NATIONAL AUDIT OFFICE OF LITHUANIA

To the Seimas of the Republic of Lithuania

OPINION ON THE COMPLIANCE WITH THE FISCAL DISCIPLINE RULES OF MUNICIPAL BUDGETS DURING 2021–2022

2 June 2022 No BPE–5

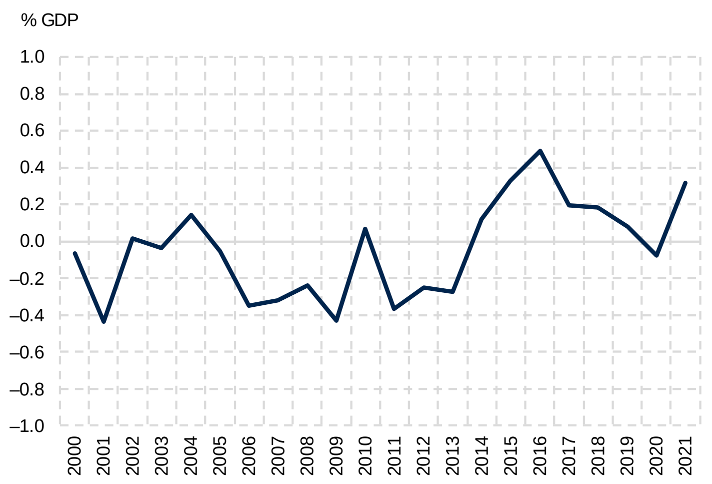
Vilnius

The National Audit Office, implementing the functions of the fiscal institution (hereinafter – Fiscal Institution in the NAO), in accordance with the Constitutional Law on the Implementation of the Fiscal Treaty of the Republic of Lithuania (hereafter referred to as the Constitutional Law), submits its opinion on the assessment of the compliance with the fiscal discipline rules of municipal budgets attributed to the general government to the Seimas.

The objective of the performed assessment is to provide an opinion on whether the fiscal discipline rules laid down in the Constitutional Law were adhered during the adoption of the 2022 municipal budgets attributed to the general government. The Opinion also provides an *ex-post* assessment of municipalities to provide an opinion on whether the 2021 municipal budgets were implemented in accordance with the fiscal discipline rules.

The assessment of 2021 *ex-post* and 2022 *ex-ante* compliance of municipal budgets with the fiscal discipline rules shows that the rules were complied with. In accordance with Article 4(2) and (4) of the Constitutional Law, two groups of municipalities were analysed: those for which the approved appropriations exceed 0.3% of GDP in the preceding year at current prices and those for which the appropriations do not exceed this threshold. Municipalities' compliance with the fiscal discipline rules is

Figure 1. Dynamics of the local government sub-sector balance

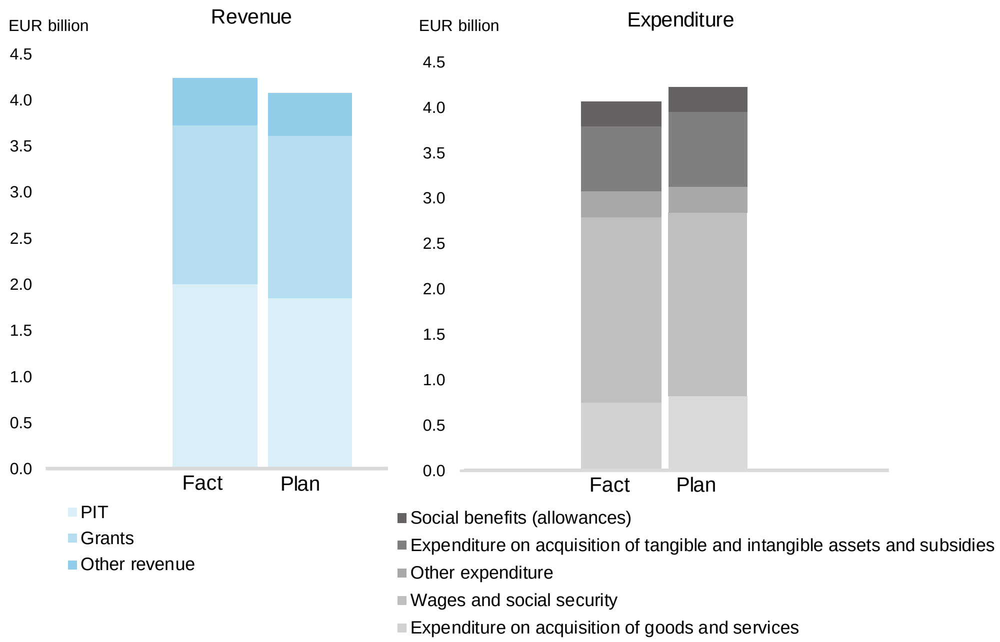


Source: Statistics Lithuania, calculations of the Fiscal Institution in the NAO assessed by taking into account the level of the output gap. More information on the assessment is provided in Annex 1 of the Opinion.

In 2021, the surplus of the local government sub-sector was one of the highest since 2000 (Figure 1). The local government surplus amounted to EUR 174.3 million, or 0.3% of GDP. In October 2021, when the draft state and municipal budget for 2022 was presented, a deficit of 0.1% of GDP was projected for the local government sub-sector.

This surplus was due to the fact that in 2021, municipal budgets received more revenue and spent less than foreseen[1] (Figure 2). The largest share of municipal revenue comes from personal income tax. This tax was almost 8% (or EUR 140.5 million) higher than expected due to rapid wage growth. The grants received amounted to around EUR 50.0 million less than planned. Out of the planned expenditure in 2021, EUR 237.0 million remained unused, mainly due to lower expenditure on the acquisition of tangible and intangible assets (EUR 112.8 million) and goods and services (EUR 74.6 million).

Figure 2. Actual revenue and expenditure of 2021 municipal budgets compared to the plan at the end of 2021

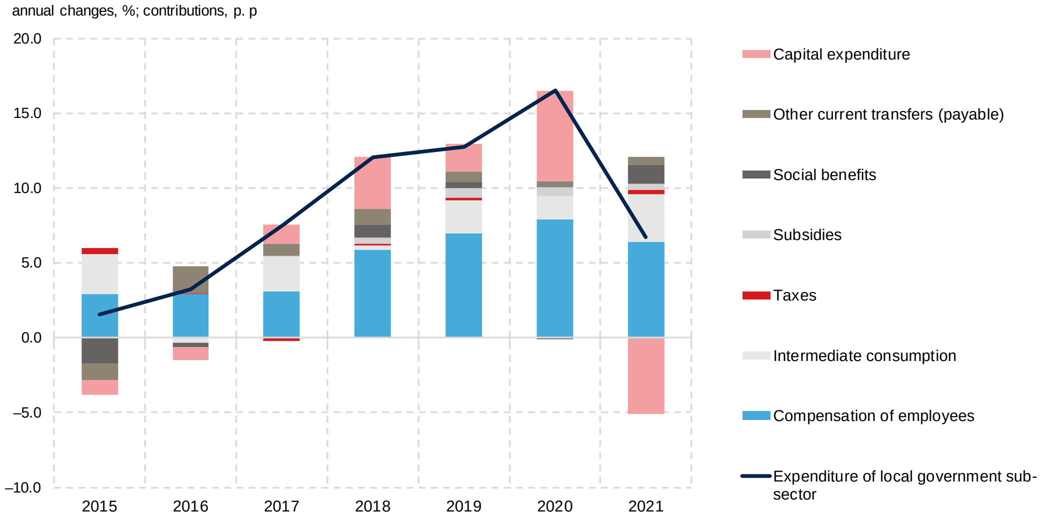


Source: www.lietuvosfinansai.lt, calculations of the Fiscal Institution in the NAO

Capital expenditure had a significant impact on the dynamics of local government sub-sector expenditure over the 2020-2021 period (Figure 3). In 2020, capital expenditure grew by 40.6%, largely due to the measures implemented against COVID-19. In 2021, capital expenditure decreased by almost 30% due to a smaller economic stimulus package and the base effect. This dynamic was driven both by higher prices in the construction sector and prolonged procurement procedures. Over the year, total expenditure in the local government sub-sector grew by 6.7%, down by 9.8 p.p. compared to 2020.

[1] Comparison is made between the data of execution of municipal budgets and their updated plans at the end of 2021. Internet access: https://ataskaitos.lietuvosfinansai.lt/selfserv/sense/app/0baa01af-3d48-444d-982d-bda42142a93a/overview.

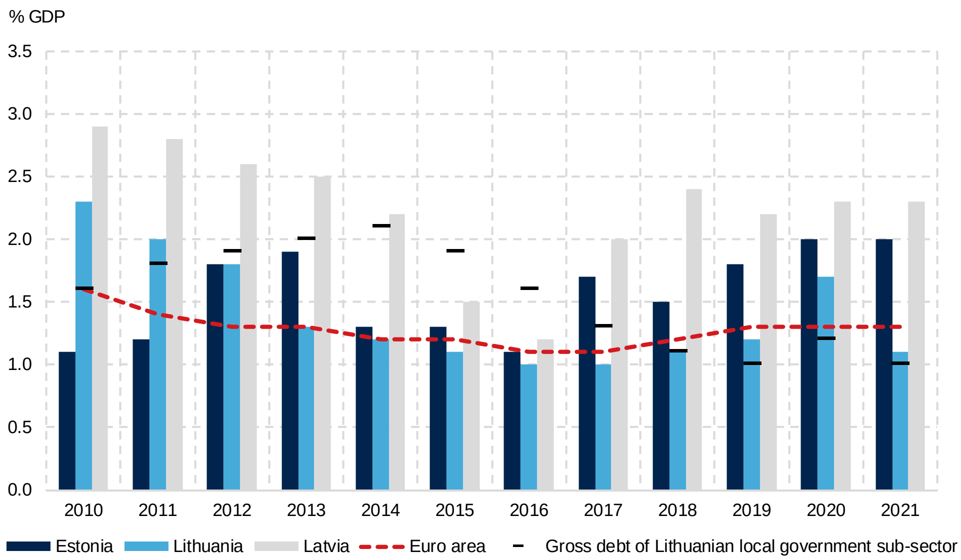
Figure 3. Growth of expenditure in the local government sub-sector and its contributions



Source: Statistics Lithuania, calculations of the Fiscal Institution in the NAO

The level of gross fixed capital formation (investments) in the local government sub-sector in Lithuania is below the euro area average and remains the lowest among the Baltic States (Figure 4). Local government investment is an important driver of regional development, which can attract both domestic and foreign capital and develop the local labour market. Although strong regional growth is one of the Government's priorities as Lithuania's economy converges towards the most developed countries, local government investment in Lithuania accounted for 35.5% of total public investment in 2021, compared to 44.1% in the euro area. There is also a trend for local government expenditure on gross fixed capital formation (GFCF) to GDP to remain below the euro area average since 2015 (with the exception of 2020, which recorded a sharp increase due to the COVID-19 one-off measures). In 2021, local government expenditure on GFCF in Lithuania, Latvia, Estonia and the euro area amounted to 1.1%, 2.3%, 2.0% and 1.3% of GDP respectively.

Figure 4. Expenditure of the local government sub-sector on gross fixed capital formation



Source: Eurostat, calculations by the Fiscal Institution in the NAO

In the Organisation for Economic Co-operation and Development's 2021 assessment[2] it is noted that a cross-country comparison shows a link between local government investment and debt. It should be noted that, even without possible additional borrowing, local government of Lithuania have been in surpluses in recent years, and the full flexibility allowed by fiscal discipline rules has not been fully used. However, if borrowing possibilities were to be expanded in order to stimulate public investment by local governments, it must be ensured that this would not endanger fiscal sustainability. Ensuring the reliability of municipal financial data and the introduction of an automatic debt correction mechanism in case of risks to the sustainability of public finances are important to this end. In the European Commission's Communication to the Council of 2 March 2022 it is pointed out[3] that medium-term fiscal plans should include provisions on promoting and sustaining nationally-funded, high-quality public investment.

The National Audit Office of the Republic of Lithuania, implementing its functions of the budget policy monitoring institution, is responsible for the monitoring of the compliance with fiscal discipline rules established in the Constitutional Law on the Implementation of the Fiscal Treaty of the Republic of Lithuania[4]*, as well as for monitoring the implementation of the assignments and is authorised to prepare and present independent opinions to the Seimas of the Republic of Lithuania on the compliance with fiscal discipline rules and macroeconomic developments.*

This opinion is accompanied by ex-post and ex-ante municipal fiscal discipline compliance spreadsheets.

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Deputy Head of Department Jaroslav Mečkovski

[2] Increasing municipal public investment in Lithuania. Ensuring quality while maintaining financial sustainability. Internet access: https://lrv.lt/lt/naujienos/ebpo-lietuvos-vyriausybei-regionine-pletra-yra-vienas-is-svarbiausiu-politikos-prioritetu.

[3] Internet access: https://eur-lex.europa.eu/legal-content/LT/TXT/PDF/?uri=CELEX:52022DC0085&from=EN.

[4] Constitutional Law on the Implementation of the Fiscal Treaty. Internet access: https://e-seimas.lrs.lt/portal/legalAct/lt/TAD/6be2c020699a11e48710f0162bf7b9c5.

ANNEXES

Opinion
On the Compliance With the Fiscal Discipline Rules of Municipal Budgets During 2021–2022
Annex 1

Assessment of the compliance with fiscal discipline rules

Ex-post assessment

When assessing the *ex-post* compliance with the fiscal discipline rules of municipalities for the year 2021, the actual data from their budget execution accounts were analysed. Since the estimated output gap for 2021 was positive[5], the budgets of 56 municipalities (all except Kaunas, Klaipėda, Šiauliai and Vilnius cities) had to be implemented in such a way that allocations did not exceed revenues. The municipal budgets of Kaunas, Klaipėda, Šiauliai and Vilnius cities had to be implemented in such a way that they were either in surplus or in balance according to the structural balance indicator on accrual basis. In 2021, all municipal budgets were implemented in accordance with the rules of the budgets attributed to the general government.

Ex-ante assessment

As regards the *ex-ante* assessment of the 2022 budgets approved by the municipal councils according to the Law on Budget Structure, the municipal councils had to approve these budgets within two months after the approval of the State budget and the financial indicators[6] of the municipal budgets. As a result, when adopting their initial budget plans, the municipal councils could not yet take into account the threat of war in Ukraine and the potential additional costs of aid to war migrants from Ukraine. During the year, municipalities adjust their budgets by taking into account possible expenditure and revenue. The actual compliance of municipalities with the fiscal discipline rules in their 2022 budgets will be assessed in the first half of 2023.

Since the estimated output gap for 2022 is negative[5], the budgets of 56 municipalities (all except Kaunas, Klaipėda, Šiauliai and Vilnius cities) should have been planned in such a way that appropriations would not exceed revenue by more than 1.5%. In the municipal budget plans of Kaunas, Klaipėda, Šiauliai and Vilnius cities, expenditure may have been reported as exceeding revenue, thus resulting in a nominal deficit the size of a municipality's cyclical component. All 2022 primary municipal budgets were planned in accordance with the rules of the budgets attributed to the general government.

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[5] In the 31/03/2022 Communication from the Ministry of Finance On the Potential Gap Between Gross Domestic Product and Output Gap During 2021–2025, the estimated output gap for 2021–2022 were 0.4 and 0.7 p.p. of GDP. Internet access: https://finmin.lrv.lt/uploads/finmin/documents/files/Prane %C5%A1imas%20d%C4%97l%20potencialaus%20202203.pdf.

[6] Law on the Approval of Financial Indicators of the State Budget and Municipal Budgets for 2022 was adopted on 14/12/2021. Internet access: https://e-seimas.lrs.lt/portal/legalAct/lt/TAD/dec7de105f2211ecb2fe9975f8a9e52e?jfwid=yerqn2tbx.