BUDGET POLICY MONITORING

To the Seimas of the Republic of Lithuania

OPINION ON THE COMPLIANCE WITH THE FISCAL DISCIPLINE RULES OF MUNICIPAL BUDGETS DURING 2022–2023

30 May 2023 No BPE–3

Vilnius

MUNICIPALITIES RISK THEIR ABILITY TO INVEST BY FAILING TO ENSURE THE RELIABILITY OF THEIR FINANCIAL STATEMENTS AND COMPLIANCE WITH FISCAL DISCIPLINE RULES

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 (hereinafter – Constitutional Law), submits its opinion on the assessment of the compliance with the fiscal discipline rules (hereinafter – FDR) of municipal budgets attributed to the general government to the Seimas.

Fiscal discipline rules of municipalities, which are part of the general government sector, contribute to the sustainability of public finances. The *ex-ante* assessment of the Fiscal Institution in the NAO aims to identify the risks of non-compliance with the FDR, and to enable the municipalities to assess and, if necessary, to adjust their budgets before the end of the current year in order to avoid non-compliance at the time of the *ex-post* assessment. The initial budget adopted by the Council of one municipality in 2023 does not comply with its requirements. There is also a problem with the reliability of the data – the assessment shows that not all the information provided is accurate. The analysis shows that the balances of municipalities tend to be better than planned since revenue and expenditure plans differ significantly from their implementation. The amendments to the Constitutional Law give municipalities more flexibility to promote investment. In order to ensure the sustainability of public finances and the growth of municipal investment, municipalities need to address data reliability issues.

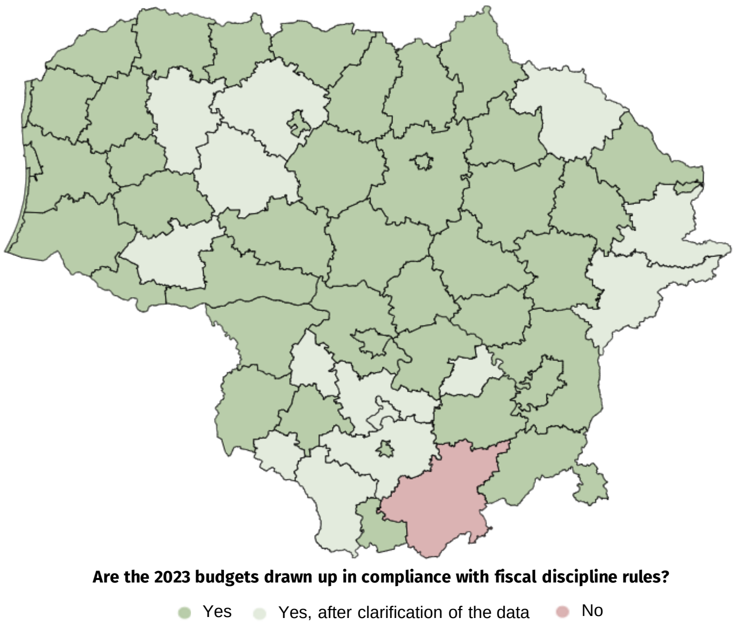
1. **According to the planned municipal budgets for 2023, there is a risk that one municipality will not comply with its fiscal discipline rule**
2. **The reliability of the municipalities' financial statements is not ensured: if the assessment was based on not clarified data, the number of non-compliant municipalities would rise to 15 if the assessment was based on not clarified data**
3. **In recent years, municipal budget balances have been better than planned and cautious municipal revenue planning has contributed to compliance with fiscal discipline rules in 2022**
4. **To encourage investments, legal changes to fiscal discipline, which have entered into force in 2023, expand borrowing capacity of municipalities**

1. ACCORDING TO THE PLANNED MUNICIPAL BUDGETS FOR 2023, THERE IS A RISK THAT ONE MUNICIPALITY WILL NOT COMPLY WITH ITS FISCAL DISCIPLINE RULE

According to the Law on Budget Structure, municipal councils had to approve their budgets for 2023 within two months of the adoption of the Law on Financial Indicators of the State Budget and Municipal Budgets for the current year. During the year, municipalities adjust their budgets. As part of the *ex-ante* evaluation, the Fiscal Institution in the NAO analysed the initial budgets approved by the municipal councils. The actual compliance of municipalities with the fiscal discipline rules in their 2023 budgets will be assessed in the first half of 2024.

Not all municipalities' budgets for 2023 comply with their requirements. In accordance with Article 4(2) and (4) of the Constitutional Law, when the output gap is negativel[1], the municipalities of Vilnius, Kaunas, Klaipėda and Šiauliai cities were allowed to plan for a deficit of the cyclical component[2], while the remaining municipalities were obliged to ensure that their appropriations did not exceed their revenues by more than 1.5%. The information of the municipalities' financial statements, the clarified information on the unused part of accrued revenue and appropriations for international assistance co-financing, both of which was requested by the Fiscal Institution in the NAO[3], was used for the assessment. According to this data, there is a risk that 1 municipality out of 60 will not comply with the fiscal discipline rule, as the planned deficit is higher than allowed by the regulations (Figure 1). A detailed assessment of the rules can be found in the *MS Excel* spreadsheet provided with the opinion.

Figure 1. There is a risk that 1 municipality will not comply with its fiscal discipline rule in 2023



Source: www.lietuvosfinansai.lt, Public Sector Accounting and Reports Consolidation Information System, data submitted to the Ministry of Finance and clarified data from municipalities, calculations by the Fiscal Institution in the NAO

[1] In the 21/12/2022 Communication from the Ministry of Finance on the potential gap between gross domestic product and output gap during 2023–2026, the estimated output gap for 2023 reached 2.5 p.p. of GDP. Internet access: https://finmin.lrv.lt/uploads/finmin/documents/files/Pranesimas_del_potencialaus_2022_gruodis.pdf.

[2] Cyclical budget component – an indicator expressed in monetary units and showing the impact of output gap on the municipality balance indicator over the reporting period. The estimates used for this indicator can be found on the Ministry of Finance website. Internet access: https://finmin.lrv.lt/lt/veiklos-sritys/fiskaline-politika/informacija-savivaldybems-sodrai-ir-psdf/savivaldybiu-sodros-psdf-biudzetu-cikliniu-komponenciu-dydziai.

[3] On 16/05/2023, the municipalities were informed of the risk of non-compliance with the FDR and asked to inform the Fiscal Institution in the NAO about possible data discrepancies. The last municipal revisions were submitted and included in the assessment on 25/05/2023.

2. THE RELIABILITY OF THE MUNICIPALITIES' FINANCIAL STATEMENTS IS NOT ENSURED: IF THE ASSESSMENT WAS BASED ON NOT CLARIFIED DATA, THE NUMBER OF NON-COMPLIANT MUNICIPALITIES WOULD RISE TO 15

According to the financial statements, 15 municipalities' budgets for 2023 are not in line with fiscal discipline rules. The number of non-compliant municipalities has been reduced to 1 after taking into account additional information provided by the municipalities. For the assessment, the Fiscal Institution in the NAO uses data from the reports submitted by the municipalities to the Ministry of Finance. Municipalities that were initially assessed as non-compliant with the fiscal discipline rules were asked to revise their data when it was noted that the information provided might not be accurate. Including clarified information from 15 municipalities, the calculations show that 14 of them nevertheless complied with fiscal discipline rules. The accuracy of the filing of the financial accounts should also be brought to the attention of those municipalities which, in the initial assessment, complied with the fiscal discipline rules, In order to avoid similar errors later on. Importantly, the *ex-post* evaluation will only use the unused part of accrued revenue that has been earmarked for appropriations, i.e. its annual changes, and not the total unused part.

The reliability of financial statements is not ensured. The analysis revealed that most of the municipalities initially assessed as non-compliant with the fiscal discipline rules did not provide data on the unused part of accrued revenue or provided incorrect data in their budget implementation reports to the Ministry of Finance. In 2019[4], the Fiscal Institution in the NAO has already highlighted the lack of coordination, internal control and clear rules for the completion of the revenue and expenditure accounts. Following the entry into force of the amendments to the Constitutional Law in 2023, municipalities were informed about the data needed to assess compliance with fiscal discipline rules. The forms used for the assessment are available from January 2023 onwards in the municipal fiscal discipline rules compliance spreadsheet on the National Audit Office website, which is regularly updated[5]. The Ministry of Finance has published a Frequently Asked Questions and Answers section[6]. It should be noted that, despite the changes in the law, the information on the unused part of the revenue required for the valuation on line 105 of Form 1-sav has not been changed.

The purpose of the *ex-ante* evaluation carried out by the Fiscal Institution in the NAO is to help municipalities to assess their budget data for compliance with the FDR. Municipalities have the possibility to adjust their budgets before the end of the current year. It should be noted how important it is for municipal administrations and their control and audit services to ensure the accuracy of the information provided in the reports. In future, only the data officially submitted by municipalities to the Ministry of Finance will be used for *ex-ante* and *ex-post* assessments.

[4] 04/07/2019 assessment of the compliance with the fiscal discipline rules in 2019 municipal budgets. Internet access: https://www.valstybeskontrole.lt/EN/Product/23853/key-messages-from-the-assessment-of-the-compliance-with-the-fiscal-discipline-rul.

[5] Budget monitoring section of the government control budget, information for municipalities. Internet access: https://www.valstybeskontrole.lt/TVS/Content/Biudzeto_stebesena/FDT_skaiciuokle_savivaldybems.xlsx.

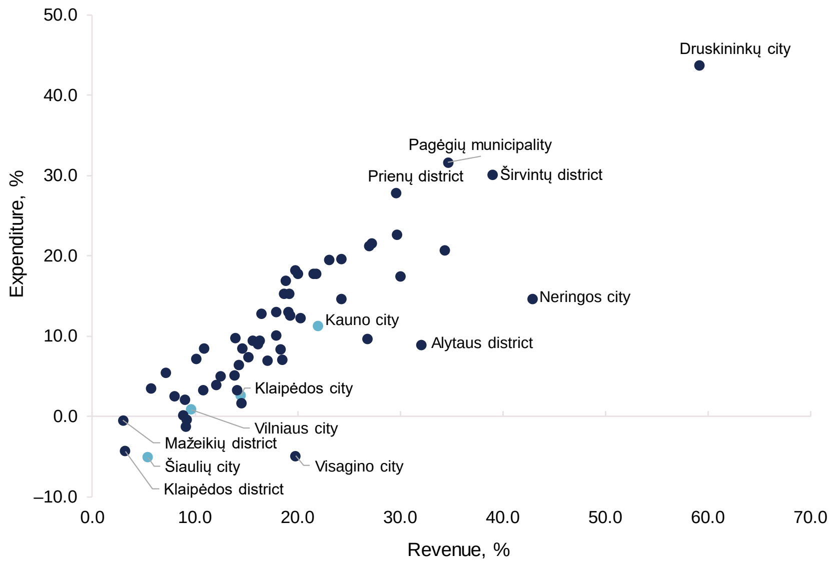
[6] Ministry of Finance, FAQs asked by municipalities. Internet access: https://finmin.lrv.lt/lt/veiklos-sritys/savivaldybiu-duk.

3. IN RECENT YEARS, MUNICIPAL BUDGET BALANCES HAVE BEEN BETTER THAN PLANNED AND CAUTIOUS MUNICIPAL REVENUE PLANNING HAS CONTRIBUTED TO COMPLIANCE WITH FISCAL DISCIPLINE RULES IN 2022

In 2022, all municipalities complied with their fiscal discipline rules. As the municipal budgets of the cities of Vilnius, Kaunas, Klaipėda and Šiauliai had positive budget balances and the appropriations of the other municipalities did not exceed their revenues by more than 1.5%, the budgets of all the municipalities in 2022 were implemented in accordance with the rules on general government budgets[7]. The balance of the local government subsector was positive and reached 0.2% of GDP in 2022, notwithstanding the fact that the negative estimate of the output gap[8] could have led to municipalities running deficits.

Most municipalities' actual revenues and expenditures are above the initial budgets approved by the municipal councils. Comparing municipal budgets for 2019–2022, actual revenues on average exceed their plan by 18.8% and expenditure by 10.8%.[9] (Figure 2). As a result, most municipalities usually run smaller deficits or have budget surpluses. According to the assessment of the Fiscal Institution in the NAO, at least half of the higher revenue is due to grant income and personal income tax (PIT). In recent years, higher-than-forecasted wage growth has led to a higher share of PIT revenue being transferred to municipalities than was approved in the Law on Financial Indicators of the State Budget and Municipal Budgets of the Republic of Lithuania for the respective year. Similarly, municipal budgets typically raise more their own income than planned, but at a lower level than the above-mentioned sources of revenue from PIT or grants. In interpreting these figures, it should be noted that this period includes three years of exceptional circumstances.

Figure 2. Between 2019 and 2022 municipalities' actual revenues and expenditures were significantly higher than those approved in the municipal councils' initial budgets



Average deviation of municipalities' actual revenue and expenditure from revenue and expenditure plans for 2019–2022. A more detailed analysis for each year is provided in Annex 1.

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

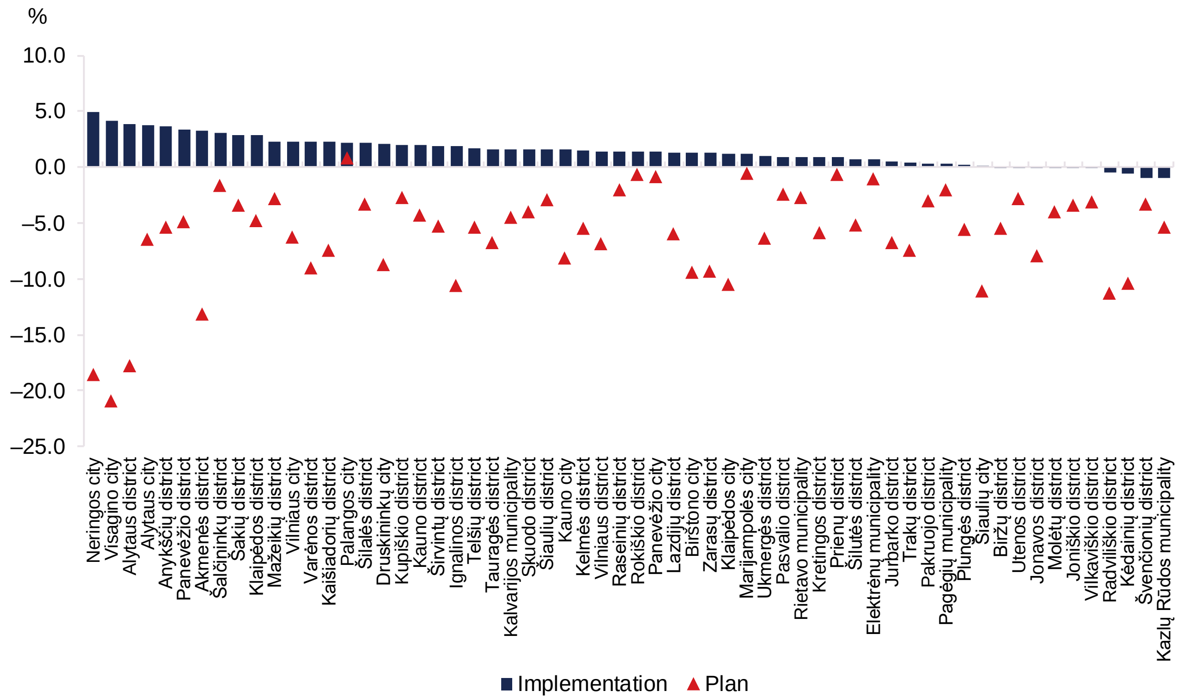
[7] A detailed assessment of compliance can be found on the web page in the *MS Excel* workbook accompanying this opinion. Internet access: https://www.valstybeskontrole.lt/EN/BudgetPolicyMonitoring.

[8] In the 24/03/2023 Communication from the Ministry of Finance on the Potential Gap Between Gross Domestic Product and Output Gap During 2022–2026, the estimated output gap for 2022 were 0.4 p.p. of GDP. Internet access: https://finmin.lrv.lt/uploads/finmin/documents/files/Pranesimas_del_potencialaus_2023_kovas.pdf.

[9] By comparison, the state budget for 2019–2022 was 0.8% lower in revenue than approved in the original laws and 3.9% higher in expenditure. Excluding EU funds, revenue is up by 2.7% and expenditure by 10.7%.

Actual revenue growth outpaced expenditure, resulting in better-than-expected municipal budget balances. When comparing planned deficits to actual deficits for 2019–2022, actual surpluses prevailed in almost all municipalities (Figure 3). It is also notable that in most municipalities, the unused part of revenue has increased since 2019. For example, in 2022, the total unused part of municipalities' revenue was EUR 85.6 million higher than in 2021. It is worth noting that the data for the unused part of revenue have fluctuated considerably during the period 2019–2022. This raises questions, as the data sometimes show that the unused part of revenue has decreased or does not exist when the municipality had a budget surplus. The plans sometimes show a higher share of unused revenue than the year before, even though the municipality plans a budget deficit. The unused part of the revenue is added to municipal revenue when assessing the compliance with the FDR, thus improving municipal balances.

Figure 3. In 2019–2022, actual budget surpluses prevailed instead of planned deficits in municipal budgets



Municipalities' actual and planned balance sheets are compared with actual and planned revenue. Analysis for each year is provided in Annex 2.
Source: www.lietuvosfinansai.lt, calculations of the Fiscal Institution in the NAO

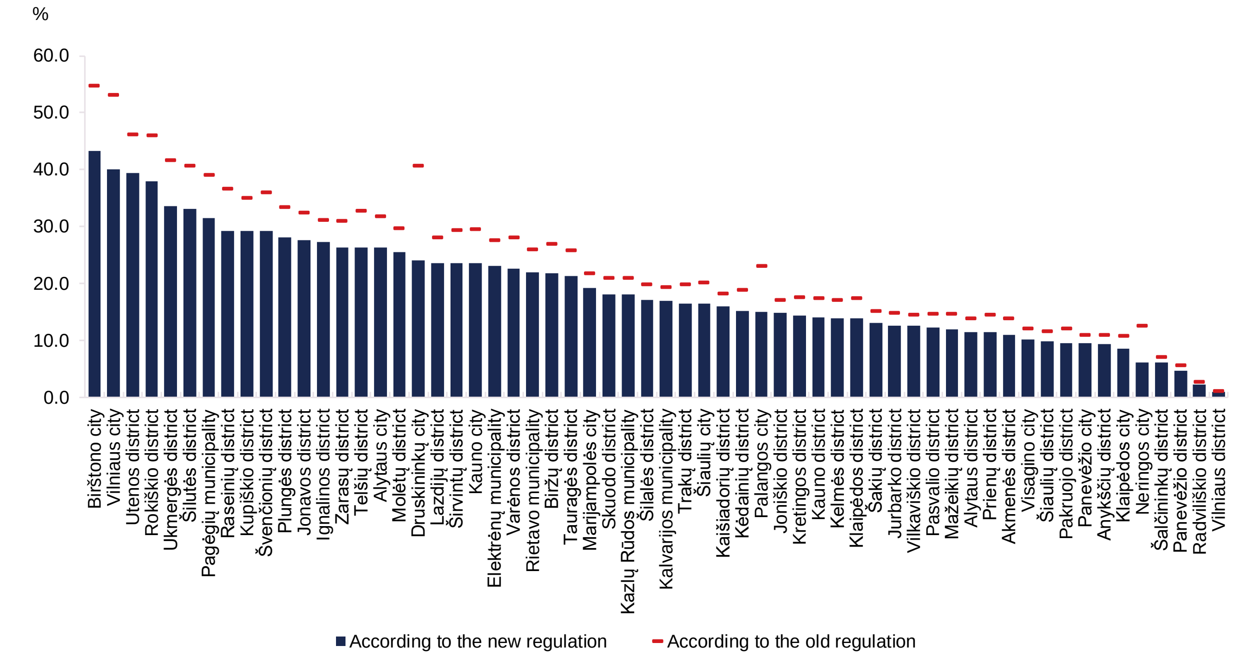
4. TO ENCOURAGE INVESTMENTS, LEGAL CHANGES TO FISCAL DISCIPLINE, WHICH HAVE ENTERED INTO FORCE IN 2023, EXPAND BORROWING CAPACITY OF MUNICIPALITIES

Changes to the Constitutional Law, which have entered into force in 2023, provide more borrowing opportunities. In the Law on Approval of Financial Indicators of the State Budget and Municipal Budgets of the Republic of Lithuania, the debt-to-revenue ratio was calculated on the basis of the projected PIT, but according to the amendments of the Constitutional Law, on the basis of the total municipality revenues. The debt-to-revenue ratio used to calculate the municipal debt limit[10] under the amended Constitutional Law would have been around 19.0% in 2021, compared to 23.0% under the regulation prior to amendments. The municipalities with the highest own revenue collection are the resort

[10] Municipal debt cannot exceed 60% (75% in Vilnius).

municipalities of Birštonas, Druskininkai, Palanga and Neringa. This is also the reason for the largest expansion of borrowing by these municipalities (Figure 4).

Figure 4. Illustration of the extension of municipal borrowing capacity based on 2021 data



Source: www.lietuvosfinansai.lt, Public Sector Accounting and Reports Consolidation Information System, calculations of the Fiscal Institution in the NAO

The amendments to the Constitutional Law extending the application of the flexibility rule leave room for municipalities to correct the resulting deviations from the non-compliance with the fiscal discipline rule. According to the amended Constitutional Law, appropriations and revenues for all municipalities are assessed on an accrual basis. In addition, there is the possibility of contributing to revenue the accumulated unused part of the revenue from all previous years, and appropriations can be increased by co-financing from the EU and other international financial assistance. Such extension of the flexibility rule gives municipalities more fiscal space when drawing up their budgets for the current year. In addition, there is a possibility to correct the deviation of non-compliance with the FDR within a two-year period. However, the flexibility rule no longer applies once the debt level set in the Budget Law is exceeded. The application of the flexibility rule is particularly relevant for accessing a wider range of investment opportunities.

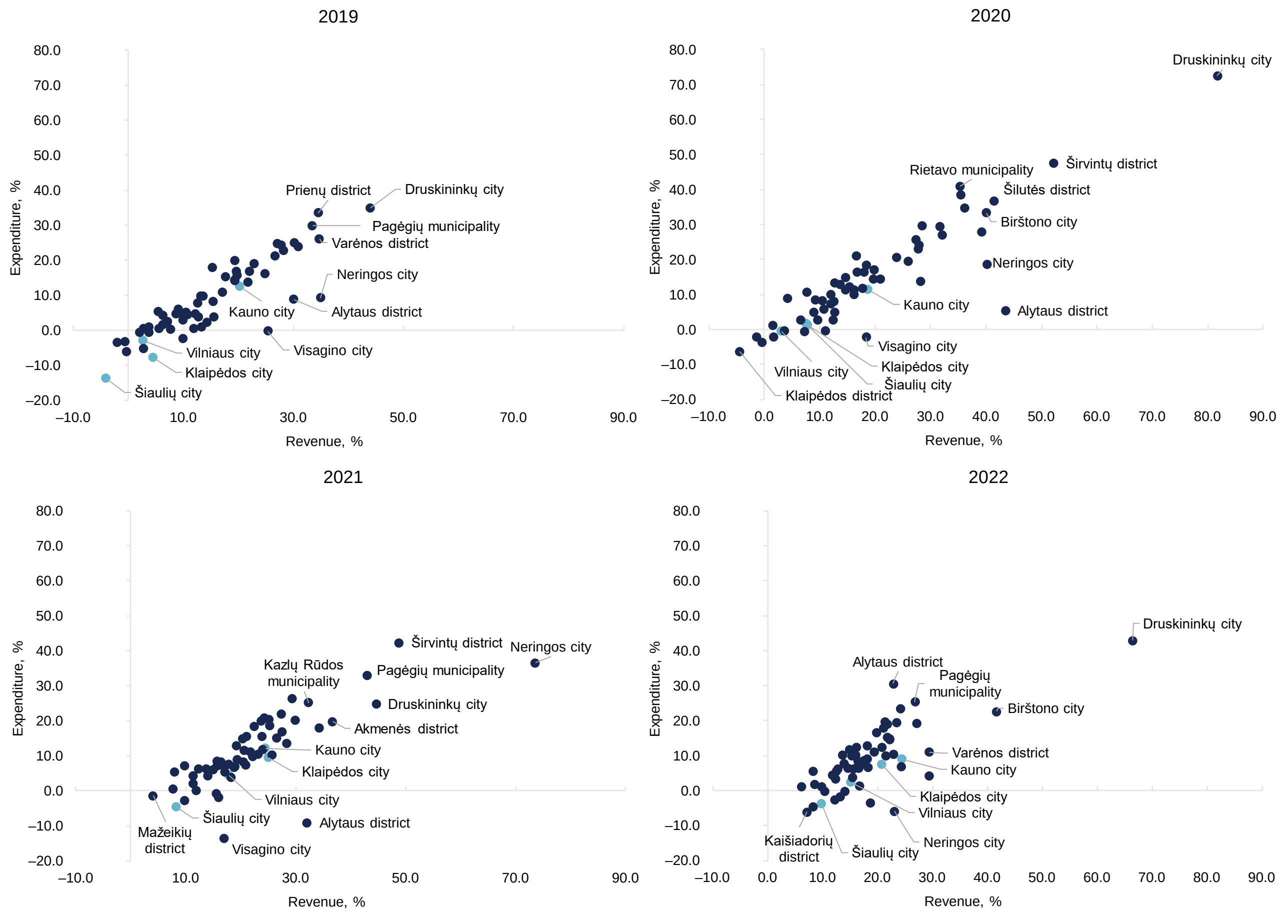
The National Audit Office, implementing its functions of the budget policy monitoring institution, is responsible for the monitoring of the compliance with fiscal discipline rules established in the Constitutional Law on the Implementation of the Fiscal Treaty of the Republic of Lithuania, as well as 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. Pursuant to Article 4(2)(4)(5)(6)(7) of the Constitutional Law on the Implementation of the Fiscal Treaty of the Republic of Lithuania and Point 7 of Article 8(7) of the Law on National Audit Office, the National Audit Office submits its opinion to the Seimas of the Republic of Lithuania.

Head of Budget Monitoring Department Jurga Rukšėnaitė

ANNEXES

Opinion
On the Compliance with the fiscal discipline rules of municipal budgets during 2022–2023
Annex 1

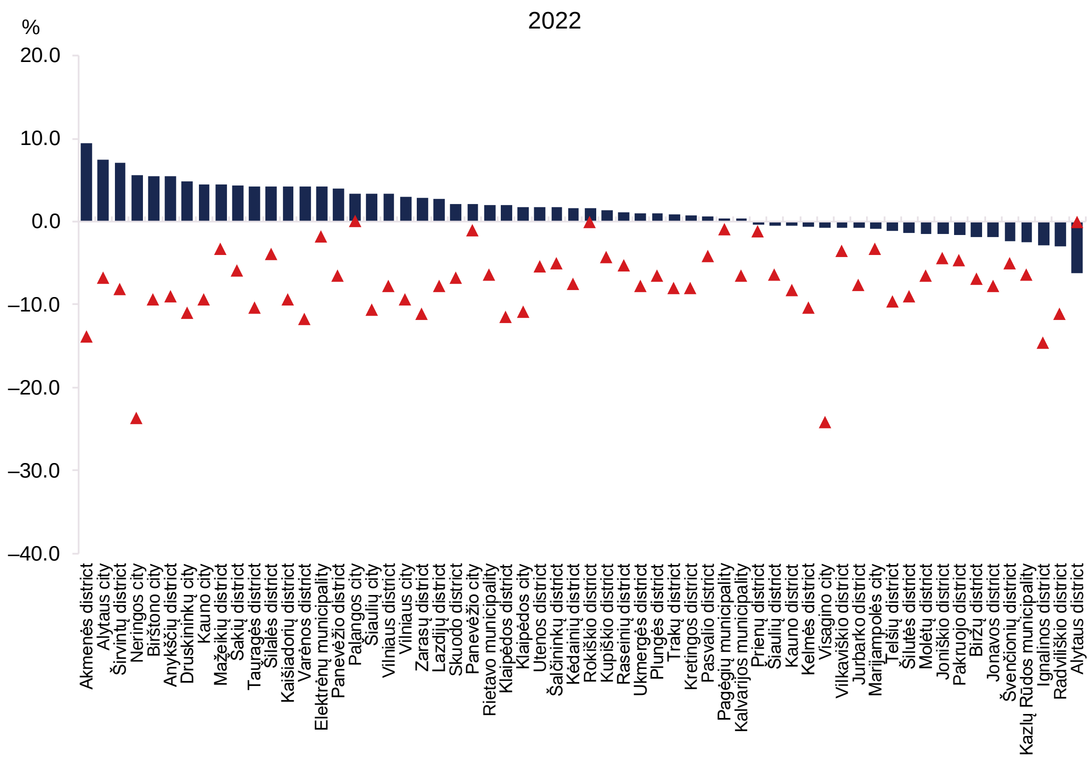
DEVIATIONS OF ACTUAL REVENUE AND EXPENDITURE FROM REVENUE AND EXPENDITURE PLANS

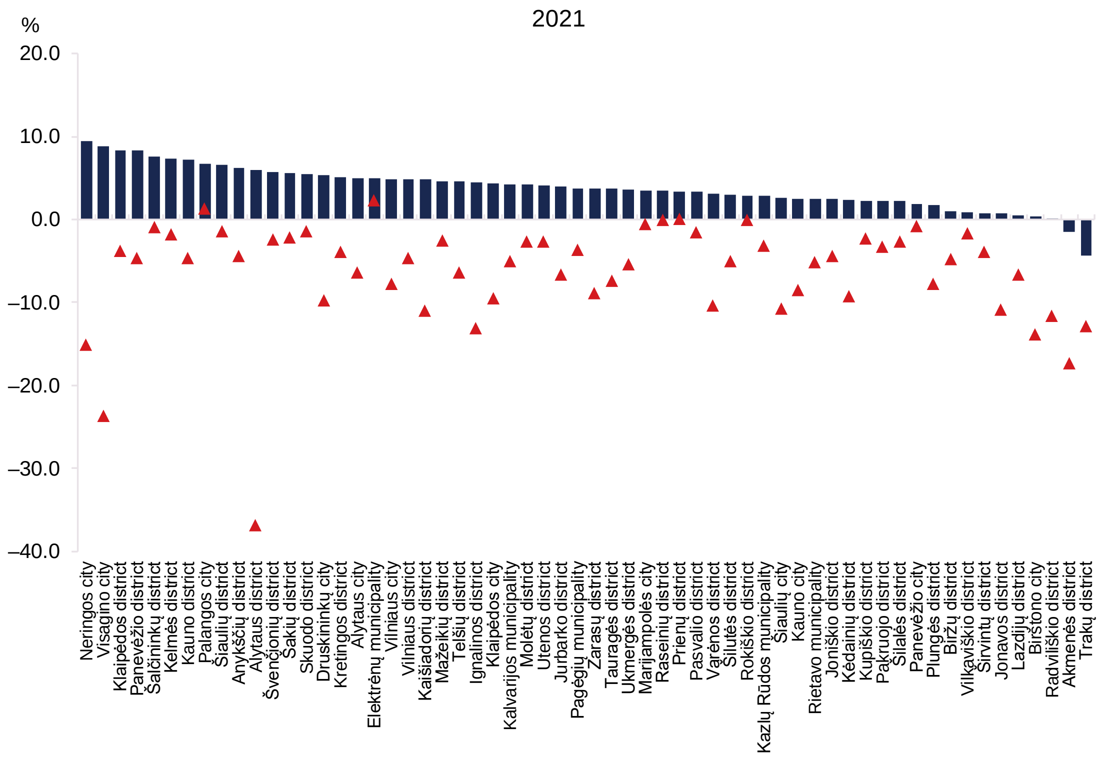


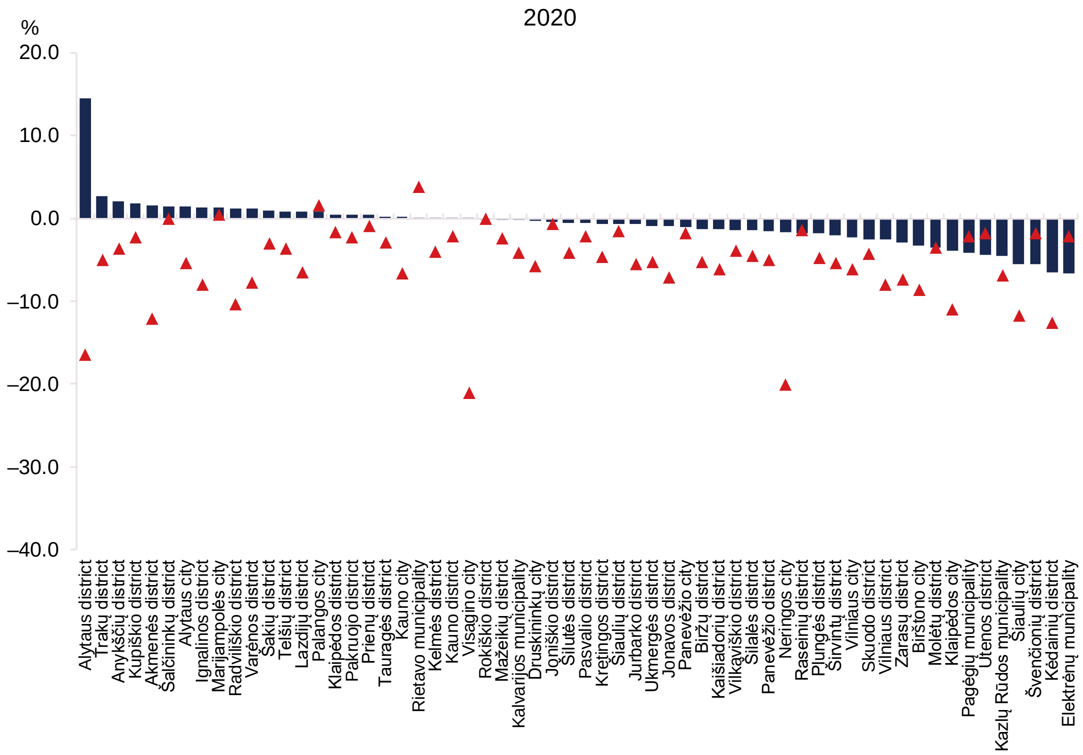
Source: www.lietuvosfinansai.lt, calculations of the Fiscal Institution in the NAO

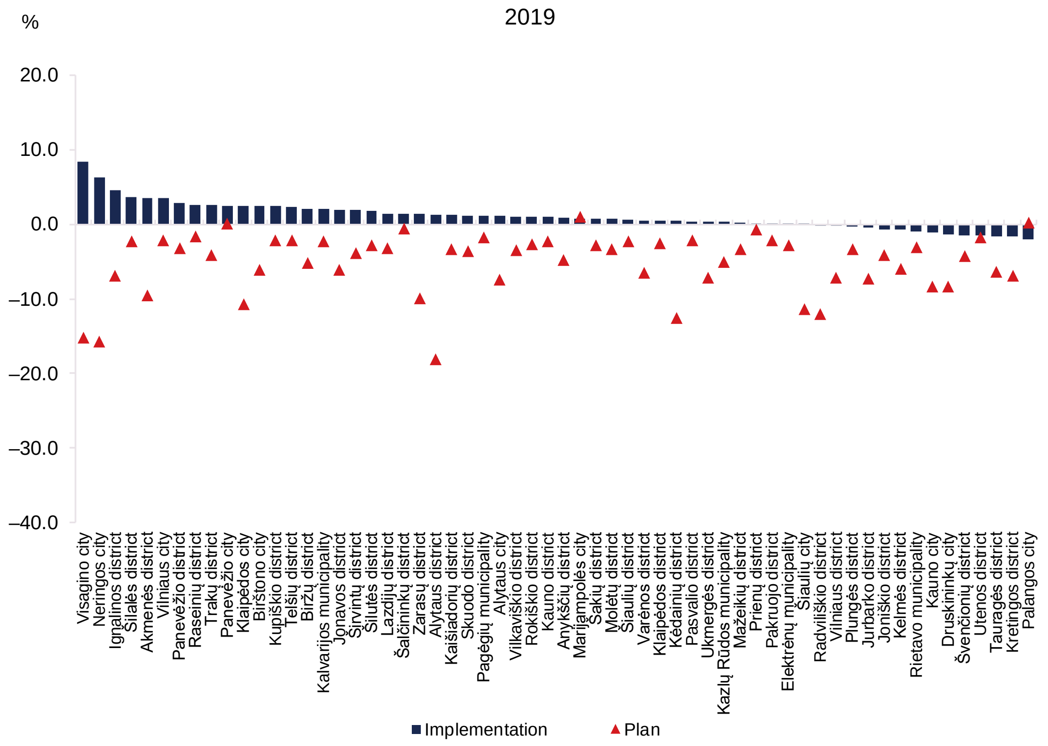
Opinion
On the compliance with the fiscal discipline rules of municipal budgets during 2022–2023
Annex 2

COMPARISON OF ACTUAL AND PROJECTED BALANCE SHEET PROJECTIONS ACROSS MUNICIPALITIES









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