



Raising Local Public Investment in Lithuania

Ensuring quality while maintaining financial sustainability





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Abbreviations and acronyms

ALAL	The Association of Local Authorities of Lithuania	LGFA	Local Government Funding Agency
BBR	Balanced Budget Rule (zero deficit)	LGs	Local Governments
BPMD	Budget Policy Monitoring Department	MoF	Ministry of Finance
CEB	Council of Europe Development Bank	MTO	Medium-term Budgetary Objective
CG	Central Government	NIB	Nordic Investment Bank
CLIFT	Republic of Lithuania Constitutional Law on the Implementation of the Fiscal Treaty	OECD	Organisation for Economic Co-operation and Development
CPMA	Central Project Management Agency	PIT	Personal Income Tax
EBRD	European Bank for Reconstruction and Development	PPPs	Public and Private Partnerships
EEA	European Economic Area	RRDF	Rural Regeneration and Development Fund
EIB	European Investment Bank	SNG	Sub-national Government
ESIF	European Structural and Investment Fund	SOSE	Solutions for Economic System S.p.A.
EU	European Union	URDF	Urban Regeneration and Development Fund
GFC	Great Financial Crisis	VIPA	Public Investment Development Agency
GG	General Government		
ICT	Information and Communications Technology		
IFI	Independent Fiscal Institution		
IMF	the International Monetary Fund		

Local public investment is crucial to support regional development by attracting private domestic and foreign direct investment and fostering local labour markets, in order to improve well-being of all residents.



Executive Summary

Lithuania's government has set up regional development as one of its highest policy priorities. The report shows that local public investment is crucial to this end, to attract private domestic and foreign direct investment, to improve well-being of all residents and to foster local labour markets. In addition, there is a window of opportunity now, as fostering growth enhancing or socially beneficial local public investment would help mitigate the economic impact of the COVID-19 pandemic.

This report identifies the factors which reduce LGs' capacity to fund and finance public investment in Lithuania, following the analytical framework developed for this Project. It analyses how these factors work today in Lithuania, and how Lithuanian practices compare with international practices, with a special focus on five benchmark countries: Denmark, Finland, Ireland, the Netherlands and New Zealand.

The main bottlenecks identified for LG public investment in Lithuania are:

- LGs have little capacity to generate fiscal space for public investment, because own source revenue is low and because reliance on earmarked intergovernmental grants provides little spending autonomy.
- LGs have little capacity to plan public investment, because Intergovernmental grants are volatile and there is no medium-term commitment from CG on these, LG administrative capacity is low, and strategic planning practices are weak and purely formal (not linked to budgets).
- LGs' rely heavily on donor funding (in particular the EU) to fund their public investment, which is not sustainable as EU funds are expected to decrease as the country develops.
- LGs borrowing capacity is heavily constrained by very tight fiscal rules on the one hand, and a lack of capacity to generate sufficient revenues to repay their loans on the other hand.
- There are missed opportunities of LG cooperating, either to pool expertise (shared service centres), pool projects to reach larger scales and more bargaining power to reduce costs (for example for PPPs).
- There is a lack of specialised facility dedicated to municipal investment financing.
- CG public investment funds are fragmented and narrowly defined, and may result in incentives for LGs to develop projects to fit a particular funding source, rather than responding to a need or a development opportunity.

Each chapter provides detailed recommendations for overcoming these bottlenecks. The last chapter presents a summary table of the recommendations, and a diagram showing how these relate to each other in order to achieve the final objective: increasing good quality municipal public investment while ensuring financial sustainability.

The analysis in this report lies on an international benchmarking exercise, where the OECD carried out in-depth analysis of the LG investment funding and financing frameworks in five benchmark countries: Denmark, Finland, Ireland, Netherlands and New Zealand.



Introduction

Lithuania's government has set up regional development as one of its highest policy priorities. Local public investment is seen as crucial to this end, to attract private domestic and foreign direct investment, to improve well-being of all residents and to foster local labour markets. Well-designed local investment can support economic growth, fight social exclusion, address the risk of poverty and contribute to territorial cohesion within the country. In today's economic downturn triggered by the COVID-19 pandemic, sustaining or even increasing public investment is also a crucial counter-cyclical measure to support employment and growth (OECD, 2020_[1]). The role of local governments and their ability to finance public investment is therefore all the more important. There may now be a window of opportunity in Lithuania for improving the framework for financing and funding local public investment. In the wake of the covid-19 pandemic, the government set up the "DNA plan for the future", involving investment worth more than 4% of GDP.

Currently municipal resources are limited, and Lithuania is heavily dependent on national and EU assistance for local and regional investment.¹ LG capital investment accelerated after joining the EU in 2004 reaching 2.3% of GDP in 2010, but declined sharply in the aftermath of the GFC and in 2018 to only 1.2% of GDP (Figure 1.3). Local governments only account for 33% of public investment in Lithuania, while on average sub-national governments (SNG) account for 46% of public investment in the OECD. Tight fiscal rules for SNG² – in particular a nominal balanced-budget rule – and weak own-source revenue add to weak investment

capacity at the municipal level. As the world is going through a period of historically low interest rates, low LG borrowing and public investment may entail missed investment opportunities. In addition, as Lithuania will be dealing with the economic downturn caused by the COVID-19 pandemic, the framework for municipal funding and financing of public investment should allow LGs to help the recovery and avoid pro-cyclical policy.

The tension between municipal financial needs and available funds is likely to increase in the coming years for two reasons: *First*, local investment needs are likely to rise, driven by persistently high regional disparities, increasing pressures of urbanisation, and ageing, as well as the economic stimulus policies following the COVID-19 induced economic crisis. *Second*, municipalities are highly dependent on EU structural funds to finance their investments, and these will substantially decrease. This decrease will be especially felt in the capital region, which exits the *less developed region* group and enters the *transition region* group, which implies that matching funds required from the capital region to receive EU investment grants will increase from 15% to 45% from 2021 onwards. Besides, future EU funds will be concentrated on a smaller number of policy objectives and narrower policy objectives, which will affect funding supply in the rest of Lithuania.³ Against this background, this report argues that the government will need to increase and reorganise

1. Cohesion policy funding represent 74% of LGs' public investment.

2. Stated in the Constitutional Law on the Implementation of the Fiscal Treaty (CLIFT).

3. These policy objectives are: (1) A smarter Europe (innovative & smart economic transformation); (2) A greener, low-carbon Europe (including energy transition, the circular economy, climate adaptation and risk management); (3) A more connected Europe (mobility and ICT connectivity); (4) A more social Europe (the European Pillar of Social Rights); and (5) A Europe closer to citizens (sustainable development of urban, rural and coastal areas and local initiatives). Needs of municipalities to finance local development and public service provision are largely limited to Objective 5 funding which in itself is constrained by the thematic concentration and the need to respect minimum allocations of funds to other Objectives (1+2).



funding at the local level, probably requiring a higher share of self-financing of local investment projects.

Lithuanian municipalities raise comparatively few own financial resources to fund public investment. Instead, they heavily rely on European and national assistance in mobilising resources. Access to borrowing is weak, held back by limited capacity to develop projects which could attract lenders, and by tight fiscal rules. These factors are partly responsible for investment gaps on the municipal level, hampering economic, social and territorial development and cohesion. Against this background, this report shows that municipalities need a financial framework that strengthens their capacity to plan, finance, fund and manage investment projects, and underpins both local and national fiscal sustainability objectives.

The objective of the Project “improving Lithuania’s framework for municipal funding and financing of public investment” is to provide insights and recommendations to Lithuanian authorities to carry out institutional, administrative and growth-sustaining structural reforms in order to improve Lithuanian municipalities’ financial capacity for local investments, while maintaining the local and national fiscal sustainability objectives. This Project follows Lithuania’s requested support from the European Commission and thus the Structural Reform Support Programme (SRSP), which contracted the OECD to propose a new municipal investment financing and borrowing framework.

This report identifies the factors which affect LGs’ capacity to fund and finance public investment following the analytical framework developed for this Project. It analyses how these factors work today in Lithuania, and how Lithuanian practices compare with

international practices, with a special focus on five benchmark countries: Denmark, Finland, Ireland, the Netherlands and New Zealand.

The first chapter of this report justifies why it is important to look at and enhance the capacity of LGs to carry out public investment in Lithuania. The second chapter presents the analytical framework for municipal funding and financing for public investment developed by the OECD. This framework lays out the main factors affecting local government (LG)⁴ borrowing capacity and the different “systems” for ensuring fiscal sustainability. Chapters three to eight describe the practices in Lithuania for each of the elements highlighted in the analytical framework, and contrasts these with the benchmarks in order to identify the reform potential. Preliminary recommendations are provided after each section. Finally the last chapter presents all the recommendations to improve Lithuanian municipalities’ capacity to fund and finance public investment, while ensuring the quality of the investment projects and the fiscal sustainability of municipalities.

A separate report presents the findings of the benchmark case studies and how these could inspire reforms in Lithuania.

4. Please note that in the literature and in this report, the terms “local government” and “municipal” refer to the same level of government and are used interchangeably. The term “sub-national governments” by contrast encompasses both the municipal/LG level, and the regional/provincial/state level of government, which today does not exist in Lithuania.



There is a window of opportunity today to increase public investment, due on the one hand to the need to provide economic support and stimulus following the Covid-19 crisis, and on the other hand to the historically low interest rates.

1. Why is municipal capacity to carry out public investment important?

Despite strong economic growth, regional disparities in Lithuania remain large and growing. Public investment, a frequently-used instrument to reduce regional disparities, remains weaker in Lithuania than in OECD countries' average and has been declining since the 2008 crisis. In addition, most public investment goes to urban areas, thus further increasing urban/rural disparities. Increasing local government's participation in public investment could help better achieve Lithuania's regional development goals. There is a window of opportunity today to increase public investment, due on the one hand to the need to provide economic support and stimulus following the Covid-19 crisis, and on the other hand to the historically low interest rates. This report presents a framework of municipal funding and financing of public investment that will help Lithuania reach its regional development objectives.

Regional disparities in Lithuania are large and growing

Regional differences in GDP per capita, productivity, employment and poverty in Lithuania are among the largest in the OECD, and they have increased over the last decade (OECD, 2020_[2]). While GDP per capita and productivity levels have soared in the capital area and large conurbations, a large part of the peripheral countryside and most small and medium towns are lagging. Lithuania is amongst the OECD countries

with the highest GDP per capita growth between 2003 and 2007, but also with the highest variation in GDP per capita between regions (Figure 1.1).

The capital region – Vilnius County – represents 145% of national GDP per capita while the least performing region – Tauragė County – represents only 56% (Panel A, Figure 1.2). Lithuania has been struggling with such centre-peripheral polarisation since regaining its independence in the 1990s (Pociūtė-Sereikienė, 2016_[4]), and no catch up has been observed in recent years. In 2018, peripheral regions represent around 57% of GDP per capita of the capital region.

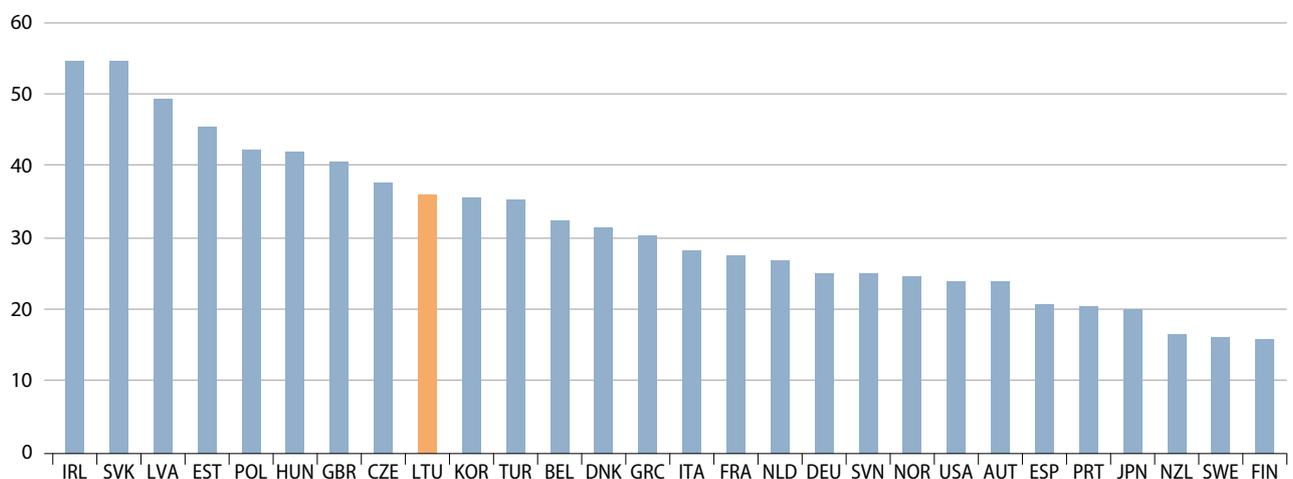
LG public investment in Lithuania is lower than the OECD average, and has been declining since the 2008 crisis

Municipal resources are relatively limited in Lithuania, and Lithuania is heavily dependent on national and EU assistance for local and regional investment.¹ LG capital investment accelerated after joining the EU in 2004 reaching 2.3% of GDP in 2010, but declined sharply in the aftermath of the GFC and in 2018 to only 1.2% of GDP (Figure 1.3). Moreover, sub-national governments (SNGs) only account for 33% of public investment, while

1. Cohesion policy funding represent 74% of LGs' public investment in Lithuania.

Figure 1.1. Regional disparities are large

The coefficient of variation for regional GDP per capita, 2017

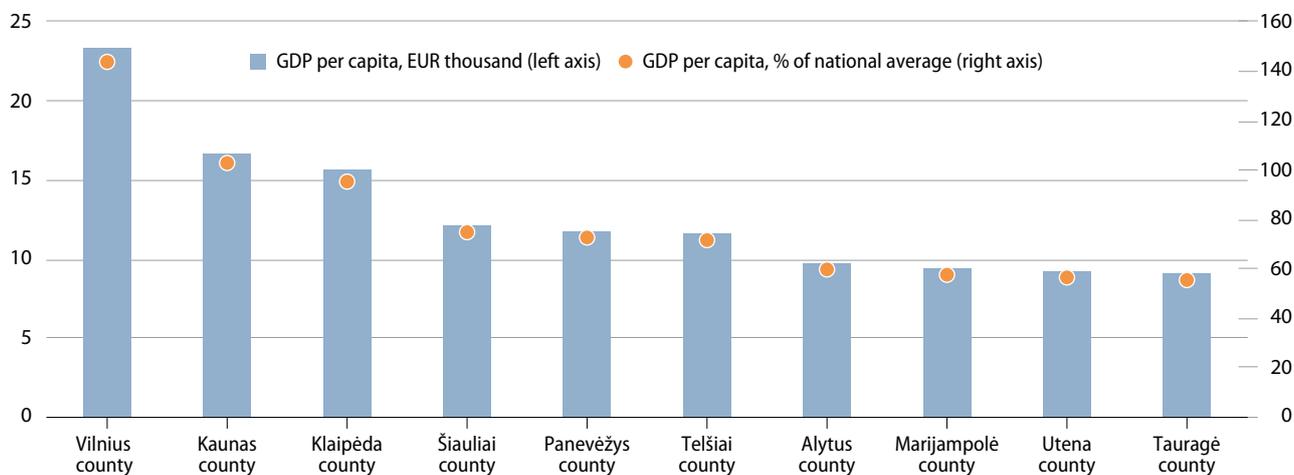


Note: The vertical axis refers to the coefficient of variation for regional GDP per capita.

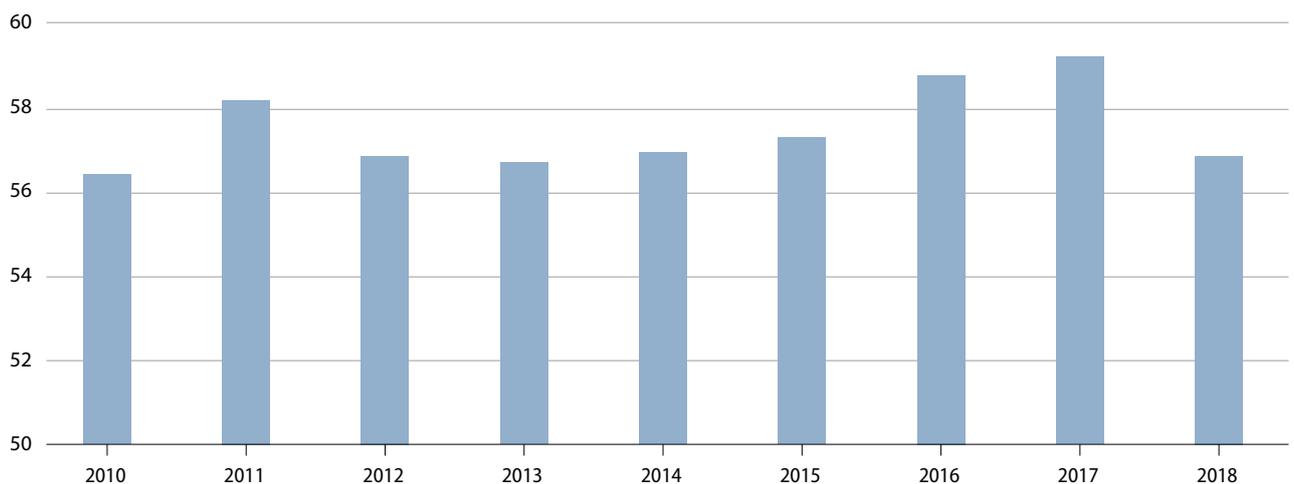
Source: OECD Regional database (2020_[3]), <https://doi.org/10.1787/6b288ab8-en>.

Figure 1.2. Regional disparities across Lithuania

Panel A: GDP per capita at current prices, 2018



Panel B: GDP per capita of peripheral regions, as percentage of capital region



Note: Authors' calculations. Following the classification of Statistics Lithuania, peripheral regions represent the whole Lithuania except the capital region.

Source: Statistics Lithuania (2019^[5]), GDP per capita at current prices.

they tend to play an important role in public investment in OECD countries, where they are responsible for 46% of public investment, on average.

In addition, more than half of public investment in Lithuania goes to urban areas

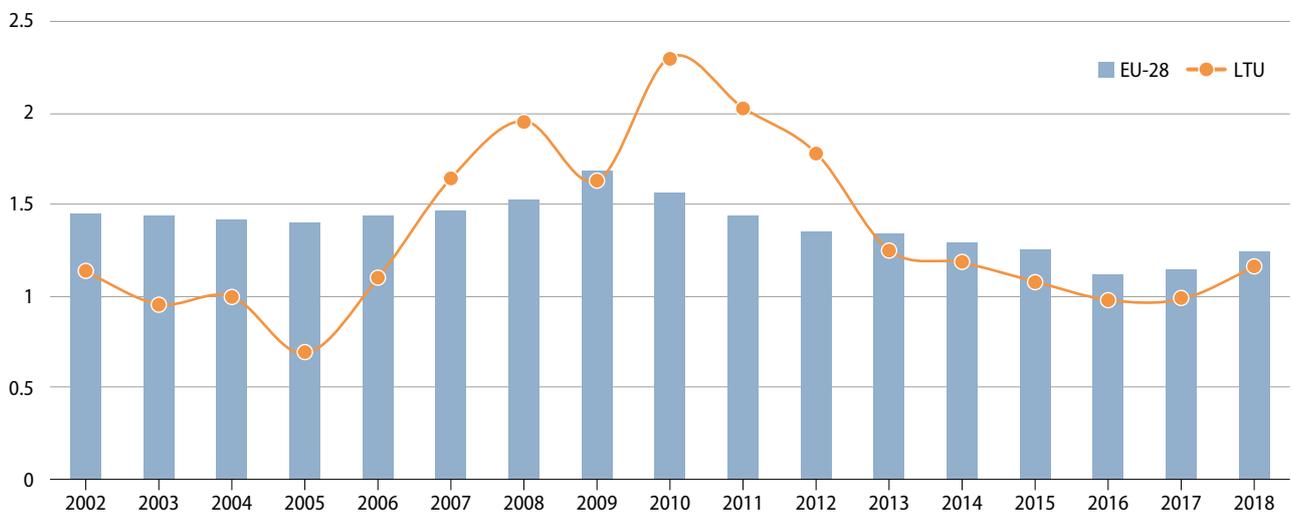
Public investment – including EU structural funds – are concentrated in urban areas (Figure 1.4). This might exacerbate regional disparities as some key infrastructure is insufficient in large parts of the territory. In rural areas, the lack of fast broadband connectivity prevents part of the population from taking advantage of the digital and technological transformation (OECD, 2020^[7]). While house prices in Lithuania are low in comparison with OECD countries, in some fast growing. The supply of

social housing by municipalities is low and often in areas far from job opportunities. Municipalities often lack the resources to provide necessary infrastructure, and they have few incentives to do so since they bear the costs of increased population and activity, while the additional tax revenues which results from growth accrues largely to the central government.

Experience of OECD countries shows that persistent regional disparities need to be addressed through place-based policies

To improve economic performance in struggling regions, policy makers need to address the underlying causes of weak economic performance. While common challenges can be identified in many regions, the

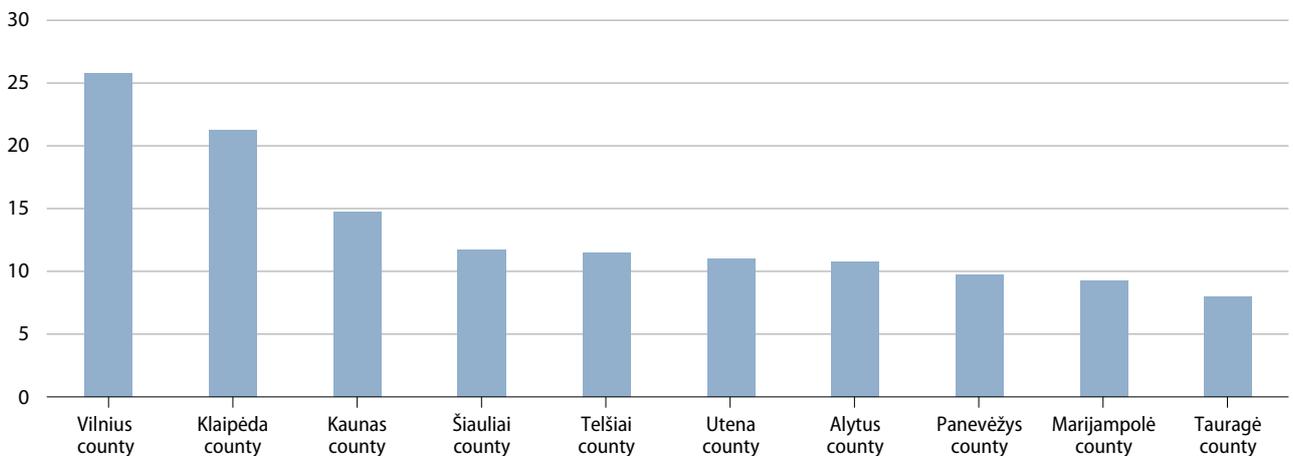
Figure 1.3. **LG Capital Investment as a share of GDP**



Note: *Lithuania joined the EU in 2004.

Source: Eurostat (2020[6]), The Government Finance Statistics (GFS), <https://ec.europa.eu/eurostat/web/government-finance-statistics/data>.

Figure 1.4. **Total investment per capita by county**



Source: OECD Regional database (2020[3]), <https://doi.org/10.1787/6b288ab8-en>; and Ministry of Economy.

combination of factors that leads to poor economic outcomes is usually unique to a region. They are related to economic, social, political, geographical and cultural factors and are often closely linked to a region's history. As these factors are often closely linked to each other, successfully overcoming them requires multiple parallel policy reforms (OECD, 2019_[8]). Place-based policies refer to a set of coordinated measures that are designed specifically for a region. They aim to use the endogenous growth potential of a region and can include a wide range of instruments, such as investments in upskilling programmes, financing for innovative start-ups, linkages between universities and businesses, and coordination mechanisms among regional stakeholders (Table 1.1).

LG public investment is known to have positive effects to support growth, reduce regional disparities and improve social wellbeing

Most OECD countries experience investment gaps, in particular for infrastructure, and total public and private investment is still below the pre-2008 crisis levels (OECD, 2019_[10]). Megatrends, such as urbanisation, climate change, demographic pressures and digitalisation will increase the demand for more and better public investment at both central and sub-national government levels in all OECD countries. The OECD work on effective public investment across levels of government (2019_[10]) has shown that regional and local governments in OECD countries

Table 1.1. **Characteristics of modern place-based regional policy**

Regional policy characteristics	
Problem recognition	Low productivity (levels and growth); underused regional potential; lack of regional competitiveness; inter-regional and inter-personal inequality.
Objectives	Increasing productivity growth; delivering high-quality of life and well-being to people across economic, social and environmental dimensions.
General policy framework	Tapping underutilised regional potential through regional programming; building on existing strengths; developing regional innovation systems.
Spatial orientation	All regions within a country are targeted with policies adapted to each region.
Actors	All levels of government; relevant non-governmental stakeholders (public, private, academia, non-governmental organisations).
Unit for policy intervention	Interventions should consider both administrative and functional geographies where appropriate. Functional geographies cover the areas in which people live, work and interact (e.g. rural-urban linkages, functional urban areas, cross-border regions, etc.).
Time dimension	Should provide a stable long-term policy environment while responding adequately to newly emerging challenges and opportunities.
Policy fields	Context-specific; considering all relevant policy areas and regional characteristics (economic, geographic, demographic, social, cultural, etc.).
Focus	Endogenous development based on local assets and knowledge.
Instruments	Broad range of instruments, including targeted investment in human capital (e.g. higher education, vocational training, early childhood education, etc.); infrastructure investments; support for business development (e.g. business incubators, credit provision, etc.); research and innovation support; co-ordination between non-governmental actors (businesses, universities, etc.).
Operational approach	Encourages policy co-ordination across sectors, levels of government and jurisdictions; and promotes participation and dialogue with private stakeholders and citizens.

Source: Revised and updated from OECD (2010_[9]), Regional Development Policies in OECD Countries, <https://dx.doi.org/10.1787/9789264087255-en>.

play a key role in filling these gaps, as they invest in areas which are critical for growth and well-being (e.g. transport, energy, broadband, education, health, housing, water and sanitation). In recent decades, the responsibilities of subnational governments in these fields have increased in a majority of OECD countries. Sub-national governments are now in charge of 57% of public investment in the OECD on average, and they are responsible for 64% of environment and climate related public investment (2019_[10]).

Typical benefits from well-designed fiscal decentralisation and well-managed public investments at the local level include:

- *Supporting growth.* “An increasing body of work points to the positive effects of public investment on growth. OECD research shows that countries with higher levels of public investment increase their productivity faster than countries with lower levels of public investment” (OECD, 2019_[10]; Fournier, 2016_[11]).

- *Reducing regional disparities.* Research shows that in countries “with a balanced fiscal structure, where local spending is mainly financed by local taxation, fiscal decentralisation reduces regional disparities, by providing an incentive to better use local resources and implement policies that favour economic development” (Bartolini, Stossberg and Blöchliger, 2016_[12]).
- *Increasing well-being and happiness of residents.* Cross-country research suggests that people are happier in decentralised settings (Frey, 2010_[13]).

In the current crisis triggered by the COVID-19 pandemic, supporting local public investment is crucial

Drawing on the experience from the 2008-09 crisis (Blöchliger et al., 2010_[14]; Vammalle, Ahrend and Hulbert, 2014_[15]), it is essential to avoid a pro-cyclical reaction from LGs and ensure LGs do not cut expenditure and public investment.

OECD experience (OECD, 2020_[1]; OECD, 2011_[16]; OECD,

2020^[17]) has shown that public investment, in particular at the sub-national level, is a key driver for economic recovery, as it both supports economic activity in the short term, and increases social welfare and productivity in the longer term. As Lithuania will be fighting with the economic consequences of the COVID-19 pandemic, supporting local government public investment, in particular by reforming its funding and financing framework and improving efficiency of spending, can be an important instrument to support employment in regions, while bridging some of the infrastructure gaps.

Historically low interest rates reduce the opportunity cost of borrowing for public investment

With long-term interest rates historically low, the social rate of return on public investment is likely to exceed the financing costs for many projects (OECD, 2020^[17]). Investment is particularly needed in areas that have large positive externalities for the rest of the economy and where under-investment might otherwise occur due to market failures, including in regional development and in areas which are LG responsibilities. If the institutional framework allowed Lithuanian municipalities to borrow,

they could benefit from the low interest rates to finance growth and welfare enhancing investment projects.

The government's recent White Paper on regional development is a good starting point

As a response to the persisting regional imbalances, the Lithuanian government published a White Paper on regional development in 2017 (White Paper, 2017^[18]). The strategy's main objective is to raise the growth potential of physical and human capital in each region through adequate institutional and governance reforms, rather than to redistribute wealth between rich and poor regions. The development strategy brings up the concept of "functional zones", defined by regional labour market or catchment areas of public services. Mid-2020, the Parliament, established regional development councils, responsible for planning and coordinating the implementation of national regional policy in a specific region. Moreover, these bodies may assist municipalities in organising joint public service functions, as well as to represent the region. The regional councils are mainly funded through the EC Cohesion Policy Programme.





The overall objective of a municipal investment funding and financing framework is to allow municipalities to carry out efficient public investment while ensuring municipal and national financial sustainability.

2. A framework for assessing the drivers of municipal investment funding and financing capacity

This chapter presents the analytical framework used in this project to assess countries' municipal investment funding and financing frameworks.¹ It highlights the different elements which affect municipal investment financing capacity, and how they work together successfully. The overall objective of a municipal investment funding and financing frameworks is to allow municipalities to carry out efficient public investment while ensuring municipal and national fiscal sustainability.

The first section describes the funding and financing sources and the multi-level governance drivers affecting the capacity of local governments to finance public investment (Box 2.1). The second section outlines how these different elements need to work together in a coherent way to ensure both efficiency and sustainability of the municipal investment-financing framework. It identifies four types of local fiscal and financial systems to ensure fiscal sustainability:² market based, cooperative approach, rules-based, and direct control based.

Box 2.1: FUNDING VS. FINANCING PUBLIC INVESTMENT

All the languages do not have a distinction between the terms “funding” and “financing”, so it is important to clarify the concepts behind these two terms, and explain why they are different in English.

Financing refers to the money needed to meet the upfront payments for public investment. Financing sources typically consist of borrowing (from commercial banks, the central government or other financial institutions), PPPs or institutional investors.

Funding refers to how the investment is ultimately paid for (loans repayments, PPP payments or investors returns). Funding typically comes from taxes, intergovernmental grants, fees, tariffs other mechanisms such as capturing land value, commercial activities, etc.

THE FUNDING AND FINANCING SOURCES FOR LOCAL PUBLIC INVESTMENT AND THEIR DETERMINANTS

Following the 2008-09 Global Financial Crisis and the trend towards tighter fiscal rules, in particular for sub-national governments (SNGs), local public investment declined in the European Union, from 1.6% of GDP in 2009 to just above 1% of GDP in 2017 (EUR 171 billion) in the EU-28 countries. Public investment in Lithuania followed the same trend.

The largest sources of funding financing for LG public investment in the EU are (Dexia, 2012^[19]):

- **Self-financing:** own current revenues, or reserves accumulated through past budget surpluses;
- **Capital transfers:** either from CG or from supra-national institutions (such as the EU);
- **Private stakeholders:** through off-budget schemes such as public private partnerships, which have grown in importance in many countries over the past decade;
- **Debt:** borrowing on the markets, from public institutions, or CG.

The share of each funding source varies across countries and over the years, with debt-financed funding making up only a relatively small part of total local public investment. In Lithuania, local public investment makes up around 1% of GDP, overwhelmingly financed by capital transfers through the European Union's cohesion programmes.

The drivers shaping the availability of funding and financing for local public investment can be divided into six groups (Figure 2.1): the funding framework, fiscal discipline mechanisms, financial instruments, financial institutions, the public financial management system and multi-level governance.

The funding framework refers to how the investment is ultimately paid for. The capacity to fund public investment depends on:

1. This framework draws heavily on: Vammalle, C. and C. Hulbert (2014[105]), A sub-national perspective on financing investment for growth I – Measuring fiscal space for public investment: influences, evolution and perspectives, <https://dx.doi.org/10.1787/5jz5j1qk8fhg-en>.
2. Based on Ter-Minassian T. (1996[20]), Borrowing by Subnational Governments: Issues and Selected International Experiences.

Figure 2.1. **Factors affecting the capacity of LGs to finance public investment**



Note:

CG – Central Government,
 LGFA – Local Government Financing Agency,
 MLG – Multi-Level Governance,
 PFM – Public Financial Management,
 PPPs – Public Private Partnerships

- **Revenue mix** refers to the share of own revenues (mainly taxes and fees) and transfers (earmarked grants and general purpose grants) in the revenues of LGs. The revenue mix determines the capacity of LGs to increase their own revenues (by raising their tax rates for example). Revenue autonomy affects LG capacity to carry out public investment, either by increasing revenues, or by borrowing (as it determines the capacity to repay loans, thus the risk and the cost of borrowing).
- **Expenditure autonomy** allows LGs to reallocate funds to higher priority areas, in particular public investment. Expenditure autonomy encourages efficiency gains as the savings can be used to fund other expenditure, in particular investment projects.
- **Donor funding** refers to capital grants from international or national institutions (other than

CG). In EU countries, the main source of donor funding are the EU Cohesion and Structural Funds, which typically takes the form of capital grants. Other sources could be for example donations from philanthropy or crowdfunding.

Fiscal discipline mechanisms consist of fiscal rules and direct controls, monitoring and enforcement mechanisms and insolvency frameworks. Fiscal discipline mechanisms affect mainly the capacity of LGs to borrow to finance public investment. Indeed, while fiscal rules with stringent monitoring and enforcement mechanisms may limit the capacity of LGs to issue debt, they also increase the credibility of LG's solvability, thus making access to credit easier and lowering its cost.

Financial instruments consist on debt (loans and bonds), PPPs, and alternative financing. Loans can be regular loans from private banks or multi-lateral financial

institutions (such as the EIB, EBRD, NIB), from local government financing agencies or from the CG. Unlike loans which are a bilateral contract between a borrower and a lender, bonds are issued on financial markets and traded amongst a large number of investors. Bonds usually have longer maturities than loans, however, to attract investors, they must have a sufficient size and liquidity, which is rarely possible for small LGs to achieve. Alternative sources of financing are the availability of private partners to enter into public-private partnerships to finance local investment for example, special purpose vehicles or lease contracts, crowdfunding, etc. Guarantees can be provided directly by the CG, or through a guarantee fund. Guarantees can be provided to individual LG loans or to pooled LGs loans.

Financial institutions refer to the intermediaries and institutions which make funds available to LGs for public investment, determine the criteria under which these funds can be accessed, and the conditions for accessing them (returnable or not, time period, cost of financing, etc.). The most frequent financial institutions for LG public investment are local government financing agencies (LGFAs) and public investment funds (created and funded by the CG or supra-national institutions such as the EU). Public investment funds refer to funds created by CGs or other public institutions to finance local public investment. These provide for example subsidised loans or capital grants. Guarantee schemes are also an important institution which can reduce cost of borrowing for LGs, and in some cases, enable them to access financial resources.

Public financial management (PFM) systems are composed of budgeting practices, strategic planning practices and administrative capacity of LGs. Good PFM practices are necessary to plan and design quality public investment projects, increase the appetite of lenders to finance LGs' investment projects - thus increasing the capacity of LGs to borrow -, and help attracting alternative funding, such as private partners for PPPs.

Multi-level governance (MLG) consists of vertical and horizontal coordination mechanisms. Vertical coordination mechanisms are necessary to align policies across levels of government, ensure monitoring of LGs' situation, and when needed, provide them technical support. Horizontal coordination allows to increase efficiency by avoiding redundancies of projects, and pooling resources together.

DIFFERENT SYSTEMS TO ENSURE LOCAL FISCAL EFFICIENCY AND SUSTAINABILITY

Fiscal and financial frameworks vary greatly from country to country, with some countries giving large autonomy to LGs, for example in terms of revenue-raising capacity, expenditure decisions or borrowing rules. Other countries place a much tighter grip on LG autonomy and decision-making power. The different elements affecting LGs' capacity to finance and fund public investment are not independent of one another but are often put together to form various types of financing systems. In particular, there are different ways for ensuring LGs do not issue too much debt which could be a threat to the national fiscal sustainability.³ Following a standard classification, there are four types of systems for ensuring SNG's fiscal sustainability.

These systems also apply to LGs⁴:

- *Market-based systems* mainly rely on lenders to monitor local debt, ensuring the quality of debt-financed investment projects and fiscal sustainability. Market-based systems are very close to borrowing frameworks for sovereign governments. Thus, to borrow in good terms on financial markets under such systems, LGs must have a high level of capacity and autonomy. In addition, there are some pre-requisites for such systems to work effectively. For example, the “no-bailout” clause must be credible. This implies first, that LGs must be able to increase their revenues to repay their debt (for example, by having a relatively high share of taxes in LG revenues, and a high level of tax autonomy), and second that an insolvency framework provides rules to resolve unsustainable local borrowing. Lenders must have high-quality financial information on the LG, thus implying high-quality PFM systems, requiring well-functioning deep and diversified financial markets. In this type of system, fiscal rules are not very relevant, or could be self-imposed by the LG themselves.
- *Cooperative approach to debt controls*. In this approach, limits on the indebtedness of LGs are not dictated by the CG, but rather negotiated amongst the

3. For a deeper discussion on the potential risks of SNG debt, see: OECD (2016_[103]), Monitoring sub-central government debt: Trends, challenges and practices, in: Fiscal Federalism 2016, Making Decentralisation Work.

4. These three LG investment financing frameworks draw on the SNG borrowing frameworks presented in: Ter-Minassian, T. (1996_[20]), Borrowing by Subnational Governments: Issues and Selected International Experiences.

different levels of government. Under this approach, SNGs participate actively in the definition of the macroeconomic objectives and the allocation of deficit and debt targets across levels of government. According to Teresa Ter-Minassian (1996_[20]), “The cooperative approach has clear advantages in promoting dialogue and exchange of information across various government levels. It also raises the consciousness, in subnational-level policymakers, of macroeconomic implications of their budgetary choices. It seems, however, to work best in countries with an established culture of relative fiscal discipline and conservatism. It may not be effective in preventing a build-up of debt in conditions where either market discipline or the leadership of the central government in economic and fiscal management are weak”.

- *Rules-based systems.* Decisions on borrowing are made by LGs within limits set by central-government-set fiscal rules. Fiscal rules typically consist of limits to the absolute level of LG indebtedness, restricting borrowing to specific purposes (typically investment), setting limits to the debt-service to revenues ratio, or requiring repayment of short-term liquidity loans before the end of the fiscal year. The role of the CG in this system is usually limited to ensuring compliance with the rules. Vertical coordination mechanisms are thus very important, as well as monitoring and enforcement mechanisms. CGs rarely interfere in the choice of the investment, hence requiring a high level of capacity from LGs (to design strategic plans, procure the projects, develop the financial instruments, etc.), and good quality PFM. Rules-based systems are praised for being transparent and equitable and provide an environment in which both investors and borrowers can assess the risk of the transaction. However, they are criticised for their lack of flexibility and are often prone to circumventing of the rules (through creative accounting practices or use of debt instruments, which are not included in the fiscal rules).
- *Direct controls systems.* At the other end of the spectrum, some countries rely on direct CG control over LG borrowing. These controls can take different forms, such as setting annual limits on individual LG debt, an *ex-ante* CG review and approval of LG debt transactions, the centralisation of all borrowing at the central level, and on-lending to LGs for specific projects (usually public investment). In this type of

system, the quality of investments and sustainability of LG finances is essentially ensured by CG control. Fiscal rules become almost irrelevant, with CG explicitly or implicitly guaranteeing LG debt. The responsibility to ensure sufficient revenues for LGs to repay their debts therefore lies with the CG, and revenue autonomy is not important and insolvency frameworks are not necessary. In such systems, LGs tend to have a low level of investment funding capacity, as the decision power lies at CG level. In addition, the CG itself lends to LGs, as it can do so on better conditions than private lenders. A common criticism to this type of system is that the criteria used to review and authorise borrowing operations may be variable or unclear. Insufficient capacity of LGs is often quoted by CGs to justify direct controls. However, it is rational for LGs not to develop the capacity if they do not need to use it. Moving away from this type of system thus requires measures to reinforce the capacity of LGs.

In practice, most national frameworks consist of a mix of these four systems, although some lean more towards one or the other. As such, it is important to highlight the need for internal coherence among the different elements, which is a precondition for efficiency and sustainability of local public finances. There is not one system or mix of system which could be considered as the optimal or more effective system. Indeed, different combinations of the elements can yield similar outcomes. In addition, while the government could influence some of these elements, many are constrained by exogenous factors such as the institutional framework, the existence of supra-nationally imposed fiscal rules, the level of capacity of LGs, the culture of the country and the preference of people.





Stable and sufficient funding sources for municipalities, and access to financing sources are essential to increase municipal investment.

3. Funding local public investment

Following the approach presented in Chapter 2 (Figure 3.1), this section describes Lithuania’s practices for funding local public investment, compares each element with the practices in the benchmark countries and provides preliminary recommendations (which will be further developed in the recommendations report).

LG REVENUE MIX

LG revenue mix in Lithuania

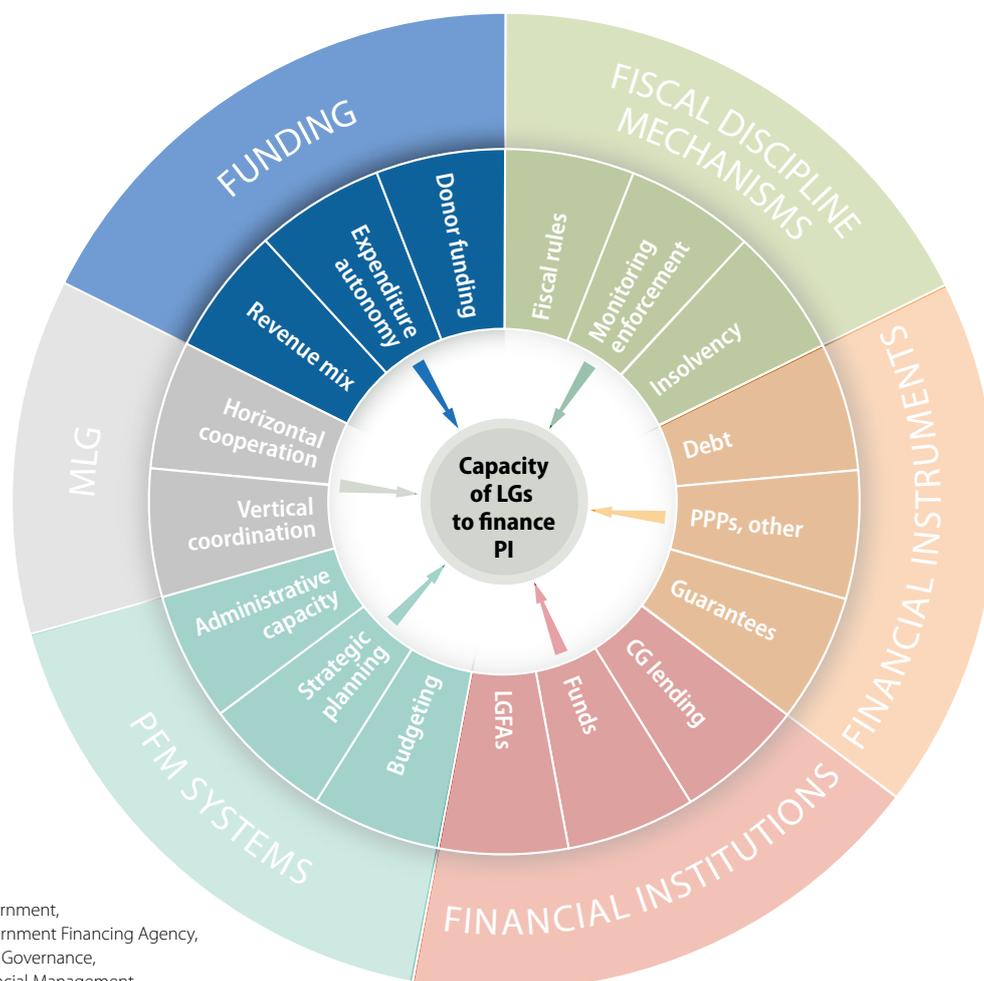
LGs rely mainly on grants

Real LG revenues spiked during the Great Financial Crisis of 2008-10 (Figure 3.2). Since 2013, however, real LG revenues have been growing very slowly, and LG revenues as a share of GG remained virtually flat. The main sources of municipal budgetary revenues and the

procedure for calculating and allocating CG transfers are determined by the Law on the Approval of Financial Indicators of the State Budget and Municipal Budgets.

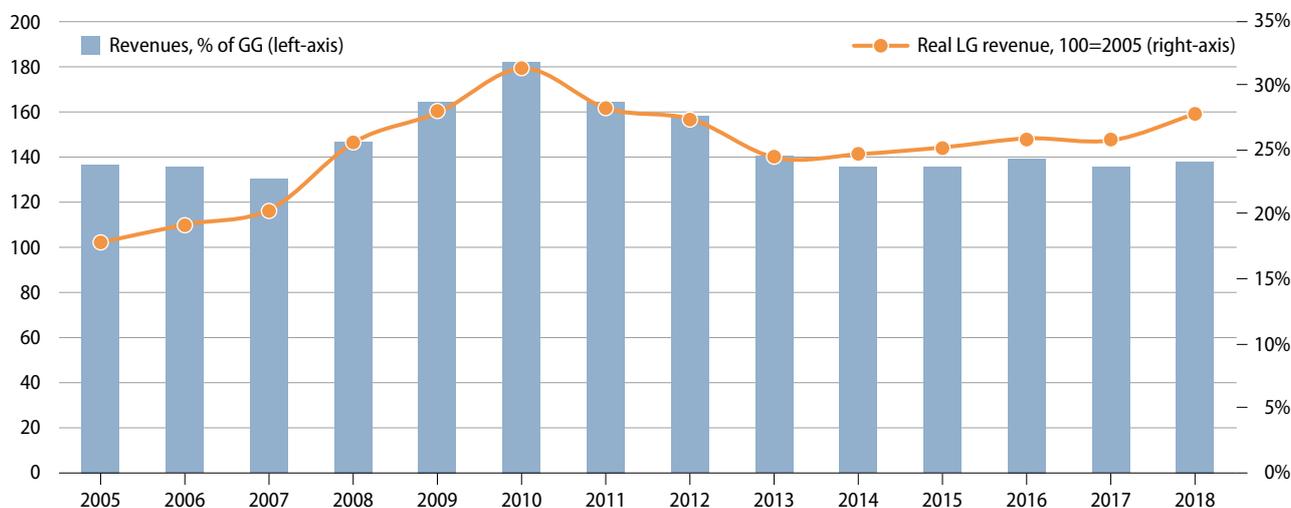
A general purpose grant based on the Personal Income Tax (PIT) is the primary source of municipal revenues, representing over 52% of total revenues (Figure 3.3). A part of the overall PIT is allocated to municipalities through a fiscal equalisation mechanism. While revenues from the PIT can be spent freely by LGs, these are considered as transfers since the implementation of the SNA 2008 accountability system in 2014. This makes LG’s reliance on grants in Lithuania amongst the highest in OECD countries, with CG transfers representing 87.7% of municipal revenues (Table 3.1 and Figure 3.3). Earmarked grants represent 35.6% of municipal revenues.

Figure 3.1. Analytical framework: funding



Note:
 CG – Central Government,
 LGFA – Local Government Financing Agency,
 MLG – Multi-Level Governance,
 PFM – Public Financial Management,
 PPPs – Public Private Partnerships

Figure 3.2. Evolution of LG revenues in real terms



Note: LG revenue growth is adjusted for real GDP growth to retrieve annual real LG revenue growth rate, which is used to calculate real LG revenue from a base year (2005).

Source: Authors' calculation based on Eurostat (2018^[21]), Government revenue, expenditure and main aggregates [gov_10a_main]; Eurostat (2020^[22]), GDP and main components (output, expenditure and income), [nama_10_gdp].

These grants finance delegated functions, as well as the “students and class basket” – an education grant covering teaching costs – investment projects and construction, repair and maintenance of local roads. However, a recent study by the National Audit Office (2019^[23]) shows that funding of state delegated functions is sometimes insufficient, requiring resorting to own funds.

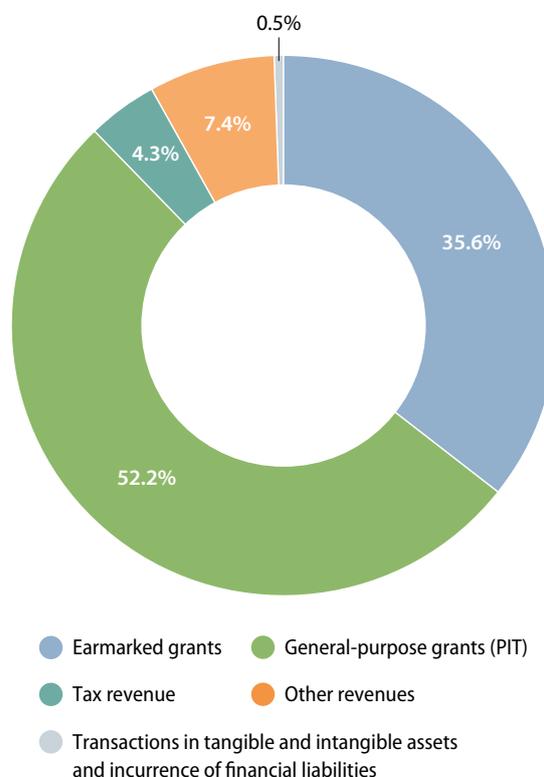
Own taxes and fees represent only about 4% of LG revenues, and general-purpose grants (PIT grants) about 52% (Figure 3.3). Revenues which can be freely spent therefore represent about 56% of LG revenues, used to finance independent functions.

The tax-raising capacity of Lithuanian municipalities is particularly low

The share of tax revenue represents only 4.3% of total revenue (Figure 3.3). Municipalities’ tax revenue primarily consists of immovable property and land taxes, which they can levy within pre-defined limits.¹ These comprise around 94% of total tax revenue. Importantly, there are some signs of race-to-the-bottom, as smaller municipalities tend to set these rates to the minimum according to the interviewed municipalities. In comparison, larger LGs would like the tax base to be expanded. Municipalities also have a right to grant tax reliefs for inheritance tax, which they must compensate from their own budget, but the rate is set

1. The property tax can be set between 0.3% and 3% of the taxable value of real estate. The land tax can range between 0.01% and 4% of the taxable value of land.

Figure 3.3. Composition of municipal budget revenues in Lithuania, 2019



Note: the local share of the PIT is considered as a transfer since an individual municipality's share is not proportional to what that municipality collected on its territory.

Source: Ministry of Finance (2019^[24]), Savivaldybių biudžetų pajamų struktūra (Municipal budget revenue structure), <https://bit.ly/2xo9sl0>; Law on the Approval of Financial Indicators of the State Budget and Municipal Budgets, 2019.

Table 3.1. **Revenue structure of LGs, comparison with benchmark countries, 2018**

	Taxes	Grants and other revenues	Tariffs & fees	Social contributions
LTU	4.2%	89.2%	6.5%	0.1%
DNK	36.0%	59.3%	4.7%	0.1%
FIN	45.9%	32.1%	22.0%	0.0%
IRL	18.9%	51.7%	26.3%	3.1%
NLD	10.3%	74.4%	13.7%	1.5%
NZL	52.3%	31.6%	16.1%	0.0%

Source: OECD (2019^[30]), Government at a Glance: Public Finance and Economics, <https://www.oecd.org/gov/government-at-a-glance-2019-database.htm>.

in the Law. Moreover, pollution tax is a shared tax, with municipalities having no control over neither rate-setting nor tax reliefs. Tariffs, fees and other non-tax derived income (e.g. fines, rents) represent slightly over 7.4% of total municipal income (Figure 3.3).

The PIT is used for fiscal equalisation, and despite a recent reform, provides weak links between LGs' development efforts and increases in their revenues

The Personal Income Tax (PIT) – classified as a general-purpose grant – is the primary source of funding for independent functions of municipalities. However, municipalities do not have the autonomy to levy this tax at their own discretion. The CG defines the rate of the PIT and the share of tax attributed to the municipal budgets. In 2020, LGs received nearly 47% of the total PIT collected. 43% is fixed by law, while the remaining variable share of the PIT (around 4% in 2020) depends on the estimated change in municipal expenditure caused by CG decisions, as well as on other factors.

The PIT is redistributed through a fiscal equalization mechanism.² The main criterion used to determine the relative contribution to the equalization system is the average projected PIT per capita of all municipalities. Above-average municipalities are donors. In 2020, eight LGs were net contributors to the equalization system, namely, Vilnius City, Kaunas City, Klaipėda City, Neringa, Kaunas district, Klaipėda district, Vilnius district and Trakai district municipalities. Until 2019, the CG fully compensated changes in revenues or expenditure directly affected by CG decisions by increasing the PIT share allocated to municipal budgets.

A new amendment to the Law on the Methodology for Determining Municipal Budget Revenues was introduced

in 2020 allocating an additional share of the PIT to municipalities with average or low economic growth potential exhibiting a growing payroll indicator. In 2020, the CG allocated EUR 9.9 million to this measure. It is intended to better reflect municipal efforts in developing economic activity and encourage municipalities to promote business development, create new jobs and attract investments.³

CG grants tend to be volatile

Grants received from the CG tend to be volatile, especially if earmarked and general-purpose grants are considered separately (Figure 3.4). Average growth rate of earmarked grants has fluctuated between -15% in 2007 to +23% in 2008, and in recent years, it has decreased from +12% in 2016 to zero in 2017 and back to +15% in 2019. Regarding the general-purpose grants, their rate of increase was 30% per year in 2007 and 2009, before dropping to -20% in 2009 and remaining negative for two years. In 2014, it spiked at close to +30%, then oscillated between +9% and +20% in 2015-2019.

Given that grants represent on average 90% of LGs' revenues, this makes it very difficult for LGs to plan ahead, as they cannot correctly forecast the growth in their revenue levels. Good practices in designing revenue frameworks for LGs state that LGs revenues should be stable and predictable, protecting LGs from economic cycles (Musgrave, 1969^[25]; Blöchliger et al., 2010^[26]).

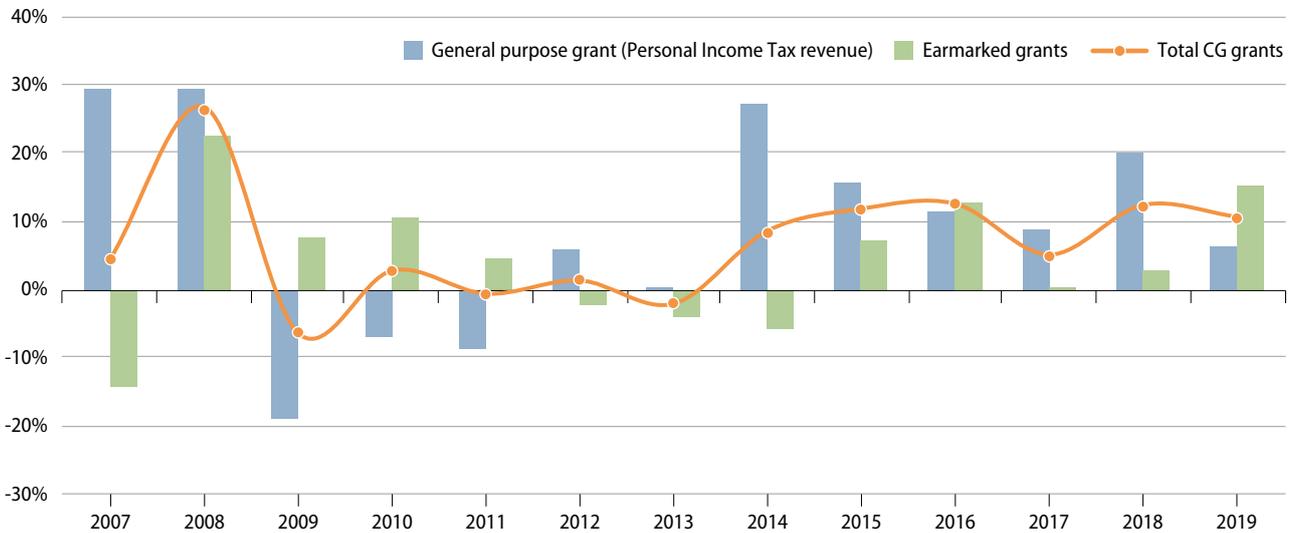
**Comparative analysis of LG revenue mix
LG reliance on taxes is lower in Lithuania than in most OECD countries**

In Lithuania, own taxes represent only 4% of LGs' revenues, the lowest share amongst the benchmark countries, and amongst the lowest in the OECD. Countries such as Denmark, Finland or New Zealand

2. "Fiscal equalisation is a transfer of fiscal resources across jurisdictions with the aim of offsetting differences in revenue raising capacity or public service cost. Its principal objective is to allow sub-central governments to provide their citizens with similar sets of public services at a similar tax burden" (Blöchliger et al., 2007^[10]).

3. While municipalities do not have officially functions of promoting economic activity or development, de facto, they do perform actions and activities in this area.

Figure 3.4. Volatility of CG Grants to LGs in Lithuania (YoY percentage change, 2007-2019)



Note: Authors' calculations.

Source: Statistics Lithuania (2020^[27]), Municipal Budget Revenue.

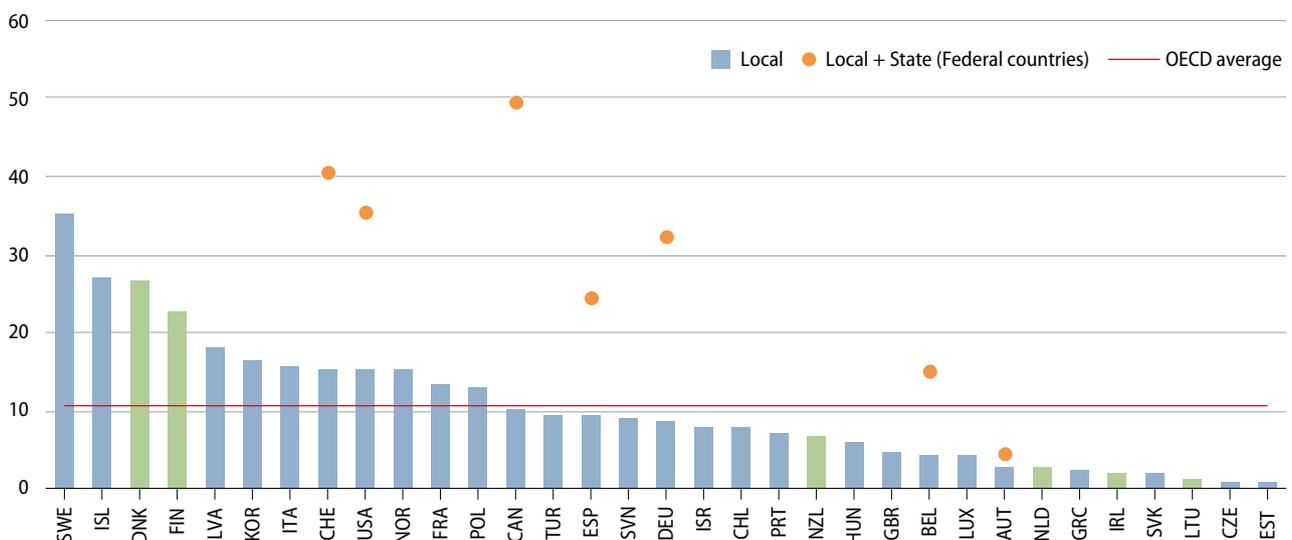
have a strong reliance on own taxes (36%, 46% and 52% respectively), which gives them great autonomy in increasing their revenues to finance for example public investment (Table 3.1). Fiscal federalism good practices usually assign property taxes to LGs, as these tend to be the most stable tax base. This is the case in Lithuania, where the main LG tax is the property tax. However, among the countries where LGs have a high reliance on own taxes, New Zealand is the only one where property tax is the main LG tax. In the other two countries in this

category, Finland and Denmark, LGs mainly rely on the Personal Income Tax.

As a consequence, the LG share in overall taxation is very low

Lithuanian municipalities raise only 1.2% of total public tax revenue while OECD counterparts raise 11% on average. In the benchmark countries, LGs raise around 2% and 3% in more centralised countries such as Ireland and the Netherlands and up to 23% in Finland and 27% in Denmark (Figure 4.6).

Figure 3.5. LG tax revenue, % of general government tax revenue in Lithuania



Note: data unavailable for Australia, Japan, Mexico;

Source: OECD (2018^[28]), Global Revenue Statistics, <https://www.oecd.org/tax/tax-policy/global-revenue-statistics-database.htm>

Cross-country comparison shows a positive correlation between share of taxes in LG revenues and participation of LGs in public investment

A simple correlation analysis also suggests that countries where LGs rely relatively more on taxes tend to show a higher participation of LGs in total public investment (Figure 3.6).

Property taxes are less important in Lithuania than in benchmark countries

The tax on immovable property makes up around 1.2% of GDP across the OECD. In a majority of OECD countries, property tax is exclusively assigned to the local level. Lithuania stands out in two respects: it has one of the lowest shares of property taxation in the OECD with around 0.4% of GDP, and a part of the residential property tax is assigned to central government. The tax exempt threshold value is still very high in international comparison, reflecting that the property tax has long been considered a “luxury tax”. Moreover, publicly-owned property (state property) is not taxed.

Unlike several OECD countries, LGs in Lithuania have no ability to set the personal income tax rate

In some countries, a share of the personal income tax (PIT) is retained at the local level, with countries

having some tax-rate setting autonomy. In Finland, municipalities are allowed to set tax rates freely on their share of the PIT. In others such as Portugal, upper and lower bands set limits on tax autonomy. In Lithuania, LGs do not set PIT rate since CG decide on the PIT rate. Therefore, the share of PIT allocated to the municipal budget has the form of an intergovernmental grant determined by a per-capita system and fiscal equalisation (OECD/UCLG, 2019_[31]).

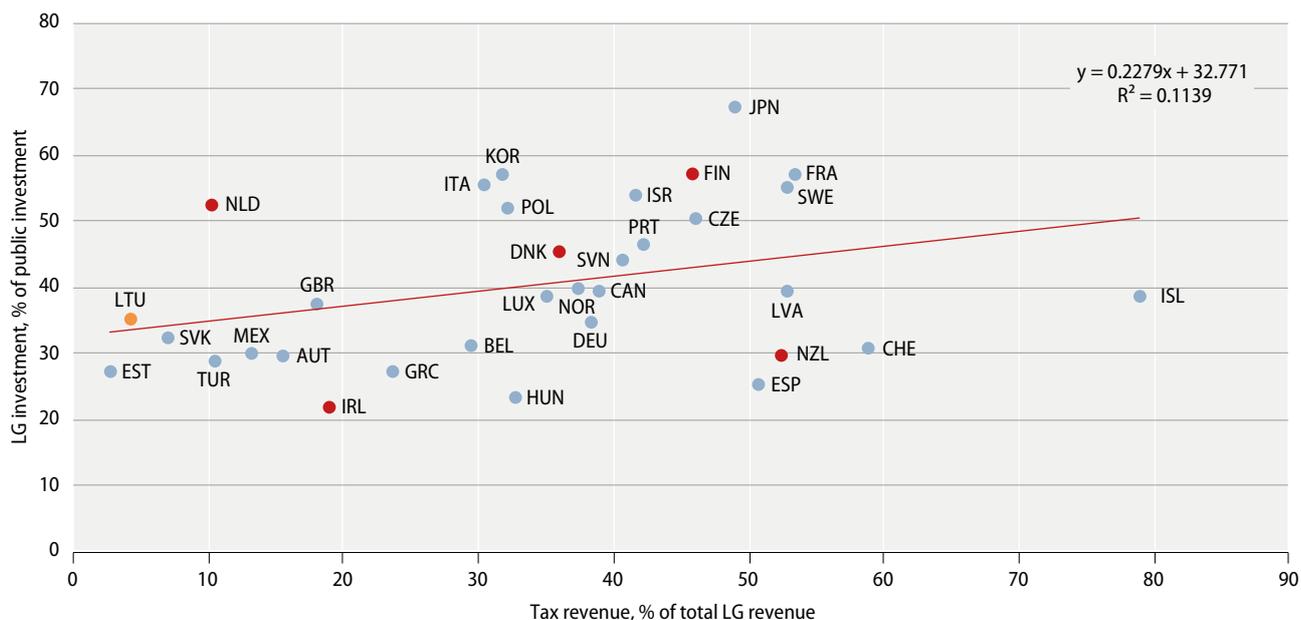
Revenues from tariffs and fees are lower in Lithuania than in benchmark countries

Tariffs and fees are another frequent source of own revenues for LGs, which allows the beneficiaries of the investments to support part of the investment cost. These are an important source of LG funding in Ireland Finland and New Zealand (Table 3.1). Revenues from tariffs and fees are also low in Lithuania, representing only 6.5% of LGs’ revenues. Indeed, CG often regulates fees and tariffs based on social criteria, which prevents municipalities from fully recovering investment costs.

Lithuania is the OECD country where LGs’ reliance on grants is the highest

Grants however represent almost 90% of revenues, among which about half are earmarked, giving

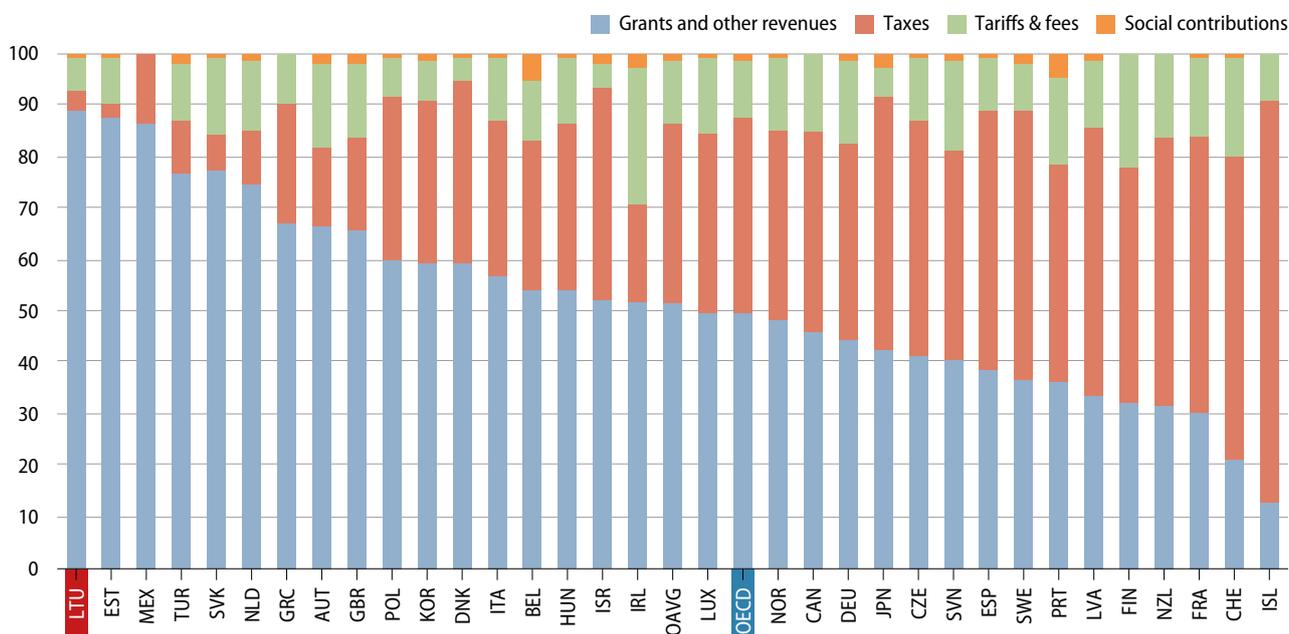
Figure 3.6. Correlation between share of taxes in LGs revenues and participation of LGs in total public investment, 2018



Note: Gross capital formation is used as a proxy for investment (GP5P), data unavailable for Australia, Chile, USA, data for New Zealand refers to 2017.

Source: Calculations based on OECD (2019_[29]), National Accounts: Government deficit/surplus, revenue, expenditure and main aggregates, https://stats.oecd.org/Index.aspx?DataSetCode=SNA_TABLE12; OECD (2019_[30]), Government at a Glance: Public Finance and Economics, <https://www.oecd.org/gov/government-at-a-glance-2019-database.htm>.

Figure 3.7. **Composition of LG revenues across OECD countries**



Source: OECD (2019_[30]), Government at a Glance: Public Finance and Economics, <https://www.oecd.org/gov/government-at-a-glance-2019-database.htm>.

Lithuanian LGs very little spending autonomy, defined as the capacity of LGs to prioritise spending and reallocate funds. Lithuania is the OECD country where LGs’ reliance on grants is the highest (Figure 3.7).

Recommendations on LG revenue mix
Ensure stable and predictable revenues for LGs and increase the share of own taxes

Increasing the level of LG public investment requires ensuring that LG revenues are sufficient to cover their expenditure responsibilities,⁴ and that LGs have the capacity to increase their revenues if they wish to finance public investment. This therefore calls for increasing the share of own taxes in the revenue mix of LGs and allowing LGs to set user fees when relevant.

Revenue and expenditure balance and predictability are essential for investors. When analysing a loan request, financial institutions assess “local creditworthiness”, i.e. whether the entity will have the capacity to repay its debt in time and in full (Kalcheva and Anderson, 2018_[32]). Financial analysis is the main element in the assessment of municipal creditworthiness by banks. Financial analysis assesses three elements: revenue streams, cost structure and the operating balance between revenues and operating expenditures.

4. The adequacy of Lithuanian LGs revenues to their spending responsibilities is analysed in details in the project completed by SOSE (Solutions for Economic System S.p.A.), which was funded by DG Reform.

High and stable own revenues, with an important share of own taxes is considered by investors as contributing to municipal creditworthiness (Kalcheva and Anderson, 2018_[32]). The higher the capacity of LGs to introduce new taxes or raise existing ones, the higher the appetite of investors to lend. In Finland for example, the right of LGs to levy a personal or corporate income tax gives municipalities the same credit risk as the central government. In New Zealand, the capacity of LGs to raise property taxes also contributes to their solid credit rating and therefore, borrowing capacity.

Assign the residential property tax entirely to the local level
 To increase local property tax revenue, the government should assign all property tax to the local level (as planned) and ensure proper valuation of property values. The tax exempt threshold value should be lowered further.

Rearrange the share of the personal income tax assigned to local governments
 The government should reform the allocation of the personal income tax and reward municipalities for increasing tax revenue. The current PIT allocation should be replaced by an arrangement where LGs set their own surtax on the national PIT, with the national PIT being reduced accordingly. an equivalent arrangement would be to change the PIT allocation so that a part of the PIT share allocated to each LG becomes strictly proportional to what is collected in that LG. Moreover, municipalities

should be allowed to set tax rates on their PIT surtax, at least within some bands set by central government.

Integrate intergovernmental grants fully into the medium-term budgeting framework (MTBF) and make the commitment to the intergovernmental grants in the MTBF binding

See section 7.1.2

LG EXPENDITURE AUTONOMY

LG expenditure autonomy in Lithuania
Expenditure responsibilities and spending autonomy are limited

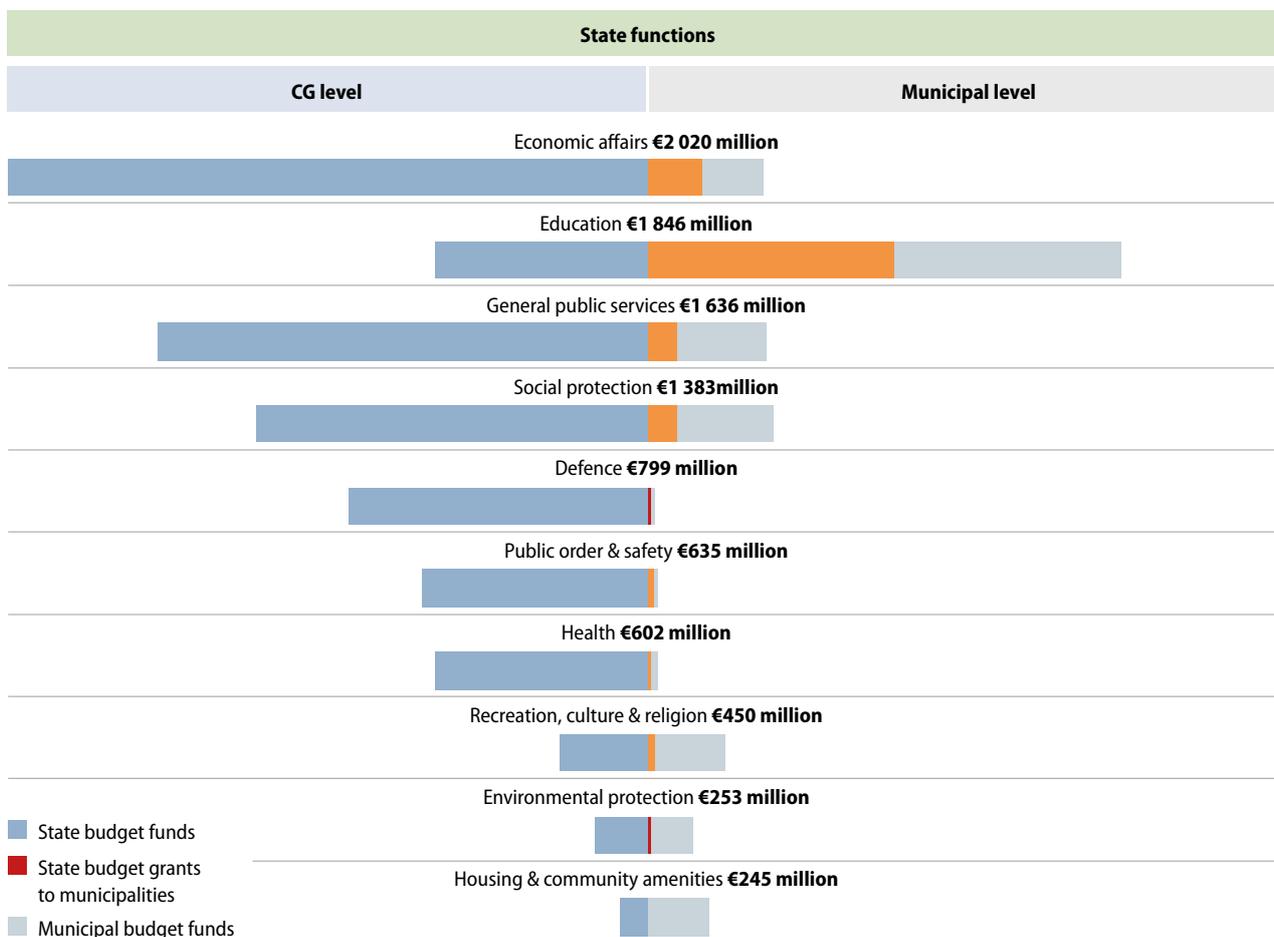
The Law on Local Self-Government distinguishes two categories of municipal functions: delegated and independent. Out of the 80 municipal functions in Lithuania, 36 are delegated by the responsible Ministries and other authorities, and 44 are independent. Delegated functions are directly and exclusively funded by the

responsible national authority. They mainly relate to labour market policy, agriculture and rural development. Municipalities independently organise and implement the remaining 44 functions (Annex A, Table A A.1 presents a non-exhaustive list of municipal functions). In practice however, some of the municipal functions are mixed. For example in education, the CG provides a transfer for teaching, and LGs fund the schools.

In recent years, there has been a tendency towards centralisation of municipal functions. Since 2008, responsibilities have been reassigned seven times, mostly transferring responsibilities to the CG such as the protection of children’s rights in 2018 or specialised case in 2015, or turning independent functions into delegated functions.

Regarding decision power over expenditure, some areas such as defence, public order and safety or

Figure 3.8. **Decision-making and funding by level of government across functions**



Note: state budget funds refer to funds, which are spent by CG; state budget grants to municipalities refer to CG grants to LGs.

Source: National Audit Office (2019_[23]), Does the System of Municipal Functions and their Funding Provide Conditions for Efficient Operation.

health are almost exclusively under CG funding and responsibility. Other responsibilities are shared between CG and municipalities. Among these, decision-making power, proxied by the relative share of expenditure, lies predominantly on the CG side. Even in education, which is an important municipal spending area, about half of municipal spending comes from CG earmarked transfers (Figure 3.8).

COMPARATIVE ANALYSIS OF LG REVENUE AND EXPENDITURE AUTONOMY

Table 3.2 provides a comparative summary of revenue and expenditure autonomy in Lithuania and benchmark countries.

Decentralization in Lithuania is lower than in the average of OECD countries

Lithuania is a unitary country with one local government level, comprising 60 municipalities. While

some municipalities are small, the average population in Lithuanian municipalities is 46,000 inhabitants, larger than the 9,800 inhabitant's average local government (LG)⁵ size in OECD countries.

Decentralisation in Lithuania is relatively low compared to OECD countries. The share of Lithuanian municipalities in general government public debt is amongst the lowest in the OECD, with only 4%, while the OECD average is 11% (Figure 3.9, Panel A). Amongst the benchmark countries, only Ireland has a lower share of LGs in total public debt, and it is up to 22% in Denmark (Panel C, Figure 3.9). In terms of municipal expenditure, Lithuanian municipalities are close to OECD average. However, local tax raising capacity is particularly low.

5. Local government units are institutional units whose fiscal, legislative and executive authority extends over the smallest geographical areas distinguished for administrative and political purposes. In this study, local government refers to level of government lower than state government in the case of federal countries and lower than national government in the case of unitary countries.

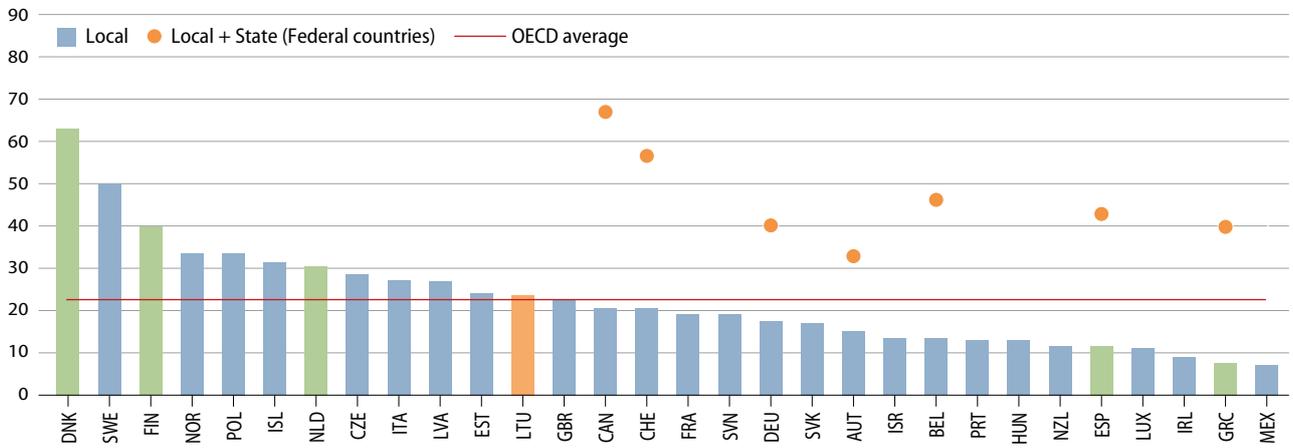
Table 3.2. **Comparative summary of revenue and expenditure autonomy in Lithuania and benchmark countries**

Revenue and expenditure autonomy					
LITHUANIA	Denmark	Finland	Ireland	Netherlands	New Zealand
Low	High	High	Low	Moderate	High
CG transfers represent almost 90% of LG revenues.	CG transfers represent 60% of total LG revenues.	CG transfers represent only 32% of total LG revenues. Grant allocation is centralised mainly in the Ministry of Finance.	LGs heavily rely on CG grants and subsidies, which represent around 52% of LG revenues.	Dutch SNGs substantially rely on CG transfers, which represent over 74% of LG revenues.	CG transfers represent 32% of total LG income.
Tax raising capacity is particularly low (4% of total income). Main local taxes: property and land taxes.	Tax raising capacity is high. Local taxes represent 36% of LG revenues. Main local tax is municipal income tax for which LGs can set the rates.	Tax raising capacity is high representing 46% of total LG revenues. Unlimited right of LGs to levy the Personal Income Tax (PIT). This gives municipalities a risk close to the sovereign.	Tax raising capacity is moderate – around 19% of total revenue.	Tax raising capacity is relatively low – 10% of LG revenue. Municipalities have a right to set a property tax rate within pre-defined limits. Property taxation constitutes the largest share of local tax revenue.	Tax raising capacity is high representing 52% of LG income. Property tax represents about half of LGs' revenues and can be set freely (subject to citizen consultation).
Only 60% of LG spending is non-earmarked pointing to low spending autonomy. Own reserves are low.	To avoid municipal income tax increases, CG imposes a tax stop on the aggregate tax revenues. Regions are mainly financed by state grants and subsidies through an equalization system.	Long tradition of strong LGs' autonomy.	LGs raise around 26% of total revenue through commercial rates (fees) (commercial water charges, rental income, parking charges and similar).	Several grant funds exist which are redistributed based on an equalization system.	LGs have "power of general competency" on expenditures, meaning they are free to choose the activities they understand to fulfil their statutory role, subject to public consultation.
	CG guarantees sufficient financing for LGs.	High discretion over expenditures.	Very limited spending responsibilities, mainly in social protection and housing sectors.	Moderate discretion over expenditures. Municipalities receive earmarked grants (around 12% of revenues) which are subject to checks related to the objectives and conformity with rules.	
	High discretion over expenditures.				

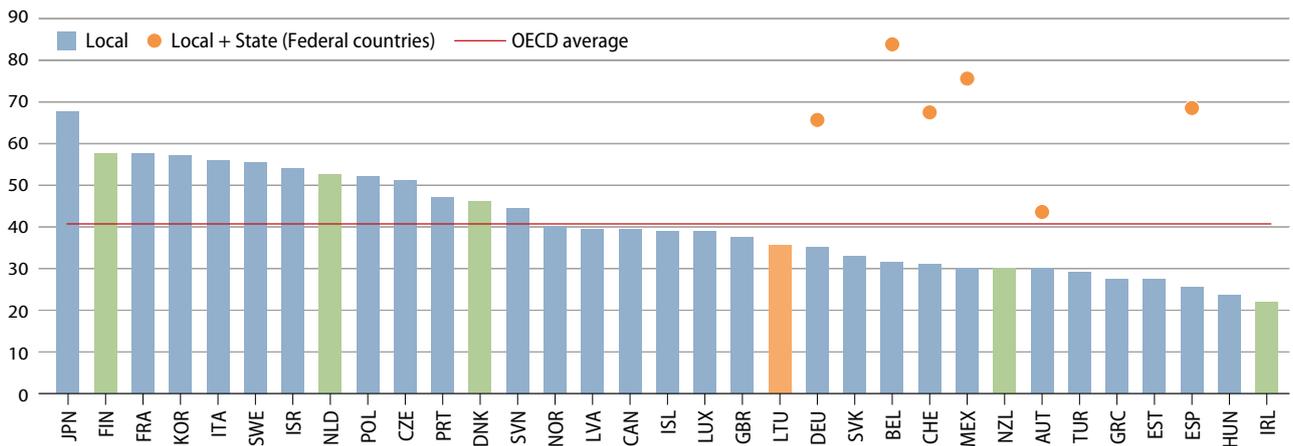
Source: Authors' analysis.

Figure 3.9. Key indicators of the relative weight of LGs in general government

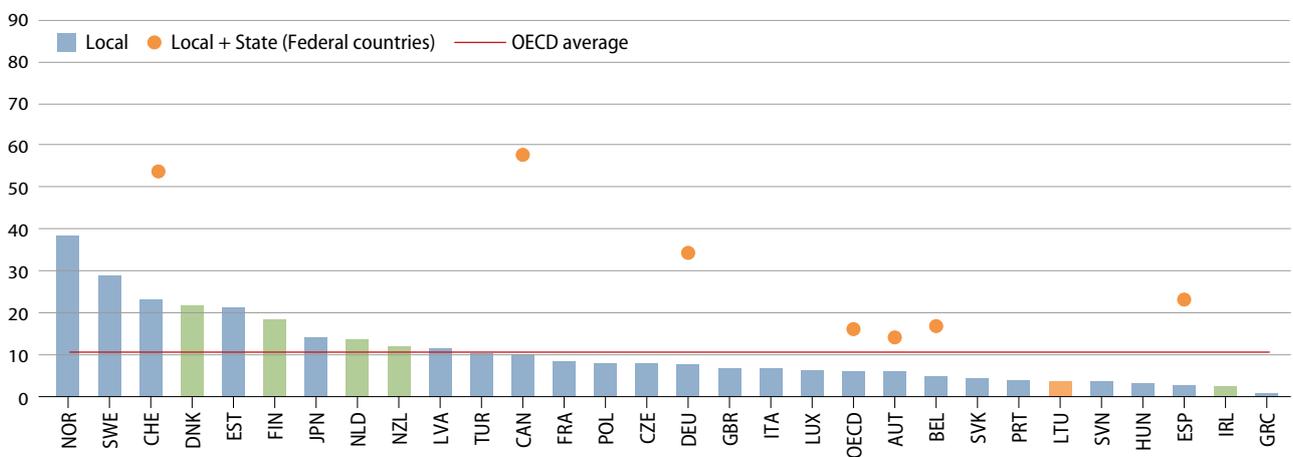
Panel A: LG expenditure, % of general government expenditure



Panel B: LG investments, % of general government investments



Panel C: LG debt, % of general government debt



Note: Green colour indicates benchmark countries and red highlights Lithuania. Panel A: data unavailable for Australia, Chile, Japan, South Korea, Turkey and USA; Panel B: Gross capital formation is used as a proxy for investment (GPSP), data unavailable for Australia, Chile, USA, data for New Zealand refers to 2017; Panel C: data unavailable for Israel, Australia, Chile, Iceland, South Korea, Mexico, USA.

Source: Panel A: OECD (2019^[33]), OECD Fiscal Decentralisation Database, <https://www.oecd.org/ctp/federalism/fiscal-decentralisation-database.htm>; Panel B: Calculations based on OECD (2019^[29]), National Accounts: Government deficit/surplus, revenue, expenditure and main aggregates, https://stats.oecd.org/Index.aspx?DataSetCode=SNA_TABLE12; Panel C: OECD (2019^[30]), Government at a Glance: Public Finance and Economics, <https://www.oecd.org/gov/government-at-a-glance-2019-database.htm>.

Public investments financed by LGs represent 35% of total public investment in Lithuania, while this share is over 41% in the OECD on average. The share of LGs in PI is smaller in both New Zealand (30%) and in Ireland (below 22%). Finland is the benchmark country with the highest participation of LGs in public investment (57%) (Panel B, Figure 3.9).

Spending autonomy of LGs in Lithuania is lower than in most benchmark countries

Countries such as Denmark, Finland and New Zealand have a long history of LG autonomy, in particular regarding spending decisions. LGs in Ireland in contrast have very limited spending responsibilities and discretion over expenditure. Lithuania is more similar to Ireland in this regards, with a relatively low spending autonomy for LGs: non-earmarked revenues represent only 60% of total LG revenues.

Recommendations on LG expenditure autonomy for Lithuania

Increase spending autonomy of LGs and give incentives for efficiency gains: Allow municipalities to retain and reallocate efficiency savings on all grants

Allow municipalities to retain and reallocate efficiency savings on all grants (both earmarked and general purpose). This would on the one hand, generate incentives to increase efficiency of spending (for example by establishing joint service centers with neighboring municipalities), and on the other hand, allow LGs to reallocate these funds to other priority areas (such as public investment).

Increase spending autonomy of LGs: reduce the share of earmarked grants and move away from input control toward output regulation

As fiscal rules constrain the budget, spending autonomy (understood as the capacity of LGs to re-allocate funds to priority areas and proxied by the share of non-earmarked revenues) is important to ensure the fiscal rules can be respected. Lithuania could increase the spending autonomy and re-allocation capacity of LGs by increasing the share of taxes in the revenue mix, and turning some earmarked grants into general purpose grants. Agree with LGs on which outputs should be delivered and the amount of the transfers, but privilege using general purpose grants than earmarked grants. This would leave LGs more flexibility on how to provide the goods and services and increase the incentives for LGs to seek efficiency gains while retaining quality standard of public services, as they could reallocate savings to other

priorities. Finally, explore options to move away from input regulation towards output regulation.

Reform the financing framework for delegated functions: merge the different sectoral grants into a smaller number of larger general purpose grants

Today, LGs receive earmarked grants from several different ministries. There is no ex-ante coordination of these ministries on their strategies in the LGs, which leads to fragmentation and inefficiencies. Grouping transfers from several sectoral ministry into larger grants and making them general purpose rather than earmarked would give LGs more flexibility for designing and implementing their policies. Controls should be on outputs (for example through regulation or contracts between levels of government) rather than on inputs.

DONOR FUNDING AND OTHER FUNDING SOURCES FOR LGs

Donor funding and other funding sources for LGs in Lithuania

LGs in Lithuania rely heavily on donor project funding support, especially from the European Union

Lithuanian municipalities substantially rely on donor project support to fund their public investments, with the European Structural and Investment Funds (ESIF) being the most significant.⁶

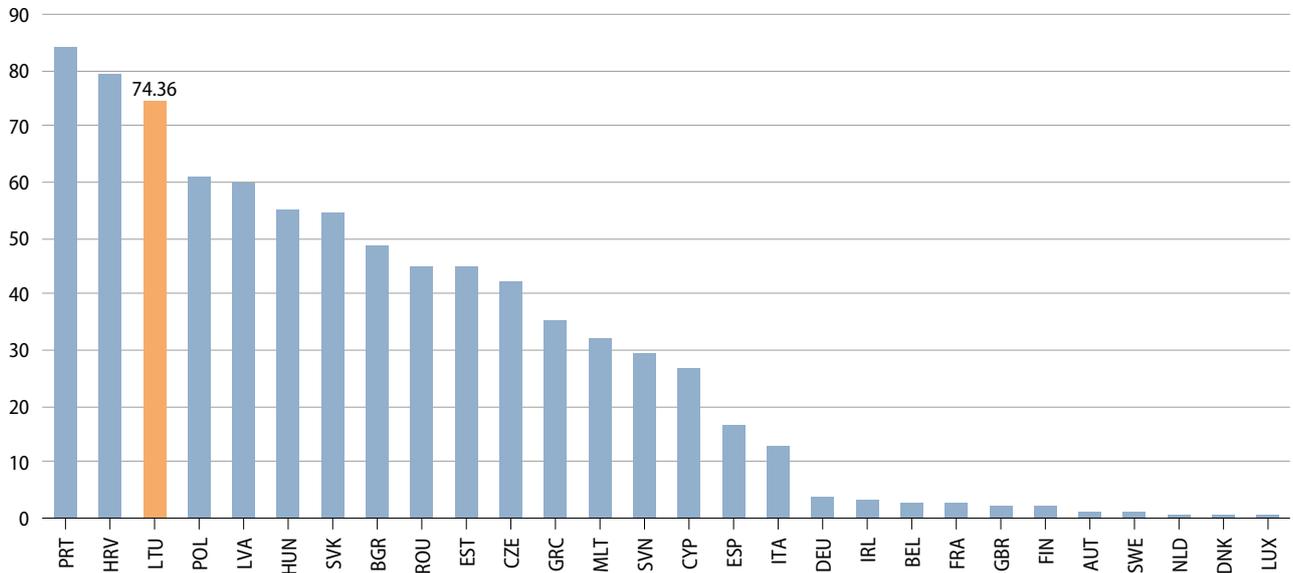
Some smaller but potentially growing grant schemes are also available for Lithuanian municipalities, including EEA and Norway Grants, Swiss bilateral cooperation programs and others.⁷ One of the primary areas of support is modernizing the public sector through cooperation between local authorities and public institutions in Lithuania and Norway. Co-financing rates vary depending on the project and lender.

Comparative analysis of donor funding and other funding sources

Table 3.3 provides a summary of the reliance of LGs on public investment grants in Lithuania and benchmark countries.

6. The ESIF allocated EUR 8.44 billion, or an average of EUR 2 849 per person, to three national programs over the 2014-2020 period. Lithuania's national contribution accounted for EUR 1.56 billion, resulting in a nearly EUR 10 billion investment budget (European Commission, 2020^[99]). Over this period, Lithuania submitted over 31 000 project applications and over 20 000 projects are in the implementation stage or are already finished (ES Investicijos, 2020^[98]).
7. As an example, the EEA and Norway Grants program allocated EUR 117.6 million for the 2014-2021 period aiming at reducing economic and social disparities and promoting cooperation. The amount of grants received has nearly doubled since Lithuania joined the program (EEA Grants, 2020^[33]).

Figure 3.10. Cohesion policy funding as an estimated share (%) of public investment 2015-2017



Source: European Commission (2020^[34]), Cohesion Policy Funding in Public Investment, <https://bit.ly/3hiNAPV>.

Figure 3.11. Funding from the EEA and Norway Grants to Lithuania have increased

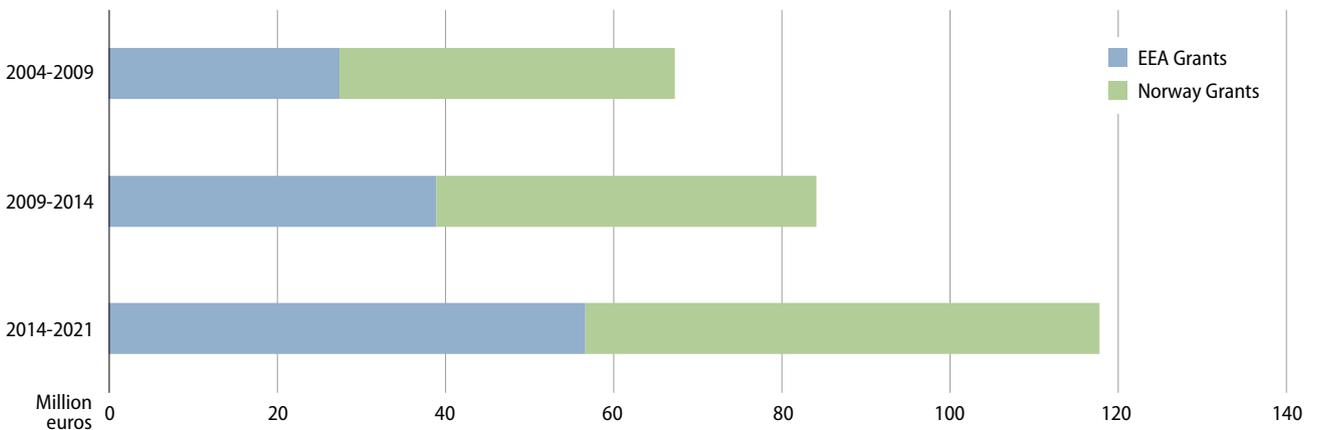


Table 3.3. Comparative summary of reliance on public investment grants in Lithuania and benchmark countries

Reliance on public investment grants					
LITHUANIA	Denmark	Finland	Ireland	Netherlands	New Zealand
Extremely high	Low	Low	High	High	Moderate
LGs heavily rely on donor project funding support, especially European Structural and Investment Fund (ESIF) support. Line ministries provide sectoral earmarked grants for local investments.	ESIF support is low. However, smaller municipalities sometimes engage in such practices and typically finance the matching part from their own funds rather than via borrowing.	Municipalities mostly use MuniFin loans to fund investments and barely rely on the assistance from the EU or other international organisations	ESIF support has been decreasing after having benefited substantially during the Cohesion period. In 2018, the CG created two competitive funds, which provide grants to LGs' public investment projects.	ESIF support is low. Most of the local investments are directly financed by line ministries through grants.	CG provides only a matching grant for transportation (roads).

Source: Authors' analysis.

Lithuania, as several benchmark countries, strongly relies on sectoral earmarked grants for public investment

Policy makers from different sectors and levels of government tend to work in silos. The lack of co-ordination is often recognised by all levels of government as one of the main impediments to effective investment (Pillar 1 in OECD (2019_[10])). High reliance on sectoral earmarked grants for LG public investment is a fragmented approach which often misses opportunities of complementarity of investment between sectors, and therefore leads to sub-optimal results in terms of regional development. For example, investments in housing need to be complemented by the right investment in transport network to attract citizens. The Dutch Multi-year programme for infrastructure, spatial planning and transport can provide an interesting insight of an integrated regional development approach (Box 3.1).

Lithuania's reliance on EU Cohesion funding is stronger than in the benchmark countries

Even if in 2021 Lithuania will receive record high funding from the EU through the Recovery and Resilience facility,⁸ the funding related to EU Cohesion Programmes is expected to decrease in subsequent periods, due to Lithuania's convergence within the EU. However, such decreases in Cohesion funding from EU are likely to be uneven, with Lithuania split in two regions: the capital region, which will see a sharp decline following strong catching up, and the rest of the country, where EU funding may still remain important.

Ireland provides a good example of a country which has successfully transitioned out of a high reliance on EU structural funds. As it was catching up with the EU average GDP per capita, Ireland has gradually replaced the EU funds with CG funding for LG public investment. It has recently created two funds for LG public investment which are funded through annual budget allocations from CG, and which use similar mechanisms as the EU structural funds for project selection and evaluation (Box 3.2).

8. The Recovery and Resilience Facility consists of large scale financial support (up to €310 billion in grants and up to €250 billion in loans) to the EU member states aimed to help rebuild more resilient economies in the aftermath of the Covid-19 pandemic (European Commission, 2020_[102]).

Box 3.1. DUTCH MULTI-YEAR PROGRAMME FOR INFRASTRUCTURE, SPATIAL PLANNING AND TRANSPORT (MIRT)

In the Netherlands, the Multi-Year Plan for Infrastructure, Spatial Planning and Transport (MIRT) is an investment programme set up by the Ministry of Infrastructure and Water Management, with the objective to improve the coherence among investments across several areas: spatial planning, economic development, mobility and liveability. In addition, the MIRT is organised in "Areas Agendas" (to be referred to in the future as "Regional Agendas"), where cooperation among national, provincial and municipal governments and third sector actors can take place.

Any Dutch Ministry and regional partners (provinces, municipalities, transport regions, or district water boards) can launch and/or participate in MIRT programmes. Each submitted project must pass through a MIRT Consultation Committee, guided by regional agendas, before being finalised in a collective agreement. This programme is funded through two funds emanating from the Ministry: an Infrastructure Fund, and a Delta Fund for water projects. The MIRT also sets a framework with rules and procedures to access national investment funding in order to guide project proposals and project selections (Dutch Ministry of Infrastructure and Water Management, 2018_[36]; Government of the Netherlands, 2019_[37]).

Source: OECD (2020_[38]), OECD Multi-level Governance Review. The Future of Regional Development and Investment in Wales, UK.

Recommendations on donor funding and other funding sources

Integrate sectoral funding sources into a coherent regional development approach

Lithuania should develop a place-based regional development strategy tailored to different places. It could use the newly created Regional Development Councils to seek complementarities among sector strategies. Sector policies should also be reviewed at an early stage to ensure that the impacts on the different types of regions and LGs are adequately considered.

Lithuania should seek alternative sources to EU structural funds to fund LG public investment funds

It could, for example, follow the Irish path, creating CG funds to finance regional development through LG public investment. This option will be explored in more details in section 6.2.

Box 3.2. TWO COMPETITIVE FUNDS IN IRELAND TO ENSURE SUFFICIENT FUNDING

In 2018, Ireland established two funds to fund public investment by local authorities: the Urban Regeneration and Development Fund (EUR 2 billion) within the Department of Housing, Planning and Local Government, and the Rural Regeneration and Development Fund (EUR 1 billion) within the Department of Rural and Community Development. These funds are inspired by the EU structural funds' competitive bid process and matching requirements and are fully funded by the state budget. The differentiation between urban and rural funds allows LGs with different needs, size and administrative capacities to access funding, avoiding competition for funding between rural and urban areas and projects. Eligibility criteria for these funds ensure that all local authorities are entitled to apply to one of the two funds.

Importantly, the funds are not bounded by thematic or sectoral requirements and thus do not create conditions for "policy follows funding" effect. On the contrary, the key evaluation criteria create incentives for Irish LGs to come up with complex and multi-dimensional and multi-sectoral projects, further strengthening their capacities. After the first call for tender in 2018-19, the key evaluation criteria were amended, considering what type of projects were submitted to encourage LGs and respond to their needs.

Irish LGs participating in these measures are required to co-finance at least 25% of the project. As municipal borrowing is somewhat restricted in Ireland (ceiling on the new annual borrowing), finding matching funds is sometimes a limiting factor. LGs in Ireland own land. When investment projects require land, LGs may provide the land as part of their contribution. Otherwise, LGs rely on their own revenues from property taxes and commercial rates as well as fund-raising from local communities and private donors to match their own contribution.

The evaluation process of the projects applying for these funds is sophisticated and no appeal is permitted. The submitted projects go through a thorough ex-ante evaluation process. LGs may request a feedback session in case of refusal. However, these are not systematic and are often replaced with better public communication of the key criteria. The performance review of the approved projects may also be conducted at any time throughout the implementation of the project. The finalised projects, moreover, are also subject to an ex-post assessment against the key criteria.

Source: OECD (2021^[39]), Financing and funding municipal public investment: analytical framework and application to five OECD countries, forthcoming.





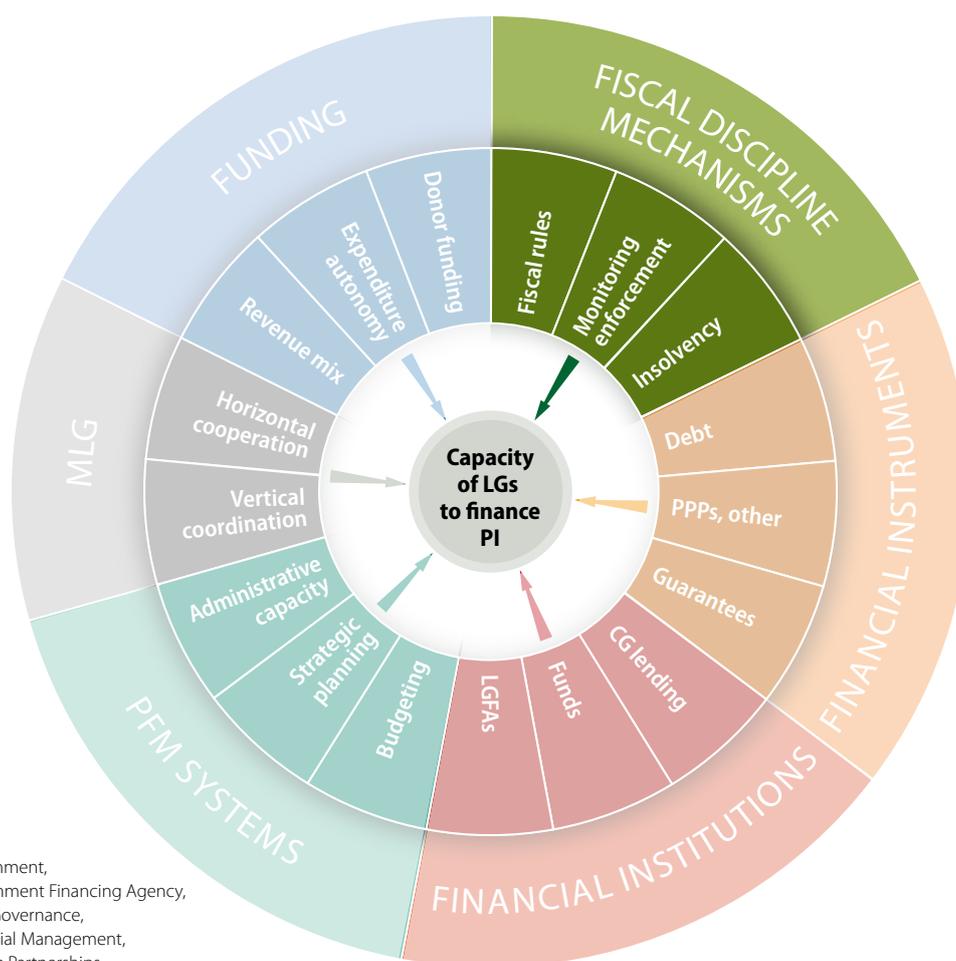
Fiscal rules that allow for municipal borrowing require tighter monitoring and enforcement mechanisms, which are key to ensure fiscal sustainability.

4. Fiscal Discipline Mechanisms

Following the approach presented in Chapter 2, this section describes Lithuania's current fiscal discipline mechanisms for LGs (Figure 4.1), compares each

element with the practices in the benchmark countries and provides preliminary recommendations (which will be further developed in the recommendations report).

Figure 4.1. **Analytical framework: fiscal discipline mechanisms**



Note:

CG – Central Government,
 LGFA – Local Government Financing Agency,
 MLG – Multi-Level Governance,
 PFM – Public Financial Management,
 PPPs – Public Private Partnerships

FISCAL RULES AND RULES ON LG ACCESS TO DEBT FINANCING

Fiscal rules and rules on LG access to debt financing in Lithuania

LGs in Lithuania are subject to various fiscal rules

On the fiscal rules side, municipalities are subject to:

- **Balanced budget rule (zero deficit):**

- Large municipalities whose expenditure exceed 0.3% of GDP (i.e. only four: Vilnius, Kaunas, Klaipėda and Šiauliai City) follow an annual structural balanced budget rule calculated on an accrual basis;

- All other municipalities are subject to an annual nominal balanced budget rule in cash terms.

- **Exceptions to the balanced budget rule (zero deficit):**

- In case of a negative output gap, a budget deficit up to 1.5% of projected revenues is allowed. This is applicable to all municipalities, except the large ones.
- The budget balance rule can be applied over a four-year period (instead of one year) for the municipalities which participate in the CG lending facility created in 2019 (Box 4.1).

When evaluating the municipality's budget compliance with the balanced budget rule, unspent funds of the previous years can be considered as revenues – excluding borrowed funds as well as balances of earmarked grants, which must be returned to the GC budget at the end of the year.

In addition to the budget rules, the Law on the Approval of Financial Indicators of the State Budget and Municipal Budgets specifies additional constraints on municipal borrowing. These constraints are revised annually.

- **Debt ceiling.** The annual Budget Law sets a ceiling to the total municipal debt.¹ This ceiling can change every year. It has decreased from 70% to 60% of projected revenue in 2018, except for Vilnius city which has a higher ceiling, which decreased from 135% for 2016 to 75% for 2020 (Table 4.1).
- **Net borrowing limit (debt to revenue limit):** The Annual budget law also sets a limit for the total annual net municipal borrowing as a share of total municipal revenues. These limits vary every year and are, therefore, difficult to predict (Table 4.1).
- **Guarantee limit:** municipal guarantees to municipal-owned enterprises cannot exceed 10% of the projected municipal revenues.

1. Short-term debt is not counted in these limits, but debt of municipal owned enterprises is counted.

- **Escape clause:** In case of exceptional circumstances, the CG can call a general escape clause and temporarily suspend fiscal rules. While many OECD countries have triggered a general escape clause following the COVID-19 pandemic, and allowed LGs' deficits and debts to increase, this has not been the case in Lithuania. Instead, in order to support LGs without breaking the fiscal rules, the CG has given LGs short-term loans, which will be counted as revenue when checking against the balanced budget rule.

Box 4.1: SPECIAL INCENTIVE TO ENCOURAGE HIGH-QUALITY MUNICIPAL INVESTMENTS IN LITHUANIA

In 2019, the Ministry of Finance created a mechanism to encourage municipalities to implement high-quality investments, i.e. investment projects that would either contribute to regional and socio-economic development objectives, or reduce budget expenditure and/or increase budget revenue. It allocated funds (EUR 17 million in 2019, EUR 9 million in 2020) to lend to municipalities who presented high quality investment projects, which must be assessed and approved by the CPMA. In 2019, 26 projects were financed for a total amount of EUR 13.6 million.

As part of this measure, the budget balance rule is relaxed to four years (instead of one) for the municipalities participating in this borrowing facility. However, annual net borrowing for these projects cannot exceed 10% (5% in 2019) of projected municipal revenue for an individual municipality.

Table 4.1. Recent modifications to the net borrowing limit

Year	Debt ceiling, % of projected revenue	Debt ceiling for Vilnius City municipality	Net borrowing limit
2016	70%	135%	Large municipalities: 15% of projected revenues (excluding earmarked grants); Small municipalities: 1.5% of budgetary revenues; Additional borrowing restrictions to municipalities with debts higher than 40% of projected revenues (excluding earmarked grants).
2017	70%	130%	Large municipalities: 15% of projected revenues (excluding earmarked grants); Small municipalities: annual net borrowing cannot be a positive indicator.
2018	60%	85%	Annual net borrowing cannot be a positive indicator.
2019	60%	85%	Annual net borrowing for projects selected by the Ministry of Finance cannot exceed 5% of projected municipal revenue in a given municipality. Total net borrowing for all municipalities participating in this measure cannot exceed 1% of total revenues.
2020	60%	75%	Annual net borrowing for projects selected by the Ministry of Finance cannot exceed 10% of projected municipal revenue in a given municipality. Total net borrowing for all municipalities participating in this measure cannot exceed 0.5% of total revenues.

Source: Lietuvos Respublikos valstybės biudžeto ir savivaldybių biudžetų finansinių rodiklių patvirtinimo įstatymas (2016, 2017, 2018, 2019, 2020).

Lithuanian municipalities are not subject to an expenditure rule, and they do not need to request the authorisation of CG to borrow, provided they stay within the above-mentioned limits.

The balanced budget rule (zero deficit) is the most binding rule

The average debt to revenue ratio for municipalities in Lithuania is 26%, and all municipalities are far below the 60% (75% in the case of Vilnius city) debt ceiling except two (Vilnius city and Rokiškio district) (Figure 4.2). Given the strict balanced budget rule (zero deficit) in cash terms and calculated on an annual basis, it is impossible for the levels of debts of municipalities to grow. The debt ceiling therefore appears irrelevant.

The current system led to a reduction in LG debt levels, as well as their investment levels

In financial terms, the current system for funding and financing LG public investment may be considered successful, as the finances of LGs have been in aggregate surplus over the past five years, and LG debt levels have declined steadily (Table 4.2, Panel A). However, in economic terms, such a tight system may prevent potentially desirable public investments from being implemented, and LG public investment has shown a

sharp decline since 2010 (Table 4.2, Panel B). Given the current historically low interest rates, this generates missed opportunities for financing socially and economically desirable investments.²

Comparative analysis of fiscal rules and direct controls

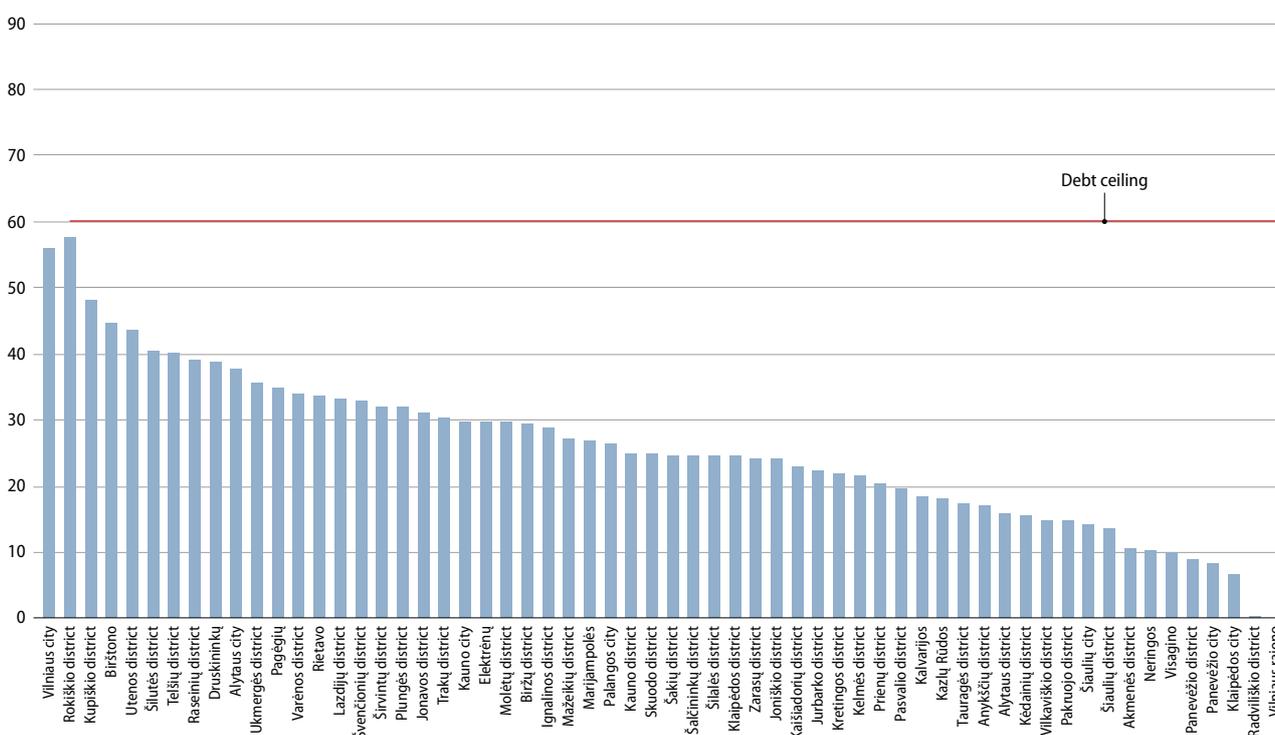
Table 4.2 provides a comparative summary of fiscal rules and direct controls in Lithuania and benchmark countries.

Lithuania’s fiscal rules for general government are amongst the most stringent in the Euro zone

Lithuania has a long history of tight budget rules. It introduced a balanced budget principle for general government in the Organic Law in 1992, and gradually strengthened fiscal rules since (Figure 4.4, Panel A) to become some of the tightest in the EU (Figure 4.4, Panel B). In 2015, in the context of transposition of the EU legislation (Box 4.2), the structural balanced budget principle was written in the Constitutional Law on the Implementation of the Fiscal Treaty (CLIFT), which also specifies the rules for LGs (Box 4.2).

2. By desirable, we mean that the social and economic benefits of an investment outweigh its costs.

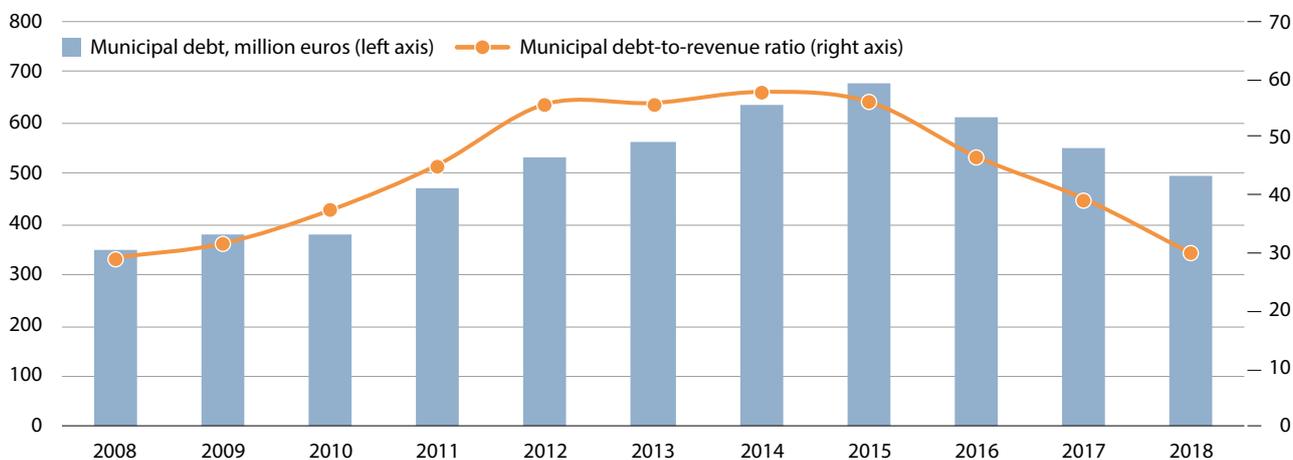
Figure 4.2. Debt as a share of projected revenues for Lithuanian municipalities, 2018



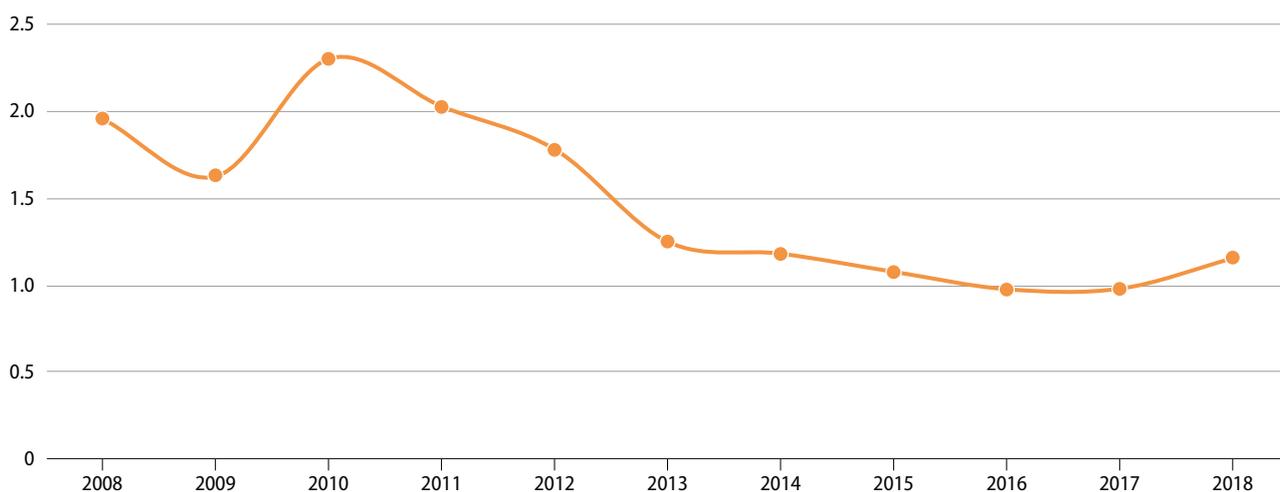
Source: Source: Ministry of Finance (2018_[40]), Savivaldybių skolinimosi limitai, <https://finmin.lrv.lt/lt/veiklos-sritys/biudzetas/biudzeto-vykdydas/savivaldybiu-biudzetai/savivaldybiu-skolinimosi-limitai>.

Figure 4.3. Debt levels have been declining since the introduction of the CLIFT

Panel A. Evolution of LG debt levels since 2008



Panel B. Evolution of LG capital investment as a share of GDP since 2008



Source: A: National Audit Office (2020_[41]), Presentation on Municipal Debt in Lithuania, B: Eurostat (2020_[6]) The Government Finance Statistics (GFS), <https://ec.europa.eu/eurostat/web/government-finance-statistics/data>.

BBR for LGs (except the four largest municipalities) in Lithuania is amongst the most stringent in the OECD

While all benchmark countries have a balanced budget rule (BBR) for LGs (i.e. budgets balance must be zero or positive), there are in practice large differences in the stringency of these rules and their implication for the capacity of the LGs to finance public investment through borrowing. Indeed, there are different types of BBRs, depending on the accounting standards used (cash or accruals), the coverage of the BBR (current, capital or overall expenditure, includes off-budget funds or not), the target for the rule (submitted budgets, approved budgets, realised budgets) and finally, its cyclicity (annual, multi annual or structural).

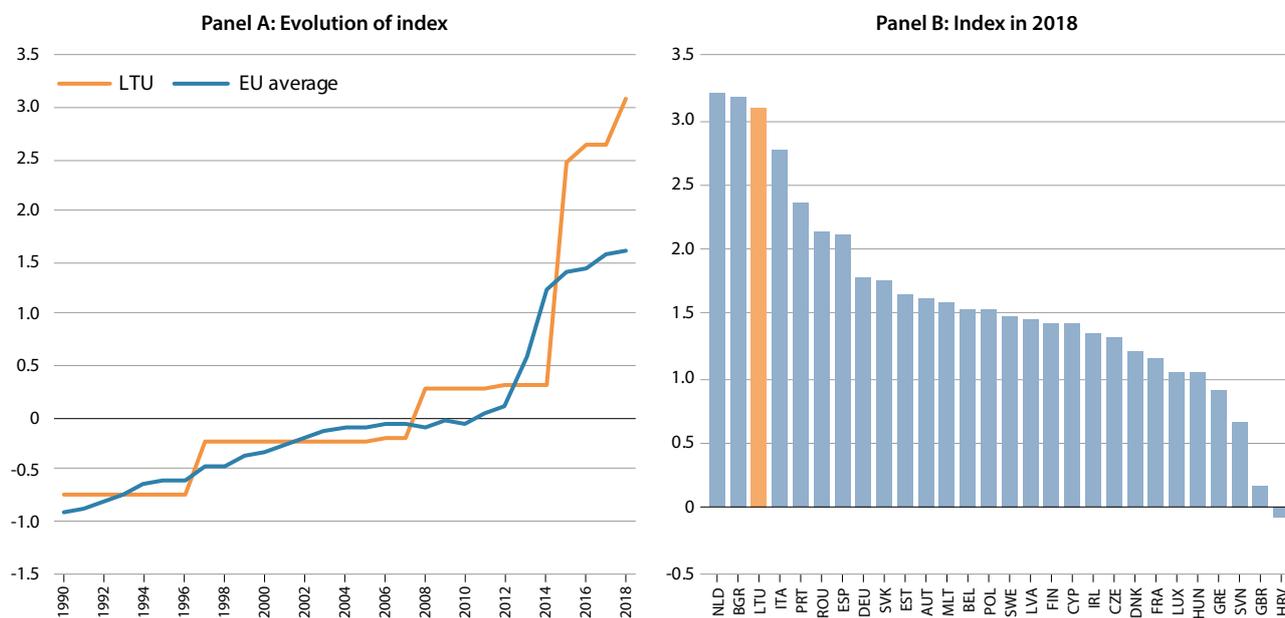
The BBR for all but the four largest municipalities in Lithuania is calculated in cash, which implies that the whole cost of the investment is allocated to the year when it is financed. It is annual, therefore the cost of investment cannot be distributed on several years, and it applies for both capital and current expenditure (Table 4.3 and Box 4.3). Only Luxembourg and Poland have a BBR with such stringent characteristics for their LGs (see Table 4.3 and Table A B.1 in Annex B). The BBR in Lithuania covers both the current and capital accounts in aggregate, and applies to the realised budgets – but with no obligation to offset the realised deficits in subsequent years (Figure 4.5). Finally, the statutory basis for the fiscal rules for LGs in Lithuania is a constitutional law, while in most OECD countries, these are set in ordinary laws or political commitments (Table 4.4).

Table 4.2. **Comparative summary of fiscal rules and direct controls in Lithuania and benchmark countries**

Fiscal rules and direct controls						
	LITHUANIA	Denmark	Finland	Ireland	Netherlands	New Zealand
Fiscal rules and direct controls	<p>High</p> <p>LGs are subject to annual balanced budget rules in cash terms (except four largest municipalities which calculate the rule in accruals).</p> <p>In case of a negative output gap, a budget deficit up to 1.5% of projected revenues is allowed for small municipalities. The deficit for large municipalities in this case cannot exceed the cyclical component of the budget.</p> <p>The BBR applies to both current and capital budgets together.</p> <p>LGs are also subject to a net debt to revenue limit and debt ceilings, which are set annually and modified frequently.</p>	<p>High</p> <p>LGs are subject to a structural balanced budget rule (on operating and capital budgets in aggregate).</p> <p>Expenditure ceiling (separate for services and capital expenditure) – ceiling on aggregate LG expenditure, not on individual municipalities.</p>	<p>Moderate</p> <p>Strict and tightly enforced balanced budget rule. LGs must present financial plans in balance or surplus (calculated in accruals and including both capital and operating budgets), and if a deficit happens, it must be covered within four years.</p>	<p>Low</p> <p>LGs are subject to the balanced budget rule on their operating budget (golden rule) calculated in accruals.</p> <p>Deficit rule applied to LG sector as a whole not on individual municipalities.</p>	<p>High</p> <p>Structural balanced budget rule (on both operating and capital budgets and off-budget funds) calculated in modified cash basis.</p> <p>Multi-annual budget balance requirement – similar to that of CG.</p> <p>Borrowing limits on short and long term borrowing to limit risks of an interest rate change.</p>	<p>Low</p> <p>Only balanced budget rule on operating expenditures (golden rule) calculated in accruals. No restriction for capital expenditure.</p>
Direct controls	<p>Low</p> <p>LGs do not need to request the authorisation of CG to borrow.</p>	<p>Extremely high</p> <p>Generally, borrowing is not permitted. Several exceptions exist: borrowing for utility services and borrowing with a prior agreement for other types of investments is allowed. .</p>	<p>Low</p> <p>Municipalities are allowed to act at their own discretion as long as they are within the established rules.</p>	<p>Extremely high</p> <p>LGs can only borrow from CG and are subject to an annual debt ceiling for new borrowing.</p>	<p>Low</p> <p>No CG direct controls with regards to borrowing.</p>	<p>Low</p> <p>Reporting mechanisms are very developed, but there are no direct controls.</p>

Source: Authors' analysis.

Figure 4.4. EC numeric fiscal rules index for general government



Note: Panel A: EU average represents unweighted averages. A composite index captures the strength of fiscal rules, using information on i) legal base, ii) binding character, iii) monitoring bodies, iv) correction mechanisms, and v) resilience to shocks. The fiscal rule index adjusted for the sector coverage.

Source: European Commission (2020_[42]), Numeric fiscal rules database, https://ec.europa.eu/info/publications/fiscal-rules-database_en.

Box 4.2. THE CONSTITUTIONAL LAW ON THE IMPLEMENTATION OF THE FISCAL TREATY

Lithuania was one of 25 European Union Member States that signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union on 2 March 2012 and committed to transpose its provisions to the national law. The Seimas ratified the Treaty on 28 June 2012 and adopted the Republic of Lithuania Constitutional Law on the Implementation of the Fiscal Treaty (CLIFT) on 6 November 2014.

The main objective of the CLIFT is to ensure the sustainability of general government finances and stable development of the economy by managing the structural general government balance. The EU two-pack provisions that came into effect after the adoption of the euro in 2015 also aim to increase fiscal discipline in Lithuania, since stricter control by the EU Commission is applied. These provisions help to identify emerging macroeconomic imbalances as early as possible and take measures to reduce them.

The CLIFT lays down a number of rules that constrain the national budget. Each year, except in years of exceptional circumstances, at least one of four conditions must be satisfied:

1. General government sector is actually in surplus in structural terms;

2. If output gap is positive:
 - a. Actual structural general government sector balance indicator in absolute value is lower than the medium-term objective in absolute value
 - b. and is annually decreasing,
3. If output gap is negative:
 - a. Actual structural general government sector balance indicator in absolute value is lower than the medium-term objective in absolute value.
4. Actual structural general government sector balance indicator adjustment towards the medium-term objective in absolute value is not lower than the targeted structural adjustment in absolute value.

The CLIFT also sets out rules in relation to a medium-term budgetary objective (MTO). Fiscal rules pertaining to municipalities are also specified in the CLIFT: the budget for small municipalities must be nominally balanced every year and for large municipalities it must be structurally balanced every year.

The monitoring of compliance with the rules envisaged by the CLIFT and implementation of annual SITs is performed by the National Audit Office – Budget Policy Monitoring Department – Lithuania’s Independent Fiscal Institution.

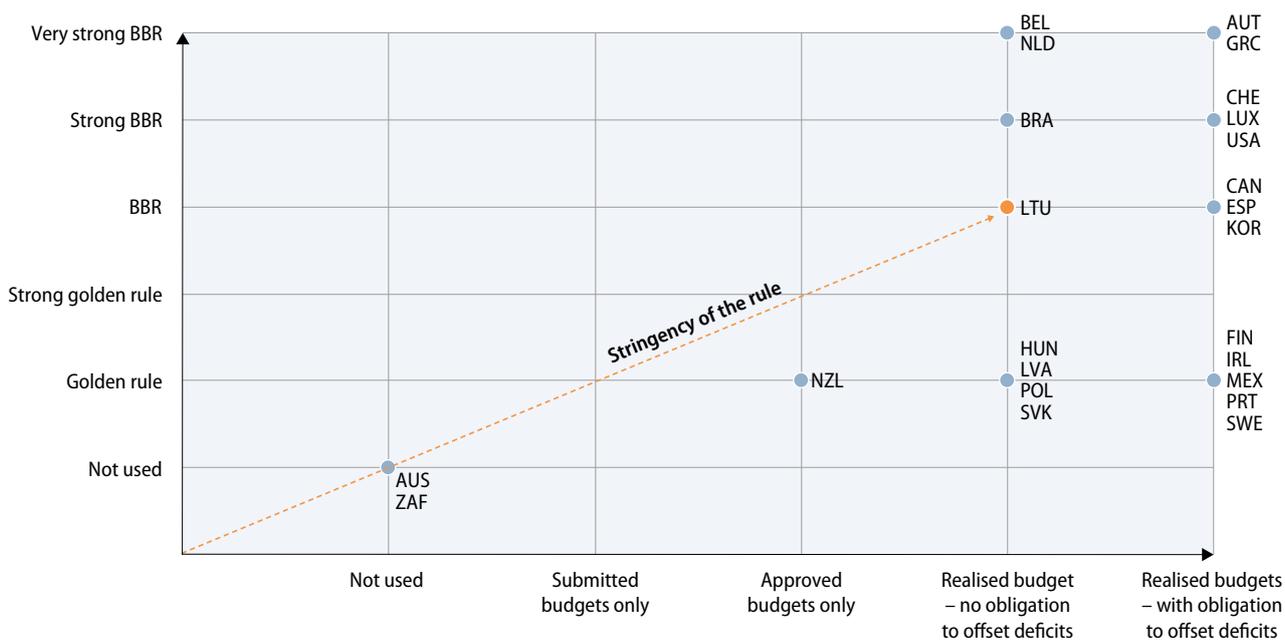
Table 4.3. Cyclical standards used for BBR

Not used	Varies with the length of the economic cycle	Pre-determined multi-annual period (years)	Annual	Other
USA***		CAN*	BEL	AUT
TUR		GRC (4)**	BRA	
		USA (2)***	CAN*	
		ESP (3)	GRC**	
		FIN (4)	HUN	
		SVN (3)	IRE	
			KOR	
			LTU	
			LUX	
			LVA	
			MEX	
			NLD	
			NZL	
			POL	
			PRT	
			SVK	
			SWE	
			USA***	
3	0	6	10	1

Notes: * Depends on a province, for some the BBR applies annually, for others it may range from 3 to 5 years; ** The medium term target refers to the total local government subsector and instructions for the preparation of the annual budgets of local governments take into consideration the targets set by the medium term fiscal strategies; *** Federal reimbursements and aid happen for specific purposes, tax collections do not always go through appropriations process and some states do not require universities to collect money on an annual or biennial basis.

Source: Vammalle and Bambalaite (2021^[43]), Fiscal rules for Sub-national governments. The Devil in the Details (forthcoming) based on OECD (2020^[44]), Survey on Fiscal Rules for Sub-National Governments, 2019 update, question 2.3.

Figure 4.5. Stringency of the BBR according to the coverage and target of the rule



Note: Values are subject to change after vetting from respective countries.

Source: Vammalle and Bambalaite (2021^[43]), Fiscal rules for Sub-national governments. The Devil in the Details (forthcoming) based on OECD (2020^[44]), Survey on Fiscal Rules for Sub-National Governments, 2019 update, question 2.1, 2.4 and 2.5.

Box 4.3. STANDARD & POOR'S METHODOLOGY FOR ASSESSING INITIAL BUDGETARY PERFORMANCE

To ensure comparability despite the use of different accounting standards in LGs, S&P carries out adjustments in order to form a modified cash base. To do this, they eliminate the noncash items, such as depreciation and provisions.

S&P's initial assessment of a LG's budgetary performance relies on two key ratios:

- **Operating balance as a percentage of adjusted operating revenues.** S&P considers that the operating balance, when calculated on a cash or modified cash basis as a percentage of adjusted operating revenues gives a good proxy for a LG's cash flows from operations. The ratio reflects the extent to which a LG can finance its operational costs and public services from recurring revenues (mostly taxes and operating subsidies).
- **Balance after capital accounts as a percentage of total adjusted revenues.** S&P considers that the balance after capital accounts represents a proxy for the overall funding needs or surplus that a LG derives from its operating and capital activities, and would generally correspond to changes in net debt (debt net of cash and liquid assets) in a pure cash-based accounting system. A LG can finance the balance either by drawing on its cash reserves, or by borrowing.

Note that Standard & Poor's uses a modified cash base, but does not require these balances to be zero or positive. The size of the deficit is assessed against other parameters such as the level and volatility of LGs' expected cash flows (operating and capital), budget flexibility and other forms of underspending (such as pension, off-budget financing and accounts payable).

Glossary:

- **Operating revenues:** recurring revenues that LGs receive. Operating revenues comprise taxes and non-tax revenues such as grants, operating subsidies, fines, fees, tariffs, rents and other sources from which LGs derive revenues. They exclude capital revenues such as capital subsidies and proceeds from asset sales, and any revenues from borrowed funds.
- **Operating expenditure:** correspond to the costs of a LG's operations, wages paid, its administration and its provision of services to the population, directly or through other public bodies, as well as interest expenses.
- **Adjusted operating balance** equals adjusted operating revenues minus adjusted operating expenditures.
- **Adjusted operating revenues:** operating revenues adjusted for material noncash and pass through items when deemed relevant.
- **Adjusted operating expenditure:** operating expenditures adjusted for material noncash (provisions, depreciation) or pass-through items.
- **Balance after capital accounts** = operating balance + capital revenues - capital expenditure.

Source: S&P Global Ratings (2019^[45]), Methodology for Rating Local and Regional Governments outside of the U.S.

Table 4.4. Statutory base of BBR for local governments

Constitutional or higher than ordinary law	Ordinary law	Political commitment
Bulgaria	Belgium	Ireland
Cyprus	Finland	
France	Germany	
Italy	Luxembourg	
Lithuania	Poland	
Slovakia	Romania	
	Sweden	
6	7	1

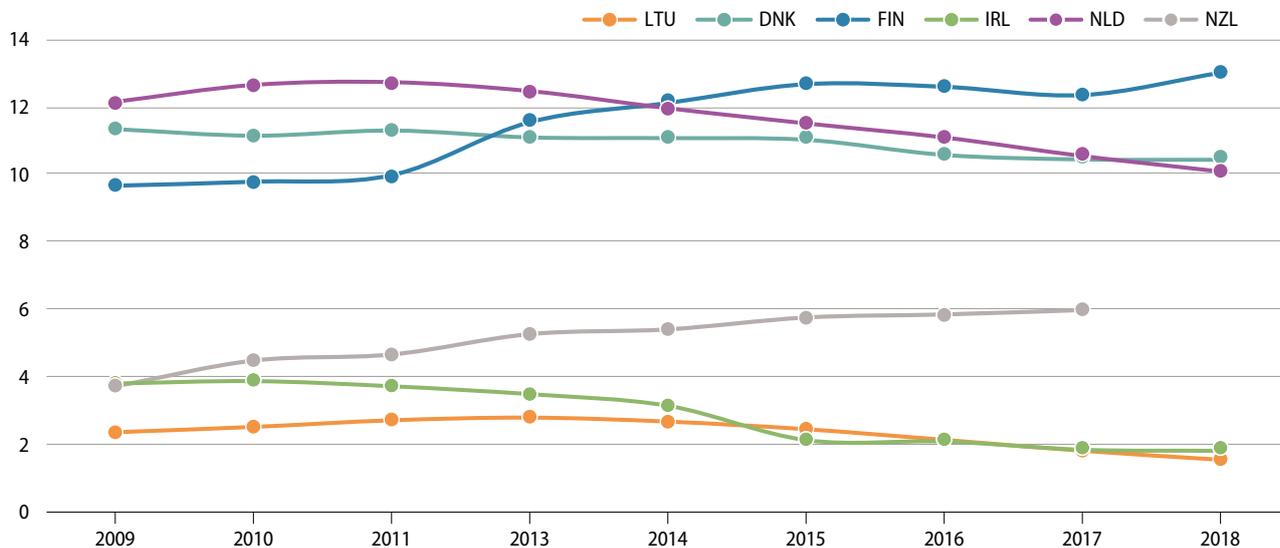
Source: European Commission (2020^[42]), Numeric fiscal rules database, https://ec.europa.eu/info/publications/fiscal-rules-database_en.

The share of LG debt to GDP in Lithuania is the lowest in the OECD and amongst benchmark countries, and has been declining since 2013

The share of LG debt to GDP in Lithuania is now below 2% of GDP (Figure 4.6). Ireland's LGs debt is similar to Lithuania's. In New Zealand, this ratio has increased from 5% to 6% between 2009 and 2017. In Denmark and the Netherlands, the ratio is slightly above 10% (down from about 12% in 2009-2012). The highest is Finland, where the LG debt to GDP ratio has increased from 10% in 2009 to 13% in 2018.

There is a clear correlation between LGs' public investment and debt levels as a share of GDP (Figure 4.7). As fiscal rules in Lithuania highly constrain LGs' capacity

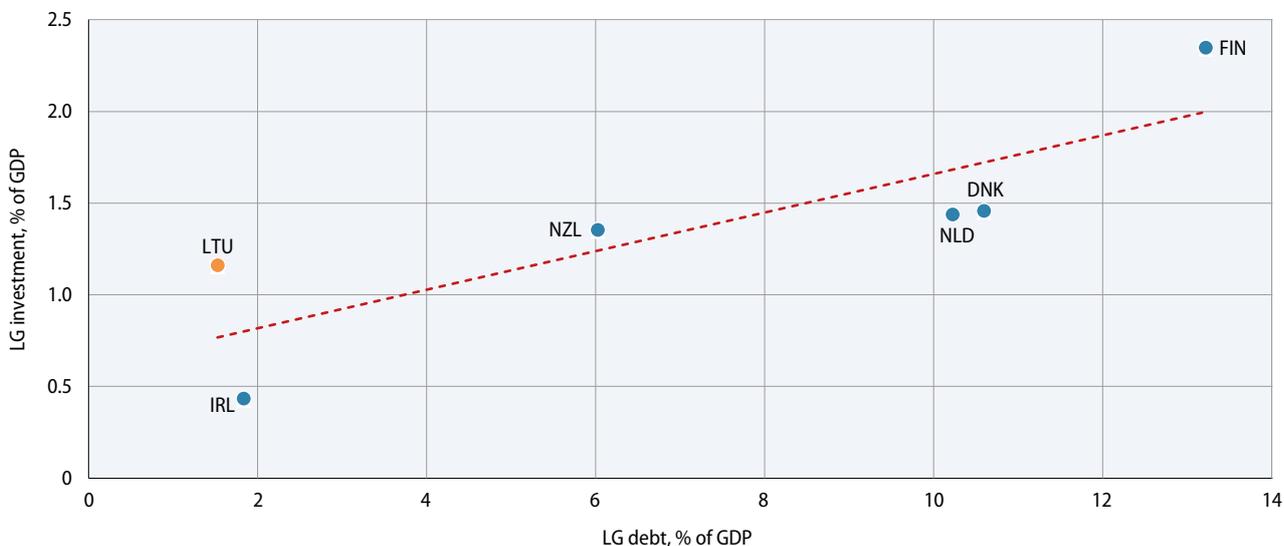
Figure 4.6. LG debt as a share of GDP, 2018



Note: Data for 2018 for New Zealand not available.

Source: OECD (2019_[30]), Government at a Glance: Public Finance and Economics, <https://www.oecd.org/gov/government-at-a-glance-2019-database.htm>.

Figure 4.7. Relation between LG debt and investment as a share of GDP, 2018



Note: Data for New Zealand refers to 2017.

Source: Calculations based on OECD (2019_[30]), Government at a Glance: Public Finance and Economics, <https://www.oecd.org/gov/government-at-a-glance-2019-database.htm>; OECD (2019_[46]), National Accounts: Gross Domestic Product (GDP), <https://stats.oecd.org/index.aspx?queryid=60702#>.

to borrow – in particular the net borrowing rule –, it is not surprising that LGs’ public investment also represent a smaller share of GDP than the benchmark countries (except Ireland, where LGs’ role in public investment is even smaller than in Lithuania). This implies that if Lithuania wants LGs to increase their level of public investment (to generate growth, or nowadays, to fight against the economic downturn caused by the COVID-19

crisis), it needs to tolerate a slightly higher level of LG debt. As the examples of the benchmark countries show, there are fiscal and governance frameworks to allow this to happen without threatening the fiscal sustainability of LGs or the country. In addition, LG debt represents less than 2% of GDP today, which hardly affects the room for the CG to borrow within the EU fiscal limits (60% of GDP for general government debt).

The BBR in Lithuania is more stringent for smaller municipalities than for larger ones. While many countries have different rules for states/provinces than for LGs, none of the benchmark countries has different rules for different types of LGs

The BBR in Lithuania is much more stringent for smaller municipalities (whose revenues represent less than 0.3% of GDP) than for the four largest ones. Smaller municipalities are subject to an annual BBR calculated in cash, while the larger ones have a structural BBR calculated in accruals. Smaller LGs are therefore much more constrained in their borrowing capacity for financing public investment than larger ones.

The BBR for smaller municipalities is calculated on an annual basis, except when there is a negative output gap, where a deficit of 1.5% of projected revenues is allowed. This could be described as an asymmetric structural rule, where deficits can be built in years with a negative output gap, but these do not have to be offset by surpluses in the years with a positive output gap.

Lithuania is the only country analysed where LGs are subject to annually set debt ceilings and net borrowing limits

In addition to the BBR, Lithuanian LGs are also subject to debt ceilings and net borrowing limits (new borrowing minus repayments as a share of total municipal revenues). These ceilings are set annually and frequently modified. Amongst the benchmark countries, only Ireland sets annual debt ceilings. The Netherlands has pre-established ceilings which differentiate for short-term and long-term debt.

As most benchmark countries, Lithuanian LGs are not subject to expenditure ceilings or direct borrowing controls

Lithuanian LGs do not have expenditure ceilings. The only benchmark country which has an expenditure ceilings is Denmark. But these are not set on individual LGs, but on the aggregate spending by all LGs, letting the LGs allocate the room for expenditure amongst themselves.

Finally, Lithuanian LGs are not subject to direct controls, unlike Ireland, where LGs must request an approval from the Ministry of Finance to be allowed to issue debt. In Denmark, the default rule is that LGs cannot borrow. However, there are a number of exceptional cases where they can borrow, but they must first apply to a “loan pool” and get approval from the Ministry of Interior.

Recommendations on fiscal rules and rules on LGs access to debt financing for Lithuania

Simplify the system of FRs: Unify the rules by applying the annual structurally balanced budget rule based on accruals to all municipalities, remove the net borrowing limit and change the debt ceiling less frequently

The present system consists of overlapping fiscal rules and is quite complex, as determining which fiscal rule is binding depends on several parameters (output gap, participation in the 2019 CG lending facility, etc.). In addition, two of the limits are set annually and modified frequently, therefore making it difficult for LGs to anticipate what will be their capacity to borrow, and therefore, to develop and implement a medium-to-long-term infrastructure plan.

Applying tighter fiscal rules to smaller LGs in terms of GDP can have the unintended effect of widening even more the gap between the richest and the poorest LGs, by preventing those that would most benefit from growth enhancing investments to carry them out.

The same annual structurally balanced budget rule based on accruals should therefore be applied to all municipalities. For smaller municipalities, the national output gap could be used for calculating the structural balance. Alternatively, the rule could be changed into a multi-annual balanced budget rule calculated in accruals, which would be easier to calculate.

Separate operating and capital accounts and apply the annual multi-annual balanced budget rule in accruals to the operating budget only (Golden rule)

When discussing fiscal rules for LGs, it is important to distinguish between the operating balance, and the capital balance (or balance after capital accounts) (Box 4.3).

LGs should maintain balanced or positive operating budgets, and borrowing to finance operating deficits should be avoided as it could lead to uncontrolled increases in debt (Kalcheva and Anderson, 2018^[32]). Indeed, the operating balance reflects the extent to which a LG can finance its operational costs and public services from recurring revenues (mostly taxes and grants). Under normal economic circumstances, good financial management practices and a well-designed multi-level fiscal framework should ensure that LGs can achieve a positive net operating balance each year. When this is not the case, it is important to assess whether the assigned revenues and revenue raising

capacity are adequate to cover assigned expenditure responsibilities, and whether the financial management capacity of the LGs is sufficient.

Regarding the capital account, there is a wide consensus that LGs should be able to run deficits on these, in order to finance economically sound and socially desirable public investment (“Golden rule”). Of course, applying this rule implies that LGs financial management practices differentiate between capital and operational budgets and accounts. Borrowing for public investment should be allowed, under strict scrutiny of the quality of the projects (i.e. LGs need to demonstrate the projects will have a positive economic, social or environmental outcome). While quality should be monitored, the area and type of project should be left to the appreciation of the LG (with CG technical support when needed), to avoid opportunistic behaviour from LGs to develop projects following finance opportunities, rather than prioritizing projects according to their needs, and then searching for the financing sources.

Use the existing debt ceiling (calculated as a share of revenues excluding earmarked grants) to ensure fiscal sustainability. As mentioned previously, LGs should also have an increased capacity to generate own revenues, which would then allow them to leverage a higher level of borrowing and finance more investment projects.

MONITORING AND ENFORCEMENT MECHANISMS

Monitoring and enforcement mechanisms in Lithuania **The main consequence for breaking LG fiscal rules is losing CG co-financing grant for EU funds**

Lithuanian monitoring and enforcement mechanisms are quite clear, and very few LGs breach the rules (only three out of the 60 were in non-compliance during 2019,³ for example). Debt levels are monitored by the Ministry of Finance (including debts of municipal-owned enterprises, even if the latter are less scrutinised). In case of non-compliance with the rules, the main sanction is that the LG loses the possibility to receive CG grants (“non-returnable subsidies”) for the co-financing of projects from the EU Structural Funds.⁴

3. According to the ex-ante compliance assessment performed by the Independent Fiscal Institution (IFI) (2019_[81]). The IFI holds a mandate of annually assessing municipalities’ ex-ante and ex-post compliance with the balanced budget rule.

4. The four biggest municipalities do not participate in the non-returnable subsidy scheme.

With regards to borrowing, municipal councils, which have the exclusive right to make decisions on taking loans and provide guarantees for long-term loans, can take loans only to finance investment projects upon receipt of the opinion of the municipal controller.

LGs breaching fiscal rules are also subject to “moral sanction”

In case of *ex-post* non-compliance with the balanced budget rule, which have caused deviation from the GG structural budget balance, municipalities are subject to “moral sanction”: they must submit to the Ministry of Finance a written explanation of the breach. Following the official letter submission, the municipality, at its own discretion, can decide upon the corrective measures for the next year. These may include raising tax rates and/or reducing spending. These measures are not of compensatory nature and, therefore, apply only to the year following the year where the deviation was registered. There is no transitional period for returning to the balanced budget rule, as municipalities must plan their annual budgets in accordance with the rule.

The Ministry of Finance has the responsibility of monitoring LGs compliance with fiscal rules

The Ministry of Finance has a mandate of administrative supervision over the performance of municipalities. It conducts in-year monitoring of municipal debt levels and the adherence to borrowing limits by assessing quarterly submitted financial statements and municipal audit conclusions. However, the scrutiny and monitoring of municipal-owned enterprises’ debt levels are quite weak, according to the Ministry of Finance. This is particularly relevant in the cases when municipal-owned enterprises borrow using municipal guarantees, which are subject to a limit set in the Law on the Approval of Financial Indicators of the State Budget and Municipal Budgets.

CPMA is developing a tool to identify risks related to property liabilities for municipalities

For the moment, liabilities from PPPs are regularly monitored, but there is no monitoring of long-term property liabilities of municipalities and the risks and costs associated with these. There is no information about the kind and age of municipal properties, and when renovation (i.e. increased spending) will be necessary. The CPMA is trying to create a tool for municipalities to consolidate all their property liabilities and forecast costs. If successful, this tool would help plan borrowing needs and PPPs. A pilot is currently being experimented in Kaunas district municipality.

Table 4.5. **Comparative summary of monitoring and enforcement mechanisms in Lithuania and benchmark countries**

Monitoring and enforcement mechanisms					
LITHUANIA	Denmark	Finland	Ireland	Netherlands	New Zealand
Moderate	Extremely high	Extremely high	Moderate	High	High
Compliance with fiscal rules is strictly monitored by the Ministry of Finance. In case of non-compliance, the main sanction is that the LG loses the possibility to receive CG grants for the co-financing of EU Structural Funds. LGs are also subject to a “name and shame” sanction, but the Ministry of Finance cannot impose measures nor replace the LG administration. Deficits do not need to be compensated in following years.	Compliance with fiscal rules is monitored by the Economic Council within the Ministry of Interior. In case of non-compliance, with the fiscal rules, gaps must be compensated the following year. The CG may reduce transfers. In case of the breach of the overdraft facility, an automatic correction procedure is triggered and municipalities are “put under administration” until fiscal sustainability objectives are reached.	The MoF monitors five deficit and debt indicators. If indicators break the threshold, municipality enters the “assessment mechanism” and must develop a correction plan together with the Ministry of Finance. In severe non-compliance, municipal mergers can be imposed, but such cases are very rare. Strong scrutiny of municipal fiscal position from the Municipal Guarantee Board and MuniFin for approving loans	Borrowing constraints and monitoring and enforcement mechanisms are less relevant in Ireland due to stringent controls from the CG. The National Oversight and Auditing Commission for Local Governments oversees LG performance and examines the value for money in service delivery.	Provinces conduct ex-post compliance with fiscal rules, checks and monitors other financial sustainability indicators. It may put municipalities in financial distress under direct supervision. Bailout mechanisms for municipalities in financial distress exist. However, these are rarely used due to sound fiscal stance of municipalities and well-established equalisation system.	High Monitoring mechanisms and peer pressure are very strong. Many LGs have credit ratings, the LGNZ association also rates the councils, LGFA monitors their debt levels. All accounts are audited by the Office of the Auditor General. In case of severe mismanagement, CG can temporarily replace the LG administration with CG officials.

Comparative analysis of monitoring and enforcement mechanisms

Table 4.5 provides a comparative summary of monitoring and enforcement mechanisms in Lithuania and benchmark countries.

Fiscal rules are well respected in Lithuania, despite weaker possible sanctions than in most benchmark countries in case of infringement

The Ministry of Finance in Lithuania closely monitors the compliance with fiscal rules. However, the enforcement mechanism, based on reputational effects and not providing new transfers is weaker than in benchmark countries. In addition, the balanced budget rule was only introduced in 2016, it has not yet been tested. Monitoring and enforcement mechanisms are stronger in benchmark countries. For example in Denmark, CG can reduce transfers to LGs in case breaches to the fiscal rule are not compensated in the following year. Denmark, Finland, the Netherlands and New Zealand have some sort of “evaluation/administration” mechanism for LGs facing financial difficulties, where the CG can directly intervene in LGs’ decisions, temporarily replace their administration, and in the case of Finland, even force municipal mergers. The latter is not only an extremely strong instrument, it is also very credible, as it has been exercised several times in the last decade. In most

cases, these mechanisms are triggered automatically after certain clear criteria are breached, thus reducing discretion and reinforcing the credibility and effectiveness of such fiscal discipline mechanisms.

Unlike some benchmark countries, Lithuania does not have an early warning mechanism to identify LGs at risk of excessive debt and take early corrective measures

Today, Lithuania does not have an early warning mechanism to identify municipalities at risk of having unsustainable levels of debt, as it does not allow municipalities to build up debt. When reforming fiscal rules for allowing municipalities some room for borrowing, it is important to create such a mechanism. In Finland for example, municipalities have large autonomy to borrow, and the Ministry of Finance carries out a continuous monitoring of some key indicators, to identify deviations from sustainable path early on and impose corrective measures (Box 4.4).

Recommendations on monitoring and enforcement mechanisms for Lithuania

Tighten automatic enforcement mechanisms and increase LGs possibilities to issue debt

Many OECD countries bundle greater autonomy in decision making with very tight enforcement mechanisms and sanctions in case of breaching

Box 4.4. CRITERIA FOR TRIGGERING THE ASSESSMENT MECHANISM IN FINLAND

Criteria laid down in the Local Government Act:

1. The assessment procedure may be started if a municipality has not covered the deficit in its balance sheet within the four-year period.
2. The assessment procedure may also be started if the latest consolidated financial statement of the municipality shows a deficit of at least EUR 1 000 per resident and the preceding financial statement a deficit of at least EUR 500 per resident, or if the financial key figures for finance adequacy or solvency have reached the following limits in *two successive years*:
 - a. The ratio between the annual contribution margin and the depreciations falls below 80% in the consolidated income statement of the municipality;
 - b. The municipality's rate of local income tax is at least 2 percentage points higher than the weighted average rate of local income tax of all municipalities;

- c. The amount of the loans and rental liabilities in the consolidated financial statement of the municipality per resident exceeds the average amount of loans and rental liabilities in the consolidated financial statements of all municipalities by at least 50%;
- d. The computational loan coverage ratio of the consolidated financial statement falls below 0.8%.

Note: the computational loan coverage ratio is calculated using a formula where interest income is added to the annual contribution margin of the consolidated income statement and the resulting amount is divided by the amount of interest income and computational loan repayments. The computational loan payments shall be arrived at by dividing the amount of loans by eight.

Source: Local Government Act (2020^[47]), Section 118, available at <https://bit.ly/2WAEAOZ>.

rules. The benchmark country with the greatest LG autonomy, Finland, is also the one with the strongest and systematic sanctions in case of breaching rules, as the CG can temporarily replace LGs' administration, and impose municipal mergers. As Lithuania increases the possibilities of LGs to issue debt, enforcement mechanisms, in particular sanctions in case of breaching rules should be strengthened. These should preferably include limited discretion.

Continue and develop the tool for forecasting investment needs related to municipal properties, and reinforce monitoring of LGs debts by creating an early warning system

Debt ceiling could be complemented by a more comprehensive set of debt sustainability indicators as it is the case in Finland. The extended set of indicators should be regularly monitored allowing to introduce early warning system (for example with green/yellow/red flags). This would provide central government and municipalities with a better understanding of debt sustainability levels in single municipalities.

Monitoring of municipally owned enterprises should be improved

While monitoring of LGs deficits and debts is very strong, several reports point to a lighter scrutiny of municipally owned enterprises. The deficits and debts

of municipally owned enterprises should be monitored just as strictly as those of LGs. To this end, ensure that municipally owned enterprises regularly publish financial reports and financial indicators, that they are monitored, and that their budgets are consolidated with the municipal budget.

INSOLVENCY FRAMEWORKS

Insolvency framework for LGs in Lithuania

Insolvency frameworks provide rules to resolve unsustainable borrowing in an orderly and prompt way. They define how to proceed when a sub-national entity has gone bankrupt. They clarify how debt will be restructured, which public services will be maintained and what steps need to be undertaken to restore the financial health of the insolvent SNG. They stipulate the debtor's and creditors' rights and regulate third-party intervention. Insolvency frameworks serve to enable a fresh start and to promote a fiscal recovery of highly indebted governments. They may also underpin the commitment of upper-level governments to a no-bailout policy and thus may prevent sub-national governments from piling up debt to unsustainable levels (Herold et al., 2020^[48]).

Lithuania does not have a formal municipal insolvency framework. When a municipality experiences financial

Box 4.5. FINANCIAL DISTURBANCES IN VILNIUS CITY MUNICIPALITY

Vilnius City municipality has experienced financial disturbances before the introduction of the CLIFT. The municipality had accumulated unsustainable levels of debt levels (over 200% of their revenues) and was accumulating arrears.

After the Vilnius Region Administrative Court ruling in 2016, the government committed to return a share of previously collected PIT (over EUR 270 million) to Vilnius City municipality, which used these funds to cover its outstanding liabilities. After 2016, the financial situation improved, both thanks to the strengthened fiscal discipline mechanisms, and to the economic upturn.

Source: OECD/UCLG (2019^[31]), 2019 Report of the World Observatory on Subnational Government Finance and Investment – Country Profiles, <https://bit.ly/2VPjyLQ>; Vilniaus Apygardos Administracinis Teismas (2016^[49]), <https://bitly.com/>.

difficulties, the CG offers different financial support options (Box 4.5). In case of short-term liquidity issues, municipalities can borrow directly from the CG to cover in-year cash flow fluctuations (these loans must be repaid within the year). In addition, CG may review municipalities on a case-by-case basis and allocate grants in case they show signs of financial difficulties.

Comparative analysis of insolvency frameworks

Table 4.6 provides a comparative summary of insolvency frameworks in Lithuania and benchmark countries.

As all benchmarks which rely on ex-ante controls and fiscal rules, Lithuania does not have – nor need – an insolvency framework for LGs

As stated in the Benchmark Report, there are four different systems to ensure LGs’ fiscal sustainability, avoid moral hazard and build up LGs’ debts. The rule based and control-based systems relies on ensuring ex-ante that

LGs will not issue excessive debts through fiscal rules or direct controls. Such systems do not require insolvency mechanisms.⁵ Cooperative mechanisms also ensure ex-ante sound joint decisions on spending and borrowing by LGs and do not require insolvency frameworks either. The only system where such frameworks are important is the one where LGs’ discipline is ensured by the market, through increasing cost of borrowing by lenders when a LGs’ fiscal situation gets risky – which should reduce appetite of the LG to borrow. In this case, credibility of the no-bailout clause is essential, as otherwise lenders would not reflect the risk in the cost of lending as they would expect a bailout, and therefore, LGs would not have incentives to control their debt levels.

These theoretical insights are perfectly reflected in the practices in Lithuania and the benchmark countries (Table 4.6). Denmark, Finland, Ireland and the Netherlands have ex-ante mechanisms in place to make sure municipal defaults cannot happen. New Zealand by contrast, where fiscal rules and direct controls are weak and which relies on market control, has a very clear insolvency framework. In this framework, the lenders can appoint a receiver to collect the property tax in case of LG default. This is a strong guarantee for lenders, and a strong incentive for LGs to keep sustainable finances.

Recommendations on insolvency frameworks for Lithuania

Lithuania does not need to create an insolvency framework for LGs

Lithuania does not have an insolvency framework for LGs, but as it relies on ex-ante fiscal rules, it is not needed either. It would only be necessary to create one if Lithuania decided to go towards a market-based system as in New Zealand, which is not the path suggested in the policy recommendations.

5. See Table 1.1 in Benchmark Report.

Table 4.6. Comparative summary of insolvency frameworks in Lithuania and benchmark countries

Insolvency frameworks					
LITHUANIA	Denmark	Finland	Ireland	Netherlands	New Zealand
Low	Low	Low	Low	Low	High
None: strict fiscal rules and early CG interventions ensure no LG defaults	Municipal bankruptcies are not allowed.	No formal insolvency mechanism. Early prevention mechanisms make municipal default very unlikely.	None: direct CG controls and transfers ensure no LG defaults.	Municipal bankruptcies are not allowed.	In case of a LG default, lenders can appoint a receiver who can collect the property tax directly for the lender.

Source: Authors’ analysis.





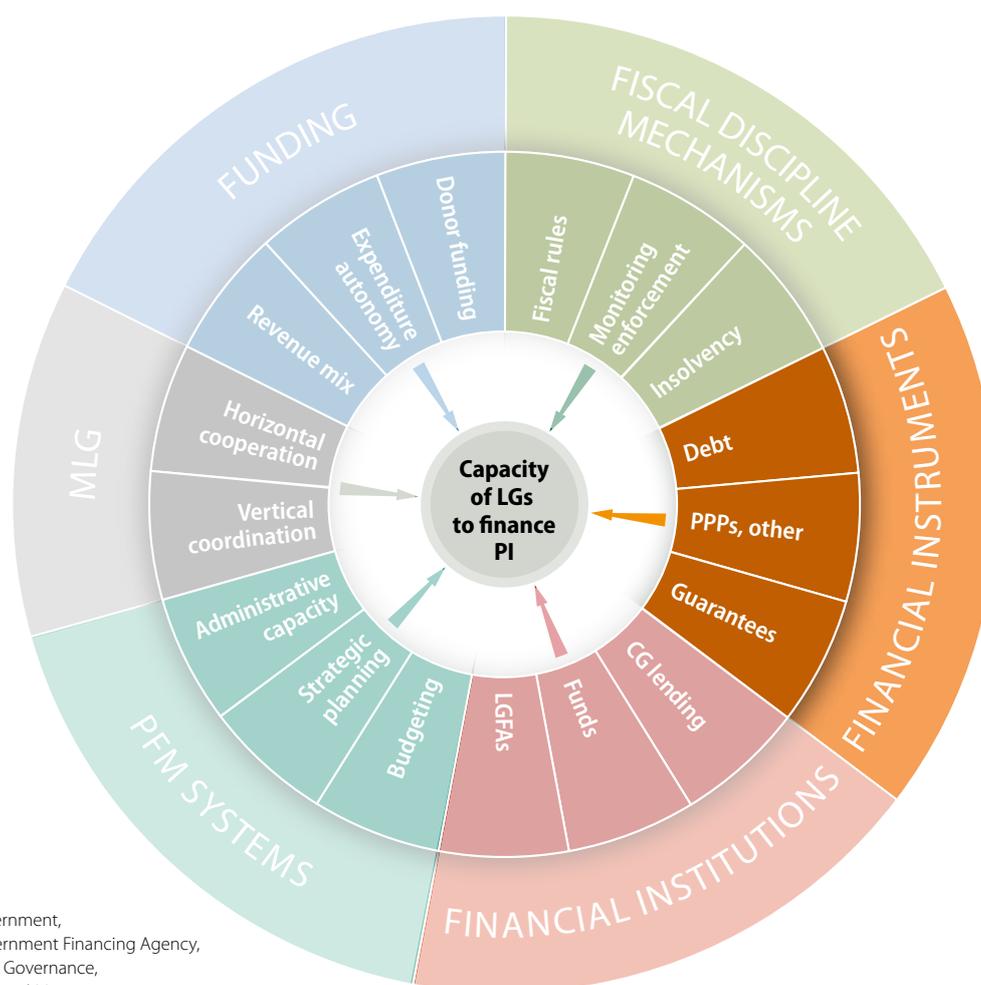
Financial instruments help bridging short term and long term financial needs. They are the link between funding (annual revenues) and financing (meeting upfront payments).

5. Financial instruments for local public investment

Following the approach presented in Chapter 2, this section describes Lithuania's current financing sources for local public investment (Figure 5.1), compares each

element with the practices in the benchmark countries and provides preliminary recommendations (which will be further developed in the recommendations report).

Figure 5.1. **Analytical framework: financial instruments**



Note:

CG – Central Government,
 LGFA – Local Government Financing Agency,
 MLG – Multi-Level Governance,
 PFM – Public Financial Management,
 PPPs – Public Private Partnerships

COMPOSITION OF LGS DEBTS

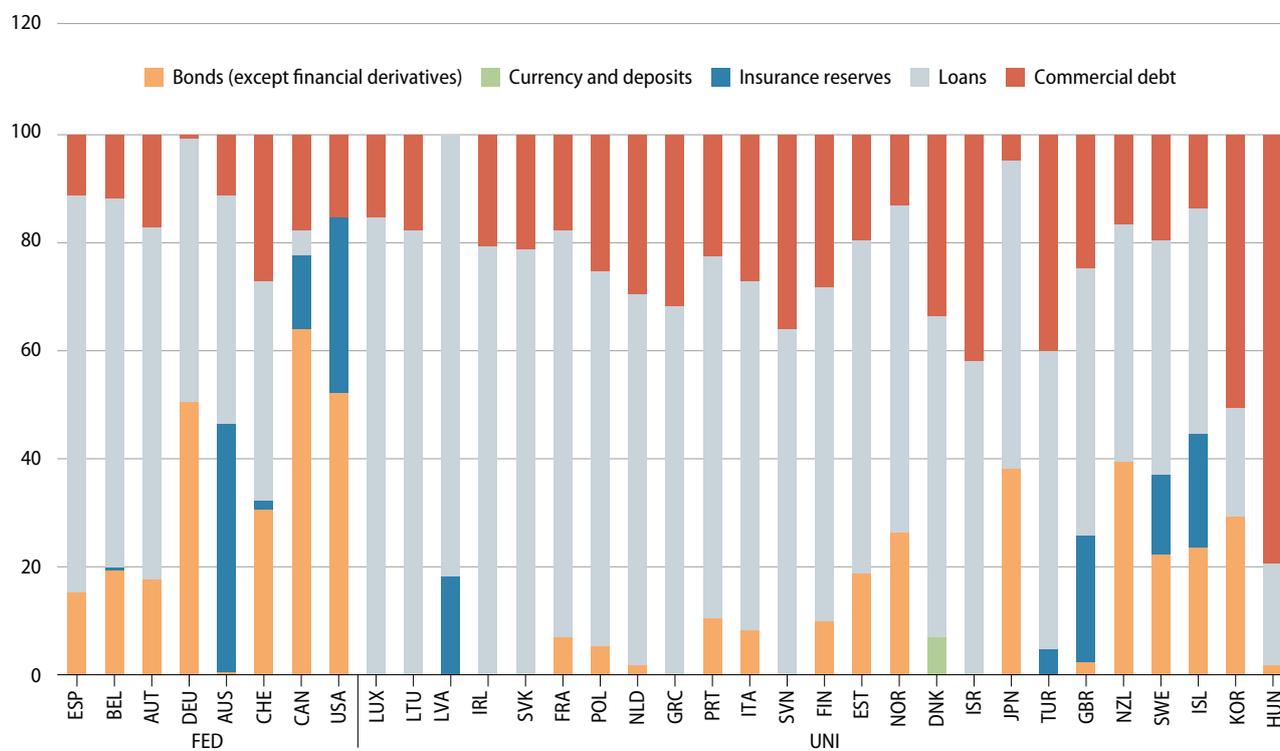
Composition of LGs debts in Lithuania

Most LG debts consist of commercial loans

Lithuanian municipal debt is composed mostly of loans (82%), the remaining 18% consists of other accounts payable (i.e. unpaid bills with providers). Other accounts payable (commercial debts) are lower in Lithuania than in most countries and reliance on bank loans is higher (Figure 5.2).

Borrowing is mainly used to finance the matching requirements from the EU funds, which constitute the main source of funding for LGs' public investment. Most of the borrowing is from commercial banks. However, municipal lending represents a small share of Lithuanian commercial banks' total lending activity, around 0.1% of the total portfolio.

Commercial loans carry on average seven to ten year-terms. Some municipalities, however, ask for shorter maturities due to very stringent borrowing constraints.

Figure 5.2. **Composition of SNG debt, 2016**


Note: Reference year: 2016.

Source: OECD-UCLG (2019_[31]), "World Observatory on Subnational Government Finance and Investment", <http://www.sng-wofi.org/data/>.

Some LGs can negotiate favorable loan rates and contract conditions, and sometimes even obtain contract fees waivers.

Municipal projects tend to be small and struggle attracting investors, but a few large municipalities attract international investors

Some municipal investment projects, especially those of smaller LGs, are too small to attract even local commercial banks, and thus sometimes fail to attract funding. The biggest municipalities, however, can attract institutional and international investors such as the Nordic Investment Bank (NIB), the European Investment Bank (EIB), the European Bank for Reconstruction and Development (EBRD), the Council of Europe Development Bank (CEB) and similar institutions. Interestingly, in January 2020, the EIB opened a regional office in Vilnius to strengthen its presence in the Baltics. This is expected to increase the co-operation between Lithuanian public entities and the EIB and to add to the diversification of financing options (EIB, 2020_[50]). However, it is not evident to what extent the presence of international investment banks contributes to the diversification of funding options for a wide range of

municipalities as only big scale projects that generate sufficient revenue are eligible.

The CG provides subsidised loans for specific purposes and non-returnable subsidies to LGs

There are currently nine different funds which provide subsidised loans to municipalities, each specialising in a specific purpose (e.g. renovating municipal buildings, drinking and wastewater networks, facilitation of matching requirement for EU funds, etc.) (Table 6.3). These funds are managed by the Public Investment Development Agency (VIPA) and sometimes operated by commercial banks.

In addition, LGs can apply to *non-returnable municipalities' subsidies*. These are drawn from the Municipality grants fund, created in 2016. This fund aims at securing municipalities' contribution to EU Structural Funds for investing in budget saving projects and in projects which increase their revenues. This instrument is very popular and successful, as it allows in principle to reduce municipal borrowing. However, these grants may have to be repaid if LGs do not fulfil a certain number of conditions. The rate of repayment depends

on the municipality's capacity to fulfil certain criteria, such as the participation in some of the "financial instruments" proposed by VIPA (Table 6.3) employment creation in municipalities, cost-saving and compliance with fiscal rules. VIPA assesses ex-post compliance with these criteria and provides a conclusion on the rate of repayment of the subsidy (i.e. a full repay in case of a failure to comply with criteria, a partial repayment or no repayment in case of successful achievement of the criteria listed above. Since 2016, over 345 projects received these grants but most did not yet undergo the ex-post assessment stage. The largest cities – Vilnius, Kaunas, Klaipėda and Šiauliai – do not participate in the implementation of this financial measure.

Lithuanian municipalities are not allowed to issue bonds

The Ministry of Finance expressed concerns about the potential negative impact on solvency if individual municipalities were granted unrestricted access to capital markets (EBRD, 2018_[51]). Moreover, the State

Treasury claimed that municipalities do not have substantial credit history nor sufficient experience in negotiating with potential investors and hence would incur high costs associated with issuing bonds. The Ministry of Finance, therefore, is the only governmental entity authorised to issue bonds in Lithuania.

Comparative analysis of composition of LGs debts

Table 5.1 provides a summary of the composition of LG debts in Lithuania and benchmark countries.

Other accounts payable (commercial debts) are lower in Lithuania than in most countries and reliance on bank loans is higher

Lithuania has recently managed to reduce the level of its commercial debts, which is a positive outcome. Loans represent more than 80% of total LG debts in Lithuania (Figure 5.2). This is higher than in most OECD countries (including the benchmark countries), in part due to the low level of commercial debts, and in part because LGs in Lithuania cannot issue bonds.

Table 5.1. **Comparative summary of the composition of LG debt in Lithuania and benchmark countries**

Type of instrument	Role of various lenders for financing LGs					
	LITHUANIA	Denmark	Finland	Ireland	Netherlands	New Zealand
Loans	High Municipalities heavily rely on commercial debt to finance the matching part for EU funded projects. Some projects, however, tend to be too small-scale even for commercial banks. Largest municipalities are able to attract international investors (e.g. EIB, EBRD, NIB).	High Municipalities do not rely on commercial debt. However, reliance on loans is high, as the KommuneKredit loans are a preferred investment financing option for Danish municipalities.	High Municipalities heavily rely on loans, most of which are from MuniFin. Only biggest municipalities take loans from commercial banks. Finnish municipalities are able to attract international investors (e.g. EIB, EBRD).	Moderate Commercial debt is not allowed: LGs can only borrow from the state agencies. The Housing Finance Agency is a state agency from which municipalities borrow for housing related projects.	High Dutch municipalities heavily rely on loans, most of which are from the Municipal Bank of the Netherlands (BNG Bank).	Moderate Loans represent only about 40% of total LG debt. Most LG borrowing is done through LGFA. Municipalities do not rely on commercial debt. Only Auckland is too large to fully rely on the LGFA and regularly borrows from commercial banks.
Bonds	N/A Municipalities are not allowed to issue bonds.	Moderate Municipalities do not issue individual bonds. KommuneKredit places bonds on financial markets.	High The biggest municipalities issue their own bonds. MuniFin places bonds on financial markets.	Moderate Municipalities are not allowed to issue bonds. The Housing Funding Agency raises its funds on the domestic and international capital markets.		High Auckland issues bonds internationally. The New Zealand LGFA issues bonds on domestic and international markets.

Source: Authors' analysis.

Lithuanian LGs rely more heavily on commercial bank loans than benchmark countries

Most of the benchmark countries analyzed in this project have well-established public – often municipally owned – financial agencies which specialise in municipal lending (e.g. MuniFin in Finland, KommuneKredit in Denmark). Commercial loans therefore are rarely used as these local government financing agencies provide better conditions in terms of interest costs and fees. Only the largest municipalities do some borrowing with commercial banks and/or issue bonds, as their financing needs would un-balance the portfolio of the local government financing agency.

LGs in Lithuania cannot issue bonds, and few LGs in benchmark countries do

In many countries, LGs are not allowed to issue bonds. When it is allowed, often only the largest municipalities can afford to undergo the required assessments and obtain credit ratings before issuing bonds. Indeed, for most municipalities, such an option may be too costly and thus may not be optimal (Box 5.1). In Europe, SNG bond issuing is not prevalent, while it is more frequent in the US or other federal countries such as Canada, Switzerland (Box 5.1) where bonds represent a large share of total SNG debt (Figure 5.2). In Lithuania, LGs are not allowed to issue bonds, and bond issuance is not very developed: bonds are not allowed even for strategic national projects. In some countries, the largest municipalities issue their own individual bonds. In New Zealand for example, financing needs of Auckland would unbalance the New Zealand LGFA's portfolio if it borrowed exclusively through this institution, so Auckland issues its own bonds. As the local market in New Zealand is also rather small, these are often issued on international markets. LG bonds are sometimes designed to finance specific investments (e.g. green bonds). In France for example, the capital region of Ile-de-France issues green bonds to finance investment projects related to public and sustainable transportation, social housing and facilities for education and leisure (OECD, 2020^[38]).

Recommendations on composition of LGs debts for Lithuania

Ensure payment in arrears remain low

Debts with providers are and should remain low. This is especially important in the COVID-19 context, where economic activity has been severely hit, and providers need to receive cash to avoid bankruptcy. Several OECD countries have shortened payment periods to providers to support private business through the crisis (OECD, 2020^[53]).

Box 5.1. NECESSARY CONDITIONS TO ISSUE BONDS ON FINANCIAL MARKETS

Most LGs across the OECD cannot issue bonds on financial markets. In some countries this is forbidden, and even when it is allowed, LGs are usually too small and need to borrow too infrequently to attract investors.

Indeed, for issuing bonds on financial markets, an issuer needs to have large borrowing requirements:

- To absorb the transaction cost related to a bond issue – such as marketing, rating and legal support;
- To be able to supply the market with liquid bonds, easily tradable. This means that each issuance should be of a significant amount;
- To be able to borrow frequently in the market, so that the markets become acquainted with the issuer and price the bonds appropriately.

Furthermore, the borrowers need to have considerable knowledge of the functions of the market and of the different financial instruments, which is rarely the case in LGs.

Source: Andersson (2019^[52]), Local Government Investment Financing – Understanding the LGFA concept.

Allow large municipalities to issue bonds

Bonds are not an efficient instrument for small municipalities with infrequent and small borrowing needs. However, for larger municipalities, with regular and large borrowing needs, and a strong level of capacity, issuing bonds could be allowed, in order to allow them to tap into a larger pool of funds.

PPPS AND OTHER ALTERNATIVE FINANCING SOURCES FOR LGs

PPPs and other alternative financing sources for LGs in Lithuania

Lithuanian municipalities often engage in PPP agreements (mostly concessions)

The PPPs and real-estate leasing are alternative modes of infrastructure investment delivery available for municipalities. Lithuanian municipalities, however, cannot freely dispose of the state land on their territory. They are thus required to include a third party in order to complete the project – the National Land Service under the Ministry of Agriculture, which is responsible for administering state-owned land. This may limit their capacity to attract certain private investors due to administrative burdens.

Lithuanian municipalities are actively engaged in partnerships with the private sector for infrastructure investment delivery. As of January 2020, 28 municipalities concluded 55 PPP contracts (Ministry of Finance, 2020_[54]). However, all of them are under concession partnership contracts with one exception in Vilnius Municipality for Balsiai School (Ministry of Finance, 2020_[55]). Typically, municipalities use PPP agreements for street lighting projects, culture, sports and leisure facilities, utilization, recycling and management of waste and energy. PPPs are particularly beneficial, as LGs all across OECD are vulnerable to underestimating maintenance expenses and life-cycle costs (OECD, 2018_[56]).

The average size of projects is small, projects are not pooled, and there are only few potential providers

Often the value of individual municipal projects tends to be too low for engaging in a costly and time-consuming preparation of PPP documentation. Moreover, the municipal PPP market is relatively small – only four to five active private partners – and thus competitive pressure is low. In some municipalities, single bidding in the context of public procurement is highly prevalent (European Commission, 2018_[57]). National-level PPP contracts in Lithuania have a higher value, in line with patterns observed in other OECD countries (OECD, 2018_[56]), and tenders even receive international bidders. According to *PPP Lithuania* (see below), pooling of PPP projects proved difficult due to substantially differing views on infrastructure across municipalities.

A CG agency provides support to LGs for developing and negotiating PPP projects

The administrative capacity of Lithuanian LGs necessary for launching and sustaining a PPP is limited. Only Vilnius and Kaunas City have specialised units dealing with PPPs. Nonetheless, Lithuanian LGs can benefit from the expertise of the PPP Competence Centre (*PPP Lithuania*) established within the *Central Project Management Agency*. *PPP Lithuania* develops, assesses (including cost-benefit analysis), supervises PPP projects, and individually provides consulting and trains public officials. Importantly, *PPP Lithuania* provides them with methodological guidance and tools for the preparation and assessment of PPP projects. To streamline the PPP process, *PPP Lithuania* will seek to centralise the PPP application process and to prepare sectoral templates since 2013. Hence, municipalities will no longer need to develop individually their own contract, and will only need to adapt the existing contracts to their needs.

An alternative financing source, the “repayable assistance” model, is currently under development

A CG agency (VIPA) is currently developing a repayable assistance model for financing renovation of government buildings and water supply and wastewater. The model is based on the idea that after implementing a project, the beneficiary shall repay the funds in size of the annual energy savings, thus directly linking the funds to be repaid to the projects results. This compensation mechanism is also being used under the Climate Change Programme and in the case of PPP contracts.

Land value capture instruments are recently being developed

A 2020 law on municipal infrastructure allows municipalities to create funds by collecting a fee from investors. This law allows municipalities to create funds by collecting a fee from investors.

Comparative analysis of PPPs and other alternative financing sources for LGs

Table 5.2 provides a summary of the use of PPPs and alternative financing for public investment by LGs in Lithuania and benchmark countries.

LGs in Lithuania use PPPs more often than in most benchmark countries

In Finland, LGs were not allowed to use PPPs until 2018, as these were thought to be too costly and the number of potential providers on the market too low to create a competitive market. Lithuania faces the same challenges: the value of individual municipal projects tends to be too low for justifying to engage in a costly and time-consuming preparation of PPP documentation; and the municipal PPP market in Lithuania is relatively small – only four to five active private partners – and thus competitive pressure is low, and administrative capacity to handle PPPs is lacking in most municipalities. While PPPs by sub-national governments are not very developed in the benchmark countries, on average across OECD countries, most PPPs occur at the sub-national level (OECD, 2018_[58]). In 2012, OECD countries endorsed the OECD Recommendation on the Public Governance of PPPs (Box 6.2).

Land-value capture mechanisms are widely used by LGs in OECD countries to finance public investment

Developing new land into housing or commercial areas should generate a higher revenue stream in the future, as property taxes and taxes related to the commercial activities increase (such as business taxes, VAT, etc.).

Table 5.2. **Comparative summary of the use of alternative financing for public investment by LGs in Lithuania and benchmark countries**

Alternative financing for public investment by LGs					
LITHUANIA	Denmark	Finland	Ireland	Netherlands	New Zealand
Moderate	Low	Moderate	Low	Low	Moderate Possibly high in the future
<p>Municipalities can and do engage in PPP agreements (mostly concessions).</p> <p>However, only few municipal projects only are large enough to justify using PPPs, and there are a limited number of providers in the market, thus reducing competitive pressure and increasing costs.</p>	<p>Municipalities and regions sometimes engage in PPP agreements. KommuneKredit may provide funding for PPPs</p>	<p>LGs were not allowed to use PPPs until 2018. Since there are only 5-6 providers in the market, therefore, capacity constraints are high.</p> <p>Real-estate leasing and repurposing are actively used.</p>	<p>LGs typically rely on CG funding and rarely engage in different types of financing.</p> <p>Projects for PPPs are bundled together to achieve greater economies of scale (around EUR 100 million), but these are typically carried out at the CG level.</p>	<p>Municipalities rarely engage in alternative financing for public investment practices.</p>	<p>A bill is currently under discussion to create a "Levy Model" to finance infrastructure.</p>

Source: Authors' analysis.

The value of the land also usually increases thanks to such new developments. There are various ways that governments use to anticipate and capture those future revenue streams in order to finance the initial development costs. Depending on the revenue mix of LGs, these may have various degrees of incentives to carry out such developments. Indeed, when LGs do not get a proportional share of the business tax or the personal income tax generated by commercial developments for example, they have little incentives – and less collateral – to use such schemes to finance development investment.

Property taxes financing model

Many LGs use future property tax revenues as a pledge to obtain bank loans. The LG then borrows money to finance the supporting infrastructure for developing new land and is responsible for the construction of the assets (i.e. debt to revenue ratio of LG increases). Developers build houses on this land which they sell to homeowners. Once houses are sold and new homeowners arrive, property tax income of the LG will increase and be used to repay the initial loans (Figure 5.3).

Development contributions model

In this model, the LG borrows to finance the supporting infrastructure, and is responsible for construction of the infrastructure assets. Developers building the houses on the new land pay a contribution to the LG,

Box 5.2. OECD PRINCIPLES ON THE GOVERNANCE OF PPPs

The OECD Principles in the Governance of PPPs

In 2012, the 34 OECD member countries endorsed the PPP Principles. It brings together the lessons learnt by the member countries over many years with respect to PPPs. The 12 Principles are organised under three broad headlines that focus on:

- Building a clear, predictable and legitimate institutional framework supported by competent and well-resourced authorities;
- Grounding the selection of PPPs in Value for Money and carefully managing throughout the project life-cycle;
- Using the budgetary process transparently to minimise fiscal risks and ensure the integrity of the procurement process.

Source: OECD (2012^[23]), Recommendation of the Council on the Public Governance of Public-Private Partnerships.

which is used by the council to repay the loans. The advantage compared to the previous model is that the LG receives the revenues for its investments faster, reducing the time mismatch between disbursement of funds and collection of revenues (Figure 5.4). This mechanism is often used in New Zealand and Ireland for example.

Figure 5.3. **Property taxes financing model**

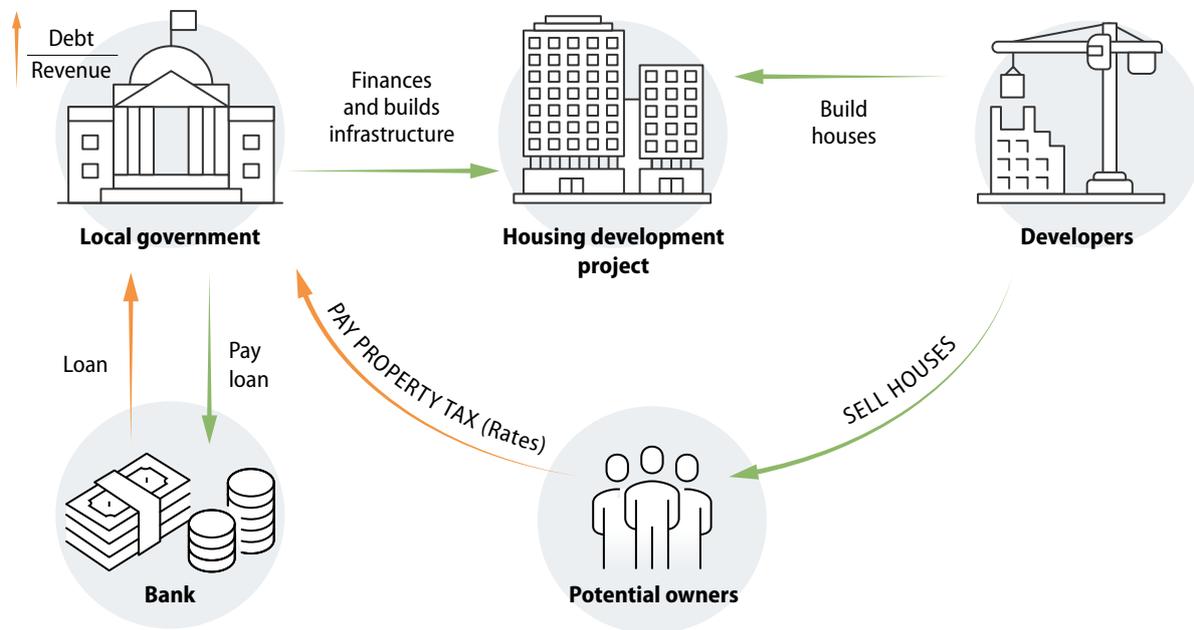
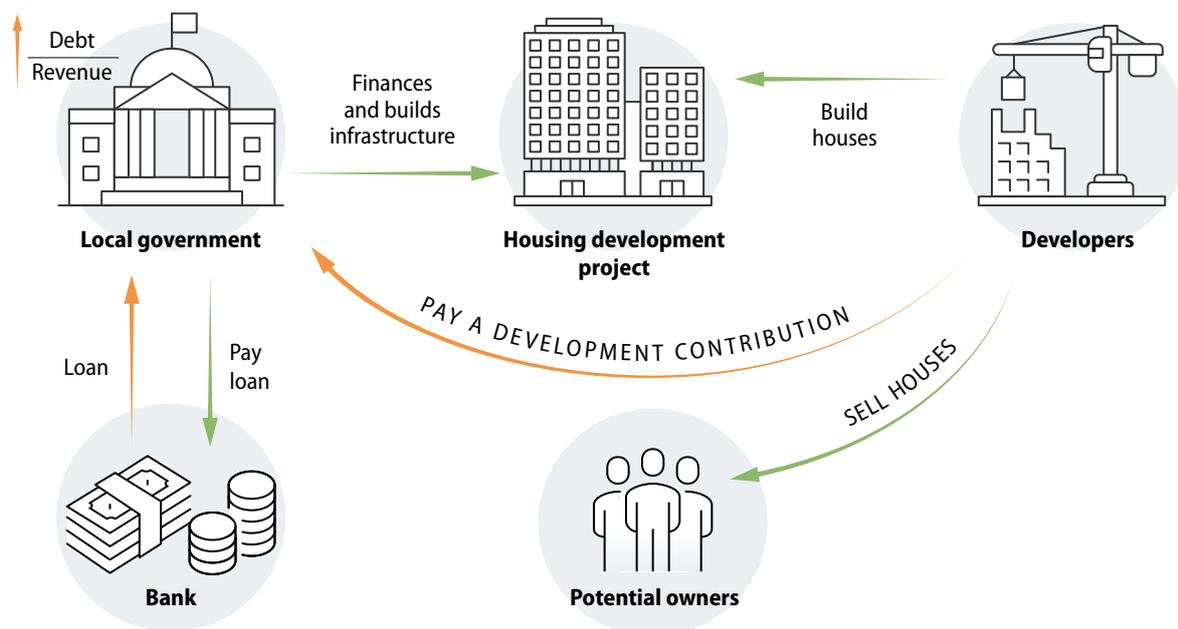


Figure 5.4. **Development contributions model**

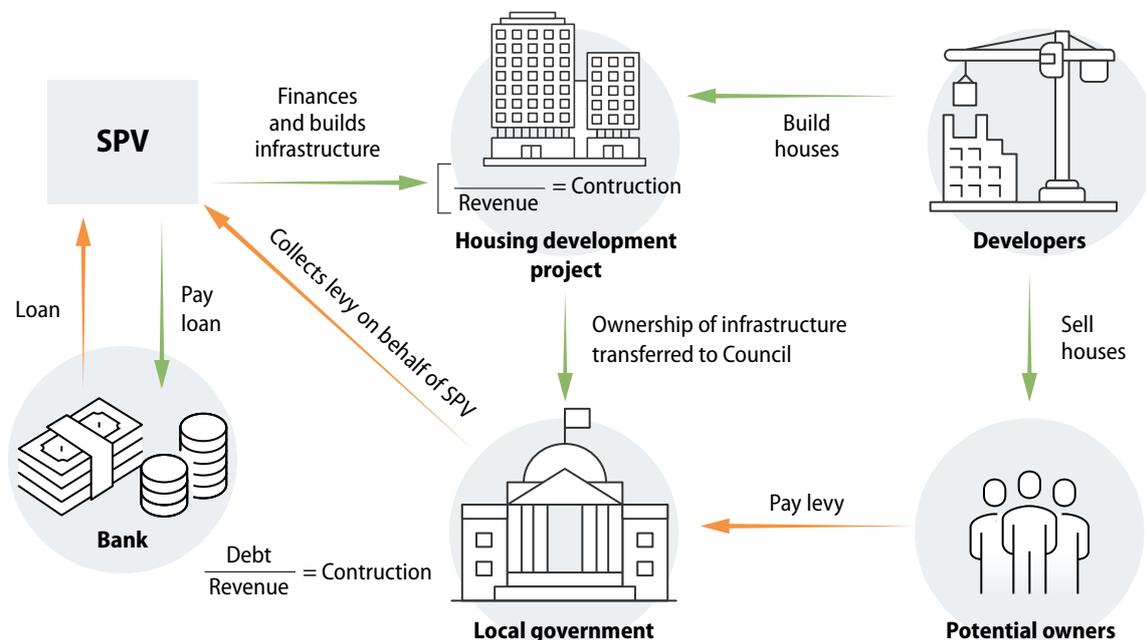


Special Purpose Vehicles and the New Zealand “Levy model”

New Zealand is developing a model for financing infrastructure through a special purpose vehicle, which would allow the financing of local public infrastructure without involving the LGs’ budgets. The core of the proposed Levy Model involves the setting of a multi-year infrastructure “Levy”, which is paid by the beneficiaries

(or Levy payers) of the infrastructure projects. The Levy will be enabled by legislation and can only be struck following an Order in the Councils, which will set out the terms of the Levy. A Special Purpose Vehicle (SPV) will be responsible for financing all or part of the project and will have the power to collect the Levy which is used to support the financing (Figure 5.5).

Figure 5.5. The “Levy” Model



The Levy will be used to service financing raised by the SPV to cover the costs of the infrastructure. In most cases, the SPV will be responsible for construction of the infrastructure assets. Once constructed, the infrastructure will then be vested with the relevant council (or public body).

Importantly, the Model aims to separate the financing decision of the infrastructure from the Council’s usual financing processes and constraints, including the debt being ring-fenced from a Council’s balance sheet. It is about providing the flexibility the local authority infrastructure funding and financing system to be able to respond to infrastructure demands.

While the Model separates the financing decision, it does not absolve Councils of their responsibility to their current and future communities to provide the infrastructure they need. The aim of this Model is to enable new housing supply that otherwise would not proceed.

Some countries use civic crowdfunding to fund local investment

Crowdfunding is “a way of financing projects, businesses and loans through small contributions from a large number of sources, rather than large contributions from just a few. In practice, individuals deposit money on an online platform, committing that money to a specific

project, business or loan and have that relationship mediated by the platform. Depending on the business model, the individual investor may or may not receive a financial return” (Davis and Cartwright, 2019_[60]).

Civic crowdfunding can channel funds towards small-scale projects and, in particular, projects that traditional funders don’t finance due to limited profitability. They have the additional benefit of signalling the projects that are indeed relevant and desired by the community. Civic crowdfunding typically uses the donation-based model, where people donate money to improve their community, for example by bringing a community asset back to use. A possible drawback of civic crowdfunding may be that it could favour already more affluent regions, where communities have a greater capacity to mobilise resources.

Crowdfunding emerged at the beginning of the 2010s and is widely used in the UK, in particular in the following five sectors: renewable energy, construction, community and social enterprise, technology and environment and clean tech. It is however still very new in the public sector, with only a few experiences of LGs financing public investment through it. The UK has developed a highly diverse ecosystem of platforms (Box 5.3). Crowdfunding models vary, ranging from donation-based to municipal bonds. Donation-based crowdfunding models offer limited opportunities in terms of amount and

Box 5.3. THREE MAIN CATEGORIES OF CROWDFUNDING PLATFORMS IN THE UK

1. Donation/rewards-based crowdfunding platforms

- These platforms facilitate the financing of individuals, charities or other smaller non-profit organisations;
- Donors participate principally because they believe in the cause;
- They do not receive a financial return on their money, but may receive alternative non-financial rewards.

Example: Crowdfunder specialises in enabling individuals to back socially-useful projects or activities.

2. Debt security or loans-based crowdfunding platforms

- These platforms facilitate the provision of debt finance to organisations and companies bypassing the need for traditional banks;
- Depending on the specific model of the platform, investors lend money via a loan or debt security (i.e. bond / debenture);
- Lenders receive interest on the money lent and, if all goes well, their capital is returned as either a single payment or over the life of the investment;
- Platforms that deal in loans or debt securities are regulated under two related but fundamentally separate regimes: Debt securities sit within the EU-derived Markets in Financial Instruments Directive (MiFID) regime, whereas loans are governed by UK specific legislation introduced in 2014;
- It is generally understood that debt security platforms face higher regulatory standards;

- The debt category of crowdfunding is the most populated and diverse, which reflects the wide variety of use cases for debt financing within the economy.

Example: Abundance Investment is a debt security platform focused on providing short- and long-term debt to infrastructure companies and public sector organisations. Funding Circle is a loan-based platform focussed on providing working capital and growth capital to the UK SME sector.

3. Equity-based crowdfunding platforms

- These platforms support equity-based capital raising by new or established businesses;
- Investors allocate capital to a given opportunity of their choice in exchange for transferable shares;
- Currently, the sector is focussed primarily on the early stage or start-up phase of company growth, so investors are typically hoping that the shares they purchase will increase in value.

Example: Crowdcube is a leading equity crowdfunding platform for entrepreneurs of start-ups and growing businesses to connect with potential investors. Seedrs was the first regulated equity crowdfunding platform and is focussed on enabling investors to buy shares in early stage high growth businesses.

Source: Davis, M. and L. Cartwright (2019_[60]), Financing for Society: Assessing the Suitability of Crowdfunding for the Public Sector, University of Leeds, <http://doi.org/10.5518/100/7>.

scale, and should be reserved for social projects led by local authorities. Projects requiring larger financing contributions can rely on crowdfunding in the form of municipal bonds (Davis and Cartwright, 2019_[60]).

Blended finance schemes are seen as promising to mobilise private investments

Blended finance,¹ which implies a common financing scheme that builds on public and private funds, helps to catalyse investments and encourage private capital

participation. It also provides complementary expertise from private actors and allows bridging the financing gap, especially for projects that may not be eligible for different funding schemes. Most importantly, co-investing in schemes established using blended finance principles allows first-time investors in a particular area to mitigate the risks and later scale-up their investments once track record is established (OECD, 2020_[61]).

Against this background, blended finance is being increasingly used in developing countries, such as India (Box 5.4). However, the approaches to the use of blended finance and the familiarity with the instrument varies across countries (OECD, 2018_[62]).

1. Blended finance is defined as the strategic use of public finance for the mobilisation of additional private finance towards sustainable development (OECD, 2018_[62]). It is aimed to encourage private investors to participate in achieving sustainable development goals by investing in underdeveloped or unfamiliar markets.

Box 5.4. ENABLING MUNICIPALITIES TO TAP CAPITAL MARKETS TO FUND INFRASTRUCTURE DEVELOPMENT IN INDIA

Municipalities in the state of Tamil Nadu, India, lacked access to finance to undertake local infrastructure investments. To address this, in 1996, the government of Tamil Nadu created the Tamil Nadu Urban Development Fund. This Fund was established as a public-private partnership to attract private domestic financing for different types of infrastructure investment. However, getting access to capital markets to fund infrastructure projects remained a challenge for small and medium sized municipalities.

To this end, in August 2002, the Tamil Nadu Urban Development Fund instituted a special purpose vehicle called the Water and Sanitation Pooled Fund, to disburse loans to smaller urban local bodies. The German development bank provided a EUR 10 million concessional loan to the Indian government to fund the subordinated tranche (35%) of the Water and Sanitation Pooled Fund.

The Government of Tamil Nadu provided equity support as cash collateral of 10% to provide an additional cushion against potential losses.

The Water and Sanitation Pooled Fund issued two bonds, in 2012 and 2013, mainly to institutional investors at the local and state levels including public and private pension funds. “The combination of the German development bank concessional loan (with an interest rate of 0.75%) and interest on the bonds (the first bond issued at 10.6%) permitted on-lending on a revolving basis to municipal projects at a sustainable level. In early 2017, a third bond was issued with an additional support from the German development bank of EUR 5 million for the subordinated tranche” (OECD, 2018_[63]).

Source: OECD (2018_[63]), Making Blended Finance Work for the Sustainable Development Goals, OECD Publishing, Paris.

Interestingly, the EU is among the most prominent promoters of the use of blended finance in developing regions. For instance, they have increasingly used public grants to mobilise public and private investment for sustainable development, which is now considered as a

key development mechanism (European Commission, 2019_[64]). The EU support can be provided in a form of technical assistance, investment grants, interest rate subsidies, guarantees, risk capital, or any mix of these (European Commission, 2015_[65]). To better navigate between different approaches, the OECD provides a step-by-step guidelines to designing a blended finance scheme (Box 5.5).

Box 5.5. A STEP-BY-STEP GUIDE TO DESIGNING A BLENDED FINANCE SCHEME

OECD DAC Blended Finance Principle 2: *Design blended finance to increase the mobilisation of commercial finance* provides a detailed step-by-step guide on how to establish a blended finance scheme:

- Step 1: Determine development objective, development additionality and theory of change;
- Step 2: Identify financing gap;
- Step 3: Identify market failure;
- Step 4a: Choose financial instrument while minimizing concessionality;
- Step 4b: Determine target mobilisation;
- Step 5: Coordinate intervention with the eco-system;
- Step 6a: Monitor and evaluate development impact;
- Step 6b: Exit once commercial markets are functioning.

Source: Source: OECD (2020_[61]), OECD DAC Blended Finance Principle 2: Guidance, OECD Publishing, Paris, <https://bit.ly/3orF6tK>.

Recommendations on PPPs and other alternative financing sources for LGs in Lithuania

Ensure PPPs are only used when they demonstrate better value for money than traditional procurement

PPPs should not be used as a means to circumvent fiscal rules and borrowing limits. PPPs should be used with strong care of potential adverse effects and in compliance with the OECD Recommendations on the Governance of Public Private Partnerships (OECD, 2012_[66]).

Not all infrastructure projects represent strong candidates for PPP procurement. The choice to sue a PPP should be motivated by value for money compared to traditional procurement. Small scale projects in particular, which may appeal to LGs are not appropriate for the PPP approach. They do not necessarily represent value for money and are often not commercially viable. The promotion of PPP projects should be directed primarily at the larger jurisdictions which already have the general and fiscal capacities required, and also towards priority infrastructure sectors (OECD, 2018_[58]).

Create legal framework to allow LG investment pooling and pool LG investment projects by nature to increase size and increase efficiency of PPPs

Pooling projects from different municipalities by nature (e.g. street lighting, recycling and waste management, energy, etc.) would increase the size of projects and help attract more bidders (PPPs). This would ensure better conditions for LGs, and distribute the fixed cost of developing a PPP contract among a larger number of projects/LGs, thus reducing cost per project. Today, there is no legal framework for such pooling to occur, and there is no culture of inter-municipal cooperation and coordination, or institution where such discussions could take place. The CG could develop a legal framework for pooling PPP projects, provide LGs both incentives to pool projects together (for example by providing technical assistance, or participating in the cost of the project), and a platform for identifying the relevant projects and coordinating among LGs.

Continue with the CG support for LGs to develop PPPs

The CPMA provides support to LGs to develop PPPs, and prepares templates which LGs can use for their PPP contracts. Providing CG support and standardised documents and examples of contracts adapted to different sectors is a good practice, as it reduces the preparation costs of PPPs. Peer-to-Peer knowledge exchange platforms for LGs are also a good tool which could be developed and promoted to support inter-municipal coordination.

Continue to properly account for and disclose all costs, guarantees and other contingent liabilities of PPPs and alternative financial instruments in budget documents and create a database to follow PPP performance

PPPs may generate risks for the sustainability of LGs finances through guarantees or contingent liabilities. These should therefore be carefully and fully disclosed in budget documents. The CG should continue its efforts for collecting data on PPP performance to gather evidence for improving future PPPs.

Improve quality of LG investment projects and support land-value capture mechanisms

Land-value capture mechanisms are based on two prerequisites: (1) that the investment project generates an increase in the value of properties/land and taxes; (2) that some of these revenues generated by the projects are allocated to the LG that initiated and financed it. The first condition requires ensuring the quality of project planning and selection (will be analysed further in the

planning and capacity building section); the second condition requires allocating some activity-based taxes to LGs (see LG revenue mix section).

Experiment civic crowdfunding for some small-scale but visible projects

Civic crowdfunding is particularly well suited for lower cash-value, short-term projects with high visibility and impact, such as local community projects that would have trouble raising external funding. In the case of infrastructure, participatory mechanisms can support investment for construction and restoration, for creating or improving green and public spaces, and providing community infrastructure and equipment (OECD, 2020^[38]). To maximise the impact of such investments, LGs can match the amounts committed through crowdfunding budget with a certain share of their own budget. Lithuania could follow the example of the UK (Box 5.3) and experiment civic crowdfunding for LG investment projects. This would require setting up an enabling regulatory framework. The UK regulatory framework provides a good benchmark.

Mobilise resources for establishing a blended finance scheme

In the presence of underdeveloped capital markets, a blended finance scheme could provide private investors with opportunities to mitigate risks when investing in unfamiliar areas. The model that is often used in developing countries can be experimented following the step-by-step guide described in Box 5.5. Importantly however, this scheme acts as a catalysator for investment in underdeveloped markets and hence, it should bare a sunset clause to be discontinued once markets reach maturity and are well-established.

GUARANTEES

Use of guarantees for LGs debts in Lithuania

There are no explicit guarantee schemes for municipal borrowing in Lithuania, and municipalities do not provide joint guarantees to a pooled financing instrument

There is no general guarantee scheme for municipal borrowing. However, municipal enterprises may access guarantees for individual loans through INVEGA. Municipalities may also apply for guarantees for energy efficiency projects and, in particular, ones related to street lighting through VIPA.

Table 5.3. **Comparative summary of guarantees in Lithuania and benchmark countries**

Guarantees					
LITHUANIA	Denmark	Finland	Ireland	Netherlands	New Zealand
Low	High	High	High		High
<p>No explicit guarantee scheme for LG borrowing exists, and LGs do not provide joint guarantees to a pooled financing instrument.</p> <p>Municipalities may provide guarantees for municipal enterprise loans.</p>	<p>Municipalities jointly and severally guarantee KommuneKredit funding.</p>	<p>MuniFin funding is guaranteed by the Municipal Guarantee Board.</p>	<p>CG provides an explicit guarantee for LG borrowing.</p>		<p>LG debts are guaranteed by their property tax revenues. Lenders can appoint a receiver to collect the tax.</p> <p>LGFA debt and bonds is guaranteed by all its shareholders (30 LGs) and all LGs borrowing above NZ\$20 million. There are currently 45 guarantors.</p>

Source: Authors' analysis.

Comparative analysis of the use of guarantees for LG debts

Table 5.3 provides a summary of the guarantees in Lithuania and benchmark countries.

None of the benchmark countries provides guarantees to individual municipal loans, but most benchmark countries have some type of LG joint guarantee for pooled financing instruments such as LGFAs

In Lithuania, unlike in the benchmark countries, a general municipal borrowing guarantee scheme does not exist except for guarantees on individual loans for municipal enterprises and guarantees for municipal projects related to energy efficiency and, in particular, street lighting. Guarantee schemes are set up differently in different countries based on the level of CG direct controls, capacity to raise taxes and other institutional features. Importantly, these do not cover individual loans of single municipalities but rather liabilities of the public LG financing agency.

The explicit guarantee for LGFA funding may be provided by the CG as in the case of the Housing Funding Agency in Ireland. However, in a country with lower levels of direct controls from the CG than that of Ireland, such explicit CG guarantee scheme may pose moral hazard concerns.

In Denmark, all municipalities jointly and severally guarantee KommuneKredit funding. However, for this type of guarantee to have enough credibility, municipalities must have sufficient capacity to raise

taxes. In Denmark, this guarantee implies that the KommuneKredit funding is backed by the entire tax base of the Danish population.

In Finland, MuniFin funding is guaranteed by a separate institution – Municipal Guarantee Fund (MGF) – which in turn, has an access to the entire tax base of the Finnish population. Finnish municipalities, which are all members of the MGF, have unlimited right to levy personal income tax hence providing a sufficient collateral for MuniFin funding.

Recommendations on the use of guarantees for LG debts for Lithuania

Providing explicit guarantees to LG borrowing is risky as it would generate moral hazard

Providing explicit guarantees to LG borrowing is usually not recommended, as lenders may be less cautious in analyzing the solvability of LGs and may lend to fiscally fragile LGs, as they would expect a bailout in case of problems. Providing explicit guarantees requires very strong ex-ante monitoring mechanisms such as CG authorizing LG loans (as in Ireland) to prevent moral hazard.

If/when created, a LGFA would require a guarantee scheme to get good borrowing conditions on international markets

At present, LGs have little fiscal space or capacity to raise revenues to be credible guarantors – but this could/should change. If/when an institution specialised in lending to LGs is created, the CG could create a guarantee fund to guarantee the capital levies of that institution.





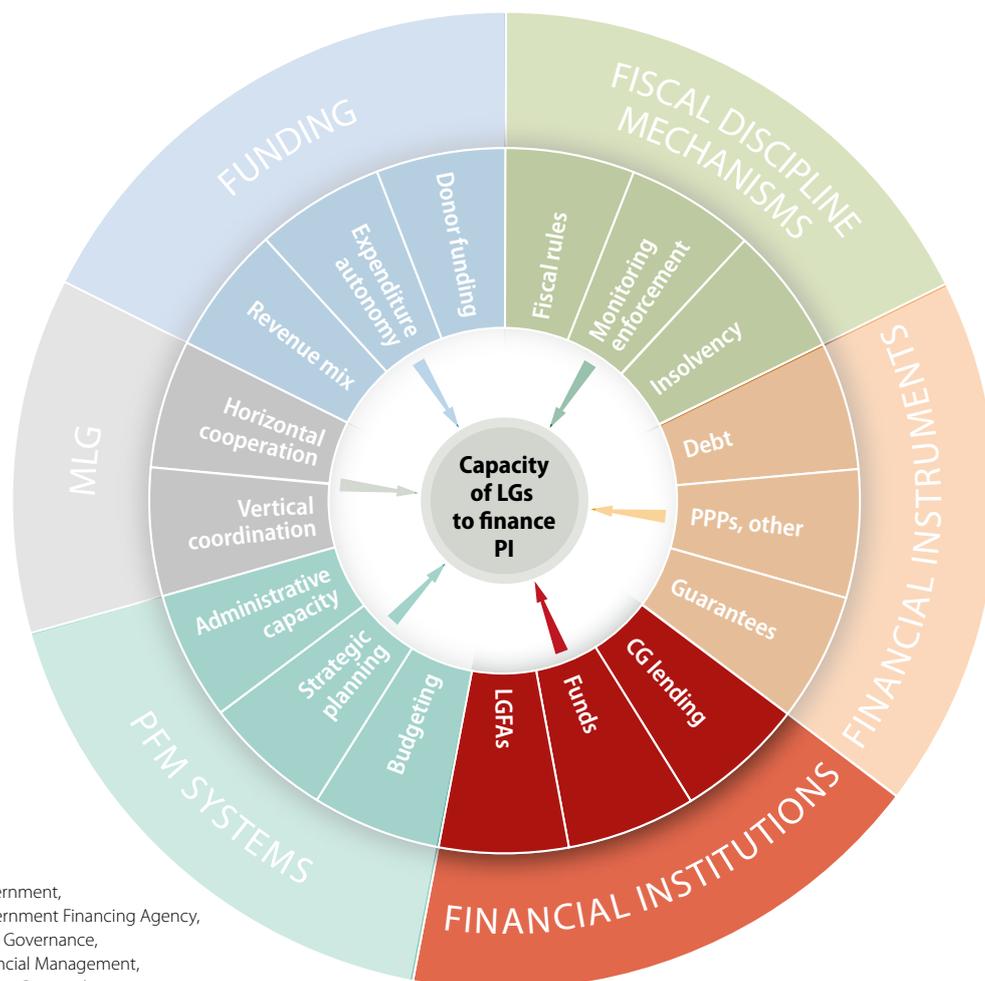
Financial institutions can help overcome the fragmentation of available funds, and scale up the size of projects and loans, thus reducing borrowing costs and supporting strategic planning.

6. Financial institutions for LGs' public investment

Following the approach presented in Chapter 2, this section describes Lithuania's current financing institutions for LG public investment (Figure 5.1), compares each element with the practices in the

benchmark countries and provides preliminary recommendations (which will be further developed in the recommendations report).

Figure 6.1. **Analytical framework: financial institutions**



Note:

CG – Central Government,
 LGFA – Local Government Financing Agency,
 MLG – Multi-Level Governance,
 PFM – Public Financial Management,
 PPPs – Public Private Partnerships

CG DIRECT LENDING TO LGS

CG direct lending to LGs in Lithuania

In normal circumstances, the CG does not provide direct loans to finance LGs public investment

In normal times, the CG only provides short-term loans to LGs which must be repaid within one year or relends funds from international banks to LGs to meet co-financing requirements of EU investments. Following the COVID-19 pandemic and the need to provide fast financial support to LGs, the CG has given

LGs loans in 2020. A share of these will be transformed into exceptional grants in 2021 and will not have to be repaid. They are not counted in the calculation of the fiscal rules either. The CG does not provide loans to LGs to finance public investment.

Comparative analysis of CG direct lending to LGs

Table 6.1 provides a summary of the use of CG direct lending to LGs for public investment in Lithuania and benchmark countries.

Table 6.1. **Comparative summary of the importance of CG loans to LGs in Lithuania and benchmark countries**

LITHUANIA	Denmark	Finland	Ireland	Netherlands	New Zealand
Low	Low	Low	High		Low
In normal circumstances, the CG does not provide direct loans to LGs with an exception of short-term loans that must be repaid within a year.	CG does not lend to municipalities.	CG does not lend to municipalities.	Municipalities can only borrow from CG agencies: National Treasury Management Agency and Housing Finance Agency.		CG does not lend to municipalities.

Source: Authors' analysis.

In only one benchmark country the CG lends directly to LGs

Ireland is the only benchmark country where the CG lends directly to LGs. Moreover, LGs are only allowed to borrow from the CG (National Treasury Management Agency or Housing Finance Agency) and cannot take up commercial loans. The rationale is that the CG can get much better borrowing conditions than LGs and borrowing directly from the CG is therefore cheaper.

Recommendations on CG direct lending to LGs for Lithuania

The CG could re-lend funds to LGs to finance public investment

The CG can get funding on international markets on better terms and conditions than LGs and re-lend to LGs on favorable terms. This would allow CG to have a close monitoring on LGs loans and projects (as in Ireland), by de-facto approving the projects by facilitating their financing. This could be processed through institutions such as VIPA (see next section), but without imposing conditions on the sectors, but rather on the quality of the projects presented and possible impact. It is to note that loans from the CG to the LGs do not increase the debt to GDP ratio for EU Treaty calculations, as the EU Fiscal rules consider general government debt to GDP (and the credit of the CG would therefore compensate the debt of the LG). Only if the CG borrows to lend to the LGs would this increase the debt-to-GDP ratio.

PUBLIC INVESTMENT FUNDS

Public investment funds in Lithuania

Lithuania has a myriad of narrowly targeted public investment funds

Following the structure and operational framework of the EFSI funds, Lithuania has several funds to support LG public investment, usually based on EU structural funds and other international support. Each fund is specialised in a different sector (municipal buildings, cultural heritage, water supply and wastewater, street lighting, energy efficiency, etc.), and usually provides loans, and sometimes guarantees for individual loans.

Beneficiaries can be municipalities or their subsidiaries (water suppliers or sewage collection network managers, for example) (Table 6.3).

Many of these funds are managed by VIPA (Public Investment Development Agency), a national promotion institution (Box 6.1 and Box 6.4). VIPA holds EUR11 million in its equity, EUR9 million of which has been paid in at the end of 2019. The Ministry of Finance holds 100% of VIPA's shares and the Central Bank of Lithuania acts as a supervisor. However, for some large and credible municipalities, the cost of borrowing from these funds is sometimes higher than that of commercial banks, making this channel less attractive than regular bank loans. These are, however, popular among smaller municipalities, which otherwise have difficulties accessing commercial loans due to the small size of their projects.

Comparative analysis of the use of public investment funds

Table 6.4 provides a summary of the role of public investment funds in Lithuania and benchmark countries.

Most benchmark countries do not have targeted public investment funds

Public Investment funds are not prevalent in the benchmark countries with the exception of Ireland, which recently created two funds: the Urban Regeneration and Development Fund and the Rural Regeneration and Development Fund. These two funds are funded through CG budget allocations and are competitive funds to which the LGs must present projects (Box 6.2). However, unlike the funds managed by VIPA, these funds do not have narrowly defined thematic conditions to foster inter-sectoral approach to investments. Their conditionality are upon the quality of the projects presented rather than the areas financed. This helps ensure a coherent planning, as LGs do not develop opportunistic projects to fit into a specific type of available funding. The two funds are differentiated according to the nature of the beneficiary LGs (urban or rural), in order to ensure ring fenced budgets for each type of LG.

Box 6.1. NATIONAL PROMOTION INSTITUTIONS IN LITHUANIA

Following the European legislation, the Law on National Promotional Institutions in 2018 granted three state-owned financial institutions the status of National Promotional Institution (NPI) – the Agricultural Credit Guarantee Fund, Invega (Investment and Business Guarantee Fund) and

VIPA (Public Investment Development Agency) (Table 6.2). National Promotion Institutions aim to operate in those areas and sectors which demonstrate market deficiency, i.e., where there is a lack of private investors and/or where the supply of funding is insufficient.

Table 6.2. **National Promotional Institutions in Lithuania and their mandates**

Name	Main functions
Agricultural Credit Guarantee Fund	Issue of state guarantees to credit institutions (up to 80% of non-recovered part of loan) and financial lease companies (up to 60% of non-recovered part) for loans by entities operating in the following industries: agriculture, forestry, fishery, rural development and food industry.
Invega (Investment and Business Guarantees)	Issue of state guarantees to credit institutions (up to 80%), provision of financial services, administration and implementation of financial and other support measures for SMEs.
VIPA (Public Investment Development Agency)	Implementation and administration of financial instruments for public-sector investment in the areas of public infrastructure, public services and projects of national interest. Provision of loans, guarantees for returnable investments and similar measures financed by national, EU and other financial assistance programmes or funding sources.

Source: For more information on each institution, see: Agricultural Credit Guarantee Fund (2020_[67]), <https://garfondas.lt/>. Invega (2020_[68]), <https://invega.lt/>. VIPA (2020_[69]), <https://www.vipa.lt/>.

Table 6.3. **Public investment funds available to Lithuanian municipalities**

Non-exhaustive list

No	Name of instrument	Description	Beneficiaries	Amount	Source of funding	Type of financial product	Managing entity
1	Municipalities buildings fund	Modernisation (renovation) of municipal public buildings to promote the increase of energy efficiency	Municipalities	EUR 37.27 million	EUR 17.27 million from the European Regional Development Fund and EUR 20 million from the Siauliai Bankas	Loan	Šiauliai Bankas
2	Cultural heritage fund	Encourage investments in cultural heritage objects	Public entities (including municipalities) and private legal entities	EUR 5.2 million	European Regional Development Fund	Loan	VIPA
3	Water supply and wastewater fund	Reconstruction of drinking water networks and sewage collection networks	Public drinking water suppliers and sewage collection network managers (municipal-owned enterprises)	EUR 30 million	Cohesion fund	Loan	VIPA
4	Street Lighting	Modernisation of street lighting systems	Municipalities and municipal-owned enterprises	EUR 14.5 million	European Regional Development Fund	Guarantee scheme	VIPA
5	Non-returnable subsidy scheme	Facilitation of EU funded investments by providing conditional subsidies to cover own-contribution.	Municipalities	Over EUR 35 million	The State budget	Conditional subsidy (ex-post assessment)	VIPA
6	EIB loan to the CG	Facilitation of co-financing of EU projects, which is also on-lent to municipalities and municipal enterprises.	Public entities including municipalities and municipal-owned enterprises	EUR 1.3 billion	EIB	Loan	Ministry of Finance
7	Short-term loans	Short term loans to municipalities to cover in-year cash-flow fluctuations	Municipalities	No specific amount but must be repaid within a year	The State budget	Loan	Ministry of Finance

Source: VIPA (2020_[69]), VIPA: paslaugos, <https://www.vipa.lt/paslaugos/>.

Table 6.4. **Comparative summary of the role of public investment funds in Lithuania and benchmark countries**

Role of public investment funds					
LITHUANIA	Denmark	Finland	Ireland	Netherlands	New Zealand
Moderate	Low	Low	High	Low	Low
Availability of funds is fragmented and sectoral.	PI funds are not prevalent in Denmark.	PI funds are not prevalent.	Two funds for public investment created in 2018 with CG funds: – Rural Regeneration and Development Fund. – Urban Regeneration and Development Fund. Co-financing rate is 25%.	PI funds are not prevalent in the Netherlands.	PI funds are small, but an important share of public investment in regions is carried out by the CG directly (ex. National roads)

Source: Authors' analysis.

Box 6.2. URBAN REGENERATION AND DEVELOPMENT FUND (URDF) AND RURAL REGENERATION AND DEVELOPMENT FUND (RRDF) ELIGIBILITY CRITERIA, EVALUATION, AND ASSESSMENT PROCESSES

The Urban Regeneration and Development Fund (URDF) and the Rural Regeneration and Development Fund (RRDF) are a competitive bid-based Exchequer-funded measures operating over a multi-annual period.

Projects submitted to the URDF are subject to a minimum funding request of EUR 2 million (EUR 10 million in metropolitan areas).

RRDF applications are separated into two categories, depending on the degree of preparation:

- **Category 1** proposals are large-scale capital projects with full planning and consents in place and are ready to commence. These projects are subject to a minimum funding request of EUR 500 000 and no maximum.
- **Category 2** proposals are projects that require support for further development to make them ready for Category 1 status. These projects are not subject to a minimum or maximum funding request.

Eligibility criteria: the applicants must provide at least 25% of total project value in matching contributions. For the RRDF, if half of this matching funding is from a community group, the fund provides 80% of total project value, instead of 75%.

Key evaluation criteria. Projects applying to this measure should demonstrate:

- **Capacity to deliver** on the objectives of different local, regional or sectoral development plans and strategies.

- **Collaboration** between different stakeholders.
- **Transformative potential**, capacity to deliver transformative change and act as a catalyst for increased activity in a rural area.
- **Additionality**, the project could not have taken place without the investment of the Fund and is not replacing investment which is already provided.
- **Value for Money**, the project will deliver outputs and outcomes, which will justify the investment.
- **Leveraging** of funding from the parties to the application, including philanthropic funders and/or the private sector where appropriate.
- **A significant and sustainable impact** on the social or economic development of rural communities.
- **Sustainability**, the capacity to deliver lasting benefits, which will outweigh the investment made and be in a position to achieve and maintain financial independence.

Project applications to both funds are subject to a thorough ex-ante assessment process. After the implementation, projects undergo a review process and ex-post evaluation.

Source: Department of Rural and Community Development (2019^[170]), *Rural Regeneration and Development Fund: Information Booklet*, <https://bit.ly/2X5PIHI>; Department of Housing, Planning and Local Government (2020^[171]), *Urban Regeneration and Development Fund*, <https://bit.ly/2TzDhh1>.

Some countries have created an institution to pool together LG public investment

In 2008, for example, the Scottish Government established the Scottish Futures Trust as a centre of infrastructure expertise and with the aim of improving the efficiency and effectiveness of infrastructure investment in Scotland. The Scottish Futures Trust works collaboratively with public bodies and the industry providing additional skills, resources and knowledge to organisations developing public sector infrastructure projects. As a result, the Scottish Futures Trust supports organisations in planning, funding,

Box 6.3. POOLING LG INVESTMENT NEEDS TOGETHER: THE SCOTTISH HUB PROGRAMME

The hub Programme is an innovative approach to develop and deliver best-value community facilities in a quicker and more efficient way. It involves a range of public sector organizations in the hub territory working in partnership with each other and together with a private sector delivery partner, in a joint venture delivery company known as 'hubCo'. The hubCo is the result of a competitive tender process, and it is constituted for a 20-year period, with a possible 5-year extension (Cuthbert and Cuthbert, 2017^[72]). The private sector partner is typically a consortium of private sector companies with expertise in construction, facilities management, and finance. The public sector organizations may include local authorities, health boards, and fire and police authorities. The Scottish Futures Trust is also part of this Public Private Partnership.

There are five hubCos across Scotland (corresponding to five geographical areas): hub South East, hub East Central, hub North, hub West, and hub South West. Each hubCo takes a long-term planning approach to identify the buildings it needs to support in order to improve community services delivery. Collectively, the hubCos have developed and delivered a diverse portfolio of community infrastructure projects, currently valued at more than £3bn (Scottish Futures Trust, 2021^[73]). Moreover, this construction work is providing many thousands of full-time jobs, and creating many graduate and apprenticeship opportunities and training positions. For instance, by 2017, the five hubCos managed 67 projects, which were either under construction or in the final stages of development, creating some 6,100 jobs (Scottish Futures Trust, 2017^[74]).

Source: Scottish Futures Trust (2021^[73]), <https://www.scottishfuturestrust.org.uk>.

delivering and managing their construction projects and buildings in a better and more inclusive way.

In doing so, the Scottish Futures Trust has developed new methods of delivering and funding projects, by a variety of different forms of Public Private Partnership. One of these initiatives is called the 'hub Programme', created in 2010 and operational since 2012 (Box 6.3).

Recommendations on the use of public investment funds in Lithuania

Select the projects based on quality and potential impact rather than on sectoral criteria

Link the choice of projects to positive spillovers and/or alignment between levels of government. Use the fund's selection criteria to foster inter-municipal cooperation. When needed, provide support to LGs to develop projects which will generate economic, social or environmental benefits.

Ensure multi-annual financing for LG public investment

Predictability of funding sources is essential to allow for LG planning of public investment. Public investment funds should therefore provide multi-annual commitments to LGs for the selected public investment projects.

Support the creation of a pooled investment institution on the model of the Hub Programme

Complement the fragmented VIPA approach with a more integrated fund, pooling funds and projects together to reach a more efficient size, pooling expertise to develop investment projects and implement them following the model of the Scottish Hub Programme.

LG FUNDING AGENCIES

LG funding agencies in Lithuania

Lithuania does not have a LG funding agency

A Local Government Financing Agency (LGFA), which could help facilitate municipalities' access to finance, does not exist in Lithuania and therefore most of the borrowing is done through commercial banks.

Lithuania is currently discussing the creation of a National Development Bank

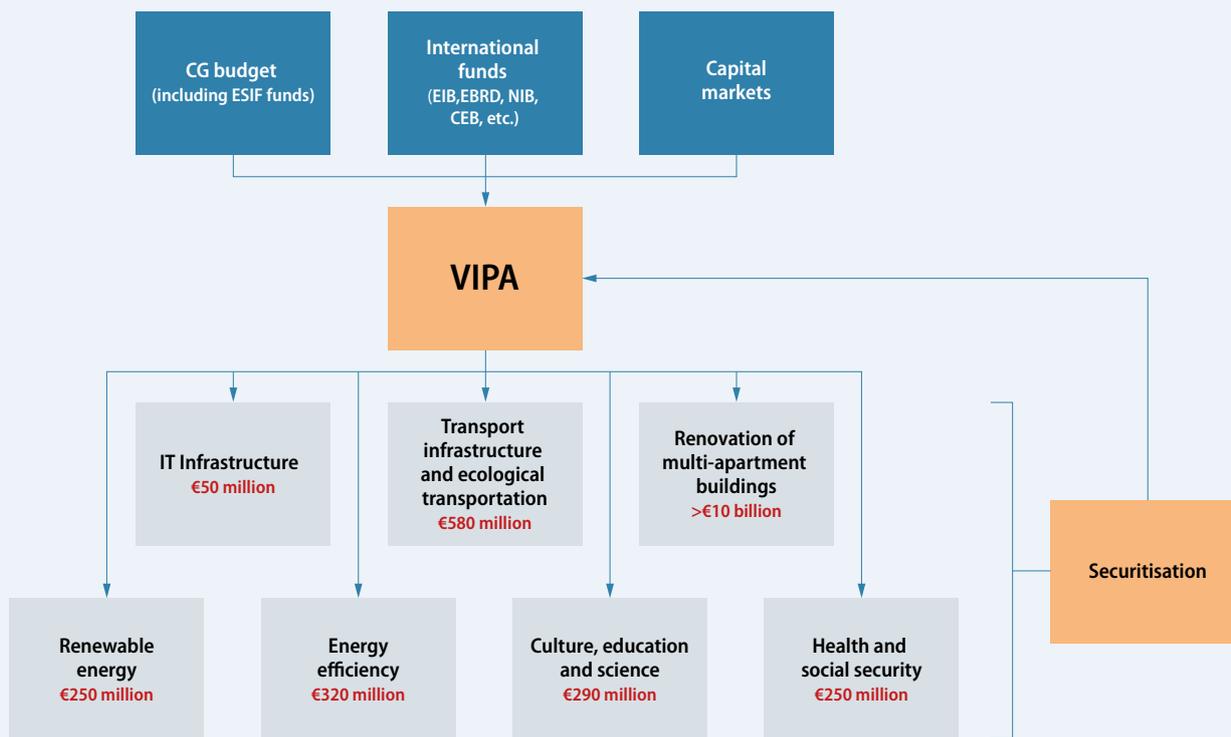
In June 2020 the Parliament requested the Government to seek for EU technical support (through DG reform of the European Commission) for the establishment of a National Development Bank. Such a bank would likely consolidate the three existing agencies: state-owned

Box 6.4. PUBLIC INVESTMENT DEVELOPMENT AGENCY (VIPA)

VIPA draws on financial resources from capital markets, institutional banks (EIB, ERDB, NIB, CEB and others) as well as the support from CG budget and ESIF funds, and manages several thematic funds (Figure 6.2), sometimes

through a commercial bank. VIPA proposes four different types of financial products, depending on the fund: loans, guarantees, non-returnable grants and repayable assistance.

Figure 6.2. VIPA implements “financial instruments” in different areas



Source: VIPA (2020_[69]), <https://www.vipa.lt/>.

credit guarantee agency, INVEGA, Public Investment Development Agency (VIPA) and the Agricultural Loan Guarantee Fund (Table 6.2 and Box 6.4). The National Development Bank would aim to ensure financing for long-term investments that benefit the wider economy and provide countercyclical lending by increasing the number of loans during economic slowdowns.

Comparative analysis of existence and use of LG financing agencies

Table 6.5 provides a comparative summary of the role of LG financing agencies.

National development banks or National Development Institutions are frequently used to channel funds for public investment

Cross-country experiences suggest that national development banks or national development institutions can play an active role in crises (IMF, 2020_[75]), while also

contributing to the development of key new sectors, such as renewables and energy efficiency (World Economic Forum, 2019_[76]). However, public banks also entail risks, such as fiscal risks arising from explicit or implicit government guarantees and inhibiting the development of longer-term private finance. Appropriate design is essential, especially as regards the need for strong governance and oversight, rigorous assessment of projects, and close monitoring of outcomes.

Most benchmark countries have a specialised LG funding agency

Unlike the benchmark countries, Lithuania does not have a LG financial agency. LGFAs are very frequent in Europe. The Danish agency Kommunekredit, created in 1898, is by far the oldest one. Amongst the most recent ones are the New Zealand LGFA created in 2011, and the French Agence France Locale, created in 2013. LGFAs are a very useful institution to pool LG borrowing needs

Table 6.5. **Comparative summary of role of LG financing agencies in Lithuania and benchmark countries**

Role of LG financial agencies					
LITHUANIA	Denmark	Finland	Ireland	Netherlands	New Zealand
N/A	High	High	Low	Moderate	High
Lithuania does not have a LG financing agency	KommuneKredit, a LG-owned bank providing lending and financial leases, holds 99% of SNG loans.	The MuniFin – a specialised municipality-owned financial institution pools municipal risk and provides loans to Finnish municipalities drawing on resources from financial markets.	Ireland does not have a LG funding agency (it has one CG-owned agency specialised in lending for housing).	Netherlands has a specialised public financial institution – the Municipal Bank of the Netherlands (BNG). Half of the bank's capital share is held by the CG and the other half by municipalities, provinces and a water board.	A publicly owned financial institution, the Local Government Funding Agency (LGFA) provides 90% of LG loans at rates below commercial banks. The CG holds 20% of LGFA's shares. The remaining 80% are held by LGs.

Source: Authors' analysis.

and obtain lower interest rates and longer maturities than if LGs approach banks individually (Box 6.5). LGFAs are usually owned by LGs, but not necessarily. In New Zealand, the CG holds 20% of the shares, and the Irish one (which specialises only in housing related loans) is owned by the CG. Often, the LGFAs also lend to municipally owned enterprises (Table 6.6). A crucial element when setting up a LGFA is ensuring sufficient guarantees for the LGFA's bond emissions, to ensure it gets a solid credit rating and therefore interesting

financing conditions which it can then pass over to its clients (Box 6.5).

Many OECD countries use pooled mechanisms for getting better borrowing conditions

Lithuania does not have a local government funding agency, and the CG does not lend to LGs.¹ Commercial bank loans are therefore the main source of borrowing for LGs. As LGs' projects are generally small and LGs do

1. With the exception of short-term loans to cover in-year cash flow fluctuations.

Box 6.5. BENEFITS FROM A LG FINANCING AGENCY (LGFA)

Most LGs cannot issue bonds individually on financial markets. However, collectively, they could enter the bond markets efficiently, and benefit from lower financing costs and longer maturities.

The form of LG financial cooperation which has proved the most successful and enduring in the Local Governments Funding Agencies (LGFAs). LGFAs are created for the benefit of LGs, usually by LGs themselves but sometimes with the participation/leadership of the CG. These agencies usually do not aim to making profits, and all surpluses are reinvested in their activities. Municipal funding agencies only operate (lend) within the borders of their countries.

The rationale for establishing a LGFA can be divided into the following points:

- Most LGs are small entities. Small borrowers get less attention from banks and capital markets than bigger borrowers. This implies that a large part of the financial markets is closed to small borrowers (LGs);

- A LGFA is potentially better equipped to market LG risk to the investors in the capital markets;
- Processing costs for pooled financing are considerably lower than if the LG borrows on its own;
- LGs often play crucial roles in the public sector of a country and have the potential of high creditworthiness, especially if they cooperate in a LGFA;
- Financial expertise is often low in LGs since their primary focus is on providing appropriate basic services to the public. The administrative staff of a LG is usually of modest size.

In all known cases, the creation of a LGFA has led to cost reductions for the LGs in their financial management. In addition, by increasing the competition in the market, the LGFA can also drive the cost of commercial banks down for LGs.

Source: Andersson (2019^[52]), Local Government Investment Financing – Understanding the LGFA concept.

Table 6.6. Comparison of different public financing institutions

	Denmark	Finland	Ireland	New Zealand
Name	KommuneKredit	MuniFin	Housing Finance Agency	Local Government Funding Agency (LGFA)
Date of creation	1899	1989	1981	2011
Legal status	Association	Publicly owned financial institution	State owned enterprise	Publicly owned financial institution
Ownership	Voluntary membership – restricted to municipalities and regions (all members).	LGs: 53% CG: 16% The public sector pension fund Keva: 31%.	CG	CG: 20% 30 LGs: 80%
Financing	Issues bonds on domestic and international capital market	Issues bonds on international capital markets	Raises its funds on the domestic and international capital markets	Issues bonds on financial markets
Aims to generate a profit for stakeholders?	No	No	No	Yes
Guarantees	Joint and several guarantee from members	Guarantee from a separate institution – Municipal Guarantee Board (MGB). All municipalities are members of MGB) and are jointly and severally ¹ guarantors for MGB.	Explicit CG guarantee	LGFA's bonds and loans are guaranteed by property taxes of all its shareholders (30 LGs) except the CG, and all LGs borrowing above NZ\$20 million. There are currently 45 guarantors
Clients	Municipalities, regions and semi-public entities guaranteed by regions or municipalities (waterworks, waste incineration, district heating etc.)	LGs, municipal enterprises, municipal federations, non-profit housing organisations	LGs for housing projects, voluntary housing sector, higher education institutions for housing projects	LGs only

Source: OECD (2021^[39]), Financing and funding municipal public investment: analytical framework and application to five OECD countries, forthcoming.

1. "Several guarantee" means that each member assumes the liability for the total amount owned by the institution.

not pool their resources together, they represent a very small share of commercial banks' portfolios and do not get very competitive conditions. There are different pooling mechanisms for improving LGs' borrowing conditions (Box 6.6). For example, projects of different municipalities could be pooled by nature (e.g. street lighting, recycling and waste management, energy) to achieve a larger size and attract more bidders and getting better conditions.

Recommendations on the creation of a LG financing agency in Lithuania

Create a specific agency specialised in LG borrowing, mutualising capital funding, for example by creating a unit specialised on LG borrowing within the future National Development Bank

Today, as fiscal rules strongly constrain LG borrowing, LG borrowing market is very small, and individual borrowing needs too small to get interesting borrowing conditions from commercial banks. Administrative costs for commercial banks to review LG financing requests are high as there is not a long-term relationship. After revising the fiscal rules in order to allow LGs to borrow

more, creating an agency specialised in LG lending would most likely reduce borrowing costs and interest rates. At present, Lithuanian LGs do not have sufficient fiscal space or revenue raising capacity to fund such an agency, and act as credible collateral for its borrowing on international markets. Therefore, the CG would need to play a key role in setting up and financing such an agency. Such an agency should however achieve an equilibrium between its financing costs and the interest rate charged on its loans and should therefore not be a burden on the CG's finances.

The projected National Development Bank, which will likely merge the three existing development agencies, would be the logic institution to carry out this task. It is therefore important when designing the statutes of this National Development Bank, to ensure that it includes a unit specialised in LG financing.

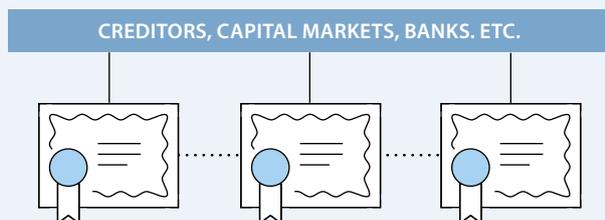
Box 6.6. POOLED FINANCING MECHANISMS AND LOCAL GOVERNMENT FUNDING AGENCIES

Many LGs are small and do not have sufficient financing needs to attract the attention of creditors. This is especially true for capital market transactions (issuing bonds), where even the largest LGs – usually large capital cities – struggle to attract investors.

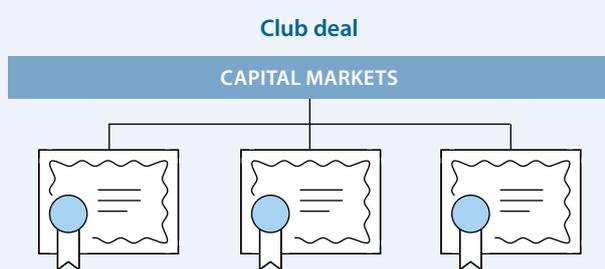


Pooled financing mechanisms can help LGs overcome the challenges caused by their small size and infrequent capital needs. Pooled financing mechanisms exist in many countries and have many different forms:

Coordinated borrowing and exchange of good practices



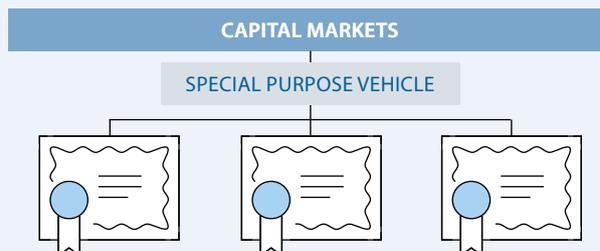
The most basic type of pooled financing merely consists on using similar procurement processes in relation to banks and other creditors to negotiate better conditions, and exchange good practices. Jointly approaching banks with standardised demands makes LGs loans more attractive to creditors.



The second stage in pooled financing mechanisms is for **several LGs to get together to issue a joint bond**. Pooling financing needs helps achieve the minimum size required for

issuing bonds. Each participating LG is responsible for its part of the payment of the interest and capital. This was commonly used in France before the creation of the Agence France Locale.

Local Government Financing Agencies (LGFAs)



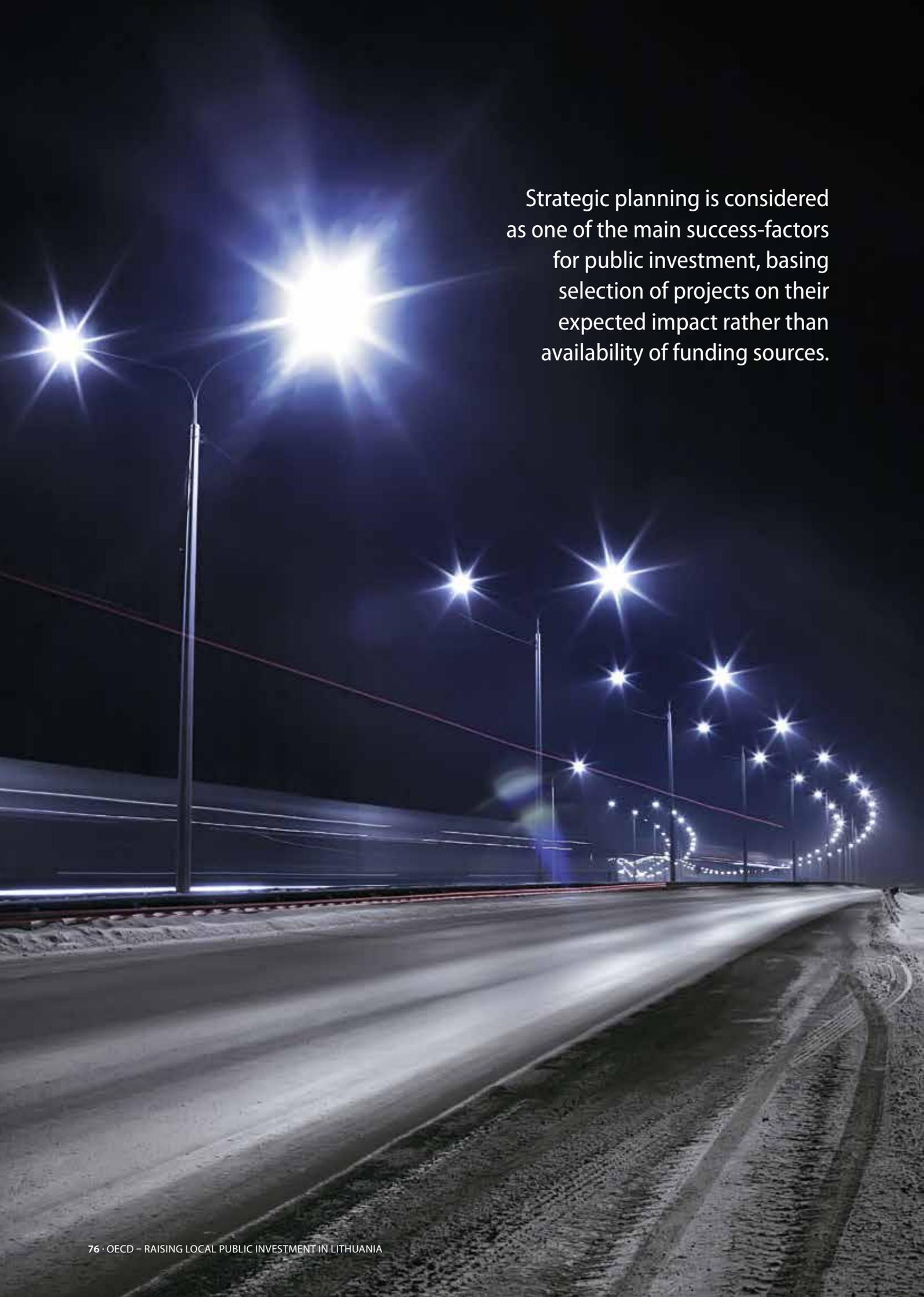
The last stage is to create a **special purpose vehicle (SPV)** to act as an intermediary between LGs and the capital market. This SPV or local government financing agency (LGFA) is owned by LGs and, in some occasions (as in New Zealand), with minority shares held by the CG. It issues bonds in the capital markets, domestically and internationally, and on-lends the proceeds to LGs which are members and/or shareholders of the agency.

The big advantage of the LGFA is that it can reach sufficient volumes in its borrowing needs to diversify its funding operations and achieve cost-efficient pricing on national and international capital markets. Diversification also means a reduction of risk, as the LGFA does not rely on a single source of funding or even one market. In addition, the specialisation of the LGFA allows it to hire financial experts to run its operations and reduce the risk.

Success factors for LGFAs

Economic strength, or creditworthiness, depends on the level of capitalisation and the existence and quality of guarantees. The guarantors can be either the LGs themselves, the CG, a third party (e.g. public sector pension funds), or a mix of these. The advantage of having a guarantee from the participating LGs is that it reinforces the LG responsibility for the LGFA.

Source: Andersson (2014^[77]), What the World Needs Now... is Local Infrastructure Investments. Challenges and Solutions with a Focus on Finance, <https://bit.ly/2EAa2G1>.



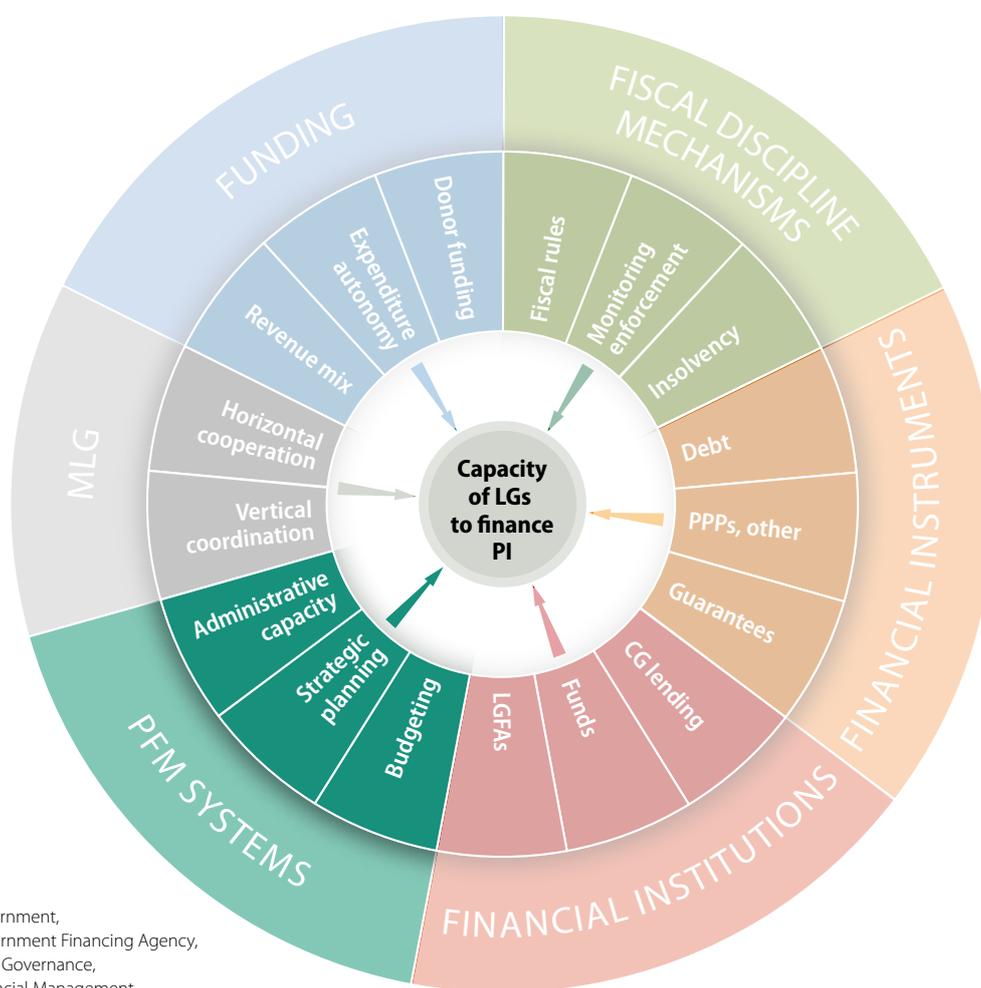
Strategic planning is considered as one of the main success-factors for public investment, basing selection of projects on their expected impact rather than availability of funding sources.

7. Public financial management systems for LG public investment

Following the approach presented in Chapter 2, this section describes Lithuania’s current public financial management systems for local public investment (Figure 7.1), compares each element with the practices

in the benchmark countries and provides preliminary recommendations (which will be further developed in the recommendations report).

Figure 7.1. **Analytical framework: public financial management (PFM) systems**



Note:
 CG – Central Government,
 LGFA – Local Government Financing Agency,
 MLG – Multi-Level Governance,
 PFM – Public Financial Management,
 PPPs – Public Private Partnerships

BUDGETING AND REPORTING PRACTICES

Budgeting and reporting practices in Lithuania **Municipalities need to wait for the approval of the CG budget to start their own budget process**

In Lithuania, municipal budgets are usually finalised and approved in January/February. The CG budget law (Law on the financial indicators of the State budget

and the municipal budget) determines CG transfers to municipalities (which constitute about 90% of LGs’ revenues), as well as LGs’ debt and net borrowing limits. This law is approved by the Parliament in December, and municipalities must submit their budgets within the two following months (Box 7.1). The CG budget law establishes financial indicators municipalities need to follow while preparing their budgets.

The CG budget includes revenue and expenditure forecasts for three years (the budget year plus two succeeding years), and the Parliament makes a non-binding resolution concerning the overall indicators of state and local government revenues and spending over the three-year period each December. However, studies

have highlighted that adherence to the multi-year expenditure ceilings is not fully binding and ceilings are modified frequently (European Commission, 2015_[78]). The lack of predictability of LGs' revenues reduces their capacity to prioritise their spending and develop medium-term infrastructure plans (Figure 3.4).

Box 7.1. BUDGET PRACTICES AND PROCEDURES IN LITHUANIA

Legal and institutional framework

The Constitution specifies the overall legal framework for the budget, as well as the budget responsibilities of the parliament and the government. The organic budget law for Lithuania – the Law on the Budget Structure – was enacted in July 1990. It defines the contents of the state and municipal budgets, the legal grounds for raising revenues and using appropriations, and the duties of appropriation managers. The Constitution and the Law on the Budget Structure provide for the budget to be approved for one calendar year and to include current services estimates for three years – the budget year plus two succeeding years.

Lithuania has separate budgets for the state (central government), the municipalities (local government) and the social insurance funds. The state budget and the main financial indicators of municipal budgets are approved in the Law on Approval of the Financial Indicators of the State Budget and Municipal Budgets. The state budget, as approved by parliament, covers the revenue and expenditures of the government ministries and other budgetary institutions, including state transfers to the municipalities. The municipal budgets are approved by the municipal councils, and cover municipal revenues and funds transferred from the state for delegated and independent functions.

Central Government annual budget process

The annual budget process is largely top down, with guidance developed by the Ministry of Finance and budget allocations resolved through a process of negotiation. The fiscal year in Lithuania runs from January to December. Prior to the start of each fiscal year, usually around February, the Government approves a Plan for the Preparation of the Draft State and Municipal Budgets for the year ahead. The plan establishes the time schedule and defines the material that the ministries and appropriation managers must prepare and submit to the Ministry of Finance.

The budget formulation cycle begins in Spring when the Prime Minister sets its annual priorities for spending in the following year. There would usually be up to eight high level

priorities, and these do not change substantially from year-to-year.

At the end of Spring (usually around May), the Government approves medium-term expenditure limits for the state and municipal budgets and submits these to Parliament. These limits are based on annual priorities, targets set by line ministries and the economic outlook.

In May and June, the Government organises budget planning meetings with the Prime Minister, the Minister of Finance and each relevant Line Minister. These meetings are used to negotiate the strategic goals, planned results and spending limits for each area of Government. During these meetings, each individual Line Minister must present proposed spending plans and show how programmes fit with the Government's annual priorities.

At the beginning of July, appropriation managers are formally notified of their expenditure limits for the next three years by the Ministry of Finance. Thereafter, each ministry and public institution draws up a Strategic Action Plan detailing projects and programmes for the spending period.

Appropriation managers then submit their budget proposals by early September, followed by negotiations between the Ministry of Finance and appropriation managers to resolve differences between their proposals and the approved allocations. In practice, this means that ceilings for some ministries would be increased compared to the initial ceiling, but at a marginal level. This process can involve last minute negotiations between the ministries and the Ministry of Finance and issue resolution by the Prime Minister. In the same month, the Ministry of Finance updates the macroeconomic forecast and, if necessary, adjusts the expenditure limits set out in the State budget allocations.

The draft State budget is finally compiled in October. It must be submitted to Parliament no later than 75 calendar days before the end of the budget year, i.e., 17 October.

Source: OECD (Unpublished_[79]), Budget practices and procedures in Lithuania, Lithuania accession report.

LGs prepare their budgets on a cash basis and their accounts in accruals

All public institutions in Lithuania (including the 60 municipalities) follow ESA 2010 accounting standard, and must, therefore, apply accrual-based principles for preparing financial statements. Municipalities submit their accounts to the Ministry of Finance via a centralised accounting system. Municipalities draft their budget execution statements on a modified cash basis and report their financial performance to the Ministry of Finance quarterly. The Ministry of Finance, in turn, prepares a consolidated balance sheet and includes it in the annual national financial statements (IMF, 2019_[80]).

Budget flexibility: LGs can carry forward unspent funds (except earmarked grants)

To provide some flexibility, the organic budget law allows municipalities to carry-over unspent funds of the previous year, except for unspent earmarked grants, which have to be returned to the state budget at the end of the year.¹ When using these funds, municipalities must first cover their arrears (short-term liabilities) and only after they can use them at their own discretion (savings,² investment projects, operating expenses, repayment of long-term loans). Unspent funds are mainly due to under estimation of PIT revenues rather than the will to set aside funds to create reserve funds. Indeed, according to the Ministry of Finance, municipalities tend to budget very cautiously and hence underestimate their budgetary revenues. In 2019, the total municipal surplus was around EUR 100 million (about 3% of total LG revenues).

Municipal current expenditure budgets can be amended an unlimited amount of times during the budget year by the municipalities.

LG financial data is published, but in formats which are difficult to exploit

Data on municipal finances (revenues, debt and guarantees) is regularly published on a dedicated website of the Ministry of Finance.³ However, the data is supplied in the pdf format and in separate documents for each municipality and for each year. This makes comparison and analysis between different indicators, years and

municipalities difficult as data has to be manually copied and pasted into a database format. LGs do not differentiate between their operational and capital budgets.

Some municipalities lack transparency in terms of financial reporting

The IMF (2019_[80]) observed that some municipalities are highly transparent and publish their cash flows as well as balance sheets quarterly, as required. Other LGs only provide aggregated information. The Independent Fiscal Institution (2019_[81]) identified that the revenue and expenditure execution reports, which municipalities are required to provide since 2016, are not comparable across municipalities. In particular, some municipalities do not record unused revenues correctly. This is mainly due to the lack of internal control, guidelines and coordination (The Independent Fiscal Institution, 2019_[81]).

Comparative analysis of budget and reporting practices

Table 7.1 provides a summary of budgeting and reporting practices in Lithuania and in the benchmark countries.

Lithuanian LGs use cash for their budgets and accruals for their accounts, as most OECD countries

Lithuanian LGs prepare their budgets in cash and their accounts in accruals, which is a common practice across the OECD (Box 7.2) (Moretti, 2016_[82]; Irwin and Moretti, 2019_[83]). Among the benchmark countries, only Ireland, the Netherlands and New Zealand prepare budgets in accruals.

Predictability of LG revenues in coming budget years is lower in Lithuania than in most benchmark countries

While Lithuania has a medium-term budget framework for the current year and two following years, these are not binding appropriations and they are often modified. LGs therefore have little predictability of their revenues (as CG grants make for about 90% of their revenues). As a comparison, LGs in the Netherlands must prepare and approve budget for four years (current year plus three following years). In Ireland, LGs receive five-year envelopes for their capital budgets, thus allowing them to develop medium-term capital plans.

Recommendations on budgeting and reporting practices ***Make the medium-term budgeting framework of CG more binding to provide information on CG transfers earlier in the budget cycle***

Multi-annual commitments from CG on the transfers to LGs would help LGs develop their medium-term plans. Regarding the annual budget, the CG should decide and

1. This is not applied in the accounting statements, but when checking against the balanced budget rule.

2. Most municipalities do not hold substantial buffers or rainy-day funds in their accounts, but some municipalities have specific reserves left for dealing with emergencies, natural disasters and their consequences.

3. See here: <https://bit.ly/2EA10v7>.

Table 7.1. **Comparative summary of budgeting and reporting practices in Lithuania and benchmark countries**

Quality of budgeting and reporting practices					
LITHUANIA	Denmark	Finland	Ireland	Netherlands	New Zealand
Moderate	Moderate	High	High	High	High
<p>LGs prepare their budgets in cash and produce accounts in accruals.</p> <p>Municipalities plan their budgets for one year.</p> <p>LG accounts are audited but some municipalities deviate from accounting standards when preparing their financial statements.</p> <p>Internal controls guidelines and coordination could be stronger.</p> <p>Financial data of municipalities are regularly published but not in a user-friendly manner.</p>	<p>LGs use cash accounting but prepare budgets on accrual basis.</p> <p>High level of budgetary transparency.</p> <p>Expenditure ceilings are decided for one year. Budget Act is scheduled to be revised in February 2021.</p>	<p>Municipalities use accrual accounting.</p> <p>Municipalities must present a financial plan for at least three years in addition to the annual budget.</p> <p>Municipalities must provide updated financial data to the Statistical Authority four times a year. The MoF uses these data to assess municipalities' fiscal position once a year in June.</p> <p>Financial information is published with built-in analytical tool.</p>	<p>Budgets are prepared on accrual basis.</p> <p>Budgeting is subject to distinct planning and financial reporting mechanisms.</p> <p>Appraisal and evaluation mechanisms are well developed.</p> <p>Predictability of future funds is high: five year envelope for capital budgets for Departments.</p>	<p>Municipalities prepare and approve budgets for four years using income and expense system.</p> <p>High level of budgetary transparency.</p> <p>Medium-term perspective in budget preparation is well established.</p>	<p>LGs use accrual budgeting since 1990.</p> <p>LGs usually rely on large international firms to prepare their accounts and financial strategies.</p>

Source: Authors' analysis.

Box 7.2. CHARACTERISTICS OF GOOD ACCOUNTING PRACTICES FOR LGS

High-quality LG accounts should be up to date, which means that they should be produced reasonably frequently and with a reasonably short time lag. They should be reliable, which means, among other things, that they should be audited. They should be easy to understand, which is more likely if, among other things, they follow a common set of standards. Finally, they should be comprehensive.

Accounting information on LGs' debt and cash flows is crucial, but early detection of problems is more likely if the accounts include more than this. A LG balance sheet, for example, may suggest problems in the maintenance and renewal of assets, while data on accrual expenses may show that cash outflows are being controlled only by delaying the payment of bills. Data on liabilities associated with pensions, public private partnerships, and sub-national enterprises may reveal serious fiscal risks even though the conventional direct debt of the sub-national government remains modest.

Of course, not even the best accounting can reveal all looming sub-national fiscal problems: a banking crisis or major natural disaster or health crisis such as the current COVID-10 pandemic, for example, can quickly create fiscal problems for sub-national governments even with strong finances. But timely, reliable, understandable and comprehensive accounting should provide early warnings of possible problems caused at least in part by sub-national policies.

Source: Irwin and Moretti (2019^[33]), Allowing the stitch in time: the role of accounting in the early revelation of sub-national fiscal risks, Paper presented at the Fiscal Network Meeting, December 2019.

communicate the transfers to LGs sufficiently early to allow LGs to develop their budgets before the budget year starts.

Make budget and reporting practices homogeneous across LGs

Today, quality of budget and reporting practices varies amongst LGs. Budgeting and accounting standards and practices are homogeneous across municipalities, however, some municipalities deviate from these standards when preparing their financial statements, which makes comparisons difficult. Data are often provided in an aggregate fashion, in formats which are difficult to exploit. A homogenous accounting standard should be developed and used by all LGs.

Publish LGs financial data should in formats which are easy to exploit

LG data should be provided and published regularly in standard data formats accessible to public (e.g. in an Excel format) and in comparable ways. Published data could be complemented with built-in analytical tools, overview tables and should include all municipalities in one data file to facilitate comparisons. This would increase transparency, reassure potential investors, and allow LGs to benchmark their situation with the other similar LGs.

STRATEGIC PLANNING PRACTICES

Strategic planning practices in Lithuania

LGs prepare strategic plans but these are often pure formal exercises with no real impact

Until recently, the Law on Local Self-Government established three types of strategic plans. The Municipal Council determined the procedures for the organization of strategic planning in the municipality, taking into account the recommendations of the government. All municipalities had to prepare three planning documents: a strategic development plan, a strategic operating plan and an annual operating plan. In addition, some municipalities also prepared operational plans for every unit, incorporating indicators for each employee.

However, according to Jurkonienė and Karčiauskienė (2017^[84]), the linkages between national and local level planning documents were often unclear, and different objectives were not well integrated. Other authors found that strategic documents were not regularly reviewed, lacked continuity and sometimes did not correspond well to the actual budgets of municipalities (Valickas, Raišienė and Arimavičiūtė, 2017^[85]; Arimavičiūtė, 2012^[86]).

These elements are currently being addressed: there are reforms under way following the new Law on Strategic Management, which aims at integrating municipal and national planning, methodological approaches and processes, and an on-going reform of the budget system, which may affect municipal financing. However, it is still too early to make assessments of these new developments.

Most importantly, administrative capacities and hence specific skills required for thorough strategic planning are often insufficient (Valickas, Raišienė and Arimavičiūtė, 2017^[85]; Arimavičiūtė, 2012^[86]). Overall, Lithuanian LGs projects follow funding, rather than LGs seeking financing for implementing their capital investment strategic plans.

LGs often do not consider the long-term operating costs of their investments

Most LGs only calculate the capital expenditure on their investment plans, and they are not required to assess the long-term operating costs and their impact on their budgets. Currently, the CPMA is developing a fiscal assessment tool for municipalities, which aims at helping municipalities evaluate financial flows throughout the entire investment project lifecycle.

Projects are often developed to fit available funding

According to the interviewed municipalities, some mayors refrain from borrowing and engaging in financial instruments and rather choose to perform investments solely depending on the availability of special donor programs.

Planned reform of the strategic planning and budgeting framework

To address some of these challenges, the Ministry of Finance, the CPMA and the Government Office are jointly developing a reform of the Strategic Planning and Budgeting framework, which is expected to be implemented by the beginning of 2021. This reform aims at establishing better linkages between medium-term budget and strategic plans. In the context of this reform, investment project selection process is reviewed, introducing assessment of possible alternatives, applying life-cycle cost analysis, carrying out impact assessments and selecting the most appropriate source of funding (PPP Lithuania, 2018^[87]). The law has been approved in the Parliament in 2020 and resulted in 40 related legislation amendments. This recent reform of strategic planning and budgeting practices has a

potential for improving the situation as there is still room for refinement (National Audit Office, 2019^[88]).

Comparative analysis of strategic planning practices

Table 7.2 provides a summary of strategic planning practices in Lithuania and benchmark countries.

Strategic planning practices for LGs are less developed and less effective in Lithuania than in benchmark countries

Strategic planning is considered as one of the main success-factors for public investment (OECD, 2020^[38]). LGs’ strategic planning practices vary significantly across countries. While in some countries, LGs must prepare multiple year detailed plans (e.g. 30 years infrastructure strategy in New Zealand and 10-year investment plan in Finland), in others, such elaborate planning is not prevalent. In Denmark for example, LGs prepare only sectoral plans, which may limit effective implementation of investment projects.

In Lithuania, local investments often follow funding and strategic planning remains a formal exercise, despite recent improvements. This can be well contrasted to the Irish approach of enforcing policy priorities through comprehensive multi-annual planning: “Funding follows policy, not policy follows funding”. In Ireland, financial

plans are strongly integrated with regional development plans. In 2018, Ireland launched Project Ireland 2040 (Box 7.3), which articulates the National Planning Framework to 2040 and the National Development Plan (to 2027). These plans also set the context for Ireland’s three regional assemblies to develop their regional spatial and economic strategies in coordination with the local authorities, to ensure that national, regional and local plans align. The Office of the Planning Regulator ensures this coordination by overseeing and approving the plans from all levels of government.

Most benchmark countries have well established methodologies to assess and evaluate investment projects and their impact on subsequent operating budgets

New Zealand for example produces a long-term (10 year) plan and financial strategy, which identified the effect of funding and expenditure proposals on future property tax rates, debt and investments. LGs have a large autonomy to propose investment projects, but must get approval from their constituencies on the impact these would have on local taxes. In Ireland’s Public Spending Code ensures a uniform approach to project appraisal and evaluation (Box 7.4).

Table 7.2. Comparative summary of strategic planning practices in Lithuania and benchmark countries

Intensity of strategic planning practices					
LITHUANIA	Denmark	Finland	Ireland	Netherlands	New Zealand
Low	Low	High	High	High	High
<p>LGs must prepare three different strategic plans: a strategic development plan – with a sectoral approach; a strategic operating plan, and an annual operating plan. Some municipalities also prepare a plan by entity.</p> <p>However, these plans tend to be considered as purely formal exercises with no real impact.</p> <p>LGs also often only consider the capital expenditure and fail to take into account the recurring operating costs of planned investments.</p>	<p>Municipalities do not prepare overall long-term strategic infrastructure plans, but sectoral plans exist.</p>	<p>LGs must prepare 10 years strategic and investment plans.</p> <p>Larger municipalities use sophisticated financial management tools to plan their investments.</p>	<p>Strategic planning practices are highly developed in Ireland. In the context of the Project Ireland 2040, the Ireland National Planning Framework (NPF) was established. It elaborates development strategies for regions, cities, towns and rural areas for the next decade.</p>	<p>Netherlands has an elaborate investment planning programme (the Multi-Year Plan for Infrastructure, Spatial Planning and Transport (MIRT)).</p> <p>Any Ministry or local or regional authority can launch or participate in the programme and is finalised by collective agreements.</p>	<p>LGs must provide a 30 year infrastructure strategy, a ten year plan and financial strategy, an asset management plan and annual plans and reports. Assumptions of these plans are audited by the Office of the Auditor General.</p>

Source: Authors’ analysis.

Box 7.3. STRATEGIC PLANNING IN IRELAND: PROJECT IRELAND 2040

Project Ireland 2040 is the Irish government's long-term overarching strategy. Established in 2018, it changes how investment is made in public infrastructure in Ireland, moving away from the approach of the past, which saw public investment spread too thinly and investment decisions that did not align with a well-thought-out and defined strategy.

National Planning Framework

In the context of Project Ireland 2040, the Government established a strategic planning framework – National Planning Framework – to guide the development of the country in economic, social and environmental terms. The National Planning Framework was prepared by the Department of Housing, Planning and Local Governments (DHPLG), following widespread public consultations. The Office of the Planning Regulator is responsible for monitoring the implementation of the National Planning Framework through local development plans and regional and economic spatial strategies.

National Development Plan

The National Development Plan 2018-2027 was published in conjunction with the National Planning Framework and sets out the capital investment required to implement the National Planning Framework. The plan is backed by investment of EUR 116 billion over the 10 years to 2027, including EUR 1 billion to the Rural Regeneration and

Development Fund (URDF) and EUR 2 billion to the Urban Regeneration and Development Fund (URDF).

Regional planning

The National Planning Framework and the National Development Plan set the context for each of Ireland's three regional assemblies to develop their Regional Spatial and Economic Strategies which co-ordinate the both the development plans and local economic and community plans of local authorities. The Office of the Planning Regulator is a statutory consultee in the process of preparing the regional strategies.

Development plans and Local Area Plans

The Development plan is a local authority's main policy document in relation to planning. It is prepared by the elected members of the local authority. The development plan sets out the overall core strategy and specific objectives for the proper planning and sustainable development of the entire functional area of the local authority. If the Office of the Planning Regulator finds a plan is not in accordance with the proper planning and sustainable development of the area, the OPR will inform the Minister and may recommend the use of Ministerial powers to rectify the matter.

Source: OECD (2021^[39]), Financing and funding municipal public investment: analytical framework and application to five OECD countries, forthcoming.

Box 7.4. PUBLIC SPENDING CODE REFORM IN IRELAND

In late 2013, the Department of Public Expenditure and Reform launched the Public Spending Code. The objective was to ensure a comprehensive and uniform approach to project appraisal and evaluation for all government departments and agencies. For projects over EUR 5 million, a Sponsoring Agency must first undertake a preliminary appraisal. This Agency can be a CG department, a local authority, a health agency, a university or another type of public body, depending on the project.

Source: OECD (2019^[10]), Effective public investment across levels of government, Principle 4.

Recommendations on strategic planning in Lithuania *Provide assistance to LGs to develop long-term development strategies and medium-term investment plans*

Streamline the number of plans LGs must prepare, but make sure that these are relevant, place-based, integrated across sectors, and generate long-term value-for-money. As designing such plans requires a high level of technical and administrative capacity, the CG or a CG agency could provide support to LGs for doing so.

Ensure LGs assess upfront the long-term impacts and risks of public investment

In many cases, the main challenge for the management of public investment is insufficient or weak planning: poor selection of projects and weak project appraisals which are often not based on sound data. Ensuring sound ex ante evaluations is important to ensure value-for-money of an investment project and ensure that its operating and maintenance costs are affordable.

Rigorous *ex ante* appraisals of economic, but also social and environmental impacts should be carried out, as well as an assessment of the risks associated with public investment (fiscal risks, but also financial, political, social and environmental). As such appraisals can be quite technical and require a lot of data, the CG or a CG agency could support LGs in this task.

CG could make the upfront assessment of the long-term impacts and risks of public investment a requirement for applying to CG investment funding, and when necessary, provide assistance to LGs to carry out these assessments.

Engage various stakeholders in the preparation of investment strategies to ensure vertical and horizontal co-ordination of investment strategies between levels of government, and between LGs

Engaging various stakeholders (such as citizens, neighbouring municipalities, central government line ministries) in the elaboration of investment strategies allows to better align the objectives and improve the quality of the projects included in these strategies (OECD, 2019^[10]). In the Netherlands, the Multi-Year Plan for Infrastructure, Spatial Planning and Transport (MIRT) programme involves different ministries, provinces, municipalities and other stakeholders, who can launch and participate in the development of projects under the MIRT programme (Box 3.1) in section 3.3.

Continue providing CG support to LGs to develop capital investment projects worth financing

Implementing cost benefit analysis (including non-monetary elements such as social or environmental costs and benefits) and estimating the recurring operating costs of projects takes time. Since 2014, CPMA provides support to LGs to carry out these analyses, develop and select projects. They have developed semi-automated tools, provide training and support for project developers.

Link funding to plans, and provide multi-year capital spending envelopes

Funding should follow well planned projects, rather than projects being developed to access specific funds. However, well planned projects are useless if they cannot access funding. The CG should therefore design a mechanism for allowing LGs with a well-designed, coherent investment project with demonstrated economic, social and/or environmental impacts to access funding. Selection of projects to be funded should

also be based on the prioritisation set up in the strategic development plans. Investment projects take time, and therefore multi-annual commitments from the CG on capital transfers would help LGs improve the quality of their plans and projects.

ADMINISTRATIVE CAPACITY IN LGS

Administrative capacity in LGs in Lithuania **Administrative capacity varies depending on the size of municipalities**

Administrative capacity varies across municipalities, often depending on size, distance to a bigger city and prior experience in engaging into different financial instruments and investment funding practices. Municipal capacity for policymaking is also limited (European Commission, 2020^[89]; Council of Europe, 2018^[90]).

The local councils and mayors (since 2015) are directly elected every four years. However, according to the stakeholders, some investment projects remain unfinished due to political changes and subsequent shifts in strategic priorities. While the mayor is the head of the municipality, the local council also appoints a director of the administration responsible for all executive tasks. The local councils may grant wards, under certain conditions, the ability to manage their own budgets (Box 7.5).

Box 7.5. WARDS – SMALLER TERRITORIAL UNITS ESTABLISHED BY THE LOCAL COUNCILS

The local council has the power to establish smaller territorial units (*seniūnija*) that, acting in a certain territory of the municipality, provide daily local services to citizens in a given municipality area. There are around 545 wards (called “elderships” and which derive from former municipalities), each headed by a civil servant appointed by the director of municipal administration. Vilnius has 21 elderships. From 1 January 2017, municipal councils can give districts that meet certain criteria set by law the ability to manage their own budgets.

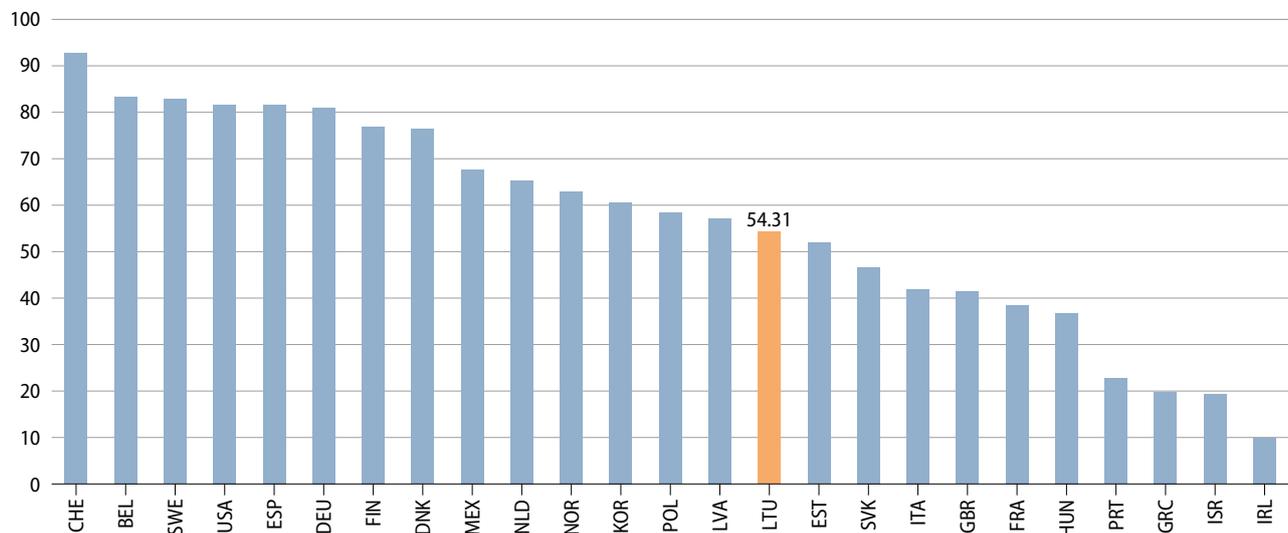
Source: OECD/UCLG (2019^[31]), 2019 Report of the World Observatory on Subnational Government Finance and Investment – Country Profiles, <https://bit.ly/2VPjyLQ>.

Many LGs face difficulties attracting qualified labour in part due to low wages

According to stakeholders, difficulties in attracting talents and widening skills shortages are highly prevalent in Lithuania. Local governments employ half of GG workers (Figure 7.2) but, nonetheless, face difficulties

Figure 7.2. **LG employs half of GG workers**

Sub-central government employment as a percentage of GG employment



Source: OECD (2019_[92]), Government at a Glance 2019, Government at a Glance 2019, OECD Publishing, Paris, <https://doi.org/10.1787/fee3c285-en>.

in attracting experts in fields such as ICT and project management. One of the contributing factors is low wages. Even at the CG level, professionals' compensation is lower than in other OECD countries (OECD, 2017_[91]). This is exacerbated at the local level, where wages are around 20% lower than in the national administration (Council of Europe, 2018_[90]). Even if cost of living is lower than in large cities, attracting and retaining talent is therefore difficult in many smaller municipalities, especially in areas such as ICT and project management.

Efforts for increasing administrative capacity are being carried out

The Central Project Management Agency provides in-house training to strengthen LGs' staff expertise, in particular for applying to EU funds or for preparing PPPs. However, they need to retrain new staff almost every year due to the high turnover of LG employees.

Moreover, the digital skills necessary for the effective use of financial instruments are often lacking, especially in rural areas. For complex tasks, LGs thus typically rely on external consultants. To that end, the Ministry of Finance provides a list of suitable external consultants, but the list is not systematically updated.

Comparative analysis of administrative capacity in LGs

Table 7.3 provides a summary of summary of administrative capacity in LGs in Lithuania and benchmark countries.

LG administrative capacity has a direct impact on the quality of public investment projects

OECD experience shows that the low level of capacities to design and implement the right investment-mix, in particular at the sub-national level, is probably one of the most important bottlenecks for effective public

Table 7.3. **Comparative summary of administrative capacity in LGs in Lithuania and benchmark countries**

Administrative capacity					
LITHUANIA	Denmark	Finland	Ireland	Netherlands	New Zealand
Low	High	High	High	Moderate	High
Municipal administrative capacity tends to be low, especially in small, rural municipalities which struggle to attract and retain qualified staff.	There are no particular differences in terms of administrative capacities across Danish municipalities due to homogeneity of municipalities.	Reliance on highly skilled municipal civil servants.	Strong focus on administrative capacity building (especially, during the Cohesion period) for the execution of capital investments.	Dutch SNG sector employs a higher share of civil servants than CG (166 000 and 115 000 respectively).	Administrative capacity is high. Mayors appoint professional Chief Executives. Most LGs outsource their treasury management to private companies (PWC in particular).

Source: Authors' analysis.

investment. Defining, structuring, implementing, operating and monitoring public investment requires a very diverse set of capacities. Investment projects may fail or engender significant waste or corruption if they lack adequate or sufficient capacities (Pillar 2 in OECD (2019_[10])).

Capacity building goes beyond a narrow approach restricted to human resource management or workforce improvement activities. Capacities refer to the institutional arrangements, technical capabilities, economic resources, and policy practices that affect public investment. Capacity building is also a “learning-by-doing” process in which national and sub-national governments can acquire the needed capacities on a daily basis through practice. Building capacities is a long-term process that requires continuous efforts (Pillar 2 in OECD (2019_[10])).

Administrative capacities in LGs in Lithuania is lower than in benchmark countries

Compared to the benchmark countries, the administrative capacity in LGs in Lithuania is low. This potentially hampers the effectiveness of local investments and may result in differences in the quality of services delivered between different regions. In Finland, Denmark, Ireland or New Zealand, LGs rely on highly skilled civil servants. Denmark mentions there are no particular differences across municipalities in the administrative capacity of civil servants, thanks to the homogeneity of size and income levels in different LGs.

Outsourcing or pooling technical staff is frequently used by LGs in OECD countries

New Zealand outsources to private firms many functions, such as financial management. Creating shared services is also a way to allow smaller municipalities to benefit from expertise it would not be able to finance alone. In some countries, the CG provides incentives for such cooperation on shared services (Box 7.6).

Some countries have used EU funding to invest in LG capacity

There are different approaches to capacity building at the local level (OECD, 2019_[10]). Lithuania could follow the example of Ireland’s continuous efforts in PFM and administrative capacity building. During its transition towards a developed economy, Ireland has benefited from the EU structural funds, not only in monetary terms, but also for building a solid capacity for executing capital investments. Ireland has endorsed through its local legislation the discipline elements taken from the EU structural funds framework: evaluations, appraisals, multi-annual development and budgetary plans. This was reinforced by Ireland’s strong focus on investments in human capital.

Recommendations on administrative capacity in LGs in Lithuania

Invest in capacity building at LG level and human capital

Decentralisation reforms should be accompanied with policies to strengthen SNG capacities for investment. The CG could develop and distribute guidance documents in areas such as planning, project appraisal, procurement or monitoring and evaluation. Establish the conditions to facilitate a “learning-by-doing” process. Provide systematic training and link pay in the public administration to productivity increases.

Provide incentives to pool expertise across jurisdictions

Small municipalities may not require a full-time technical staff, and the cost of hiring these may not be justified. One way around this is creating a pool of high-level public officials and sharing the services (and costs) among several municipalities in areas of needed expertise (e.g. PPP, procurement, regional development). As such LGs are usually reluctant to enter such horizontal co-operation, the CG could provide incentives to encourage to do so, for example by paying part of the pooled staff’s salaries, as was done in Slovenia.

Box 7.6. INCENTIVES FOR INTER-MUNICIPAL CO-OPERATION IN SLOVENIA

In Slovenia, inter-municipal co-operation has risen in recent years, in particular for projects that require a large number of users. In 2005, amendments to the Financing of Municipalities Act provided financial incentives for joint municipal administration by offering national co-financing arrangements: 50% of the joint management bodies’ staff costs were reimbursed by the CG to the municipality during

the next fiscal period. The most frequently performed tasks are inspection (waste management, roads, space, etc.), municipal warden service, physical planning and internal audit.

Source: OECD (2019_[10]), Effective public investment across levels of government, Principle 3.

Create a competence centre and a project preparation facility to support LGs develop investment projects

According to the interviewed municipalities, a competence centre that could advise them on the best-suited funding alternatives and help them to develop project proposals would be very useful and could help with a long-term capacity building.

The first mission of such a competence centre would be to identify the SNGs with the highest capacity challenges to provide them special support. This centre could develop a permanent, comprehensive, and articulated training and technical assistance system targeted to local needs.

In addition, a project preparation facility could be created to ensure quality and timely preparation of investment projects, and provide consultancy services for municipal development, pooling expertise on specific issues from public and private sector and provided to municipalities by a pool of established external experts.

The CPMA already provides support to LGs to develop PPPs and access EU structural funds. This role could be reinforced and widened to all capital investment projects.

Pooling technical staff among municipalities, for example by creating shared service centers, is frequently used in OECD countries, and facilitates attracting high level experts.





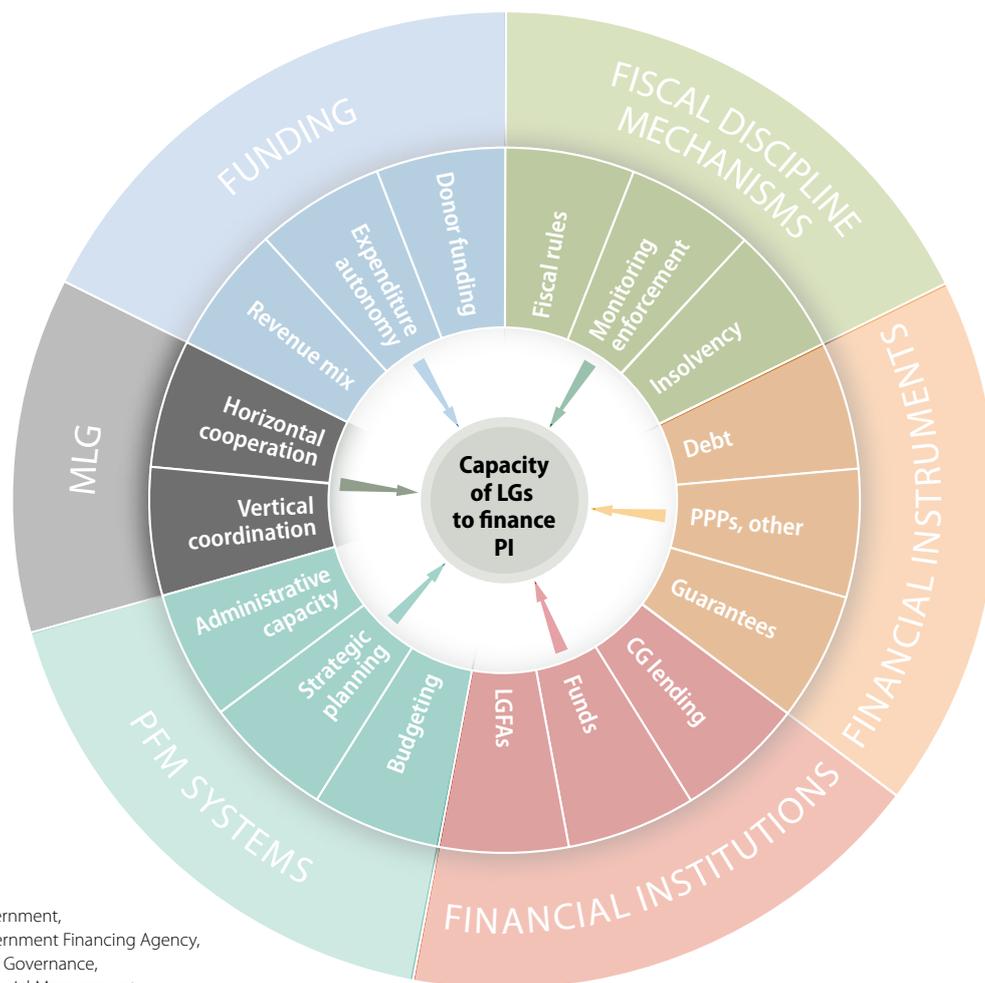
Multi-level dialogue which brings together a combination of national and subnational public, private, and third sector actors in a regular, formalised manner are frequently used for coordinating regional development and investment priorities

8. Multi-level governance for public investment

Following the approach presented in Chapter 2, this section describes Lithuania's current multi-level governance for public investment (Figure 8.1), compares each element with the practices in the

benchmark countries and provides preliminary recommendations (which will be further developed in the recommendations report).

Figure 8.1. **Analytical framework: multi-level governance (MLG)**



Note:
CG – Central Government,
LGFA – Local Government Financing Agency,
MLG – Multi-Level Governance,
PFM – Public Financial Management,
PPPs – Public Private Partnerships

VERTICAL COORDINATION AND SUPPORT MECHANISMS

Vertical coordination and support mechanisms in Lithuania

A newly created unit in the Ministry of Finance in Lithuania may improve vertical coordination

In Lithuania, LGs must address different ministries and different departments within ministries depending on the type of issue they need to get guidance and

support on (such as financial matters (Table 8.1) or for investment programs), as these tend to be sectorally fragmented between different ministries. This can sometimes be confusing for LGs. In early 2020, a new structural unit was established at the Ministry of Finance to coordinate issues related to municipal financial affairs within the ministry. This structural unit has the potential to act as a one stop shop in the future to address municipal financial matters.

Table 8.1. Responsibilities related to municipal issues within the Ministry of Finance

Department/unit	Main responsibility
Fiscal Policy Department	Fiscal surveillance, revenue analysis and planning
Investment Department	Investment policy, financial instruments
Treasury	On-lending, guarantees, accountability, administration of financial accounting system
Budget Department	Annual municipal budget planning

Note: Non-exhaustive list.

Source: Ministry of Finance (2020^[93]), Lietuvos Respublikos Finansų Ministerija: kontaktai, <http://finmin.lrv.lt/lt/kontaktai>

The Central Project Management Agency provides support to LGs to develop investment projects

In 2003, the Ministry of Finance of Lithuania created an autonomous agency, the Central Project Management Agency (CPMA) to help public institutions manage public investment. Besides administering EU Structural and Investment Fund and other international support programmes, the CPMA acts as a methodological centre and can advise public institutions on the preparation and evaluation of their investment projects. As LGs are an important beneficiary of EU structural funds,

the CPMA provides them support in developing public investment projects related to EU support or other donor funding. Since 2010 the CPMA has also a specialised PPP Competence Center and provides training to municipal officials. Since 2014, the competence center was extended to all investment projects.

Role of the association of municipalities in Lithuania is important but its scope is limited

The Lithuanian Association of Local Authorities (ALAL) was established in 1995. The ALAL represents all 60 Lithuanian municipalities in the government and other public institutions as well as in international organisations and foreign countries. However, the ALAL has limited capacity and resources and mainly focuses on reviewing national legislations and advocating for a stronger self-government. It also participates in the meetings of the bilateral commission, composed of CG and ALAL representatives, which provides a platform for discussing municipal issues.

Comparative analysis of vertical coordination and support mechanisms

Table 8.2 provides a summary of vertical coordination and support mechanisms in Lithuania and in benchmark countries.

Table 8.2. Comparative summary of vertical coordination and support mechanisms in Lithuania and benchmark countries

Vertical coordination and support mechanisms					
LITHUANIA	Denmark	Finland	Ireland	Netherlands	New Zealand
Low	High	High	High	High	Moderate
Vertical coordination is fragmented. In early 2020, a new unit at the MoF has been established to coordinate municipal financial affairs within the MoF. Role of the Association of Local Authorities is limited.	There is a strong vertical coordination where the association of Local Government (Local Denmark (LGDK)) negotiates collective expenditure, taxation and loan pool limits with the CG. The Ministry of Interior is the main contact point for LGs at the CG level and monitors LGs' financial situation.	A special department within the MoF routinely assesses municipalities' finances and assists municipalities "in very difficult financial position" in developing correction plans. Local Association of Local and Regional Authorities lobbies to secure and improve local government functions at the CG and the EU levels. A subsidiary of the Association provides consultancy services for bigger investments through a separately established entity.	A dedicated ministry responsible for municipal affairs – Department of Housing, Planning and Local Government – co-ordinates planning and manages the funding of LGs in Ireland.	Well-established vertical coordination mechanism, where provinces supervise municipalities and CG, namely, the Ministry of Interior supervises provinces	The Department of Internal Affairs is responsible for the day to day relation with LGs, and the Treasury for issues which could affect national sustainability. The LG association, LGNZ represents LGs when discussing national policies. It also assesses quality of LG management and provides recommendations and benchmarks.

Source: Authors' analysis.

CG coordination for municipal financial affairs is more fragmented and weaker in Lithuania than in benchmark countries

The main ministry responsible for supervising and supporting LGs varies from country to country. In Finland, a special department within the Ministry of Finance is the main contact point for LGs. It routinely assesses LGs' finances and assists municipalities in difficult financial situation. In Ireland where CG controls over LGs are important, there is also a unit of municipal affairs which coordinates planning and manages funding for the LGs. This unit is in the Department of Housing, Planning and Local Government. In Denmark, Netherlands and New Zealand, the main contact point for LGs is the Ministry of Interior.

In Lithuania, despite recent improvements, vertical coordination with CG is still fragmented. The recently created unit in the Ministry of Finance could take over a role like the units described above.

The role of association of LGs in vertical co-ordination and support for LGs is weaker in Lithuania than in benchmark countries

In many countries, the association of LGs plays an important role in mediating between the CG and LGs, advocating for policies and ensuring that LGs' interests are well addressed in national and sometimes supra-national (EU) policies.

In Denmark, the association of LGs plays a particularly important role, as it is the institution which negotiates with the CG the expenditure, tax, and debt limits

for LGs. In New Zealand, the LG association (LGNZ) represents the LGs' voice in national policy discussions. It also assesses the quality of LG management and provides recommendations for improving it. In Finland, the Association of Finnish Municipalities sees its role as an advocate for local and regional authorities, both with the CG, but also at EU level. The Finnish Association has offices in Helsinki and in Brussels, to oversee the interests of municipalities and regions in the EU and in international cooperation. It aims to influence EU policymaking to secure and improve local government functions. It also provides consultancy services for large investments through a subsidiary, the Finnish Consulting Group (FCG, the largest consulting company). The FCG serves large towns and cities as well as small municipalities and carries out international development consulting.

Some OECD countries have created joint CG and LG committees to foster vertical coordination

OECD experience shows that countries with well-developed vertical co-ordination arrangements, such as inter-governmental committees and regular formal meetings, have a comparative advantage when introducing and implementing reform (OECD, 2020^[38]).

Multi-level dialogue which brings together a combination of national and subnational public, private, and third sector actors in a regular, formalised manner are frequently used for coordinating regional development and investment priorities (OECD, 2018^[56]). Such bodies provide actors with the opportunity to share perspectives and experiences; understand the needs

Box 8.1. JOINT CG AND LG COMMITTEE IN POLAND

Poland supports dialogue between levels of government with its Joint Central Government and Local Government Committee. This body is composed of the minister responsible for public administration and 11 representatives appointed by the prime minister (at the request of the chair), together with representatives of national organisations of local self-government units that work in 12 "problem teams" and 3 working groups. It considers issues related to the functioning of municipalities and to the state policy on local government, as well as with issues related to local government within the scope of operation of the European Union and the international organisations to which Poland belongs. It develops a common position among levels of government and contributes to

establishing the economic and social priorities of national and subnational government on matters such as municipal service management and the functioning of communal and district government, as well as regional development and the functioning of *voivodeship* (province) government. The Joint Commission develops social and economic priorities that can affect subnational development, evaluates the legal and financial circumstances for operating territorial units, and gives an opinion on draft normative acts, programmes and other government documents related to local government.

Sources: Lubinska (2017^[94]), Decentralisation and multi-level governance in Poland: Ensuring coherence between national and subnational development strategies/policies. Government of Poland (nd^[95]), Unpublished Documents.

and problems of different levels of government; submit proposals and comments; negotiate with each other; and obtain help in the design, implementation and monitoring of policies or reforms (Box 8.1).

Recommendations on vertical co-ordination in Lithuania **Empower a single entity with the responsibility for vertical co-ordination**

Lithuania should empower one CG entity with the responsibility of vertical co-ordination, to ensure effective dialogue across levels of government. This institution should help governments share evidence, gain insight into what works well and what does not work, where to focus implementation and investment efforts, and under what conditions. This entity could be for example the newly created unit of municipal financial affairs in the Ministry of Finance).

INTER-MUNICIPAL (HORIZONTAL) COORDINATION AND COOPERATION

Inter-municipal (horizontal) coordination and cooperation in Lithuania

Inter-municipal coordination and cooperation in Lithuania is weak

Inter-municipal coordination and co-operation in development of infrastructure and service delivery is weak. Investment projects display sectoral

fragmentation and are often insufficiently coordinated, sometimes leading to similar facilities being built few kilometres apart¹. Lack of coordination also results from poor planning, as will be seen in coming section. In some cases, these projects are financed through CG funds, implying that there is scope for improving CG's role in coordinating LG investments.

Two CG driven pilot projects for inter-municipal cooperation are producing interesting results

While the legal framework would allow municipalities to delegate functions to other municipalities, there is no tradition for municipalities to get together to discuss and implement such joint projects. To that end, in 2019, the CPMA and the Ministry of Interior launched two pilot projects (Tauragė+ and Šalčininkai+) aimed at encouraging municipalities to cooperate and organise municipal services and other functions within functional zones rather than individually (Box 8.2). Four municipalities participate in Tauragė district and two – in Šalčininkai district. The initiative will be extended to other districts and is expected to include more municipalities in the future. The results from these pilot projects are encouraging.

1. For example, Prienai and Birštonas municipalities built multifunctional sports centres within 6 km distance. Palanga and Kretinga municipalities – within 12 km distance (National Audit Office, 2016_[97]).

Box 8.2. ORGANIZING MUNICIPAL SERVICES BASED ON FUNCTIONAL ZONES: TAURAGĖ+ PILOT PROJECT

In 2019, the Central Project Management Agency and the Ministry of Interior launched a pilot project in Tauragė district aimed at increasing the efficiency of sustainable regional development. Four municipalities (Tauragė, Pagėgiai, Šilalė and Jurbarkas) are encouraged to shift away from their traditional individual model of municipal service delivery, and adopt a collective approach based on functional zones. Importantly, functional zones are not based on administrative district borders but rather on synergies between neighbouring municipalities.

Collaborative municipal service provision is expected to reduce costs and improve the quality of services delivered, as well as attract investments. Moreover, this project challenges the current approach to planning. Currently, most projects are developed based on the availability of funding. Against this background, the Tauragė+ project intends to incentivise municipalities to design sound strategies first and then search for appropriate means of funding.

In the context of the Tauragė+ project, four municipalities jointly with social partners, local businesses and communities' representatives develop strategies by identifying common challenges and potential solutions. Collaborative strategies are being developed to increase investment attractiveness of industrial areas, encourage tourism in the district, adapt unused public buildings for the care of the elderly, create water supply and sewage disposal system in small towns and villages and attract qualified specialists.

The appetite of participating municipalities for collaboration seems to be increasing, especially as the certain public services seem to show lower service cost after the early stages of project implementation.

Source: CPMA (2019_[96]), Tvari regionų plėtra: kaip paskatinti savivaldybes veikti kartu, <https://bit.ly/2xIS6vG>.

Box 8.3. EVOLUTION OF REGIONAL LEVEL GOVERNMENT IN LITHUANIA

There is no regional level in Lithuania. In 2001, the government planned to create five self-governing regions that would replace and assume the functions of the 10 counties at territorial level. However, after several years of talks, the project was shelved and, instead, it was decided in 2010 to redistribute the functions of counties among the municipalities and the central government.

The Regional Development Councils serve as deconcentrated rather than self-governing entities. The councils are composed of municipal council members, mayors, government appointees and social and economic partners, which remain under the direction of the Ministry of Interior and whose administrative capacities and functions remain limited.

In a context of significant regional disparities, the Law on Regional Development was amended several times since 2010 to develop the role of the Regional Development Councils. There is now a new discussion on their deeper transformation. According to a White Paper published in December 2017, the reform could lead to increasing their responsibilities and resources, providing them with legal personality and autonomous powers, together with a modification of the regional borders. This could result in a new sub-national tier of government.

Source: OECD/UCLG (2019^[31]), 2019 Report of the World Observatory on Subnational Government Finance and Investment – Country Profiles, <https://bit.ly/2VPjyLQ>.

A newly created regional level has limited responsibilities

The Regional Development Councils, comprised of municipal council members, mayors, government appointee and social and economic partners (Box 8.3), are primarily responsible for preparing regional development plans and submit proposals to the Ministry of the Interior and the National Regional Policy Council on the formation and implementation of regional policy. More specifically, they implement policies related to distribution of EU financial resources to municipalities. However, their mandate is not strong enough to improve upon municipal coordination and cooperation (White Paper, 2017^[18]). To that end, new draft proposals to

strengthen the regional level have been put forward. However, in its current form, these regions would still not have full-fledged responsibilities and autonomous budget, which would lay in the Ministry of Interior and would be funded by municipalities. Moreover, the regional council would not be elected but would still comprise mayors of municipalities.

Comparative analysis of horizontal coordination and cooperation

Table 8.3 provides a summary of vertical coordination and support mechanisms in Lithuania and in benchmark countries.

Table 8.3. **Comparative summary of horizontal coordination and cooperation in Lithuania and benchmark countries**

Inter-municipal (horizontal) coordination and cooperation					
LITHUANIA	Denmark	Finland	Ireland	Netherlands	New Zealand
Low	High	High	Low	High	Low
<p>No tradition of municipal coordination and joint projects, shared services or joint utility companies.</p> <p>A new experiment driven by the CG is encouraging.</p> <p>Investment projects are not well coordinated between municipalities and display sectoral fragmentation.</p>	<p>There is a particularly strong horizontal coordination between LGs, which must allocate among themselves the ceilings set by the CG for aggregate expenditure, taxes and debts of LGs. These negotiations are facilitated by the association of Danish LGs (LGDK)</p>	<p>Voluntary inter-municipal co-operation is very common, usually through joint municipal authorities.</p> <p>In specialised healthcare and regional planning, LGs are obliged to form such joint municipal authorities.</p>	<p>There is no strong culture of municipal co-operation.</p>	<p>Municipalities voluntarily engage in joint structures to achieve greater scale. Over 900 horizontal cooperation structures exist.</p>	<p>There are few cases of horizontal cooperation. Some LGs sometimes buy services from larger neighbouring ones.</p>

Source: Authors' analysis.

Box 8.4. JOINT MUNICIPAL AUTHORITIES IN FINLAND

Finnish municipalities are often too small to provide health, secondary education, or social services by themselves. Therefore, voluntary inter-municipal co-operation is quite common. This is most frequently structured through a joint municipal authority, which is a legal entity, financed by member municipalities and led by a board assigned by member municipalities. Joint municipal authorities do not receive central government transfers.

While in general inter-municipal co-operation is voluntary, municipalities are obliged to form a joint municipal authority for specialised healthcare (hospitals) and regional planning. Although in recent years there have been voluntary municipal merger reforms, inter-municipal co-operation is still common, as it has enabled utilising economies of scale especially in rural and sparsely populated areas. Inter-municipal co-operation has allowed municipalities to focus on tasks that best suit their capacities. In recent years, the trend has been to form even larger co-operative units, which are able to integrate all health and social services in order to utilise both economies of scale and scope.

Source: OECD (2020^[38]), OECD Multi-level Governance Review: the Future of Regional Development and Investment in Wales, UK.

Box 8.5. SHARED SERVICES FOR LGS IN WALES

There are several, positive experiences among Welsh Local Authorities who have joined forces to cooperate in financing functions. For example, the Conwy and Denbighshire County Councils (who already share a joint Public Service Board) proposed to jointly implement and manage a financial ledger and other financial systems. Several other Local Authorities (e.g. Bridgend and Vale of Glamorgan, Rhondda Cynon Taff and Merthyr, and Monmouthshire and Newport) are also sharing internal auditing services. Furthermore, partnerships have been organised around procurement functions, including a pilot between Carmarthenshire and Pembrokeshire, Joint Head at Flintshire, and Denbighshire, and also a Regional Contractors framework in South West Wales.

Source: OECD (2020^[38]), OECD Multi-level Governance Review: the Future of Regional Development and Investment in Wales, UK.

Use of shared services between LGs is lower in Lithuania than in some benchmark countries

Horizontal cooperation such as joint provision of services, sharing costly administrative functions or specialised expertise is widely recognised as potentially allowing economies of scale, reducing costs and therefore freeing resources for other expenditure, contributing to increasing LGs' financial capacity. However, such cooperation between LGs is politically difficult and few countries provide good examples. In Finland, LGs frequently create joint municipal authorities for providing services more effectively (Box 8.4). In Wales (United Kingdom), there are some positive experiences of LG cooperation for joint procurement services or sharing high level staff (Box 8.5). In New Zealand, LGs all buy the same standardised services from a small number of providers (e.g. credit rating or financial management services) and have therefore obtained competitive tariffs.

The role of the Lithuanian association of LGs to foster horizontal cooperation is lower in Lithuania than in most benchmark countries

In some countries such as Denmark, the association of LGs plays an important role for horizontal cooperation and coordination, which is not the case in Lithuania. In Denmark, for example, the CG provides an aggregate ceiling for LG expenditures, taxes and debts, and LGs must decide and coordinate among themselves how to allocate these to individual LGs. These crucial negotiations are facilitated by the association of local governments (Local Denmark, LGDK). In France, the association of mayors (*l'Association des Maires et des Présidents d'Intercommunalité de France*) facilitates horizontal cooperation through organising (in a partnership with private actors) a forum *Salon des Maires et des Collectivités*² where LG elected officials, public and private sector actors, experts in territorial development can share recent developments in their area of expertise. In this annual event, which is held at the same time as the congress of the association, participants prepare stands allowing different municipalities to learn from peers and be informed about the new practices and new products, which could help them develop new projects, adopt best practices and find better solutions to their problems.

2. For more information see: <https://www.salondesmaires.com/le-smcl/la-communaute-smcl/>.

Box 8.6. CG INCENTIVES FOR LG CO-OPERATION IN SELECTED OECD COUNTRIES

France

To facilitate horizontal cooperation among 36 000 municipalities, France has 2 145 inter-municipal structures with own-source tax revenues, representing a 99.8% municipal participation rate. Each municipal grouping constitutes a “public establishment for inter-municipal cooperation” (EPCI). The EPCIs assume limited, specialised, and exclusive powers transferred to them by member municipalities. They are governed by delegates of municipal councils and to have a legal status and must be approved by the State to exist legally.

To encourage the formation of EPCI, the central government provides a basic grant plus an “inter-municipal grant” to preclude competition on tax rates among participating municipalities. EPCIs draw on budgetary contributions from member municipalities and/or their own tax revenues.

Spain

The Autonomous Community of Galicia has encouraged economies of scale by improving the flexibility for voluntary inter-municipal coordination arrangements, while also providing financial incentives to encourage them. Investment projects that involve several municipalities get priority for regional funds. “soft” inter-municipal agreements tend to be popular in the waste management sector. Local cooperation is encouraged in urban mobility plans for public transport involving the region’s seven largest cities in the region.

Source: OECD (2020^[38]), OECD Multi-level Governance Review: the Future of Regional Development and Investment in Wales, UK.

The role of the CG to foster LG co-operation is more limited in Lithuania than in many OECD countries

Inter-municipal cooperation is rarely natural, and it often takes a CG nudge to happen. Several countries such as France or Spain show good examples of CG incentives to foster LG cooperation (Box 8.6).

Recommendations on horizontal coordination and cooperation in Lithuania

CG should provide incentives for inter-municipal coordination of investment projects and shared services

CGs could provide incentives for LG co-operation, for example by providing special grants for the cooperative structures (as in France), giving priority for regional funds to investment projects which involve several municipalities (as in Spain), or reimbursing the joint management’s staff costs (as in Slovenia). LGs should be allowed to keep and freely re-allocate efficiency gains from co-operation.

Strengthen the role of the regional councils as inter-municipal coordination mechanism

The newly created regional councils would be the logical institution to carry out inter-municipal coordination of public investments. To this end, their financial and regulatory competences should be sufficient to carry out this task.

Continue with and scale-up the Tauragė+ horizontal collaboration pilot projects

The on-going pilot projects in Lithuania should be continued, and if found positive, scaled up. This type of collaboration should be encouraged as it could help build fiscal and management capacity by justifying the need and providing the resources to hire highly qualified staff.

Introduce a platform for exchanging good practices and information about potential joint projects and public sector innovations

Municipalities could benefit from greater sharing of information on good practices and public sector innovation initiatives in other municipalities and on on-going and planned projects, which could be carried out jointly. This could be achieved, for example, by organising annual events, in which municipalities present the latest developments and have a platform to discuss and develop solutions to common problems. The Association of Local Authorities could take on this role, as is frequently the case in OECD countries.



The overall objective of the proposed reforms is to allow municipalities to finance public investments that help promote growth, environmental sustainability and well-being while ensuring fiscal sustainability.

9. Summary of recommendations for improving municipal funding and financing of public investment in Lithuania

This section provides a synthesis of the recommendations presented in this report. These are based on the comparative analysis of the practices in Lithuania and OECD countries, with a particular emphasis on the five benchmark countries (Denmark, Finland, Ireland, the Netherlands and New Zealand), following the elements identified in the analytical framework as being the most relevant for allowing LGs to fund and finance public investment, while ensuring overall fiscal sustainability and quality of projects. The recommendations are also assessed with regard to their expected impact with regard to increase municipalities' capacity to fund and finance public investment. The expected impact (small, medium, high) relies on the OECD's assessment of reforms in other countries (Table 9.1). The overall objective of the proposed reforms is to allow municipalities to finance public investments that help promote growth, environmental sustainability and well-being while ensuring fiscal sustainability.

The recommendations are of different nature, and reforms require different time horizons for implementation. Against this background, some reforms should be combined or sequenced in a specific manner. (Figure 9.1). For instance:

- Investment will only increase if municipalities are willing and able to spend more. Providing municipalities with more own-source revenue is an essential ingredient to strengthen both willingness and capacity to invest.
- The reform of the fiscal rules framework should go together with tighter monitoring. In particular, municipalities should accept potential sanctions when infringing fiscal rules in exchange for a higher capacity to borrow. Moreover, creating new financial instruments for municipal borrowing only makes sense if rules have previously been reformed to allow municipalities to borrow.
- Administrative capacity is an essential element for achieving better impact of municipal services and investment projects. Reinforcing planning capacity in particular, capacity to develop and implement investment projects, to manage budgets, etc. is necessary to increase the quality of the projects, the outcomes, efficiency and effectiveness of spending, and reduce credit risk.
- Some regulatory reforms should be sequenced. For example, streamlining transfers to municipalities and linking them to outputs would require first defining and measuring performance and outcome indicators in order to ensure that the transferred funds achieve the intended results. Once this is done, municipalities may then keep and reallocate savings from efficiency gains.
- Finally, financial incentives to pool projects and share services might first require a legal framework for municipal joint borrowing or pooling of investment projects.

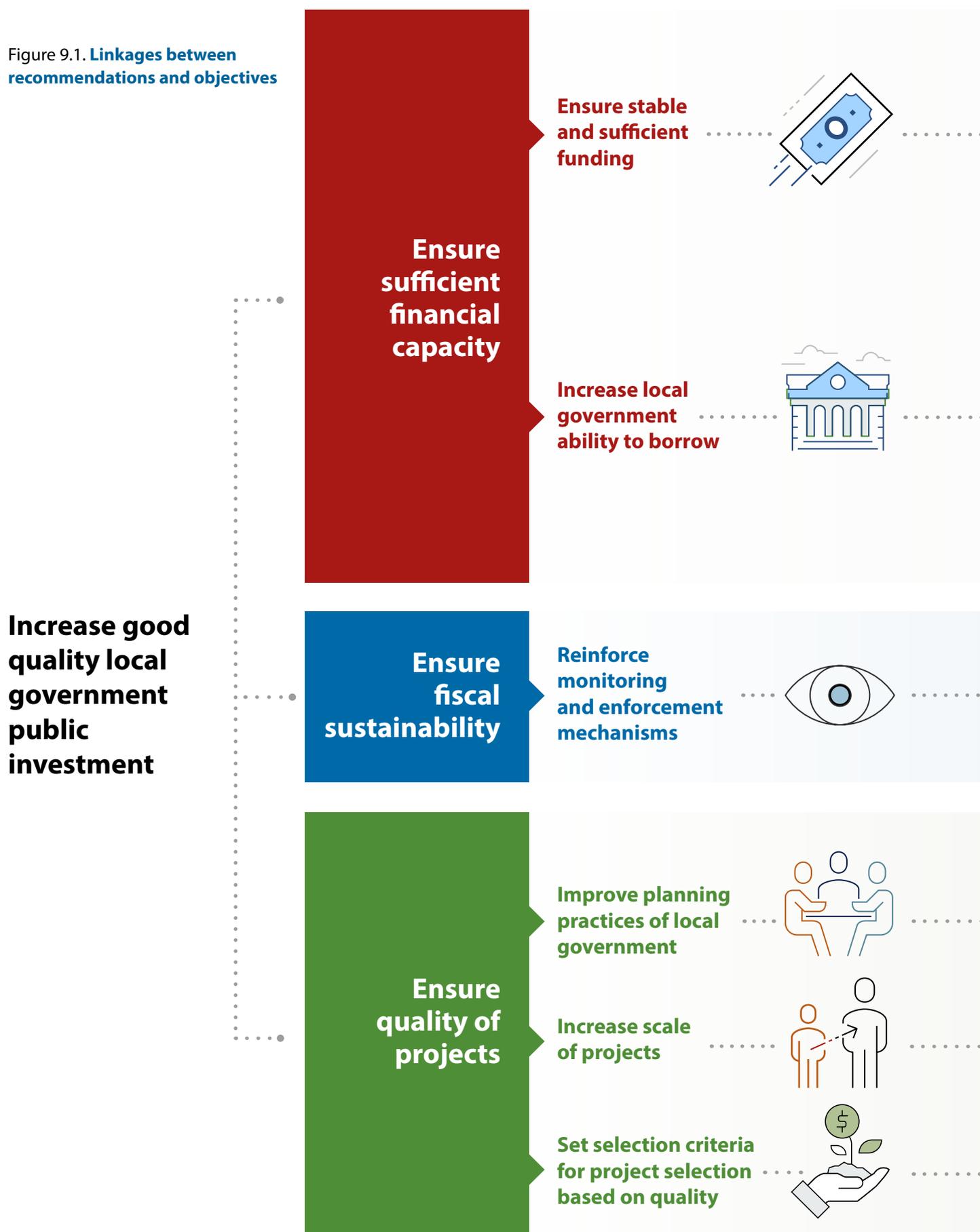
Figure 9.1. provides an overview on how individual reforms, as presented in Table 9.1., could be combined.

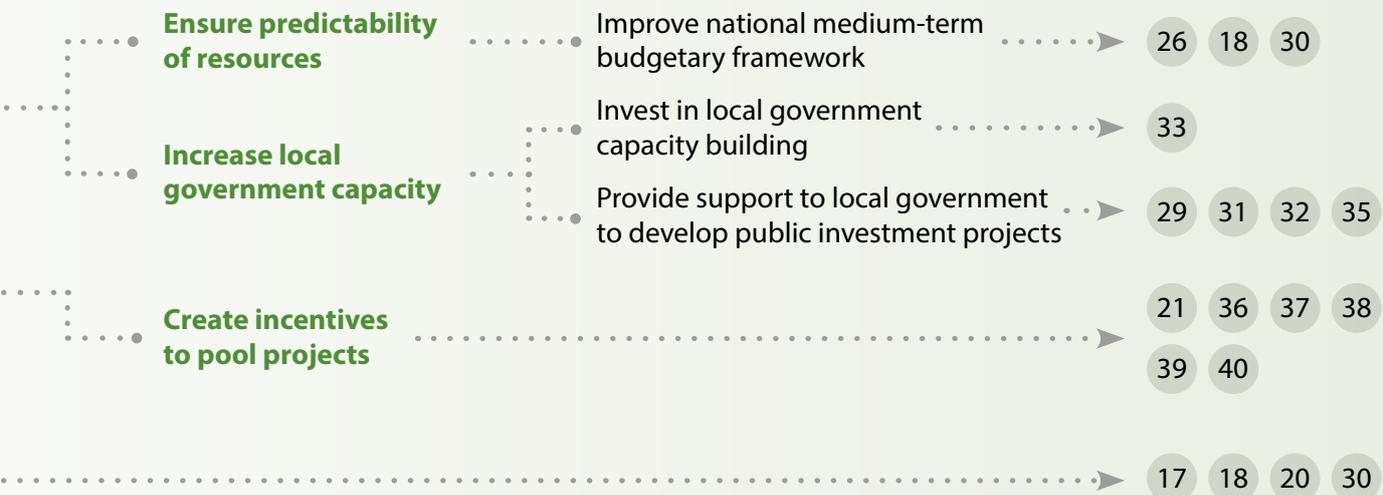
Table 9.1. Recommendations for improving municipal funding and financing of public investment

	Finding	Recommendation	Nr	
Funding	Own source revenue is low	Assign the residential property tax entirely to the municipal level	1	
		Allow municipalities to set a surtax on the personal income tax, with a corresponding reduction of the national income tax	2	
		Grant municipalities some tax rate setting autonomy over the personal income tax, maybe within bands set by central government	3	
	Grants are scattered and volatile	Ensure more stable and predictable grant revenues	4	
		Reduce the share of earmarked grants and move away from input towards output regulation	5	
		Allow municipalities to retain and reallocate efficiency savings on earmarked grants	6	
		Merge the different sectoral grants into a smaller number of larger general-purpose grants	7	
Fiscal discipline mechanisms	Fiscal rules are tight, complex, and targets often change	Unify the rules by applying the annual structurally balanced budget rule based on accruals to all municipalities	8	
		Remove the net borrowing limit	9	
		Separate operating and capital accounts and apply the annual structural balanced budget rule in accruals to the operating budget only (Golden rule)	10	
	Monitoring tools and sanctions on infringement of fiscal rules are weak	Tighten fiscal discipline mechanisms (e.g. by imposing automatic financial and administrative control measures on municipalities breaching the rules)	11	
		Complement the annual debt ceiling by an early warning system and revise the ceiling less frequently	12	
Financial institution	Municipalities do not borrow jointly and do not pool risks	Create an agency for pooled municipal borrowing, either owned by the municipalities or by the central government	14	
		Avoid explicit or implicit central government guarantees on individual municipal loans	15	
	Public investment funds are fragmented and too narrowly defined	Streamline the different funds that help finance municipal projects into a smaller number of wider instruments, or merge them into a single development fund	16	
		Set selection criteria for projects in such a fund on quality and potential impact rather than on sectoral criteria ("money follows the project" rather than the opposite)	17	
		Ensure this fund provides multi-annual financing for municipal public investment	18	
		Allow large municipalities to issue bonds	19	
Financial instruments	Municipalities are not allowed to issue bonds	19		
	PPPs are frequently used although most projects are small	Ensure PPPs are only used when they demonstrate better value for money than traditional procurement	20	
		Provide incentives and legal framework to pool municipal investment projects by nature to increase size to increase efficiency of PPPs	21	
		Continue to properly account for and disclose all costs, guarantees and other contingent liabilities of PPPs and alternative financial instruments and create a database to follow PPP performance	22	
	Increases in land value are not captured and do not generate revenues for municipalities	Strengthen land-value capture mechanisms (e.g. set up a capital gains tax or use development fees more widely)	23	
		There are no innovative financial instruments used for local public investment	Experiment civic crowdfunding for some small but visible projects	24
			Mobilise resources for establishing a blended finance scheme	25

	Finding	Recommendation	Nr
Public Financial Management (PFM) practices	The CG budget process makes municipalities' revenues unpredictable	Make the CG multi-annual budgeting framework more binding and provide information on transfers to municipalities earlier in the budget cycle	26
	Municipal budgeting and reporting practices are weak	Make budget practices and reporting homogeneous across municipalities and ensure they are aligned with the OECD Recommendation on Budgetary Governance	27
		Publish municipalities' financial data in formats which are easy to exploit (e.g. open data in an xls format with built-in analytical tools)	28
	Municipalities' strategic planning practices are weak and purely formal	Provide assistance to municipalities to develop long-term development strategies and medium-term investment plans, and	29
		Select investment fund-supported projects based on the prioritisation in the strategic plans, and provide multi-year capital spending envelopes	30
		Make upfront assessment of the long-term impacts and risks of public investment a requirement for applying to CG investment funding, and provide assistance to municipalities when needed to carry out these assessments	31
		Engage various stakeholders such as citizens, neighbouring municipalities, central government in the preparation of investment strategies to ensure they provide value for money	32
	Administrative capacity in many municipalities is low	Strengthen skills in public administration, e.g. by providing systematic training, and link pay in the public administration to productivity increases	33
		Pool expertise across jurisdictions, CG could provide incentives by supporting part of shared services costs	34
		Strengthen the role of the CPMA in supporting municipalities in managing public investment	35
Multi-level governance	Coordination and support mechanisms between central government and municipalities are insufficient and fragmented	Empower a single entity with the responsibility for co-ordination between central government and municipalities	36
	There is little inter-municipal (horizontal) coordination and cooperation	Provide incentives for municipal joint investment projects and shared services, e.g. through specific grants or conditions for investment grants	37
		Continue with and scale-up the Tauragė+ horizontal collaboration pilot projects	38
		Increase financial and regulatory competences of the role of regional councils to coordinate investment and public service delivery across municipalities	39
		Create a platform for exchanging about potential joint projects, public sector innovation and sharing of good practices	40

Figure 9.1. **Linkages between recommendations and objectives**





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Annex A. Expenditure responsibilities of LGs in Lithuania

Table A A.1. **Expenditure responsibilities: delegated and independent functions of municipalities**
Non-exhaustive list

Expenditure category	Delegated (36 functions)	Independent (44 functions)
Defense	Participation in preparation and execution of mobilization, demobilization, host country support; Civil safety.	–
General public services	Public registry services; Organisation of elections and referendums; Provision of statistical data; Organisation of resident surveys and other civic initiatives; Archives.	Preparation and approval of municipal budget; Imposition of local charges; Management of municipal property and land; Participation in preparation of strategic and regional development plans.
Public order and safety	Fire protection; Provision of state-guaranteed primary legal aid.	Public order; Crime prevention measures.
Economic affairs/ transports	Administration and registration of agriculture related activities; Spatial data collection.	Development of business and tourism; Local roads and local transportation; Territorial planning; Issuance of permits (licenses); Establishment of budgetary institutions and municipal enterprises.
Environmental protection	Participation in the management of state parks	Improving and protecting the quality of the environment; Municipal waste treatment systems.
Housing and community amenities	–	Waste and sanitation; Supply of drinking water; Street lighting; Supply of heating; Cemeteries.
Health	Public health care for pre-school, general education schools and vocational training institutions; Organisation of secondary health care in cases stipulated in legislation; Radiation protection.	Primary health care; Planning and implementation of municipal health measures; Support measures for local residents health care; Noise prevention.
Recreation, culture & religion	Control of the use and correctness of the official language	Libraries, Local cultural centres and museums
Education	Organization of pre-school education, general education, vocational training and vocational guidance, provision of compulsory education programs	Organisation of non-formal education; School bus; Organisation of catering services in educational establishments; School building maintenance
Social protection	Provision of social care for people with severe disabilities; Participation in the preparation and implementation of labour market policy measures and employment programs	Provision of social services; Social housing; Social support for low-income residents; Calculation and payment of social benefits and compensations; Implementation of youth policy.

Note: Law on Local Self-Government provides a full list in Lithuanian.

Source: Law on Self-Government; National Audit Office (2019_[23]); Does the System of Municipal Functions and their Funding Provide Conditions for Efficient Operation.

Annex B. Different types of balanced budget rules for LGs and practices in the OECD

Balanced budget rules (BBRs) for SNGs are a very widely used instrument. A 2019 survey of OECD countries shows that 16 out of 17 surveyed countries have BBRs for their LGs. However, as is often the case, the devil lies in the details, and these BBRs are actually very different from country to country, with some being much more stringent than others, depending on the accounting standards in which it is calculated (cash or accruals), the coverage of the balanced budget rule (current, capital or overall expenditure, off-budget funds), the target for the rule (submitted budgets, approved budgets, realised budgets), and finally, its cyclicity (annual, multiannual, or structural). This annex is based on: Vammalle and Bambalaite (2021^[43]), Fiscal rules for Sub-national governments, analysis of the OECD 2019 survey (forthcoming).

Coverage of the BBR: current expenditure or capital expenditure? Both? Off-budget funds?

The BBR may apply to different accounts. In particular, they may apply to the current budget only (often called “golden rule”) or to the current budget and off-budget funds (strong golden rule). In this case, the capital

account is allowed to be in deficit, i.e. borrowing is allowed to finance public investment.

In some countries, the BBR covers both the current and capital accounts (in aggregate terms), thus allowing deficits in one to be compensated by surpluses in the other. In particular, public investment may be financed with a deficit in the capital account, as long as the current account shows an equivalent surplus. Some countries require that the current and the capital accounts are balanced in aggregate, and the current account is not in deficit (i.e. a deficit in capital account could be finance with a surplus in the operating account, but not the opposite). Finally, the strongest BBR covers both current and capital budgets, and off-budget funds. The most commonly used rule in OECD countries is the golden rule, i.e. only the current budget needs to be balanced, and the capital budget may be in deficit to finance public investment (Table A B.1).

Target of BBRs: submitted, approved, or realised budgets?

BBRs can target different stages of the budget process. The weakest rule would target only the submitted budget, letting the Parliament/Municipal Council vote a budget

Table A B.1. Coverage of budget balance objectives for LGs in OECD countries

Not used	Current budget ≥ 0 only (golden rule)	Current budget including off-budget funds ≥ 0 (strong golden rule)	Current and capital budget in aggregate ≥ 0 (budget balance rule)	Current budget ≥ 0 and aggregate budget ≥ 0 (strong budget balance rule)	Current and capital budgets and off-budget funds (Very strong BBR)
AUS	IRE		CAN	USA	BEL
TUR	FIN		ESP	CHE	AUT
ZAF	HUN		DNK*	LUX	GRC
	LVA		LTU	BRA	NLD
	MEX		KOR		
	NZL				
	POL				
	PRT				
	SVK				
	SWE				
4	10	0	5	4	4

Note: * data for Denmark come from 2011 survey.

Source: OECD (2020^[44]), Survey on Fiscal Rules for Sub-National Governments, 2019 update, questions 2.4 and 2.5.

in deficit (no OECD country uses this). Some countries only require the approved budget to be balanced (thus accepting deviations in realised budgets). Most countries however require that the realised budgets are balanced, but differ on the treatment of realised deficits, with some countries only requiring LGs to take corrective actions to avoid further deficits in the future (6 countries in the 20 country sample), while other countries require them to compensate realised deficits with equivalent surpluses in the following years (11 countries in the 20 country sample) (Table A B.2).

Statutory base

BBR pertaining to local governments fall under different level of statutory base in different countries. While the majority of EU countries have the BBR for general government under the Constitutional or higher than ordinary law, BBR applicable to local governments falls under Constitutional or higher than ordinary law in six countries, including Lithuania. In seven European countries BBR falls under the ordinary law and in Ireland it is subject to political commitment.

Accounting standards: cash or accruals?

BBRs can be calculated on accounts prepared in cash, or in accruals. When using accruals accounting, only the depreciation of assets is taken into account in the

operating or capital budget balance, rather than the full cash disbursement for the asset. This allows distributing the cost of the public investment over several budget periods, thus reducing the budget deficit in the year of building/purchasing the asset. Most countries calculate their BBR for LGs in accruals (11 out of 16 in the sample).

Cyclicality of BBR: actual or structural balances? Annual or multi-annual?

Using a structural BBR helps to mitigate the pro-cyclical effects of the cycle of LGs' expenditures. However, calculating the potential GDP of LGs may be complex and unreliable, except for particularly large LGs. Some countries use the same potential GDP for LGs as for the CG, but this implies there are no large asymmetric shocks. A more pragmatic approach is to use a multi-annual budget balance rule. Most countries rely on annual BBRs for LGs (10 out of 16 in the sample) (Table 4.3).

Stringency of the different types of BBRs

Stringency of the rule (and room for manoeuvre to finance public investment through borrowing) depends on the combinations of these different factors. In broad terms, BBRs can be classified from the strongest to the weakest in the following order: BBR in cash (both current and capital) > BBR in accruals (current and capital) > BBR in cash (only current) > BBR in accruals (only current).

Table A B.2. Target for balanced budget rules

Not used	Submitted budgets only	Approved budgets only	Realised budgets	
			Deficit does not have to be corrected	Deficit to be corrected by offsetting surplus during the next budget period(s)
AUS		NZL	BEL	AUT
ZAF			BRA	CAN
			DNK*	CHE
			HUN	ESP
			LTU	FIN
			LVA	GRC
			NLD	IRE
			POL	KOR
			SVK	LUX
			SVN	MEX
				PRT
				SWE
				USA
3	0	1	10	13

Note: * data for Denmark come from 2011 survey.

Source: OECD (2020^[24]), Survey on Fiscal Rules for Sub-National Governments, 2019 update, question 2.1.

Annex C. Institutions interviewed in Lithuania

The mission to Lithuania took place on the 20-22 of January 2020. Additional discussions with relevant stakeholders were carried out via videoconferencing in April 2020.

Institutions interviewed

Association of Local Authorities

European Commission Representation to Lithuania

Government Office of Lithuania

Unit dealing with municipal finance within the Ministry of Finance

Municipality of Elektrėnai

Municipality of Kaunas

Public Investment Development Agency (VIPA)

SEB Commercial Bank

The Central Project Management Agency (CPMA)

The Ministry of Finance

The National Audit Office of Lithuania

Lithuania's government has set up regional development as one of its highest policy priorities. Municipal public investment is crucial to this end, to attract private domestic and foreign direct investment, to foster growth and improve well-being of all residents. Moreover, local public investment could help mitigate the economic impact of the COVID-19 pandemic.

However, municipal governments account for 33% only of public investment in Lithuania, while on average sub-national governments account for 46% of public investment in the OECD. Indeed, weak own-source revenue and tight fiscal rules constrain municipalities' willingness and capacity to invest.

This report analyses the Lithuanian framework for municipal public investment funding and financing in the light of five benchmark countries: Denmark, Finland, Ireland, the Netherlands and New Zealand. Based on this analysis, the report provides forty detailed recommendations to increase the capacity of local governments to carry out public investment, while ensuring the quality of investment projects and financial sustainability of municipalities.

For more information:

<http://www.oecd.org/economy/lithuania-economic-snapshot/>

or scan the QR code

