Paper on the methodological aspects related to the calculation of the net budgetary balances, Brussels European Council, 2002.

2.3 Compensatory payments under the CAP

Support for agriculture, and compensatory payments in particular, are another factor which will have an impact on Lithuanian budget policy. Indeed this is where the Lithuanian budget will change the most. Compensatory payments will provide support to farmers and the income of farming households. In the short-term, lower levels of direct payments will affect relative levels of income but would not affect the price, level or quantity of production, i.e. the competitiveness of the farm.[17]

The European Commission has set the starting level at which direct payments would be granted for 2004 at a rate equivalent to 25 per cent of EU-15 levels. In 2005 this rate will rise to 30 per cent and in 2006 to 35 per cent. These amounts for Lithuania are equal to €68.2 million (1.92 per cent of state budget expenditure) in 2004, €83.8 million (2.19 per cent of state budget expenditure) in 2005 and around €100 million (2.39 per cent of state budget expenditure) in 2006. However, payments from the EU budget will be received only a year in arrears. This means that the Lithuanian taxpayer will have to finance the direct subsidies from the budget in the current year. In 2004 these amount to €68.2 million. Nor is this a one-off problem since the level of compensatory payments will increase year on year until 2013. Thus in 2005 Lithuania will have to pay €83.8 million to farmers but receive only €68.2 million as payments for 2004. Thus in 2005 the carrying cost of these payments will be advanced payment from the Lithuania's budget of €15.6 million or 0.44 per cent of the foreseen budget expenditure. And will remain at similar levels in every year until 2013. Moreover, in the final financial package, the possibility is foreseen to top-up the direct payment to 55 per cent of the EU-15 direct payments level in 2004, 60 per cent in 2005 and 65 per cent in 2006. During this period the topping-up to 40 per cent of the EU level

[17] Fishler, F. (2002), 'Enlargement and Agriculture a Tailor-made Strategy for the New Member States', *Presentation of the Commission's Enlargement Proposals,* Brussels, 30 January 2002.

could be financed partly from funds committed for rural development under two conditions: (1) only 20 per cent of years' annual rural development allocation or 25 per cent in 2004, 20 per cent in 2005 and 15 per cent in 2006 can be used and (2) application of 80 per cent of EU co-financing rate.

Lithuania will also have the possibility to top-up EU direct payments to the total level of direct support the farmers would have been entitled to receive, on a product basis, in Lithuania prior to accession (2002) under a similar national scheme increased by 10 percentage points. However, bearing in mind the modest Lithuanian state budget and the size of additional expenditure resulting from the EU membership it is very likely that this possibility will be implemented at minimum level or will prove impossible to implement at all. The preliminary expenditure for direct payments financed from the State budget could reach around 4.30 percent of foreseen budget expenditure (see Table 9).

TABLE 9 EXPENDITURE FOR DIRECT PAYMENTS FROM STATE BUDGET 2004-2006

€ million

	2004	**2005**	**2006**
1.Advancing of direct payments	68.2	15.6	16.25
2.Financing of top-up to relevant EU level:	81.84	83.8	85.76
a) allocation for rural development	33.35	29.14	23.26
b) co-financing of rural development allocations	8.34	7.28	5.81
c) national financing	40.15	47.38	56.69
3.Financing of top-up under a like national scheme	2.41	2.41	2.41
Total (1-3)	**152.45**	**101.81**	**104.42**
% of State budget expenditure	4.3	2.7	2.5

Source: author's calculations, 2003.

Nevertheless, the total agricultural package will offer opportunities for farmers to improve their income situation via compensatory payments, agro-environmental aids, early retirement measures or the support for investment, marketing and processing, which will ensure the long-term competitiveness and income of farms.[18]

2.4 Financing the closure of the Ignalina Nuclear Power Plant

The financing of the closure of the Ignalina NPP is one of the questions which was making the Lithuanian position more specific in comparison to the other candidate countries. The closure of Ignalina will have direct socio-economic, environmental, energy-related, and other consequences, including some related to the security of supply, which will have to be tackled over a long period of time. It is foreseen that

[18] Fishler, F. (2002), 'Enlargement and Agriculture a Tailor-made Strategy for the New Member States', *Presentation of the Commission's Enlargement Proposals,* Brussels, 30 January 2002.

Unit 1 of Ignalina will be closed in 2005 and Unit 2 in 2009.[19] Moreover, Lithuania's position was that the financial support from the EU for the closure of the Ignalina should be excluded from the calculations of Lithuania's net budgetary position since the early closure of Ignalina is the specific request of the EU and not something that would have otherwise been priority expenditure. An additional argument was that the financing of the closure of the Ignalina is not a productivity or budgetary revenue generating investment.[20]

Lithuania requested 'substantial financial assistance on a long-term basis to deal with the consequences of closure of Ignalina through additional budgetary allocations provided by a programme establishing a new line in the EU budget and specifically dedicated for this purpose'.[21] Lithuania's concern was that 'EU long-term financial assistance to deal with the consequences of the closure of the Ignalina should be without prejudice and additional to the assistance provided to Lithuania through the structural funds and the Cohesion Fund, and should not be subject to calculations of Lithuania's net budgetary position'.[22] During the period of 2004-2006 the financial support for the closure of Ignalina will be €285 million (€95 million annually) and this financial support was subject to calculations of net budgetary position and that is around €48 per head (2004-2006). The scope of allocations from the State budget will be limited to the amount of co-financing (around €20 million). Moreover, due to the specific character of the objective, the financial assistance will be needed at least until 2020. That means that financial support for this should be included in the next two *Financial Perspectives* (2007-2013 and 2014-2020) and any Lithuanian part of co-financing should be stable and foreseen in advance as well.

3. Lithuanian budget policy and management of budget flows

During the first years of accession Lithuanian budget policy will face EU membership related expenditure pressure resulting from:

- Lithuania's contributions to the EU budget,
- additional co-financing for the EU structural assistance
- advanced direct payments for farmers and financing of national top-up to relevant EU level
- financing the closure of the Ignalina NPP
- additional costs of investments related to EU membership.

All these expenditures will be in conjunction with implementing Lithuanian macro-economic policy priorities and goals.

[19] Government of the Republic of Lithuania, *Additional information on Chapter 14 - Energy,* Conference on Accession to the European Union: Lithuania, CONF-LT 28/02. 29 May, 2002.
[20] European Committee under the Government of the Republic of Lithuania, D*raft Additional Information to the Position Paper on Chapter 29 'Financial and Budgetary Provisions'. November 2002.*
[21] Government of the Republic of Lithuania (2002d), *Additional information Chapter 14 - Energy,* Conference on Accession to the European Union: Lithuania, CONF-LT 28/02. 29 May, 2002, p.2
[22] Ibid., p.2

The Lithuanian budget is small and the ratio of government spending is low in comparison to the present EU member states and even the candidate countries. In 2000 the general government spending in Lithuania was 33 per cent of GDP. This percentage is considerably smaller than the average of CEEC-10 (41 per cent of GDP) or the average of EU-15 (46 per cent of GDP)[23].

The analysis of the Lithuanian budget in respect to the net budgetary position after enlargement is based on a clear distinction between the General Government budget and the State budget. The budgetary impact of EU membership should be measured only on the State budget, because the General Government budget, in addition to the State budget, includes special purpose budgets, e.g. municipal budgets. Thus the scope of possible reallocation of budgetary resources is limited to the State budget expenditure.

According to the estimate, in 2004 the direct additional demand for payments from the Lithuanian State budget will be around €292 million. This sum will increase in 2005 to €398 million and to €436 million in 2006. The table below compares the size of this additional demand with the expenditure of State budget and GDP.

TABLE 1O DIRECT ADDITIONAL DEMANDS FOR PAYMENTS FROM THE LITHUANIA'S STATE BUDGET (change over 2003)

€ million

	2004	**2005**	**2006**
1. Lithuania's contributions to the EU budget	124	191	196
2. Advancing of direct payments and financing of national top-up	126	94	99
3. Co-financing of the EU structural assistance	36	107	135
4. Contributions to EIB	6	6	6
TOTAL	**292**	**398**	**436**
% of State budget expenditure	8.2	10.4	10.6
% of GDP	1.74	2.19	2.22

* excluding expenditure for co-financing of rural development allocations used for direct payments toping-up, and excluding advanced payments of rural development allocations.

Source: author's calculations, 2003.

These calculations do not include other EU-membership related investments to be made in 2004-2006 or financial needs for co-financing the closure of the Ignalina NPP. The biggest demand for additional budgetary costs will arise from implementation of the EU *acquis* in the most public finance intensive sectors such as environment, justice and home affairs as well as agriculture. For example, for the period 2004-2006 estimated additional (i.e. arising from implementation of *acquis*, but not eligible for funding from pre-accession and Cohesion funds) costs for new administrative arrangements, monitoring and information systems in the environment sector are estimated to be at least €60 million.

Despite the fact that the net impact on the State budget generally will be positive, the foreseen expenditures are additional to planned expenditures and the gross

[23] World Bank Regional Study, *Expenditure Policies Towards EU Accession*, 2002, 3pp.

contribution to the EU budget is a new demand on the Lithuanian budget. These will impose big structural changes on budget expenditure and will need to be funded by taxes, expenditure cuts or borrowing. The Commission's calculations only partially took into account these structural budgetary imbalances, which will be caused by the contributions to the EU budget and financial assistance from the EU budget, and even the proposed extra cash flow lump sum compensation of €47 million will not cover these extra costs.

Table 10 shows that in the period 2004-2006 implementation of EU policies will lead to sharply increased payments equivalent to just over 1.5% of GDP from the Lithuanian budget (in comparison with 2003). Due to the low rate of government spending, the capacity to adjust to these budget imbalances is limited.

The possible ways to adjust the structural budgetary imbalances are constrained:

1. *Increase taxation*
   Increasing VAT rates would increase inequality and poverty in a country with an already very low disposable income and the impact on the most vulnerable social groups will be significant.[24] Levels of corporate income tax are sensitive to international and regional competitive pressures as are payroll tax rates. Finally, income tax rates in Lithuania already exceed 60 per cent and any further increase would risk incentives to work.[25] Harmonization of indirect taxes after accession will in any case increase excise duties on fuel and cigarettes and the remaining VAT exemptions will be abolished by the end of 2003 as well. Thus even more tax increases in response to EU membership could affect support for the project. In any case, this solution is not satisfactory mainly because the lags in the system will mean that the short term financing problems will remain acute.

2. *Increase budget deficit*.
   The option to increase the budget deficit is constrained because of the Lithuanian aim to join Economic and Monetary Union already in 2006 (it currently operates a currency board based on the euro). The financing costs of Lithuania's membership of the EU will increase the general government fiscal deficit in 2004 to 3.6 per cent of GDP (3.2 per cent and 2.0 per cent of GDP in 2005 and 2006) taking it above the qualifying level under the Maastricht treaty.[26] Even if membership of EMU were not an immediate objective Lithuania would be in prospective breach of the Excessive Deficits procedure. Any increase in the deficit and debt levels even if financed by loans from international financial institutions at low rates of interest would lead to higher interest rates and increased state debt administration costs.

[24] European Committee under the Government of the Republic of Lithuania, *Draft Additional Information to the Position Paper on Chapter 29 'Financial and Budgetary Provisions'. November 2002*.
[25] European Committee under the Government of the Republic of Lithuania, *Draft Additional Information to the Position Paper on Chapter 29 'Financial and Budgetary Provisions'. November 2002*.
[26] ibid.

3. *Intra-budgetary redistribution*
   The increased expenditure could be financed by redistributing funds within or among sectors. However, these options are also limited. The intra-budgetary redistribution of expenditures will have a negative impact on those sectors that do not benefit directly from EU structural support. If Lithuania's contributions to the EU budget and additional co-financing needs are to be financed only through redistribution of budgetary expenditure, allocations to health care, social security, education, justice and public order sectors would have to be reduced by more than 20 per cent in 2004 in comparison to 2003.[27] This would be politically very difficult. The only alternative might be redistribution within the sectors benefiting from the EU support. However, the pressure on these sectors will already be high due to the additional co-financing needs.

In the short-term the main economic policy goals will be a stable macroeconomic situation: competitive economy, fast economic growth with a low level of unemployment and stable prices as well as favourable conditions for business development and successful implementation of structural reforms with deeper economic integration to the EU. Together with these goals Lithuania will seek to fulfil Maastricht criteria and prepare itself for membership of the EMU. These goals will put pressure on fiscal policy, i.e. mainly on the budget deficit and state debt policy.

Fiscal policy will be key to attaining macroeconomic policy priorities - to ensure macroeconomic stability by pursuing anti-cyclical fiscal policy; to create favourable conditions for improvement of labour efficiency, to stimulate reforms in energy and agriculture sectors, in the tax system and budget management; and to harmonise the fiscal policy with the priorities of social policy.[28]

The government investment strategy is reflected in the Public Investment Program (PIP) which defines the need for the funds to finance investment projects implemented as part of government-supported programs, as well as the sources of financing and the timeframes for implementation of the investment projects concerned. Currently the PIP attributes priority to investment projects co-financed by the EU and those contributing to NATO and EU accession. The financing for projects included in the PIP is subject to limits that are set annually taking into account the status of the Lithuanian economy, international commitments of the country and other factors.[29] The volume of funds needed to implement commitments will be revised, *inter alia,* in the process of elaboration of the National Development Plan (NDP).

Upon accession to the EU however, the size of public investments will largely be conditioned by the needs for co-financing of projects under the EU Structural and Cohesion Funds, the economic justification of which are to be outlined in the Single Programming Document (SPD) for 2004-2006. Once Lithuania becomes an EU member and the European Commission approves the SPD, the SPD will serve as a point of reference for allocating the EU structural support funds to investment

[27] European Committee under the Government of the Republic of Lithuania, *Draft Additional Information to the Position Paper on Chapter 29 'Financial and Budgetary Provisions'. November 2002.*
[28] Government of the Republic of Lithuania, *Lithuania's Pre-accession Economic Programme,* August 2002, Vilnius.
[29] ibid.

projects. Preparations to absorb the EU structural support funds will necessitate changes in the PIP structure and principles of development by gradually moving from the project-based to program-based principle and by fully integrating public investment plans and EU programmes to the strategic planning system.[30]

4. Outcomes of negotiations and conclusions

It is obvious that Lithuania couldn't expect a transitional period for its contributions to the EU budget. The previous enlargement showed that the lump sum compensations on the EU budget expenditure side were more transparent and predictable ways to improve a country's budgetary situation during accession to the EU. However, Lithuania has not so far qualified for sufficient lump sum compensations to bridge the gaps in its financing because of its positive net budgetary position in the first years of accession. It seems that Lithuania will have to cope with the impact of membership on its budgetary flows alone with insufficient external support.

Moreover, in Lithuania's case, limiting receipts to 25 percent of the EU-15 level of direct subsidies (with an annual increase of 5 percent) is equivalent to €586 million not received during the 3 years 2004-2006 - equivalent to 1.1 percent of forecast GDP during this period. Because of lengthy administrative procedures, access to financial assistance through structural actions and rural development funds is forecast, according to the Commission's calculations, to result in over €976 million of funds being under-used during 2004-2006 (measured as the difference of commitments appropriations and payments appropriations).[31] Also, in 2006 around €150 million of assignment for commitments appropriations will be withheld from Lithuania because of the 4 per cent of GDP capping rule. However, Lithuania still has to pay full contributions to the EU budget of €510 million during the period of 2004-2006.

As was mentioned before during the first years of EU membership Lithuania's budget will be under pressure due to the increased budget expenditure. In most cases Lithuania will have to show a high level of flexibility in managing funds between accounts as well as within them. In order to avoid advancing expenditure from the national budget will be necessary to minimise any internal mismanagement of funds. Moreover, the efficient and rational timetable of procedures defined for distribution of funds could help to reduce the advancing of EU membership related expenditure as well.

In order to reduce budgetary imbalances it will be important to avoid undertaking additional financial liabilities as well as to shake-up state budget programmes and Public Investment Program taking into account co-financing needs.

[30] Government of the Republic of Lithuania, *Lithuania's Pre-accession Economic Programme,* August 2002, Vilnius.
[31] European Committee under the Government of the Republic of Lithuania, *Draft Additional Information to the Position Paper on Chapter 29 'Financial and Budgetary Provisions'. November 2002.*

As we have seen, the possible ways for Lithuania to manage structural budgetary imbalances are limited. Moreover, solutions from the EU side were made very simple and rather limited:

1. *Increased advance payments* (from 7 per cent to 16 per cent) of structural funds and split of 16 per cent into 10 per cent for 2004 and 6 per cent for 2005. These advance payments may facilitate preparation of project pipeline and thus will positively contribute to better absorption rates downstream. However, this solution does not tackle the real issue of budgetary imbalances. Since these payments will remain frozen in account until they are used for financing projects, the cash flow problem within the budget will remain considerable.

2. *Possibility to top up EU direct payments* that could be financed partly from funds allocated for rural development and from national budget. This decision is acceptable due to the possibility of paying higher levels of direct payments for farmers. However, this decision transfers all burden of financing to the new member states as they will have to decide whether to finance top-up direct payments and from what resources. This will have to be a political as well as economically rational decision since the pressure from farmers to finance the maximum possible level of direct payments will be huge. The decision on utilization of rural development allocations for topping up will have to be made as well.

3. *Budgetary compensations* were made according to the estimate of net balances. Only four countries will benefit from this decision (Malta, Cyprus, Slovenia and the Czech Republic). Despite the fact that these countries have the highest rate of GDP per head among all new member state they will receive additional funds from the EU budget.

4. The decision on *cash flow compensations* was made after discussions on budgetary imbalances resulting from cash flow problems (imbalances of budget revenue and expenditure in time and scope) during the first year of EU membership. These compensations were granted to all candidate countries. However, the method of calculation of these compensations led to countries with the lowest ability to pay contributions to the EU budget (or countries with small budget's and GDP level) receiving the smallest compensations. For example, during 2004-2006 Malta with contributions to the EU budget of €454 per head will receive cash flow compensation of €170 per head. In Lithuania's case, these figures are €147 per head and €14 per head respectively.

5. *Funds for special purposes.* Each new member state will receive additional funds for Schengen facility. These funds will be used according to provided instructions and control. Since Schengen facility will mean significant financial support for sectors which are financed mainly from national budget, there is the possibility that part of national financing for these sectors will be transferred to finance increased budget expenditure (e.g. contributions to the EU budget).
   Lithuania and Slovakia also received funds for closure of nuclear power plants. However, these funds will be used only for this purpose since the high costs of closing nuclear power plants will demand additional financial support from the national budget or even private funds.

6. *Special requests on flexibility of funds*. There were a few special requests from candidate countries on the flexibility of using funds. Poland and the Czech Republic were given the possibility to reduce structural funds commitment appropriations as well as payments appropriations by €1 billion and €100 million respectively. These funds will be made available as an exceptional and temporary cash flow facility in 2005-2006 in commitment and payments appropriations. Lithuania requested to change the percentage distribution of Schengen facility from equal tranches during the period of 2004-2006 to 33, 45 and 22 per cent. Malta and Cyprus requested a transfer of funds from Schengen facility to cash flow compensation.

7. *Contributions to European Investment Bank (EIB)*. All candidate countries received six years instead of four years to pay contributions (capital and reserves share) to EIB. Moreover, during the first three years of EU membership they will pay only one instalment per year. This will help to slightly reduce the increased expenditure burden.

In Lithuania's case, the negotiations on budgetary issues were more difficult bearing in mind that Lithuania will be in a good position as regards the net budgetary position in comparison to other candidate countries during the first years after accession. Calculations based on per head data showed that during the period of 2004-2006 the total financial assistance from the EU budget per head (€537) in Lithuania will be third after Cyprus and Malta. Lithuania will receive the biggest financial support for agriculture (€209 per head) and internal policies[32] (€155 per head). Lithuania together with Estonia and Latvia will be the biggest beneficiaries from structural support (respectively €441 per head in Estonia, €437 in Latvia, and in Lithuania €394). However, Lithuania's contributions to the EU budget during this period will be one of the lowest (around €147 per head).

Nevertheless, it must be underlined that the problem is not the level of net receipts but rather the destabilising budgetary management problems created by the adoption of EU budgetary rules and procedures and the gross contribution to the EU budget. If Lithuania, with the highest net receipts per head and the lowest gross contribution per head, has problems how difficult must it be for other candidates for EU membership?

[32] Including the financial support for the closure of the Ignalina.

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