



<b>1. Project Data:</b>		<b>Date Posted :</b> 06/26/2003	
<b>PROJ ID:</b> P068706		<b>Appraisal</b>	<b>Actual</b>
<b>Project Name :</b> Second Structural Adjustment	<b>Project Costs (US\$M)</b>	98.5	98.5
<b>Country:</b> Lithuania	<b>Loan/Credit (US\$M)</b>	98.5	98.5
<b>Sector(s):</b> Board: EP - General public administration sector (42%), Oil and gas (17%), Power (17%), General industry and trade sector (17%), General agriculture fishing and forestry sector (7%)	<b>Cofinancing (US\$M)</b>		
<b>L/C Number:</b> L7030			
	<b>Board Approval (FY)</b>		00
<b>Partners involved :</b>	<b>Closing Date</b>	06/30/2001	06/30/2002
<b>Prepared by :</b>	<b>Reviewed by :</b>	<b>Group Manager :</b>	<b>Group:</b>
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## 2. Project Objectives and Components

### a. Objectives

To support the Government of Lithuania in the implementation of a structural reform program with the main objective of reducing poverty by putting the economy on a path of rapid and sustainable growth in a setting of macro -economic stability, so as to better position Lithuania for accession to the EU .

### b. Components

There were 17 core conditions for Board Presentation and first tranche release, and another 17 core conditions for second tranche release in this comprehensive adjustment program . The key components are as follows . (i) **Maintain an appropriate macroeconomic framework** . (ii) **Budget management** (a) revise legal structure to ensure that all government borrowing is carried out by the Ministry of Finance and all financing for government entities is carried out through budget, (b) implement a three year rolling government revenue and expenditure forecast system to improve fiscal management and more closely align expenditures with policies . (c) introduce comprehensive financial statements, (e) develop and implement guidelines to ensure a declining level of government guarantees for commercial activities, (f) improve capacity to monitor borrowing by, and other commitments of, all public entities . (iii) **Pension reform /social assistance** : (a) government submitted to parliament amendments for the social insurance law to adjust rate of increase in retirement ages and other parameters appropriate to achieving fiscal balance in the short term, (b) government provided parliament with analyses of the current pension law's implications for fiscal balance in the long term, (c) government introduced improved disability criteria and certification procedures, (d) a satisfactory policy package was submitted to the parliament that will achieve a basic level of support for all citizens and that determines the role of privately-managed funded pensions in the mandatory social insurance pensions system . (e) submission to parliament of a program for satisfactory early retirement and other supplementary benefits in the state sector on a funded basis and that facilitated the creation of funded pensions in the private sector that are funded on a long-term basis; (iv) **Private Sector Development** : (a) for new privatizations, firm and binding commitment by the government to engage financial advisors and sales agents, as required, using open tenders, finance needed retainer fees, and use transparent and open sales procedures (b) Government will select and hire an international recognized investment bank for the privatization of Lithuanian Savings Bank, and follow transparent and open procedures, (c) government submitted to the parliament an amendment to the Law on Companies to require an audit of all joint stock companies except for small private companies, (d) a law on enterprise restructuring was submitted to the parliament consistent with best international practice, (e) a new accounting law was submitted to the parliament based on IAS and EU directives, which established a general requirement of accounting and financial reporting based on these standards and directives . (v) **Energy Sector Reform** : (a) a market model for power was selected, consistent with EU directives, and submitted to the parliament . (b) Lithuanian Power Company (LPC) established generation, transmission, and distribution entities as separate profit centers with their own accounts . (b) The government hired a reputable international investment bank to undertake the privatization of LPC's distribution

network. The government issued a request for proposals to hire a reputable international investment bank to undertake the privations of Lithuanian Gas (LG). **(vi) Agricultural Reform** : (a) introduce measures to restrict budget expenditures on market regulation and income support; (b) measures were adopted to improve the operation and financial performance of the Agri-Food Market Regulatory Agency (AFMRA). These better align AFMRA operations with EU-consistent forms and mechanisms for support and EU -consistent financial controls that reduce the unpredictability of program costs. AFRMA's governance and operational procedures were restructured to achieve stricter financial control and auditing.

### **c. Comments on Project Cost, Financing and Dates**

The project originally was designed to cost US\$ 98.5 million (EUR 108.5 million) financed by an IBRD loan in two tranches. However, only the first tranche for EUR 54.686 million disbursed, and the second tranche was cancelled at the request of the government. The project was appraised in April, 2000, approved by the Board on July 25, 2000, made effective on July 28th, 2000, and closed on June 30th, 2002, one year behind schedule.

### **3. Achievement of Relevant Objectives:**

(1) **Macroeconomic Framework** : GDP growth recovered, averaging 5.9% for the past two years, while inflation dropped to less than 1%. The current account deficit dropped from 11.2% of GDP in 1999 to 4.4 % in 2002, and external debt declined from 42.5% to 38.8% of GDP, while the fiscal deficit declined from 8.5% of GDP in 1999 to 1.2% of GDP in 2002. (2) **Budget Management** : Budget expenditures are now more closely aligned with forecasts, and appropriations more closely reflect government's policy priorities. All legislation with spending implications now required to be accompanied by a note outlining fiscal implications. Enhanced compliance with the European Union principles governing state aid. Internal audit functions were strengthened. Public liabilities are effectively monitored, and risks are now much more clearly identified. Ceilings on new guarantees were progressively reduced from Lithuanian Litas 691 million in 2000 to zero in 2003. Some costs of guarantees internalized by participants, and guarantees cannot exceed 80% of loan amount, with substantial provisions in the budget. Quasi-fiscal imbalances are better controlled. (3) **Pension Reform /Social Assistance** : Both near and long term viability of the current social insurance pension system has been achieved. The Social Security Agency's cash flow reversed from a deficit of Ltl. 284.1 million in 1999 to a surplus of Ltl. 117 million in 2002. Government has implemented a sounder basis for the provision of a basic level of protection in old age. There is improved targeting of social assistance to those in need (i.e. assistance to pay for district heating). (4) **Private Sector Development** . Government's use of best practice in privatization has increased investor confidence and yielded higher returns for the economy. The Lithuania Savings Bank has been privatized as agreed, and, with the additional privatization of the Agricultural Bank, the privatization of the banking sector is now complete. Corporate governance has improved. The new system has resulted in easier entry for new domestic and foreign enterprises, and FDI has increased. FDI is now prohibited in only a few sectors such as weapons. The improvement of governance has resulted in substantial acceleration of bankruptcy proceedings. (5) **Energy Sector** . Market models were selected that met EU directives. The structure of the power sector is now fully consistent with EU directives, and the unbundled companies are all operating independently and profitably. Third party access to electricity and gas, combined with ability of larger consumers to choose their supplier, should help provide downward pressure on energy prices (although concerning gas, see shortfall noted in section 5 below). Appropriate legal framework now in place which meets EU directives. Energy Pricing Commission (EPC) pricing criteria and their implementation appear appropriate. Electric utilities are operating profitably with no government support. (6) **Agriculture** . Increased accountability and higher transparency of the Agri -Food Market Regulatory Agency (AFMRA), steady reduction in agricultural spending from the budget while AFMRA's accumulated losses were substantially reduced from Ltl. 180 mn. in August 1998 to Ltl 57 mn. in December 2002. Although grain and sugar price supports were re-introduced in 2001, they were withdrawn in 2002 (subsequent to and despite the cancellation of the second tranche). It is expected that the approaching EU accession will anchor these latest improvements.

### **4. Significant Outcomes/Impacts:**

Government revenue projections are greatly improved, and expenditures and contingent liabilities are much more carefully controlled and accounted for. The fiscal deficit decreased to sustainable levels. Pensions were made more sustainable and social assistance rationalized. Privatization practices were substantially improved, which in view of past concerns was a major accomplishment. Accounting and auditing practice was aligned with IAS and EU practice. Power sector management was moved to a commercial basis. Agricultural subsidies were attenuated and made consistent with EU practice. All of this assisted GDP growth and substantially improved the country's creditworthiness.

Lithuania's economic reforms supported by the SAL played a major role in positioning Lithuania for EU membership in 2004.

### **5. Significant Shortcomings (including non-compliance with safeguard policies):**

There was one significant shortcoming, but, for completeness, two additional issues are noted here. The significant shortcoming was that Lithuania Gas has not been privatized as foreseen in line with a pro -competitive model. Although privatization arrangements are not yet complete, it appears likely that GAZPROM, the supplier, will be a substantial owner, which SAL conditionality was aimed at averting. This may limit the downward pressure on prices which would have otherwise been expected from reforms. However, this model is similar to that which obtained in

Latvia and Estonia, suggesting that the SAL's objective may not have been realistic, or, at a minimum, that a great deal more work towards mobilizing broad support for the SAL model was required .

Implementation of two other reforms did not occur as foreseen, but were nevertheless effectively addressed . 1. During project implementation, agricultural subsidies were not reduced as foreseen . However, these subsidies were substantially reduced after the loan closed (see Section 3 above). 2. The Bank has originally sought the privatization of LPC's distribution network, but since it is now unbundled and functioning profitably on a commercial basis, the objective represented by this condition was deemed as met with enhanced prospects for privatization in the future .

At the end of May, 2002, in view of the lack of agreement on LG privatization and concerns about agricultural pricing (which were later resolved), and in view of the Government's improved access to commercial credit markets which allowed it to borrow quite competitively and improved fiscal management which reduced the need for external funding, the Government requested the cancellation of the second tranche .

6. Ratings :	ICR	OED Review	Reason for Disagreement /Comments
<b>Outcome :</b>	Satisfactory	Satisfactory	
<b>Institutional Dev .:</b>	Substantial	Substantial	
<b>Sustainability :</b>	Highly Likely	Highly Likely	
<b>Bank Performance :</b>	Satisfactory	Satisfactory	
<b>Borrower Perf .:</b>	Satisfactory	Satisfactory	
<b>Quality of ICR :</b>		Satisfactory	

**NOTE:** ICR rating values flagged with '\*' don't comply with OP/BP 13.55, but are listed for completeness.

#### 7. Lessons of Broad Applicability:

1. As noted in the ICR, in view of difficulties encountered in implementing the privatization of LG, it may be appropriate to undertake a systematic review of privatization of infrastructure and other enterprises operating in highly imperfect markets with the objective of developing guidelines to assist task managers and Bank management in designing appropriate conditions and implementation strategies . 2. Continuity in the task team is important. Task leadership passed through three persons, with inadequate overlap in the field . Because task leaders were well-qualified and the resident mission played an important role in implementation, the dangers of this lack of continuity did not materialize in this case, but the Bank should not count on this good fortune in other exercises . 3. Resident missions should play an important role in implementation of complex adjustment operations, as was the case in this instance. 4. SALs can have an important impact on institutional development when they are combined with ongoing investment operations and supporting technical assistance including from other donors . In this case, EU-PHARE, USAID, and other donors played an important role in institutional development, as did the Bank's other projects in private sector development, energy /power sector reform, and financial sector development .

**8. Assessment Recommended?** ☐ Yes ☒ No

#### 9. Comments on Quality of ICR:

The ICR does an excellent job of explaining and analyzing a complex adjustment operation . It provides the reader with a clear statement of objectives and a detailed yet very readable description of implementation challenges and accomplishments. This is especially noteworthy given the large number of conditions in the SAL and the diverse problems which the SAL addressed. The ICR would have merited a rating of exemplary, except that it is too long to serve as a model for other ICRs. Some of the explanatory information might have been included in additional annexes.