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Executive Summary

Lithuania is still adhering to the specific Copenhagen criteria of a stable democracy and a progressively open market economy increasingly integrated in the EU.

Lithuania started its reforms from a rather disadvantaged position. The reforms have been far-reaching and sometimes painful. Nevertheless Lithuania is still determined to further additional reforms in its efforts to become an EU-member. The Country has also managed to catch up in the accession negotiations and had by end of April 2002 closed 26 of the 31 chapters.

A range of reform initiatives has spurred the economic development of Lithuania that successfully has turned its trade to the EU-markets. The export is driving the economy and Lithuania has reached a growth rate of 5.9 percentage of GDP in 2001. At the same time it has been possible to keep inflation down. That is among other things connected to the fact that the national currency, the litas, has been pegged to the Euro. However, unemployment remains very high. That could seriously damage the public support for EU-membership.

The Lithuanian reforms are well on their way and will develop the country in the right direction towards EU-membership. In other words there have been a lot of positive changes the previous year and no areas of regression have been noticed.

However, it would be beneficial to increase the pace of the reforms in order to create a more attractive business environment. The main problem is the limited administrative capacity. That means that adopted legislation is not always implemented in praxis and that civil servants interpret it differently. That leads to an unclear legislative framework hampering business activities for both domestic and foreign companies.

The legislative problems are especially apparent in the areas of customs regulations and tax regulations where more uniform and predictable rules should apply. Certification and testing is also an area with a lot to wish for. Problems in this area are quite worrying for the future functioning of the internal market.

Unfortunately corruption is still a problem at border posts and in connection with bureaucracy and lack of transparency: for instance in relation to public procurement.

Actions recommended

- Increase focus on administrative capacity and training of officials at all levels.
- Increase business community's involvement in the legislation process.
- Work for a more smooth administration in order to prevent corruption.
- Make unambiguous laws that are uniformly implemented.
- Increase the transparency in public procurement.
- Continue the work on smooth border crossing.
- Provide better information on new legislation.
- Promote standardisation and certification and finish remaining privatisation/liberalisation.

A Introduction

Methodology

This report is an assessment of the current business environment in Lithuania seen from European foreign investors' point of view. The content of the report is based on interviews with a network of more than 20 multinational companies active in a wide range of sectors. In other words the findings are based on on-location experiences from persons with in-depth knowledge of Lithuania and other markets.

The aim of this report is to identify remaining obstacles and barriers that need to be removed in connection with Lithuania's EU accession. Many reforms have been implemented in Lithuania and the business environment is gradually being transformed to EU level. However, there are still some obstacles to deal with which will be apparent in the following.

Relations between Lithuania and the European Union

The relationship between Lithuania and the European Union has developed rapidly since the European Community recognised the independence of Lithuania in 1991.

The first trade agreement was signed in 1992 and laid the basis for further co-operation leading to a free-trade agreement in 1994 and a Europe Agreement in 1995, and Lithuania began to adhere to EU regulations on trade. This approximation of legislation was reinforced by the Protocol to the Europe Agreement on Conformity assessment and Acceptance of industrial products (PECA) initialled with Lithuania in 2001.

In 1995 Lithuania submitted a membership application and began negotiations in 2000 as a part of the so-called Helsinki-group. At that time few people had imagined that Lithuania could catch up with the countries that began their accession negotiations in 1998. Today it is a realistic hope that Lithuania can be among the first post-communist countries to join the EU in time for the European Parliament election in 2004.

By now the European Union is Lithuania's main trading partner, where Germany, United Kingdom and Denmark are the main trading countries. 48% of Lithuania's total exports went to The European Union, whereas 46.5% of Lithuania's imports originated from the European Union (2000). Lithuania receives in particular machinery and electrical goods and exports textiles and other products.

The trade flows between EU and Lithuania are steadily increasing and are paving the way for increased wealth and prosperity. In addition, it is worth noting that the European Union is the main investor in the country, where Denmark, Sweden and Germany have been especially active.

Lithuania is also a key country for the European Union since it will be the link between Kaliningrad and central Russia in an enlarged EU.

Political development

Lithuania is living up to the political part of the Copenhagen criteria. It has a well-rooted democracy with accountable institutions and respect for human rights.

Nevertheless, the governments have been very unstable and only managed to stay in power for short intervals, which have hampered a focused and rapid restructuring. The current government has, however, managed to put the needed reforms on track and the question right now is more whether it is going fast enough than whether it is going in the right direction.

Lithuania's progress in conducting economic reforms and modernising the country is a result of hard and systematic work, good strategic planning, internal co-ordination and a strong commitment of all related institutions to further pursue the reform agenda.

The government's dedication to EU membership is also reflected in the accession negotiations: 26 of the 31 chapters have already been closed, which is only surpassed by Cyprus (as of March 22). The business community is very pleased with this progress but is particularly interested in following the related implementation of these negotiations. That is what will help create a level playing-field.

The Lithuanian government has seen the value of dialogue with the business community, which regularly has consultations with the top authorities. Unfortunately this dialogue is too often not reflected in the actual legislation. The fact is that primary suggestions are not always reflected when the law comes into force. Improved attention to the needs of the business community will make it easier to make the legislation work in practice.

B Economic development

Lithuania has recovered very fast from the Russian recession and achieved growth of 5.9% in 2001 and at the same time kept inflation low (Latvia was the only candidate country with faster growth). The main reason for Lithuania's fast growth was the improved export performance (increased 20% in 2001) that was at first not followed by a similar increase in imports. It was especially refined oil that increased exports but also increased demand from neighbouring markets.

Lithuania has also chosen to peg the local currency to the Euro, which will help to facilitate trade between Lithuania and the EU.

The reforms and the prospect of becoming an EU member country has resulted in a steady inflow of direct foreign investments to manufacturing industry especially, as well as wholesale and retail distribution. This inflow of capital supports the notion that business conditions are improving in the country.

The unemployment rate is unfortunately very high (12.3%). That is to be expected in a situation where major restructuring processes occur and it is also related to the government's very tight monetary policy. However, it is an unstable situation that can affect public opinion about the enlargement process.

C Progress in reforms

During the last few years there has been great progress in developing a solid market economy. In most sectors Lithuanian companies have already showed that they can compete in the EU and on the international markets. That is one of the reasons why exports are increasing. In that respect Lithuania is also living up to the economic part of the Copenhagen criteria.

The domestic business environment is considerably strengthened by the prospects of the EU Single Market. However, there are sectors with difficulties. That is mainly in the field of agriculture and meat processing where problems remain especially in the primary production phase. These sectors will need to be restructured.

Privatisation

The privatisation process has entered its last phase as more than 70% of GDP is now created by privately owned companies. The last stage will be a restructuring, liberalisation and privatisation of the energy sector and the transport sector, including Lithuanian Railways and Lithuanian Airlines.

The restructuring of Lithuanian Energy is under way. It will be divided into power generation, transmission and distribution companies. The power generation companies will, however, remain state-owned.

A liberalisation of the remaining sectors will strengthen Lithuania's competitiveness and be a welcome contribution to the Lisbon Process.

The legal framework

The legal framework in Lithuania is unfortunately still underdeveloped and exhibits a lack of administrative capacity. It is not always clear what the state of law is in various areas. That is mainly due to contradictory laws or even lack of adequate legislation. Also the frequent change of laws makes it very hard to relate to the current legislation and it is becoming difficult to plan for the future.

Another source of problems in that area is the different interpretation of laws at the lower levels of the administration. That is for instance the case in relation to tax inspection and customs, where the discrepancies are most apparent. Sometimes it is a matter of training, sometimes lack of internal information channels.

However, there have been improvements: Especially in the area of bankruptcy law and company law, where new legislation has been successfully implemented and works de facto.

Financial system

Lithuania has taken important steps regarding improvement of the financial system. That is not least the Corporate Tax Law, the VAT law and a few other laws under way (Income Tax Law for private persons and Property Tax law). According to the plans of the Ministry of Finance the income tax rate will be reduced from 33% to 29%, which will be partly compensated by the new property tax.

However, it is still too early to make a conclusion on these initiatives, but the business community is optimistic knowing that the Ministry of Finance has one of the strongest teams they have ever had. Only the future will tell if the Ministry of Finance will be able to take the lead in these areas and to what extent the laws are going to work in practice.

Certification and testing

Certification and testing are very important areas for business as it is a prerequisite for equal competition. More than 60% of the EU certifications are implemented but that still leaves a lot to be desired. That means for instance that some products contain illegal chemicals in an effort to reduce production costs. In other situations products are declared as containing a 40% solution but in reality contain a 20 or 30% solution. In other words the enforcement of standardisation and certificates is still insufficient.

Public procurement and Competition

Unfortunately there have not been any substantial positive developments within the field of public procurement. Some public procurement documents are still formulated in a way that ensures that a pre-selected company stands to win the tender. In some cases it also seems evident that corruption has influenced the procurement committee.

The selection procedure is not as transparent as it should be, and as it is in most EU member states.

Health and safety regulations

Seen from a business point of view there are no specific problems with health and safety regulations in Lithuania. The rules are well implemented and the level of control is close to EU level.

Customs

In relation to customs formalities, there is still room for improvement despite frequent constructive consultations with customs officials. It has changed for the better, but it is still quite time-consuming to cross a border and deal with the necessary formalities, where the amount of paperwork can be staggering.

However, there are substantial differences between the various border stations. For instance, not all stations have implemented the computerised database system, ASYCUDA.

The border formalities in the regions are especially problematic due to the fact that the interpretation of the legislation can vary a lot. It is the hope of the business community that the reduced number of border posts, from ten to five, also will reduce these problems.

The Customs Department has announced that it will work according to EU standards for the first time this year. The business community is anxiously following the results of this commitment.

Corruption

Unfortunately corruption is still a problem in Lithuania. It is most often connected to existing bureaucratic obstacles, where companies are expected to pay an amount in order to obtain a smooth service from the authorities. However, corruption and sometimes nepotism also occur in connection with public tenders, where the contract in some cases is won by companies related to individuals in the tender commission.

This kind of corruption is a problem for foreign companies as well as local ones. The business community recognises that Lithuania is not unique in this respect. The same could be said about other countries in the region. From that perspective corruption in Lithuania is average. However, any level of corruption is detrimental to the business environment and must be stopped.

One way of reducing corruption would be to make the legislation more clear and not subject to interpretation. In other words it is important to make all legal acts unambiguous and simple to implement in practice. That has not always been the case.

D. General evaluation

Lithuania still has a number of obstacles to clear in order to transform its legislation to EU standards. That is especially a matter of insufficient administrative capacity that prevents approved legislation from working in practice. However, the course is set in the right direction and the problems will gradually be solved if they are acknowledged and dealt with purposefully.

That will lead to better business environment, more investments, more wealth and also to an enlarged EU.

Recommendations

- *Increase focus on administrative capacity*
- *Increase training of officials at all levels*
- *Increase the business community's involvement in the legislation process*
- *Work for a more smooth administration in order to prevent corruption*
- *Make unambiguous laws that are uniformly implemented*
- *Improve information on new legislation*
- *Increase the transparency in public procurement*
- *Continue the work on smooth border-crossing*
- *Provide better information on new legislation*
- *Further promote standardisation and certification*
- *Finish remaining privatisation and liberalisation*

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