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Issues in Municipal Finance

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The Metric System is used throughout the report.

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ABBREVIATIONS AND ACRONYMS

BOL	Bank of Lithuania
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
EU	European Union
IBRD	International Bank for Reconstruction and Development
LPC	Lithuania Power Company
NATO	North Atlantic Treaty Organization
NDP	National Development Plan
NIB	Nordic Investment Bank
MSL	Minimum Subsistence Level
PIP	Public Investment Program
PIT	Personal income tax
SSI	State supported income
STI	State tax inspectorate

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FOREWORD

This report is based on the findings of two main missions to Lithuania in September and November 2001.The report was prepared by a World Bank team comprised of Messrs. William Dillinger (Task Manager), Gailius Draugelis, and Peter Doty (consultant). It was produced under the supervision of Margret Thalwitz, Urban sector manager, ECSIE, with the assistance of Jeffrey Balkind. The peer reviewers for this task were Deborah Wetzel and Robert Ebel.

The report was produced with the assistance of a wide range of Lithuanian counterparts. These include officials and staff of the city governments of Vilnius, Kaunas, Siauliai, Alytus, and Druskininkai and the district (rajon) governments of Vilnius, Anykščiai, and Pakruojis. The report also benefited from meetings with officials of the the Finance Ministry (including Vice Minister Zilevicius and staff of the departments of fiscal policy, public debt management, public investment, budget, tax inspection, EU coordination, accounting methodology, and finance control methodology), the departments of public administration and regional development of the Ministry of Interior and the department of general education of the Ministry of Education and Science, the Local Government Association, and the Committee on State Administration and Local Authorites of the Seimas. The mission also met with staff of Hansa Lithuania Savings Bank, Vilnius Bank, and the Lithuania Agriculture Bank, and took the opportunity to coordinate with the resident representative of the IMF, and two ongoing Fund missions (an Article IV mission and the Bank-Fund FSAP mission). A draft of the report was discussed at a workshop attended by many of the individuals cited above. This report reflects the results of those discussions.

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EXECUTIVE SUMMARY

i. Municipal governments are an important part of the public sector in Lithuania. They account for 34% of total government spending (excluding social security) and are the primary providers of education, public utilities (excluding electricity), and a variety of welfare programs and urban services.

ii. Since the reestablishment of Lithuania's independence, the country has made great progress in transforming its local governments from mere appendages of the central government into independent units of government. Fundamental reforms in the structure of intergovernmental relations were made in 1994 and 1997. Reforms to be implemented in 2002 will continue this process. There are, nevertheless, several issues that require the attention of the Government.

Revenue and Expenditure Assignment

iii. The first concerns the division of revenues and expenditures between levels of government and the degree of central regulation over local finance. Local governments are in a fiscal straight-jacket. Virtually all revenues are centrally collected and distributed at centrally determined rates. While local governments have nominal autonomy over their expenditures, the major items of expenditure—salaries and welfare payments—are subject to Government control. As a result, local governments have no independent means to adjust to downturns in revenues or increases in costs. Faced with such events, their only option is to run up arrears or borrow from the Government or private lenders. There is evidence that they are doing so. Over the last four years, they have run annual deficits averaging 3.5% of revenues. This has now accumulated into a stock of arrears and short term contractual debt equal to 20% of revenues.

iv. Lithuania also needs to re-examine the distribution of revenues among municipalities. The country has an extensive system of revenue sharing, in which jurisdictions with high per-capita revenues are required to share revenues with their poorer counterparts. But it is not clear that the distribution mechanism actually succeeds in putting money where it is needed.

v. Ostensibly, both problems will be addressed under reforms to be implemented in 2002. Under the reforms, several major items of municipal expenditure—including teachers' salaries and welfare payments—will become the fiscal responsibility of the Government. While local governments will continue to manage these services, the Government will be obligated to pay for them through specific appropriations in the annual budget. The criteria for revenue distribution will also change. Funding for these so-called delegated functions will be distributed according to sector-specific indicators of need.

vi. In principle, these reforms will reduce the proportion of local spending subject to revenue- and expenditure fluctuations, and will improve accuracy of targeting. Nevertheless, they leave some issues unresolved. Under the reforms, the Government will not reimburse the actual costs of education or welfare in each municipality. It will merely transfer the amount specified in the budget according to the various indicators of need. As a result, the new system will still leave individual municipalities with large mismatches between the actual costs of delegated functions

and the amounts they receive from the Government budget. These are likely to be particularly large in the case of rural municipalities, where local governments are burdened with excessive teaching staffs.

vii. The report strongly supports the proposed reform, particularly as it applies to education. Under the new approach, municipalities will be forced to confront the high costs of keeping under-enrolled schools open. This will provide a strong incentive to optimize municipal school networks. But municipalities will also need the authority to dismiss excess teachers and close redundant schools if they are to respond to this incentive. In the case of welfare, the report advocates straightforward centralization. Rather than rely on indirect indicators of need to determine the distribution of welfare transfers, the Government should make these payments directly to beneficiaries, using local governments merely as paymasters

viii. These measures alone will not resolve the financial problem currently facing local governments. To address the municipalities' propensity to run up arrears and short term debt, two fundamental changes are needed in the structure of intergovernmental relations. The first is an increase in local control over revenues and expenditures. Municipalities should be allowed to adjust local revenues, either through a surcharge on the personal income tax or through an expanded property tax, with rates subject to local control. They should also be allowed greater control over wage rates and the terms and conditions of civil service employment.

ix. At the same time, the Government needs to harden the budget constraint facing local governments. At present, the Government itself is the principal source of funding for municipal deficits. Municipal governments are likely to continue to run deficits as long as such financing is available. To encourage local government to use their newly-granted fiscal autonomy to resolve their own financial problems, the Government must harden the budget constraint they face. It should cease extending new Treasury loans to municipalities that are currently in default and insist upon prompt payment of municipal obligations to the state tax inspectorate and the Treasury. Because the Government collects virtually all sources of local revenue, it is in a strong position to do so: it can simply deduct overdue payments at source.

Financing Capital Investment

x. Lithuania also has an opportunity to improve the selection and financing of municipal capital investment. Municipalities are responsible for a variety of capital intensive services—including water supply, sewerage, and district heating. They must also finance urban road construction, and the construction and maintenance of public buildings, including schools. In the absence of any current savings of their own, they depend on the Government to finance such investment, mainly through the Public Investment Program. This raises two concerns.

xi. First, the process of project selection is heavily influenced by Government's overriding concern with EU accession. As a result, funding is largely channeled to projects aimed at this objective. Given the scarcity of investment resources, this is understandable. But, to the extent that local priorities differ from national ones, it means that local priorities go under-financed. Second, Government financing is itself running out. To date, the Government has relied heavily on the privatization fund to finance public investment. This source is now virtually exhausted.

When Lithuania joins the EU, new funding from structural and regional development funds will become available. But in the interim, the Government faces a temporary dearth of financing.

xii. Reforms in revenue allocation may resolve part of this problem. Greater local fiscal autonomy may encourage local governments to finance capital spending from their current savings. This would allow local sectoral priorities to prevail and would provide an additional source of financing to replace the privatization fund. There also appear to be many opportunities for private sector participation in the financing (as well as management) of municipal utility companies.

xiii. Should local governments be encouraged to seek long term financing from the capital market? The report is skeptical. In theory, such operations involve only two parties: the municipality and the bond market (or banking sector). Private lenders would be expected to refuse to lend to a municipality that they regarded as uncreditworthy. But the market may assume that the Government itself stands as an implicit guarantor of municipal debt, ready to assume the debt service of municipalities in default. In fact the Government may be forced into this position, if a municipal default threatens to blacken its own reputation in international capital markets or cause a domestic banking crisis. At present, the Government attempts to forestall excessive municipal borrowing through a system of controls. It is insufficient. The report recommends tighter controls on municipal borrowing, including prohibitions on borrowing in international bond markets and borrowing in foreign currency, other than the Euro (to which the Litas is pegged).

xiv. Lithuania accession to the EU will make structural and cohesion funds available through the Government . Over the medium term, the focus on capital financing reform should therefore be on improving the Government's allocation process, rather than raising additional resources from credit markets. Reforms in the Government's project review process coupled with assistance to municipalities for project preparation will assist in this regard.

xv. In addition to these reforms in the structure of municipal finance, the Government should seek to improve the quality of financial information on which policy and management decisions are made. Such reforms would include the separation of current and capital accounts, the adoption of accrual accounting for expenditures, and the consolidation of fund- and enterprise operations. The report also recommends measures to improve municipal enterprise management and reporting.

xvi. While some of these recommendations can be implemented piecemeal, the most fundamental reforms in the intergovernmental relationship cannot be. The Government cannot expect to impose a hard budget constraint on municipalities while at the same time denying them any control over their own revenues and expenditures. Reforms on these two fundamental aspects of the intergovernmental relationship must therefore proceed simultaneously.

1. INTRODUCTION

1.1 Lithuania is midway through the process of transforming its local governments from appendages of the central government to politically autonomous entities with a more arm's length relationship between the two levels. This has been accompanied by frequent changes in the legislation governing local government and ongoing disputes between the tiers of government over shortfalls in revenue and unfunded mandates. The process of revision is continuing. The system in place in 2001 has a number of problems. Many of these would be corrected by reforms to be implemented in 2002. But the reforms for 2002—while in the right direction--still leave a substantial reform agenda.

Background

1.2 Lithuania has a two-tier structure of government.[1] The national territory is divided into sixty geographical subunits—the municipalities. Unlike other Baltic countries, Lithuania does not suffer from a proliferation of small local governments. As shown in Table 1.1, the vast majority of municipalities fall within the range of 20,000-90,000 population. Only six have populations under 20,000. Municipalities are governed by elected councilors, who serve three year terms, with no limit on re-election. Councilors elect a mayor from among their members.

Table 1.1: Size Distribution of Municipalities (000)

Population Range	No. of Muns.
< 20	6
21-40	26
41-90	23
91-589	5
Total	60

1.3 There are four major issues confronting Lithuanian local government. The first is the ongoing conflict between the central and municipal governments over the division of revenues and expenditure responsibilities. This has given rise to budget uncertainty, disputes over unfunded mandates, and claims for government bailouts. It is partly responsible for the deteriorating fiscal situation of the municipalities. The second is the failure of the existing system to direct funds to where they are needed. Municipalities play a major role in the provision of social services, including education and welfare payments. While the existing system of revenue sharing succeeds in reducing disparities in municipal per capita revenues, it is not particularly effective in directing funds to jurisdictions with unusually high education or welfare costs.

1.4 The third issue concerns the financing of capital investment. With the decline of municipal current account surpluses, most investment is financed through the central government public investment program. As a result, the process of project selection is highly influenced by the overriding concern of the Government with EU accession. Funding is therefore largely

[1] The national territory is also grouped into ten counties. Although they have regional development councils acting in an advisory capacity, the counties are essentially administrative units of the central government.

channeled to projects aimed at this objective. In addition, there are accounting and financial management problems that prevent central and local governments from obtaining the accurate understanding of the existing situation that is needed to find solutions to these problems. This particularly applies to municipal enterprises, which appear to represent a growing source of municipal contingent liabilities.

2. REVENUE AND EXPENDITURE ASSIGNMENT

Expenditure Assignment

2.1 Local governments account for a large share of total government expenditures. In 2000, budgetary spending[2] by local government accounted for 34 percent of budgetary public sector spending (i.e., excluding social security), and 19 percent of public spending including social security. This proportion is roughly comparable to other Baltic countries: In 1999, the share of municipal expenditure in total public sector spending (including social security) was 23 percent in both Latvia and Estonia. It is considerably below the proportion of longer-standing capitalist countries in the region, however. In Finland, local governments account for 36 percent of public spending; in Sweden, 37 percent; and in Denmark, 55 percent.[3] As shown in Table 2.1, the share of local spending in total government expenditure in Lithuania has declined somewhat since the early 1990's. This is largely due to the transfer of health care responsibilities to the central government. Since 1996, the local share of total public sector spending has remained roughly constant.

Table 2.1: Trends in Relative Importance of Municipal Expenditures

Year	Municipal Expenditures as %	
	GDP	Public Sector
1993	10%	41%
1994	11%	43%
1995	11%	39%
1996	7%	35%
1997	na	na
1998	8%	35%
1999	8%	38%
2000	7%	34%

Source: MOF files

2.2 Lithuanian municipalities essentially perform three functions. The first, and by far the most costly, is education. Municipalities bear full responsibility for primary and secondary education. They are responsible for paying teachers' salaries and pension contributions, materials and supplies, school construction and maintenance, and bus transportation. The central government's responsibility is largely limited to specialized vocational schools and higher education. As shown in Table 2.2, spending on education consumed about 57 percent of total municipal expenditure in 2000.

2.3 Municipalities are also responsible for the payment of certain welfare benefits. While the Government directly finances old age pensions and unemployment insurance, local governments are responsible for a variety other benefits. Together they account for 15 percent of municipal expenditure. Of this amount, roughly half consists of various pro-natalist policies (non-means tested grants to families with children). Another 20 percent consists of means-tested support to low income and unemployed households. Funeral grants, and expenditures on residential facilities for children, handicapped persons and the elderly make up much of the remainder. In

[2] i.e., excluding tariff revenue of municipally owned enterprises (district heating, cold water supply, etc.) and receipts from off-budget funds (road fund, environment fund, etc.)

[3] Data for Finland is from 1998. Source: IMF Government Finance Statistics Yearbook, 2000

addition, municipalities are required to compensate municipal water, district heating, and bus companies for discounts offered to low income households.[4]

2.4 The third function is the provision of public utilities and other infrastructure services. Municipalities are responsible for the provision of district heating, water supply/sewerage, and municipal public transit. Although some of these services are now provided through contractual arrangements with private providers (particularly in mass transit), most are organized as municipal enterprises. They are, to varying degrees, supported by tariff revenues. They nevertheless represent substantial potential claims on general budgetary resources. Many are poorly managed. District heating companies, for example, are often overextended, providing heat in areas where it is not economically viable. While operating subsidies to district heating companies are not large (other than for subsidies for low income consumers), the companies finance themselves by deferring maintenance and running up arrears to suppliers; a strategy that will eventually redound to the detriment of their municipal owners. In the case of district heating, municipalities also bear the burden of substantial debts arising from the breakup of the Lithuanian Power Company. Kaunas City, for example, was required to assume LTL 200 million in liabilities when it assumed ownership of its heating company.

Table 2.2: Functional Classification of Municipal Expenditures

	Mln Litas				% of total,
Category	1996	1998	1999	2000	2000
Education	1117	1828	1904	1872	57%
Welfare	275	424	445	478	15%
Housing and Public Works	354	483	274	232	7%
Culture and Recreation	99	188	165	149	5%
General Administration	87	166	159	155	5%
Fuel, Energy, and Supplies	62	97	85	81	2%
Transportation	0	94	93	74	2%
Public Order	15	28	26	26	1%
Health Care	645	44	18	13	0%
Agriculture	1	0	0	0	0%
Other Expenditures	0	134	127	185	6%
Total	2655	3485	3295	3266	100%

2.5 Municipal governments also provide a range of other infrastructure services, including road construction and maintenance, street lighting, garbage collection, and parks and cultural facilities. (As discussed below, road construction is largely financed by the centrally operated road fund, and does not appear as an expenditure in the budget). As a whole, budgetary expenditures on public utilities and other infrastructure services consumed about seven percent of municipal expenditures in 2000.

2.6 Education and welfare have dominated total budgetary spending over the last three years. As shown in Table 2.2, their combined share of total spending has averaged about 70 percent. 'Housing and public works' is the only other major functional category of expenditure. Its share has fallen sharply since 1998, and now comprises only seven percent of total spending. The remainder of budgetary spending is devoted to culture, recreation, and general administration.

[4] The latter costs are classified as 'municipal economy' rather than welfare in the Lithuanian accounts are therefore not included in the percentages reported above.

Revenue Assignment

2.7 **Taxes.** Municipal revenues are almost entirely derived from taxes collected by the central government. The law assigns four such taxes to municipal government. By far the most important is the personal income tax, the PIT, which accounted for 76 percent of revenues in 2000 (See Table 2.3).

Table 2.3: Trends in Municipal Revenues (mln LTL)

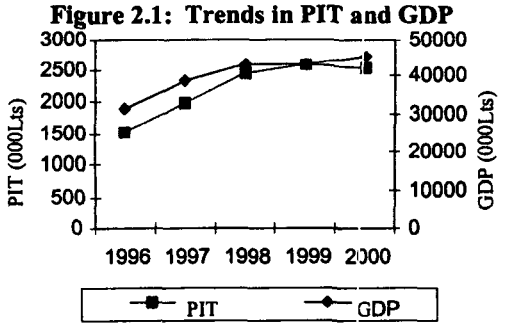
	1996	1998	1999	2000
Personal Income Taxes	1514	2422	2576	2504
Corporate Income Taxes	217	0	0	0
Property Taxes	177	235	246	259
Other Taxes	90	82	81	67
Income Property	1	3	5	4
Penalties	33	34	35	29
Income from Assets	0	0	0	0
Transfers from State	551	782	130	332
Total Revenue	2584	3558	3074	3195
Reductions in Cash*	74	91	135	79

Source: MOF
* includes some misc. non-tax revenues

2.8 The PIT is imposed at uniform, centrally determined rates. The majority of PIT revenues are collected through payroll deductions. Any firm with employees must deduct the tax due by its employees at a rate of 33 percent and remit it directly to the state tax inspectorate (STI). (Persons with only wage income do not file tax returns). Self employed persons (including owners of firms with employees) are required to file individual returns, basing their income either on a salary they pay to themselves, or by calculating a profit. Rates on such income range from 15 percent to 24 percent. (Certain categories of self employment--including translators--pay only a flat license fee). In principle, income from dividends, property, and the sale of assets is subject to taxation, though yields are insignificant. Income from pensions and welfare payments is explicitly exempt. Municipalities play virtually no role in administration of the PIT. The task of discovering unregistered businesses belongs to the central government labor inspectorate and to the police, not to local officials. Nor do municipalities have any control over tax policy. Municipalities cannot change the rates of the PIT or grant exemptions (except for license fees).

2.9 As a result, municipalities are vulnerable to changes in the underlying tax base, as well as Government-determined changes in the rate structure. As shown in the chart at the left, the PIT has been a relatively buoyant source of revenues. PIT revenues paralleled growth in the economy in the immediate post stabilization period and continued to increase in 1999, despite the recession prompted by the Russia crisis. In 2000, revenues fell (in nominal as well as real terms) despite a modest turnaround in the economy.[5] In 2002, the yield may fall again, due not to economic factors but rather to Government policy. As of January 1, 2002, the rate on the profits tax was reduced from 24 percent to 15 percent.[6] Effective April 1, the exemption level on the income tax will be raised

Figure 2.1: Trends in PIT and GDP



[5] The reason for this divergence is unclear. In part, it may reflect lags between the generation of taxable activity and the collection of taxes—thus bankruptcies in 1999 might not affect collections until the following year. It may also reflect more frequent use of loopholes and an increasing number of unemployed.

[6] This reduction applies to Lithuanian and foreign firms with less than ten employees and if revenue received does not exceed LTL 500,000, and was partly offset by eliminating certain exemptions and deductions

from LTL 214 to LTL 250. The Government is considering a reduction of the general income tax rate from 33 percent to 29 percent which would go into effect on January 1, 2003. All three factors are likely to reduce municipal revenues.

2.10 Municipalities also derive income from three forms of centrally administered property taxes; one on buildings, one on leased land, and the third on land itself. The highest yielding is the tax on buildings, with projected revenues of LTL 177.75 million in 2000, or about 5 percent of total revenues. The tax is imposed on the market value of buildings owned by enterprises. Land and buildings owned by private individuals are exempt. The rate is nationally uniform, at 1 percent of market value.[7] The second highest-yielding property tax is imposed on leased land. With projected revenues of LTL 50.9 million in 2000, much of the revenue of the land lease tax is derived from property owners awaiting completion of the restitution process.

2.11 The third form of property tax is the so-called land tax. This is imposed on land owned by physical or corporate persons. Land owned by the Government or by municipalities is exempt. Individual property assessments are based on Government-determined standard estimates of value per hectare, differentiated by region and degree of urbanization. Municipalities do have some discretion over the level of land tax liabilities. Although they cannot change the tax rate, they can grant exemptions to individual persons or companies, or to categories of persons such as the disabled. Yields of the land tax are extremely low. Projected revenues in 2000 were only LTL16.7 million, or .04 percent of GDP. This is partly because agricultural land prices are depressed and partly because, in urban areas, much of the land is owned by the Government or by the municipality. The low yield is also reportedly due to the widespread granting of exemptions by municipalities.

2.12 **Transfers.** Although all taxes are collected by the central government state tax inspectorate, not all are remitted to the municipality in which they are collected. Instead, the Government operates a complex inter-municipal revenue sharing system, in which richer municipalities are required to share part of their revenues with poorer municipalities.

2.13 The principal vehicle for revenue redistribution (as of 2000) is the equalization fund. Receipts of the fund are derived from fixed shares of tax revenues collected in higher-income municipalities. (In 2000, twenty municipalities, including all seven of the largest cities, were net contributors.) The size of each municipality's contribution is based on its estimated per capita tax revenues in the forthcoming budget year. In 2000, municipalities with per capita revenues over 65 percent of the national average were required to contribute 100 percent of the excess to the fund. (The equalization target, as well as the number of municipalities required to contribute is determined annually in the course of the budget process). Proceeds of the fund are distributed according to two major criteria. The first--the revenue equalization fund--is intended to reduce disparities in per capita revenues. Funds are allocated to all municipalities with per capita revenues less than 65 percent of the national average up to the point at which all municipalities reach this minimum threshold.

2.14 The remainder of the funds is distributed according to indicators of need. Need is measured according to a variety of factors, each measured on the basis of the municipality's

[7] Until 2002, property owned by foreign companies was exempt.

deviation from the national mean, and assigned a particular weight. The most important factor—accounting for 70 percent of the weight—is education, measured as a composite of several sub-indicators: primary school-age population, total enrollment, school floor space, and population density (as reflected by land area). Tourism receives another 25 percent of the weight, measured on the basis of square footage of lodging facilities. The remaining five percent is distributed on the basis of social indicators, including levels of unemployment and numbers of pensioners.

2.15 Municipalities are also eligible for a 'gap-filling' transfer funded from the Government budget. This is calculated during budget preparation, rather than during budget execution. To begin the process, STI estimates the level of local tax revenue it expects to collect, plus any government grants and receipts from locally administered fees and charges. At the same time, the Government negotiates with the official representative of the local governments—the Association of Local Authorities of Lithuania—over the proportion of total public sector spending to be allocated to local governments. (The current figure—33 percent--is based on the previous year's figure, and does not reflect a fundamental recalculation of the relative needs of each tier of government.) The difference between projected revenues and projected expenditures equals the amount of the gap filling transfer. In recent years, the amounts budget for the gap-filling transfer have not been large. In the 2000 budget, the budgeted amount was nil. In 2001, it was LTL 21 million. In the course of budget execution, the risks of shortfalls in revenue are largely borne by the municipalities. While the Government is obligated to transfer the amounts provided in the budget according to the formulas established in law, it is under no obligation to compensate for shortfalls in actual receipts.[8]

Expenditure Autonomy

2.16 In principle, municipalities have complete autonomy over their own budgets. But municipal expenditures are subject—directly and indirectly—to a variety of central government controls.

2.17 **Wages.** The most important item of municipal expenditure is wages. The budgetary expenditures of municipal governments are dominated by labor intensive sectors—particularly education. As a result, wages and related social security benefits dominate expenditures. As shown in Table 2.4, payroll expenses accounted for 60 percent of total budgetary expenditures in 2000. This represents a dramatic increase over the last four years. Since 1996, wages and benefits have increased by nearly 48 percent as opposed to a 14 percent increase in total spending.[9]

[8] The central government in fact has an incentive to overestimate municipal revenues: the more revenues it projects, the smaller amount of the gap filling transfer it is obligated to make. Shortfalls between projected and actual revenues, however, have not been as large as one might expect. In 1999, actual collections were about five percent below the expected amount, prompting the Government to make an *ad hoc* grant to the municipalities of LTL 25 million at the end of the year. In 2000, on the other hand, actual collections *exceeded* projections by about one percent. Shortfalls can nevertheless fall hard on individual jurisdictions. In 1999, actual revenues were eight percent below projected amounts in Kaunas and Siauliai, for example.

[9] Part of the increase is illusory, as it represents payments to SODRA for arrears from previous years.

2.18 Municipalities have little control over these expenditures. Although the municipal organic law grants local governments autonomy to set their own budgets, the degree to which they can control personnel costs is limited. The rules governing public sector employment are fixed in national legislation, and are uniform throughout Lithuania. All government employees are civil servants, with legal protection against dismissal and salaries subject to national wage setting.[10] Individual municipal councils do have the authority to fix the number of positions in each career stream and to determine the grade attached to each post. But once hired, staff are difficult to dismiss. By law, civil servants cannot be dismissed without cause. As a result, municipalities must rely on hiring freezes and a variety of subterfuges to reduce the amounts budgeted for staff on their payroll.

Table 2.4: Economic Classification of Expenditures (LTL mn)

	1996	2000	%
Total Expenditure	2852.5	3265.9	100%
Current Expenditure	2556.7	3087.9	95%
Wages and Salaries	1028.3	1498.6	46%
Social Security Contributions	295.1	457.5	14%
Other Goods, Services	239.6	533.4	16%
Interest Payments	3.4	25.0	1%
Subsidies and Other Transfers	384.9	573.3	18%
To Nonfinancial Institutions	137.9	33.7	1%
To Households	240.0	539.6	17%
Capital Expenditure	265.0	178.0	5%
Acquisition of Fixed Assets	265.0	63.2	2%
Amortization*	2.3	114.8	4%

*note that amortization is misclassified as "net lending' in the English translations of many government documents.

2.19 The problem of excessive staff is particularly acute in rural municipalities. With the decline in Lithuania's birth rate, rural schools have experienced a rapid decline in enrollment. Teacher-pupil ratios in village schools are therefore extremely high, placing a heavy financial burden on rural municipalities. The average primary school class size in "village" schools is 9.4, as opposed to a national average of 13, and target ceiling of 24. In theory, municipalities can close and consolidate rural schools. Any such proposal must be approved by the Ministry of Education, however, which requires the municipality provide a plan to reassign or retire excess staff. In practice, the binding constraint is a political one: Parents are reluctant to have their children bussed to distant urban schools. As a result, there is strong political pressure on municipal councils to keep sparsely attended rural schools open.

2.20 Municipalities can use certain subterfuges to reduce personnel costs. They can, for example, force older staff to retire. (By law, teachers over 62.5 years of age can now be put on one-year renewable contracts). Work can also be spread out. Teachers in Lithuania are paid on a per-lesson basis, subject to a maximum of 36 lessons per week and a minimum of 18. Teachers with a full teaching 36-lesson load can be forced to reduce their work time to the minimum, allowing the municipality to reduce personnel costs without dismissing any staff. It is also reported that municipalities "reorganize" in a way that leaves some staff without positions, allowing them to be dismissed. The impact of these methods is marginal.

[10] Certain positions are reserved for political appointees who can be dismissed at the pleasure of the executive.

2.21 Local governments also lack control over wage levels. The national civil service laws sets out a structure of pay scales for municipal employees, based on grade, years of employment and size-class of municipality (and in the case of teachers, number of classes taught). The pay structure is expressed as a multiple of the so-called basic wage. As a result, Government changes in the basic wage trigger autonomic increases in salaries.. In principle, municipalities can lower salaries by reducing the grades of existing staff. They are reluctant to do so however, for fear of damaging morale.[11]

Box 2.1: Reform in Civil Service

In principle, proposed reforms in the civil service code will give local government greater authority to dismiss staff. Under the legislation currently under consideration by the Seimas, all civil servants would be subject to annual performance evaluations. Under the proposed law, staff could be dismissed if performance is rated as poor for several years running. It is not clear how well this provision would work in practice.

2.22 **Welfare payments**. Municipal welfare expenditures are also centrally controlled. As shown in Table 2.5, municipal welfare costs (excluding subsidies for heating, water, and transport) have soared in the last four years, increasing by 75 percent between 1996 and 2000, and now account for about 15 percent of total expenditures.

2.23 Roughly two-thirds of all direct welfare payments (i.e., excluding costs of residential facilities and utility and transport subsidies to low income households) are directed at families with small children, regardless of income. The largest such program is the so-called family benefit, which consists of a fixed payment per child for the first three years of life.[12] Municipalities are also required to grant non-means-tested benefits to foster parents and orphans,[13] as well as lump sum child birth grants, and benefits to families with four or more children. In 1997, the government introduced an additional benefit for families with three or more children, subject to a means test. Taken together, these pro-natalist, largely non-means tested payments totaled LTL 250 million in 2000, or about eight percent of total spending. Municipalities are also required to grant means-tested benefits to the elderly, disabled, students, the unemployed, and people with low paying wage employment. These so-called social benefits accounted for one quarter of direct welfare payments in 2000.

[11] An increase in the minimum wage was the cause of a major dispute between the Government and municipalities when, in 1998, the Government increased the basic wage from Litas 95 to Litas 105. Several municipalities--most conspicuously Vilnius-responded by refusing to remit the PIT owed by its staff to the Government until adequate compensation was received

[12] One year less for families that have contributed to state health insurance and thus have coverage for first year under that program.

[13] Orphans receive a one time settlement grant upon reaching 18 years of age, and an ongoing stipend while they are attending high school or higher levels of education.

Table 2.5: Budget Expenditures on Welfare

Category	LTL mln.		%
	1996	2000	2000
Total	274.5	478.3	100%
Direct Payments	230.6	397.4	83%
Family and Child Allowances	108.4	252.7	53%
Social Benefits	77.2	88.9	19%
Funeral Grants	21.3	27.1	6%
Other Direct Payments	23.8	28.7	6%
Other Welfare Expenditures	43.9	80.9	17%
Residential Institutions	27.7	42.2	9%
Home Care	5.7	9.5	2%
Other Payment	5.5	19.9	4%
Maintenance	5.0	9.3	2%

Note: (1) Excludes subsidies to utilities and bus companies for low income customers.

2.24 While the municipalities administer and finance these programs, the level of benefits is centrally determined. These have been subject to abrupt increases over the last few years. Most welfare benefits are based on the Minimum Subsistence Level (MSL). This is calculated quarterly by the Ministry of Social Security and Labor, based on the average prices of a basket of food and other essential expenditure items. Between 1996 and 2000, the official MSL increased by 12.7 percent. The MSL that is applied in calculating benefits differs substantially from the figure produced by the Ministry of Labor, however, with the ratio varying in accordance with Government budget constraints. Over the last five years, the ratio has increased substantially. In 1996, the applied MSL equaled only 55 percent of the initial figure. By 2000, the ratio had increased to 67 percent. As a result, the level of family benefits (set at .75 MSLs per child per month) increased 37.7 percent over the four year period. Other categories of benefits have increased even further. In 2000, the Government increased the level of the foster care benefit per child per month from 1.5 to 4.0. The orphans' stipend was raised to 4 MSL and the settlement grant from 18 to 50 MSL.

2.25 Income-tested benefits are based on the State Supported Income (SSI). This is defined as the level of income required to purchase the food portion of the MSL. The size of the social benefit, for example, is equal to 90 percent of the difference between recipient's actual income and the Government specified state supported income (SSI).[14] Households with incomes below the SSI receive full compensation. Those with income greater than this limit are expected to contribute a fixed proportion of the difference. Like the MSL, this has increased substantially in recent years (albeit at a slower rate than net wages). Between 1996 and 2000, the SSI increased by 23 percent.

2.26 National legislation also requires municipalities to provide subsidies for heating, water supply, and public transport to low income households. Each municipality assesses eligibility and calculates the contribution to be paid by the household. This information is sent to the utility company which calculates the actual compensation payable and bills the individual for the remainder. The utility company then bills the municipality for the compensation due. In the case of heating, the amount of subsidy is based on a normative estimate of household heating costs (where heat meters are not installed) and on actual costs (where they are). The amount of the subsidy is subject to a ceiling, based on the estimated cost of heating a standard area of living space. (The space standard is 18 square meters for the first member of the household plus 12 m^2 for each additional member, plus an additional 20 m^2, multiplied by a standard figure for energy cost per m^2, set by the Government price and energy control commission.) Municipalities are required to subsidize the heating costs that exceed 25 percent of calculated disposable income of eligible families. Until 1999, compensation for hot and cold water were also based on national standards (per family member) with municipalities required to subsidize five percent of the costs

[14] Defined as the level of income required to buy the food portion of the MSL.

hot water and two percent of the costs of cold water. (Municipalities are now permitted to set their own consumption standards per family member). Costs of heating subsidies totaled LTL 74.78 million in 2000; costs of public transport subsidies totaled 57.4 million.[15]

2.27 As a result, of the Government's influence over personnel and welfare spending, municipalities can find themselves confronting abrupt, exogenously determined, increases in costs. Government mandated increases in welfare benefits or increases in the wage base can prompt abrupt increases in expenditure obligations. At the same time, municipalities are vulnerable to shortfalls in revenues, which--due to the Government's control over tax rates and tax administration--they cannot offset by increasing taxes. In the short term, municipalities respond through a *de facto* form of cash flow management. The year's budgeted disbursements are divided into 4 quarters. The treasurer prorates each month's collections to each department (health, education, administration etc). based that quarter's expenditure allocation. When collections exceed estimates, the treasurer builds a cash reserve until it is appropriated in a budget revision. When collections are below estimates, the municipality is in trouble. As the departments begin to receive amounts less than that quarter's disbursement allocation, bills go unpaid with the hope that collections will improve the next month.

Issue 1: The Fiscal Straightjacket

2.28 The present structure of revenue assignment and expenditure controls leaves municipalities in a fiscal straightjacket. Municipalities have virtually no control over the level of revenues they receive, and relatively little control over the level of their expenditures. As a result, municipalities are in an untenable position. They bear the risk of any shortfall between the revenues projected in the budget and actual tax collections. They bear the risk of any increase in costs—any excess in actual expenditures over the level of provided in the central government budget. And because they have virtually no control over their revenues and expenditures, they have no ready means to adjust. Their response has been to gradually run down their current account surpluses, run up arrears, default on loans, and appeal to the Government for bailouts.

Table 2.6: Trends in Financial Indicators (% revenues)

	1996	1998	1999	2000
Current Surplus	1%	na	na	3%
Overall Surplus (-Deficit)	-10%	2%	-7%	1%

2.29 As shown in Table 2.6, the municipalities as a group have run overall deficits or only very small surpluses in each of the last four years. Current spending has barely exceeded current revenues in the two years for which data are available. These figures probably understate the problem. As discussed below, municipalities record expenditures on a cash basis. Obligations incurred but not paid are not included in expenditure statements. As a result, surpluses are overstated, and overall deficits, understated.

2.30 Data on individual municipalities also show a pattern of decline. As shown in Table 2.7, Vilnius city's current surplus shrank to two percent of revenues in 2000; Kaunas' to four percent.[16] In nearly all of the nine municipalities shown in Table 2.7, the operational surplus has

[15] Source: MSSL, cited in Yu, Xiaoquing "Social Protection System in Lithuania" draft, November 2001
[16] Data on the overall deficit of these municipalities is not available.

declined to the point where revenues are barely sufficient to meet ordinary expenses. Very little is left over to finance capital additions or repayment of debt.

Table 2.7: Current Surplus of Selected Municipalities 1997-2000

	% of Revenues			
Local Government Unit	1997	1998	1999	2000
Vilnius Municipality	10%	13%	5%	2%
Kaunas Municipality	21%	18%	-7%	4%
Druskininkai Municipality	9%	8%	1%	3%
Kaunas District	NA	9%	-5%	4%
Akmene District	NA	11%	-1%	4%
Silute District	NA	20%	2%	7%
Svencionys District	NA	12%	2%	4%
Lazdiju District	NA	17%	-1%	1%
Panevezys District	NA	12%	-1%	6%

2.31 Other indicators are also disturbing. The first is the growing stock of municipal arrears. As shown in Table 2.8, the total stock of arrears as of October 1st stood at LTL 420 million, or about 13 percent of revenues.[17] Of this total, slightly over 25 percent is owed to the state tax inspectorate (for taxes payable by municipal employees). Another quarter represents overdue principal repayments on loans from commercial banks. Fifteen percent is owed to municipal public utilities; and ten percent to families eligible for family support payments. The remainder is largely due to suppliers.

2.32 The stock of short term contractual debt is also growing. Roughly half the stock of municipal contractual debt consists of short term obligations—i.e., loans with maturities of less than one year. (See Table 2.9). Slightly over half of this (as of November 2001) consisted of loans from the Treasury. Historically, the majority of this was contracted to finance teachers' summer vacation pay. (By law, municipalities are required to pay teachers three months' salary at the start of the summer vacation). These loans are intended to be short term cash flow advances, to be repaid before the close of the budget year. As of November 10, the stock of outstanding treasury loans totaled LTL 117.7 million. The budget department expected only LTL 37.6 million of this to be repaid prior to the end of the year, leaving an expected balance of LTL 80 million. The remainder consists of short terms loans from commercial banks. According to Bank of Lithuania statistics for October 6, 2001, the total stock of such debt equaled LTL 95 million.

Table 2.8: Trends in Stock of Arrears

	1-Apr-01	1-Oct-01	% total, October
Current Expenses	357.7	300.7	72%
Payroll	123.0	122.5	29%
Wages	11.9	9.7	2%
PIT	11.0	112.9	27%
Social Insurance	59.6	8.5	2%
Other Goods and Services	163.9	145.2	35%
Heating	75.1	59.0	14%
Electricity	8.6	5.2	1%
Water/Sewerage	5.8	6.5	2%
Subsidies	62.5	45.8	11%
Family Support	59.0	44.3	11%
Capital Expenditure	96.0	119.5	28%
Capital Works	7.1	8.5	2%
Arrears on Amortization	88.9	111.0	26%
Total:	453.76	420.19	100%

[17] Published statistics on municipal arrears group outstanding payment obligations under three categories. 'Total arrears' consists of outstanding obligations for goods and services received, regardless of whether they are contractually overdue. The other two categories group obligations according to the number of days that payment can be contractually deferred: 10 days or 45 days. The figure reported under each of these headings represents the value of obligations that remains outstanding beyond the expiration of the deferral period. The figures cited in the table above are the sums of overdue 10-day and 45-day obligations.

Table 2.9: Stock of Municipal Debt, Oct 1, 2001 (mn LTL)

	Total	Short Term	Long Term
Arrears	420.0	420.0	--
Treasury Loans	117.7	117.7	--
Com'l Banks	282.1	94.9	187.2
Mutilaterals	105.4	--	105.4
IBRD	37.8	--	37.8
EBRD	20.3	--	20.3
NIB	47.2	--	47.2
Total	925.2	632.6	292.5

2.33 In total, the stock of arrears and short term municipal debt, as of October 1, would appear to be nearly LTL 632 million, equivalent to 20 percent of total current expenditures in 2000. This suggests a severe liquidity problem, if the municipalities are unable to roll over their debt. They clearly lack the available revenues to amortize it. It may also represent a solvency problem, if what appears to be deficit financing in the form of arrears, overdue treasury loans, and short term commercial debt in fact reflects a permanent inability of municipalities to finance their expenditure obligations.

2.34 Some municipalities also confront an explicit stock of long term debt. As shown in Table 2.9, the stock of long term debt stood at LTL 292 million as of November 2001. Two thirds of this is owed to commercial banks. In addition, the municipalities are recorded as having a total of LTL 105.4 million in loans outstanding to multilateral development banks, consisting of LTL. 37.8 million owed to the World Bank, LTL 47.23 owed to the Nordic investment bank, and LTL 20.3 million owed to the EBRD. While this does not present an immediate liquidity problem, it does represent a significant claim on revenues. Interest payments in 2000 were equal to 20 percent of the aggregate overall surplus of municipalities.

Issue 2: Mistargeting Transfers

2.35 Budget uncertainty and growing debt are not the only problem with the existing system of municipal finance. There is also a targeting problem: a failure to direct funds to where they are needed. Despite its small geographic size, Lithuania is subject to wide variations in regional economic activity. Soviet economic planning tended to produce one-industry towns. Where these industries have been unable to adjust to market conditions, the economy is stagnating and unemployment is high. Siauliai, site of a former Soviet military base, and Druskininkai, a spa frequented by Russians on union- sponsored vacations, are conspicuous examples. Other municipalities have made the adjustment and are thriving. As shown in Table 2.10, Vilnius and Klaipeda regions appear to have made the adjustment most successfully, with per capita GDPs 37 percent and nine percent above the national average, respectively. (GDP data for individual municipalities is not available). Siauliai, Marijampole, and Taurage, on the other hand, rank at the bottom of the list.

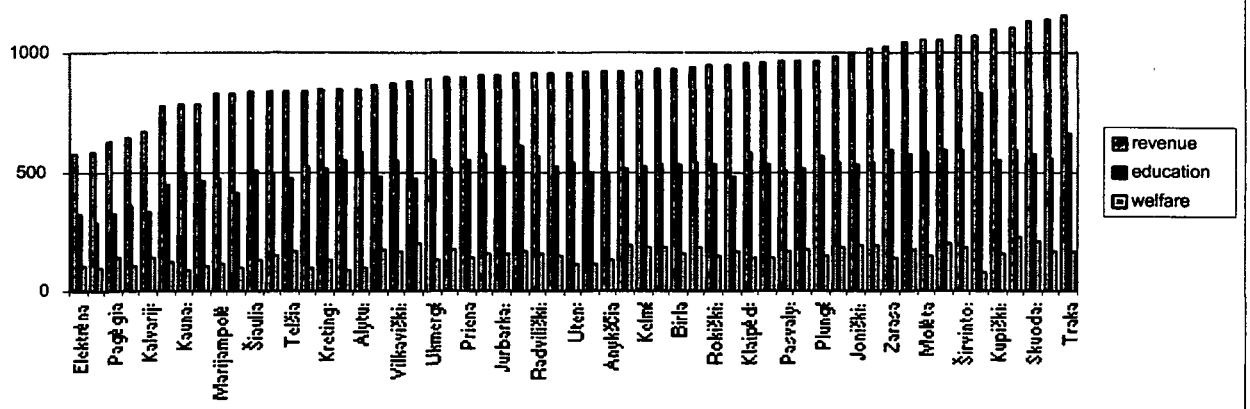
2.36 Local governments are responsible for major expenditures with important distributional implications—particularly education, aid to families with dependent children, and utility and transportation subsidies for low income households. The existing revenue sharing system,--while it achieves substantial equalization in terms of aggregate per capita revenues--does not appear to be effective in tracking variations in the costs of social services.

Table 2.10: Regional Variations in GDP per Capita (000 LTL)

County	1997	1998	1999
National Avg.	10.3	11.6	11.5
Vilnius	12.6	15.1	15.8
Klaipeda	11.0	12.5	12.5
Kaunas	10.3	11.3	11.1
Utena	9.3	10.5	10.3
Telsiai	9.1	10.2	10.0
Panevezys	10.4	11.0	9.8
Alytus	8.7	9.3	9.3
Siauliai	9.0	9.1	8.8
Marijampole	8.2	9.1	7.7
Taurage	6.7	7.1	7.0

2.37 The impact of the present revenue sharing is illustrated in the chart below, below. As shown, it is largely successful in flattening disparities in budgeted per capita revenues. With the exception of three outliers (the resort towns of Neringa, Birstonas, and Palanga) per capita revenues all fall within a range of LTL 570 to 1160. All but eight fall within the narrower band of LTL 775-1160. Excluding the three outliers, the standard deviation in per capita revenues is LTL 130 or 14 percent of the mean.. The formula slightly favors smaller municipalities: Revenues per capita are negatively correlated with population (r=-.2). As a result, Vilnius and Kaunas rank among the lowest-revenue municipalities (with per capita revenues of about LTL 780) while very small municipalities rank among the highest. Neringa, the richest municipality, has a population of only 3000. But while the revenue sharing formula flattens disparities in per capita revenues, it is not immediately obvious that it tracks variations in expenditure obligations very well. Welfare rolls or primary school costs may not be correlated with the inverse of per capita tax collections.[18] As a result, municipalities with high social expenditure obligations may not be receiving adequate compensation.

Figure 2.2: Per Capita Revenues and Social Expenditure



[18] As shown in the chart, there is some correlation between per capita revenues (after redistribution) and per capita spending on education and welfare. (The correlation coefficient for education is +.81; for welfare .51). The direction of causation is unclear however. On one hand, high levels of enrollment and poverty may be triggering higher levels of transfers, thus increasing revenues. On the other hand, higher levels of revenues may be permitting local governments to spend more on education and welfare, regardless of need.

The 2002 Reform

2.38 In principal, both problems will be addressed under reforms to be introduced for the 2002 budget year. The 2002 defines a set of functions that will become the fiscal responsibility of the Government. While these services will continue to be administered by local governments, the Government will ensure that they are fully funded. To do so, the Government is to calculate the expenditure requirements of each delegated function and will allocate sufficient funding for that amount in the budget. Part of these costs will be financed from the PIT. As of November 2001, the Government proposed to retain 40 percent of all PIT receipts, leaving the municipalities with 30 percent and the health fund with 30 percent. If the Government's share of expected PIT revenues is insufficient to meet budgeted costs of delegated functions, the Government is required to fund the difference from general revenues. Risks of any shortfalls in the Government's share of the PIT revenues will therefore be borne by the Government.

2.39 Funding for delegated functions would be earmarked for these purposes and would be distributed on the basis of sector-specific indicators. The most important of these is the so-called 'education basket'. Under this arrangement, the Government would distribute education funding on the basis of enrollment. (Rural schools would receive a proportionately higher per-pupil allocation than urban schools, ostensibly to compensate for the high teacher-pupil ratios in rural schools). For 2002, the amount per contract student is LTL 1,521. Funding for welfare benefits (the various pro-natalist and income support benefits described earlier) would be based on the amount disbursed in the preceding year, adjusted for changes in the minimum subsistence level (MSL). Funding for district heating and hot-and cold water subsidies should be directly based on the amount of compensation payable by municipalities under existing laws. Compensation for transport subsidies for low income households would be based on the actual cost of those subsidies (based on the number of discounted tickets sold and the size of the discount).

2.40 The other, so-called autonomous functions, would continue to be financed from the remaining share of the PIT, property taxes, and other local fees and charges. The municipal share of the PIT would continue to be redistributed on the basis of the current equalization formula. The basis for determining the amount to be deducted from the richer municipalities and transferred to the poorer ones would change. Instead of being based on budget projections, the redistribution of the PIT would be recalculated every month on the basis of actual PIT tax revenues in the preceding month. As a result, municipalities will no longer face the risk that Government revenue estimates prepared during budget formulation will exceed actual revenues during budget execution. They will, however, face the risk that actual revenues will fall short of their own forecasts.

2.41 The factors used to distribute funds on the basis of need will also change. Although education will now be largely financed through the education basket, education will still carry about half the weight in the allocation of needs-based equalization funds. (Twenty five percent of the funds will be distributed on the basis of the number of pre-school age children; 11 percent according to the number of school age children, and 13 percent according to the square footage of educational facilities owned by the municipality). Another 17 percent will be distributed according to land area; 13 percent according to the number of residents of pensionable age; and 13 percent according to the length of roads.

Recommendations

2.42 In theory, the 2002 reforms will address both problems with the existing system. First, it will reduce the exposure of local governments to budgetary uncertainties. With the Government now responsible for financing education, welfare, and certain other municipal functions, much of the risk of revenue shortfalls or expenditure will now be borne by the Government rather than by the municipalities. The reform will also improve targeting. Funding for delegated functions will be based on sector-specific indicators of need, rather than general revenue equalization.

2.43 **Assistance in transition** Several important issues remain. First, there will clearly be transition problems for some municipalities in shifting from the present revenue allocation system to the new one. This is likely to be most acute in education, due to the prevalence of severely under-enrolled schools in rural areas. As noted earlier, the 2002 reforms do not require the Government to reimburse the actual costs of delegated functions in each municipality. It is merely obligated to transfer the amount specified in the budget according to the various indicators of need. Under the reform, each municipality will be left with the problem of how to stretch its per-pupil allocation to cover its actual expenditures.

2.44 The intent of the education basket is clearly laudable. Under the new approach, municipalities will be forced to confront the high costs of keeping under-enrolled schools open. This will provide a strong incentive to optimize municipal school networks. But municipalities will also need the authority to dismiss excess teachers and close redundant schools if they are to respond to this incentive. Centrally determined civil service rules will make it difficult for municipalities to do so. Central government assistance for school rationalization may be required.[19]

2.45 **Centralizing welfare payments** Second, targeting for municipal welfare spending will continue to be a problem. As noted earlier, welfare benefits are classified as a delegated function, and will no longer be financed from general municipal revenues. The criteria for allocating welfare cost compensation still leaves much to be desired, however. It is to be based on spending in the preceding year, adjusted for changes in the MSL. As a result, municipalities with rapid increases in welfare costs will be required to fund such increases from their own revenues—at least in the first year.

2.46 The alternative would be for the Government to allocate funds directly on the basis of the number of eligible recipients and their respective benefit levels. In Lithuania, this is already the case for many such programs. Old-age pensions are paid directly to beneficiaries by the central government, as is unemployment insurance. There is a strong case for adding family benefits, and payments to the working poor and long term unemployed to this list. This would permit the level of payments to track actual costs, reducing the burden on municipalities with relatively high levels of beneficiaries. Municipalities could still play the predominant role in the administration of such programs—determining who is eligible (on the basis of centrally determined criteria) and administering the payment of benefits. Responsibility for funding would however rest with the national government.

[19] Note that a World Bank project to assist school rationalization in six pilot municipalities is currently under preparation.

2.47 **Increasing Municipal Autonomy** The 2002 reforms will not be sufficient to eliminate the propensity of municipalities to run arrears and seek central government bailouts. It is true that with funding for education and other delegated functions guaranteed by the central government, the absolute amount of municipal expenditure subject to the vagaries of centrally collected tax revenues and exogenously determined changes in costs will fall considerably. But municipalities would still be left with a significant level of expenditure responsibilities. The risk of revenue shortfalls in the funding of these functions will remain, although the nature of that risk will change (see paragraph 2.38). As a result, the propensity of municipalities to run up debts in the expectation of central government bailouts is likely to persist.

2.48 This can be addressed through two lines of reform. The first would consist of a hardening of the budget constraint facing local governments. The second would consist of increased municipal autonomy over revenue and expenditures. Together these would provide municipalities with the means to adjust to changing economic conditions without resorting to central government bailouts, while providing them an incentive to do so.

2.49 **Personnel regulation** There is a strong case for relaxing central regulations on expenditures—particularly on personnel. This could include eliminating job protection for

Box 2.2: Improving the Predictability of Transfers

Who should bear the risk of shortfalls in revenues? Managing municipal affairs in the face of revenue shortfalls is very difficult. Municipalities operate on very thin margins between ordinary income and ordinary expenses. Very few municipalities have cash reserves. When revenues do not match expectations municipalities postpone payments and hope that the state revenue collectors can improve collections. Late in the year when the shortfall is deemed endemic, municipalities must review and amend the budget. These anxious moments can be avoided if the revenue flow could be more dependable.

One possibility might be to base revenue sharing on the prior year's actual result. The municipal revenue flow budgeted for the year 2002 prepared before the close of the year 2001 could be based on the amounts actually collected during the year 2000. State revenue sharing would be known early in the budget process and need not be postponed until the government tax collection estimates for the next year become available.

Under such an arrangement, municipalities would of course not participate in the upside potential of tax collection increases (although they would avoid the downside potential of declines.) They would also continue to face the other half of the budget rigidity problem. As long as expenditures remain outside the control of municipal governments, municipalities can still be caught in a squeeze between fixed revenues and rising cost. An alternative--and probably more desirable approach--would be for municipalities to run sufficiently large current surplus to enable them to adjust to downturns in revenues.

certain categories of staff (who could then be employed as contractual employees under private sector legislation). The Government could also eliminate central control on the level of salaries, allowing individual municipalities to adjust wage levels according to local economic conditions and spending priorities, rather than conforming to the existing grid.

2.50 Both measures are likely to be controversial. If Lithuania is typical of most countries, the civil service represents a powerful and well organized interest group that will forcefully defend its benefits; particularly protection against dismissal. Civil service unions, moreover, typically prefer to negotiate wage agreements with the national government, where the full force of the national union can be brought to bear, rather than negotiating individual agreements with each municipality where more parochial interests might prevail. Reform is nevertheless possible. One approach , for example, would be to reduce job protection only for newly hired staff.

2.51 **Revenue autonomy** A second reform would be to loosen the reins on revenue. As noted earlier, municipalities have virtually no control over the level of their tax

Box 2.3: Choosing Among Local Taxes

Local taxes, in principle, are an appropriate means of financing services whose benefits cannot be confined to individual consumers, but nevertheless do not extend beyond the municipal boundaries. In a sense, local taxes are the collective analogue of user charges. Where user charges are the means by which individuals can express their demand for services whose benefits are largely private, local taxes are the means by which taxpayers within a community can express their demand for services that are consumed collectively. Benefit taxes also provide a degree of geographical equity to the financing of municipal services, imposing the costs of municipal services on the people who benefit from them.

Property Taxes. The property tax is the most common local tax. As a local incidence tax, it performs well: the incidence of the tax (at least its residential component) is geographically confined and its coverage is broad enough to reach the majority of beneficiaries. The property tax is, however, difficult to administer successfully. In part, the reasons are technical: the number of tax paying units is large. Assessments are often controversial because values must be imputed, rather than observed from actual transactions, and the base must be revalued annually to maintain its buoyancy. (Conditions in developing and transitional economies make the property tax particularly difficult to administer, since the basic market data on which the property assessments are based is inaccessible or unreliable.) But there are also particular political costs associated with the property tax: as a direct tax, its burden is particularly visible; and as a tax on wealth, its burden falls disproportionately on groups with great political influence.

Income and Payroll Taxes. Local income and payroll taxes are an attractive alternative to the property tax. Personal income taxes have the geographically defined incidence sought in a benefit tax, and where imposed in conjunction with a national income tax, are cheap to administer. The constraint on income taxes in developing and transitional countries is their narrow coverage. Many countries impose the income tax only on formal sector employment, collecting revenues from firms rather than individuals. But such payroll taxes fall on too small a proportion of the population to serve effectively as benefit taxes. They can also drive up formal sector labor costs, encouraging firms to remain unregistered.

Utility Taxes. Local taxes imposed in connection with utility bills--particularly with electricity bills--are also not uncommon. In principle, such taxes have localized incidence and--given the ubiquity of electric service--reasonably broad coverage. Costs of administration are low, as the tax can be imposed jointly with electricity bills. The extent to which an electricity surcharge can be relied exclusively is limited, however, by the basis of assessment: if the tax is imposed ad valorem, it distorts the price of power. If it is imposed as a flat fee it fails to capture variations in ability to pay, and is therefore limited by the tax paying ability of the poorest electricity consumers).

Taxes on Automobiles. Local automobile taxes--both recurrent taxes on automobile ownership, and one-time taxes on purchase--are also significant auxiliary sources of revenue. Except in multi-jurisdictional metropolitan areas, the incidence of such taxes is easy to confine; such taxes are relatively easy to administer, and enforce. Potential yields, however, are limited.

revenues, rendering them vulnerable to downturns in centrally-collected taxes and depriving them of a means to respond to constituents demand for better services. The obvious candidate for liberalization would be the personal income tax. It has a number of advantages, not the least of which is the fact that it is already assigned to local government. Liberalization would merely require that local governments be allowed to adjust the rate of the tax; specifically the rate on that proportion of the tax retained in their jurisdictions. This is already the practice in several neighboring countries. In Finland, local governments are allowed to impose a local income tax as well as a property tax. Together these comprise half of municipal revenues. Each local authority is allowed to set its own rate on the income tax, with no upper limit. (The property tax is subject to an upper bound). Similarly, in Denmark, local governments are allowed to set the rate of the municipal income tax. Rates currently range from 13 percent to 22 percent. In principal, Sweden also permits local governments to determine the rate of the income tax. This prerogative has been often overridden by central government manipulation of the tax base and temporary freezes on rates. It may have disappeared entirely in the course of recent reforms intended to achieve an equal level of per capita revenues in every municipality.

2.52 Judging from interviews undertaken for this report, the Government has little interest in giving local governments control over the PIT, however. This is ostensibly due to the complexity of administering a tax that is subject to local rate-setting while also subject to equalization. But this problem is readily solved. A municipality could simply be given the authority to impose a surcharge on the gross PIT receipts collected within its jurisdiction, with the revenues retained in the municipality rather than being subject to equalization. The Government does, on the other hand, have reason to worry about the policy implications of a local PIT surcharge. Under the 2002 reforms, the income tax base will be split three ways: part to the health fund; part to the Government for the financing of newly delegated functions; and the remainder to the municipalities, subject to revenue equalization. Giving local governments the power to impose a surcharge would create a fourth claimant on the tax. The Government may worry that in doing so, it is restricting its own ability to increase the rate of the existing PIT in the future.

2.53 The Government is instead considering reforms to the property tax system. Draft legislation now under preparation in the Ministry of Finance contains two major reforms. The first would give local governments control over the rate of the building tax, subject to a range of 0.5 percent to 1 percent of market value. The second would give municipalities the option of expanding the base of the building tax. As noted earlier, the building tax is now only imposed on buildings owned by legal persons (i.e. companies). Most of this consists of factories and commercial buildings. The draft legislation under preparation by the Finance Ministry would give individual municipalities the option of expanding the tax base to include property owned by natural persons. In principle, this would bring most of the housing stock into the tax base, vastly expanding its potential yield. (Ninety-seven percent of the housing stock is privatized). The legislation now under preparation would exempt the taxpayer's primary residence, however, greatly reducing the potential gain.

2.54 In principle, these two reforms could have a significant impact on local tax revenue. This would be even greater if the Government removed the exemption on the primary residences (while keeping open the option of taxing it at a lower rate). It should be emphasized, however, that the property tax is subject to administrative and political difficulties, as described in the Box 2.3 above. Political sensitivities are likely to rise as the base is broadened to include property

owned by natural persons—particularly if it includes primary residences. Unit costs of administration will increase as the base is expanded to include lower value residential property. For these reasons, property taxes are an increasingly minor source of municipal tax revenues in most industrial countries. In Denmark and Norway, they constitute about three percent of municipal revenues; in Germany, 6 percent, and in the U.K., 13 percent. Before considering further reforms to the property tax, the Government should therefore re-consider its opposition to local control over the part of the personal income tax retained in their jurisdictions.

2.55 The Government should also consider increasing local governments' role in the administration of their taxes. One wonders how diligent the Government tax collectors are in collecting taxes on behalf of the municipalities. Municipal officials should develop more curiosity and become more pro-active in the calculation and collection of the local taxes and the maintenance of tax databases. Perhaps a good beginning would be a regulation that allows municipalities to assign some employees to participate in the Government collection process and work in the STI's collection offices.

2.56 **Hardening the budget constraint** At the same time that the Government loosens controls on local revenue and expenditure, it will have to tighten controls on ad-hoc grants, debt bailouts, and other forms of relief. Local governments will have little incentive to use their new autonomy to keep their accounts in order if Government *ad hoc* aide is available. Without a hard budget constraint, further increases in arrears to the Government and demands for grants and debt bailouts can be expected.

2.57 Municipalities in the past appear to have confronted a fairly soft budget constraint. As noted earlier, they have managed to run up an immense stock of arrears and short term debt, largely consisting of unpaid obligations to the STI, default on loans from the Treasury, and debt to commercial banks (both arrears on debt service and current borrowing). The Government is now considering a general debt relief program aimed at eliminating this stock of arrears. Under the program, municipalities are required to prepare a schedule for paying off their arrears. Disbursement of debt relief funds will be conditioned upon their fulfillment of these schedules. Because the amount of debt relief is smaller than the outstanding stock of arrears in most cases, each municipality will have to liquidate some of its arrears from other resources. Under the terms of the debt agreement, these resources are to come, in part, from the proceeds of an earlier fiscal relief package (that was intended to compensate municipalities for revenue shortfalls in 1997-2000). Municipalities are required to provide quarterly reports on the use of debt relief funds to the Ministry of Finance, which will be responsible for monitoring the execution of the agreement.

2.58 In principle, such debt relief is to be avoided. Debt relief can encourage municipalities to continue to engage in reckless fiscal behavior, in the expectation of further debt relief to come. Because this specific agreement includes a *quid pro quo*—municipalities must pay off some arrears from their own resources in order to obtain debt relief funds--the signal it send to municipalities is qualified: debt relief is available but only at a price. The Government will nevertheless have to firmly enforce the terms of the agreement to ensure that this 'price' is in fact exacted.

2.59 Given the Government's monopoly on the administration of taxes, it is in a strong position to enforce a hard budget constraint on local govenments. If a municipality fails to pay the PIT on its staff, for example, the STI could deduct a corresponding amount from the PIT collected from private firms within that jurisdiction. As a lender, the Government is also in a position to refrain from making new loans to municipalities that are in default on old ones. Loans to finance teachers' vacation pay could be withheld from municipalities that have failed to amortize their previous loans. It should do so.

2.60 **Limit commercial borrowing.** In principle, deficit financing from private sources should be self-limiting. Suppliers would be expected to cease supplying if they are unpaid. Commercial banks would be expected to stop lending to municipalities that are in default on their loans. To an extent, these mechansims appear to be operating. But experience suggests that private lenders will continue to extend credit if they have a reasonable expectation of an eventual Government bailout.

2.61 Two factors raise such a risk.[20] First, the Government is intimately involved in the finances of the municipalities. As noted earlier, it collects all tax revenues on their behalf, and regulates the main items of municipal expenditures. It also regulates municipal borrowing. As a result, the Government may be perceived to be ultimately responsible for municipalities' fiscal performance—and their debt. Second, the Government has already established a track record of municipal debt relief, through its recent rescheduling of arrears. Thus a precedent has already been set.

2.62 These perceptions would not matter if they were confined to the municipalities alone. Municipalities cannot borrow if no one is willing to lend to them. But there is a risk that lenders, too, may perceive an implicit Government guarantee behind all municipal credit operations. Even where no explicit Government guarantee is provided, lenders may perceive that the Government stands ready to come to the relief of any municipality that has difficulty servicing its debt. Under these conditions, banks are likely to lend more to municipalities than they expect the municipalities to repay.

2.63 For the banks, this is clearly a gamble. Current laws on debt recovery appear to favor municipal borrowers, limiting banks' ability to recover from their borrowers. Although the civil code and other laws allow a lender to attach the revenues of a defaulting municipality, the law contains an escape clause: if garnishing revenues would have an 'adverse social impact', the lender can be required to reschedule the debt. (Vilnius Bank, for example is currently extending the maturity of one of its major municipal loans and is in the process of getting extension on a Government guarantee). Lenders also have the authority to seize the liquid assets of municipalities in default. This has little practical use, however, since the volume of such assets is often small and other claims, such as salaries--may have political priority. Faced with a choice between angry bankers and angry teachers, the Government may resort to a third option: debt relief.

[20] A full discussion of the policy issues in development subnational debt markets can be found in World Bank and IMF, *Development Government Bond Markets: A Handbook*, (Washington: 2001), pp. 323-349.

2.64 Pressure for debt relief could be particularly marked if a wave of municipal defaults threatened the banking sector itself. As yet, municipal debt does not constitute a major component of banking assets. As shown in Table 2.11, municipal obligations comprised 5.4 percent of the total debt assets of the commercial banking sector in 2000. If this proportion were to increase, bank pressure for Government relief in the event of widespread municipal defaults might increase as well.[21]

Table 2.11: Share of Local Governments in Commercial Banking

	1997	1998	1999	2000
Total LT loans / Total debt stock	41.12%	54.08%	56.70%	61.90%
Total LG loans / Total debt stock	1.21%	2.41%	4.28%	5.40%
LT loans to LGs / total LT loans	0.68%	3.75%	5.57%	5.98%
LT loans to LGs / Total debt stock	0.28%	2.03%	3.16%	3.70%
LT loans to LGs/Total loans to LGs	77%	16%	26%	32%

Source: Bank of Lithuania, Database statistic

2.65 **Toughen Regulation** There are several measures that can be taken to reduce this risk. One is to tighten borrowing controls. Lithuania already imposes a series of controls on municipal debt, illustrated in Table 2.12. But there are two problems with the existing system. One is that exceptions can be granted. In one case an exception was made to allow a loan for a wastewater treatment plan, raising the total debt stock ratio to 42.2 percent and annual net borrowing ratio to 18.7 percent.[22]

Table 2.12: Statutory Debt Limits

Ratio	1998	2001	2002
Total Debt Stock:Total Revenues	20%	25%	35%
(Vilnius Municipality)	30%	35%	50%
Annual Net Borrowing:Total Revenues	10%	15%	20%
o/w: Short Term Debt:Total Revenues	5%	10%	10%
Annual Debt Service:Total Revenues	10%	15%	20%
Approval to Exceed Limits	Ministry of Finance	Gov't Decree[1/]	Gov't Decree[1/]

1/ Allowed for projects in the PIP only.
Source: Government Decree No. 511 (28/4/98) and Article 8 of Law on Confirming State and Municipal Budget Financial Indicators for 2001 and 2002 (No. IX-89 19/12/00 and No. IX-643 13/12/01, respectively)

2.66 The second is that the indicators used to measure creditworthiness fail to do so. As shown in Table 2.12, the existing regulations use three ratios to measure creditworthiness: the outstanding debt stock, gross new borrowing, and annual debt servicing requirements. In all three cases, the denominator is revenues. This is highly misleading. Two factors determine a borrower's ability to pay debt service. One of them is revenues, as the existing ratios provide. But the other is fixed expenditure obligations. Debt service on new loans competes with other expenditure claims, many of which are inflexible. Municipalities cannot easily divert money from salaries, welfare obligations, or existing debt service to service new loans. The use of revenue as the denominator implicit assumes that all revenues are potential available. In fact they are not.

[21] Additionally, the stock of municipally-guaranteed long term debt, other than state onlending, comprises about 15 percent of total claims on non-financial public enterprises by commercial banks. Based on municipal debt and guarantee statistics provided by the Ministry of Finance and a consolidated balance sheet of credit institutions from the statistics database of the Bank of Lithuania.

[22] See Decree No. 534, Government of Lithuania (May 9, 2001). 'Revenues' excludes Government transfers for delegated functions, including the 'education basket', which comprise about half of local government revenues under the new budget classification system put in place in 2002. This has sharply lowered the ceiling of permissible borrowing.

2.67 A more prudent denominator would be the current account surplus—the difference between recurrent revenues and recurrent expenditures. (This presupposes that current expenditures are fixed and capital expenditures flexible). The surplus is an indicator of the amount of discretionary revenues available to service debt. It is not advisable to commit all the surplus to debt service. Instead, regulations should require municipalities maintain a cushion of discretionary resources, which could be diverted to debt service (or other current spending) in the event of a downturn in tax receipts. This would have a dramatic effect on the level of borrowing permitted under regulation. At the current borrowing limits, municipal debt stock would be allowed to reach about LTL 800 million[23], sixty percent above the current level (excluding arrears). If debt capacity were based on a debt service coverage ratio (i.e., the ratio of the current surplus to debt service) of 2:1, the ceiling would be about LTL 220 million, nearly one quarter of that.[24] (Note that the 2002 reforms will already reduce the debt ceilings substantially. Because 55 percent of the municipalities' current share of the PIT will be retained by the Government, the 'revenue' figure on which the ceilings are based will be cut drastically. Government transfers to fund delegated functions will not be considered "revenues". While the ceilings on borrowing were raised to compensate for this reduction in revenues, the percentage increase in the debt ceilings is far less than the percentage reduction in revenues).

Box 2.4: Additional Debt Reporting Requirements

In theory, it might make sense to impose certain additional conditions on municipal borrowing. [25] In addition to meeting borrowing limits as discussed above, the preconditions for borrowing could include: (i) a requirement that the municipality has reviewed its debt service capacity, the impact of the investment on operating expenses and capital budgets; (ii) a requirement for the municipality to have a written debt policy that identifies how much debt it plans to take and for what purposes; (iii) a requirement that the municipality have a strategic capital investment program in place, which identifies priorities and a plan of how to finance them. It might also include a requirement for public consultation.

The effectiveness of such administrative requirement is questionable however. In other countries, such requirements quickly become pro forma exercises (when they performed at all) and do not effectively improve project selection or reduce the risk of excessive borrowing

2.68 The Government should maintain tough regulation on the *supply* of credit. Currently, the Bank of Lithuania (BoL) assigns a 50 percent risk weighting to municipal loans when calculating commercial banks' capital adequacy ratios. This is the maximum recommended by the Basle capital accord. It should be maintained.

2.69 The Government should also maintain a prohibition on foreign borrowing by municipalities. International capital markets are not adept at distinguishing between the default of a subnational borrower and the default of its national government. Default by a Lithuanian

[23] Figure is based on revenues in 2000 and reflects the debt:revenue ceiling only. The debt service:revenue ratio would not be a binding constraint at prevailing maturities and interest rates. LTL 800 million, financed for five years at 7% interest would generate debt service equal to only six percent of revenues.

[24] Note that using an aggregate figure understates municipal debt capacity, since the debt capacity of municipalities with current deficits is zero, not a negative number.

[25] Adopted from Glasser, Matthew and Jokay, Charles, *Advisory Note on Regulatory Framework and Institutional Issues: Municipal Borrowing in Bosnia and Herzegovina* (RTI, Mimeo, January 2000), p. 25.

municipality on a Eurobond, for example, could harm the reputation of the Government in international credit markets, raising the risk premium on its external debt. Some municipalities may use this to their advantage, "blackmailing" the Government into providing debt relief as the price of maintaining its reputation in international markets. The Government should not give them this opportunity.

2.70 Overall, the conditions for imposing a hard budget constraint are better than they once were. Most of the short term debt to commercial banks was run up when the banks were in Government hands. They have now been privatized. Private bankers may take a harder line. More importantly, conditions for EU accession will require Lithuania to meet tough fiscal performance standards. This gives the Government a strong incentive to insist upon adequate fiscal performance by the municipalities so as to avoid the ad hoc grants and bailouts that the Government would have to finance through new borrowing.

2.71 Ultimately, the key to reducing demands for Government debt relief is to refrain from providing it in the first place. This will require sustained political will on the part of the Government. Despite pressures from banks, unpaid teachers, or failing water companies, the Government will have to scrupulously avoid bailing out local governments that have difficulty servicing their debt. One way to forestall such pressures would be an explicit disavowal of central government responsibility for municipal debt, through legislation. But this is only credible if it is carried out. Experience suggests that a simple 'no-bail-out' declaration is insufficient to remove the perception of an implicit Government guarantee. Instead, the Government will have to demonstrate through its actions that it is no longer willing to come to the aid of municipalities that have over borrowed or the lenders that have extended them credit, by standing aside and forcing borrowers and creditor to work out a solution on their own. [26]

2.72 To facilitate this, the Government may wish to consider adopting a municipal bankruptcy law. This would provide an orderly procedure for addressing municipal defaults, forestalling the breakdown in public services that might force the Government's hand.

2.73 In this respect, the Hungarian experience may be instructive.[27] Under the Hungarian Law on Municipal Debt Adjustment in 1996, a mayor must notify the city council and petition the court for bankruptcy eight days after the municipality is 60 days past due on a payment to a creditor, vendor or another party. If the court agrees that the municipality is insolvent, it declares the commencement of the bankruptcy process and appoints a trustee. The declaration of bankruptcy provides a moratorium on debt payment and creditor law suits. As a *quid pro quo*, it is accompanied by a variety of obligations imposed on the mayor, city council and actions to be taken by the creditors—one of which is adoption of an austere municipal budget providing only for mandatory services spelled out in the law. The trustee clears all payments of the municipality during the process and determines if any civil or criminal actions need to be taken by the court. If the emergency budget, reorganization plan, and workout plan are not passed by the city

[26] One way to make the process less painful (and therefore more likely to occur) is municipal bankruptcy which would lay out the procedures for allocating losses from unpayable debts among creditors and taxpayers.

[27] The case study and analysis of the Hungarian Municipal Bankruptcy legislation is taken from Charles Jokay, Gabor Szepesi, and Gyorgy Szmetana, "Municipal Bankruptcy in Debt Management: Hungary's Experiences 1996-2000," in Mihaly Kopanyi, Samir El Daher,and Deborah Wetzel, *Hungary: Subnational Modernization Challenges,* World Bank Institute , Forthcoming Summer 2002.

council within 30 days, the trustee can recommend to the court that the process move to asset liquidation. Under these conditions, the trustee takes political control the municipality and can veto decisions of the mayor and the council. If a workout agreement is not reached within 220 days, the trustee is authorized to impose an asset and debt adjustment plan of his own.

2.74 In its first four years of implementation, the law has been used successfully but sparingly. Only 11 of Hungary's 3,200 municipalities have filed bankruptcy petitions. [28] Were such an approach to be adopted in Lithuania, several politically sensitive issues would need to be addressed, including the Constitutional authority of the court (acting through the trustee) to impose budget cuts, tax increases, and asset sales on behalf of local governments. Practical obstacles may also intercede. It is not clear that municipal assets are sufficiently liquid to permit them to be used to reduce debt.

2.75 **Observe Commitments** The Government's imposition of a hard budget constraint will not be credible if the Government itself reneges on its legal obligations to local government. The 2002 reform shifts a part of the financial responsibility for municipal services onto the Government. Budget pressures could prompt the Government to cut funding for these delegated functions. This would not be unprecedented. (After Chile introduced an 'education basket' in the 1980s, the government sharply cut the per-pupil stipend in response to a national recession.) Although the reform law requires the Government to compensate municipalities for any Government-initiated increases in costs (such as increases in the minimum wage), it is not clear that this stipulation will be observed in practice. If the Government reneges on its commitments, it will be in a poor position to insist that the municipalities honor theirs'.

[28] This may understate the impact of the law. One study of the Hungarian experience study suggests that many municipalities teetering on bankruptcy have reached "preemptive" agreements with creditors to avoid bankruptcy proceedings. Charles Jokay, Gabor Szepesi, and Gyorgy Szmetana, "Municipal Bankruptcy in Debe Management: Hungary's Experiences 1996-2000," in Mihaly Kopanyi, Samir El Daher,and Deborah Wetzel, *Hungary: Subnational Modernization Challenges,* World Bank Institute , Forthcoming Summer 2002.

3. FINANCING CAPITAL INVESTMENT

3.1 Municipal governments bear responsibility for a variety of services with major capital works implications. Some—such as district heating, water supply, and sewerage--are provided by wholly-owned municipal enterprises. Others are provided by the municipality itself: roads, public lighting, schools, retirement homes. While the Government will take responsibility for the current cost implications of several important functions in the 2002 budget reform, capital expenditures will remain a municipal responsibility in the provision of all public services with the exception of health.[29]

3.2 The infrastructure municipalities manage is characterized by low quality and high running and capital costs. The facilities they inherited were built prior to the opening of the Lithuanian economy in the 1990s. "Poor standards of original design and construction, high energy requirements of equipment used, major changes in demand patterns and institutional weaknesses in the organizations responsible for infrastructure have combined to further increase costs and lower service quality."[30] The inefficiencies of municipal infrastructure are compounded by deferred maintenance. With declining current savings, municipalities have reduced capital expenditures to a level that it is safe to assume is below depreciation. With deteriorating quality and provision of services, consumers respond by not paying their bills or switching to substitutes that may not be economically efficient in the long run. In cases where services are provided by a going concern, the declining customer base has threatened the viability of the municipal enterprises as they struggle to cover high fixed costs with declining revenues.

3.3 **District heating** The district heating sector was reorganized in July 1997 into six regional district heating utilities and 10 district heating companies.[31] The shares of these companies were transferred to municipalities. Prior to 1997 district heat operated under the state-owned Lithuania Power Company (LPC). In 1998 another reorganization allowed for the separation of regional district heating into smaller units. As a result 44 municipally-owned district heating companies operate in Lithuania.[32] Only one regional district heating company remains (Panevezys District Heating Utility). These heating companies employ about 7,600

[29] Article 6 (independent functions), 7 (assigned, partially independent functions), 8 (functions delegated by the state), Article 10 (Rendering Public Services), Law on Local Self Government (No. VIII-2018, as amended, October 12, 2000). Note that payments for operating expenses of the building such as heating and water supply are not covered by the targeted subsidy

[30] World Bank Report, "Living by Serving: Infrastructure Sector Strategy – New Directions for Transition Economies" (Washington, September 1998), p. 1.

[31] See Law on Reorganization of the Special Purpose Joint-stock company "Lietuvos Energija" and the Assignment of the Heating System and its Management to Municipalities (No. VIII-182, April 8, 1997).

[32] Association of District Heating Companies in Lithuania, December 7, 2001.

persons (0.5 percent of total employed, 2 percent of total employed in public sector) and generated an annual turnover of LTL 1 billion in 2000, or 32 percent of total ordinary municipal revenues in 2000. They provide heat to about 1.5 million consumers (42 percent of total population) and 70 percent of the heat generated is sold to residents of multifamily apartment buildings.[33]

Box 3.1: Utility Tariff Policies

In principal, adjustments to utility tariffs could provide the resources needed to fund Government-mandated utility and transport subsidies, or to contribute toward capital investment costs. Although municipalities have more control over public utility tariffs than they have over taxes, their ability to raise rates is not unlimited. District heat tariffs are set by municipal councils upon the approval of the National Control Commission for Prices and Energy. The Commission is an independent body which sets energy pricing principles, approves price calculation methodologies and coordinates prices with suppliers of electricity. Charges for water supply and sewerage are also subject to Commission approval. Charges for bus transport are regulated by each municipality. Although the Government requires municipalities to offer a subsidized tariff for low income customers, the subsidy is specified as a percent of the normal tariff, not as an absolute amount.

Municipalities are reluctant to exploit this possibility, citing customer resistance and the impact high tariffs might have on potential investors. Political pressures have resulted in tariffs that are insufficient to cover operating costs. In one case, the Commission agreed to a request from a municipal council prior to elections for a tariff of 11.25 cents/kWh or 8 percent below the 12.27 cents/kWh cost price for heat delivered in that municipality. The newly elected council reapplied for a 12.51 cents/kWh tariff in the same year to cover the companies losses. In another case, a municipal council filed a request for a tariff of 12.84 cents/kWh, or a 23 percent increase from the previous tariff. This was the first such request after nearly three years of having the tariff set at 10.44 cents/kWh. The district heat utility has been operating at a loss at the lower tariff.

Source: National Control Commission for Prices and Energy, Annual Report 2000 (Vilnius: March 2001)

3.4 The district heating sector is characterized by an inefficient heat delivery system and a lack of management and governance capability in its new owners. The combination of high technical losses together with an energy inefficient residential and commercial building stock reduces the quality of heat consumed by the customer. While prices have gone up, quality has not improved. This has decreased customers' willingness to pay and as a result arrears have increased. Disconnections from the district heat network also have increased due to competition from natural gas and other alternative sources of space heating.[34] Thus, the technical and commercial losses deprive these companies of the funds to make needed capital investments. The continued disinvestments of unprofitable sections of the network by the regional utilities have left several utilities not viable. When the Vilnius regional district heating utility optimized its network and organized smaller utilities in peripheral areas, for example, the average price for these smaller utilities jumped by 40 percent in 2000.[35] The slim margins have also left the sector more vulnerable to fuel price volatility and climactic conditions. In particular, smaller utilities

[33] Association of District Heating Companies in Lithuania, December 7, 2001.
[34] National Control Commission for Prices and Energy, *Annual Report 2000* (Vilnius: March 2001), p. 21.
[35] National Control Commission for Prices and Energy, *Annual Report 2000* (Vilnius: March 2001), p. 20.

have a more difficult time of switching to cheaper fuel products due to poor technologies and capacity issues.[36]

3.5 Private capital is starting to emerge as a new source of capital investment financing in district heating. A foreign joint venture and another Lithuanian company have signed leases for 10 district heat utilities.[37] Another foreign firm is establishing new joint ventures with district heating companies, acquiring 51 percent of the venture and thereby taking over management and responsibilities for capital investment.[38] Thus far five joint ventures have been set up.[39] However, smaller utilities that have constraints on economies of scale are still unable to find the capital to upgrade to more efficient technologies of heat supply.

3.6 **Water, wastewater and sewerage** Water, wastewater and sewerage treatment facilities are owned and operated by municipal enterprises. Up to 1991, potable water supply and wastewater collection and treatment were managed by 14 regional state owned companies.[40] By 1999, municipalities owned and managed 42 water service companies in Lithuania. (See Table 3.1). It is estimated that they provide 67 percent of the population with centralized water supply and sewerage services.[41] As is common in other transition economies, water consumption in Lithuania has been steadily declining. This causes revenue gaps that barely, if at all, cover fixed costs of largely over-scaled facilities. Estimated results for the largest water utilities in 2000 showed revenues of LTL 293 million (9 percent of ordinary municipal revenues) and costs of LTL 315 million (10 percent of ordinary municipal expenditures), that is result showed a loss of LTL 23 million.[42] The Ministry of Environment estimates it would take about LTL 720 million to improve water supply services beyond those investments required to fulfill EU directives.[43] Implementing the drinking water directive will cost an additional LTL 80 million by 2004.[44] The strategy of the Government is to implement a river basin management approach to water treatment and in order to do so merge municipal water utilities according to river basins or some larger amalgamation.[45] To date there have been no private sector management contracts or other form of private sector participation in these facilities.[46]

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[36] National Control Commission for Prices and Energy, *Annual Report 2000* (Vilnius: March 2001), p. 25.
[37] Housing and Urban Development Foundation information, December 2001.
[38] National Control Commission for Prices and Energy, *Annual Report 2000* (Vilnius: March 2001), p. 20.
[39] Housing and Urban Development Foundation information, December 2001.
[40] Ministry of Environment, "National ISPA Strategy: Environmental Sector Draft Working Paper", (mimeo. October 1999), p.17.
[41] International Development Goal Data Series, World Bank, UNESCO, WHO, National statistical office, 1999.
[42] National Control Commission for Prices and Energy, *Annual Report 2000* (Vilnius: March 2001), p. 29.
[43] Ministry of Environment, "National ISPA Strategy: Environmental Sector Draft Working Paper", (mimeo. October 1999), also interview with Inesis Kiskis, Environmental Program Team Leader, World Bank.
[44] Government of the Republic of Lithuania, *Pre-Accession Economic Program of the Republic of Lithuania* (Vilnius: September 2000), p. 66.
[45] Government of the Republic of Lithuania, *Pre-Accession Economic Program of the Republic of Lithuania* (Vilnius: September 2000), p. 66. The Ministry of Environment has also commissioned a study on amalgamation, private sector participation, and EU accession requirements.
[46] However, as lease contracts are appearing in the District Heating sector there is a likelihood that some form of private sector participation will be considered for the water sector. The Ministry of Environmental Protection is discussing a potential study on the regulatory aspects of private sector participation with the World Bank.

Table 3.1: Ownership Structure of Municipal Water Companies

No. of municipalities	1	2	3+
No. of companies	34	5	3

3.7 Wastewater treatment in particular poses a huge challenge. "The total volume of wastewater requiring treatment in 1998 was 217 million cubic meters. Of this amount, 117 million cubic meters (54 percent) was treated to meet Lithuanian effluent standards, 66 million cubic meters (30 percent) was discharged into surface waters without sufficient treatment (mechanical treatment only or cleaned in ineffective biological treatment facilities) and 34 million cubic meters (16 percent) was discharged untreated."[47] The seven largest cities, which make up about 44 percent of the population, produce 67 percent of total discharges.[48] The investment costs of meeting the EU wastewater directive alone amounts to an estimated LTL 1150 million or 2.7 percent of GDP.[49] The Ministry of Environmental Protection highlighted the Directive on Municipal Wastewater Treatment (91/271/EEC) and the Drinking Water Directive (1998/83/EC) as two of the most expensive EU directives for the Government to implement.[50]

3.8 **Solid Waste**. Solid waste management is also operated by municipalities and municipal enterprises. There is about 1 landfill for every 3,500 inhabitants, suggesting a high number of landfills are serving less than 1,000 inhabitants. The Ministry of Environmental Protection estimates that 850 landfills need to be closed in order for the system to be economically feasible and operationally manageable.[51] Another priority is to upgrade the remaining larger landfills and landfill areas to meet EU standards. The investment cost required to meet the Directive on packaging and packaging waste (94/62/EC) and the Landfill directive (1999/31/EC) is estimated to be around LTL 480 million.[52]

3.9 **Urban Roads and Transport**. It is estimated municipalities maintain about 10,000 km of roads. They are responsible for their upkeep, new construction as well as environmental factors such as street cleaning and beautification. Municipalities also are owners of rolling stock – buses and trolleybuses. These transport services are provided by municipal enterprises. The transport networks are also sub-optimal and municipalities find themselves subsidizing several non profitable routes to maintain the current level of service. Some have leased routes out to private providers, but these providers service only the profitable routes. Thus, with reduced revenues, municipally owned bus companies find themselves in financial distress. On top of this, municipalities until 2002 were responsible for providing subsidized fares for various socially supported groups, including school-age and university students, pensioners and invalids.

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[47] Ministry of Environment, "National ISPA Strategy: Environmental Sector Draft Working Paper", (mimeo. October 1999), p.8. Due to the overall decline in water consumption, the figures given may overestimate the total discharge of untreated water.

[48] Ministry of Environment, "National ISPA Strategy: Environmental Sector Draft Working Paper", (mimeo. October 1999), p.19.

[49] Government of the Republic of Lithuania, *Pre-Accession Economic Program of the Republic of Lithuania* (Vilnius: September 2000), p. 66.

[50] Ministry of Environment, "National ISPA Strategy: Environmental Sector Draft Working Paper", (mimeo. October 1999), p.3.

[51] Ministry of Environment, "National ISPA Strategy: Environmental Sector Draft Working Paper", (mimeo. October 1999), p.25.

[52] Government of the Republic of Lithuania, *Pre-Accession Economic Program of the Republic of Lithuania* (Vilnius: September 2000), p. 66.

3.10 **Public Buildings: Health.** The Ministry of Health and municipalities administer investment funds for health facilities. Lithuania has 189 inpatient institutions with 34,145 beds of which 128 institutions, mainly hospitals and polyclinics, with 16,685 beds and 23,360 public employees are founded by municipalities. That is, municipalities are responsible for the upkeep and maintenance of these facilities. Total maintenance costs, including utility bills, comprised LT 13 million or 0.4 percent of total municipal expenditure in 2000. Costs of service provision are funded centrally through specialized patients' funds. Municipalities can at their own expense construct new facilities, but only upon the permission of the Ministry of Health. Practically all capital investment for health care is financed through the Public Investment Program. Thus, distortions in capital investment occur due to the fact that the costs of capital investment are separated from the price of the services.[53] This has proven to be a constraint on the private provision of health care services to those other than in the higher income brackets.

3.11 **Public Buildings: Education.** Although the 2002 reforms will guarantee central government financing for most of the recurrent costs of education, responsibility for maintenance and new construction will remain with the municipalities. In fact, the network optimization resulting from the 'education basket' reform will impose additional capital spending on municipalities in the form of school closures, upgrades and transport purchases.

3.12 **Social Housing and Maintenance.** Municipalities also bear responsibility for maintain much of Lithuania's housing stock. The vast majority of the stock has been privatized. Ninety seven percent of the housing stock is now privately owned. Nevertheless, maintenance of the stock is still largely performed by municipal maintenance companies, most of which provide low quality service at below-cost prices. Municipalities are also responsible for providing below-cost rental units for low income and other socially assisted persons. A total of LTL 20 million was provided for the acquisition or construction of social housing stock between 1998 and 2000. An additional LTL 20 million is planned for 2001.

Current Sources of Financing

3.13 With the decline of municipal current account surpluses, most municipal investment is financed through Government-mediated sources, including multi-lateral and bilateral donor funds (including IBRD, EIB, EBRD, and NIB), as well as the resources of the Government's privatization fund. Lithuanian municipalities have not issued bonds and the legal framework for this source of financing remains yet untested. Other non-recourse or limited recourse project financing schemes are still at an early stage of development for municipal services.[54] Off-budget municipal funds capitalized mainly from sales of municipal assets, rents of public space, or environmental pollution taxes (redistributed by the central authorities) have been used as supplemental financing sources, but these amounts are reported to be small relative to the main "state obtained" sources.

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[53] World Bank Project Appraisal Document *Health Project* (No. 19855-LT. Washington: November 5, 1999).

[54] Privatization as such is being considered for municipal maintenance companies which provide property administration and maintenance services to residential buildings. Also some municipalities are also considering privatization schemes of municipal enterprises providing city services such as street cleaning, park management, etc. A significant new development is the use of management leases of District Heating enterprises to private operators.

3.14 **Public Investment Program Sources.** The majority of Government-mediated sources are allocated through the Public Investment Program (PIP). The PIP incorporates funds from central government general revenues, the central government privatization fund, plus central government on-lending and guaranteed loans. The PIP is divided into 9 categories of recipients. Municipalities are one of these categories. Municipalities accounted for 14 percent of total planned PIP investments in 2001. This understates the amount of investments made within municipal boundaries because investments are recorded according to the agency responsible for implementing the project. For example, several fire stations are included in "companies and organizations" because they are subordinate to the Ministry of Internal Affairs." As shown in Table 3.2, PIP investments in the municipal category have been extremely variable over the last four years, ranging from 125.7 million in 1997 to 237.2 in 1999. The relative contribution of each source has also changed radically over the last four years. Funding from central Government general revenues has largely vanished, to be replaced by allocations from the Government's privatization fund. Onlending of government funds borrowed by the Government has been replaced by direct lending to municipalities with Government guarantees.

Table 3.2: PIP Disbursement for Municipal Projects 1997 – 2000 (in LTL millions)

	1997	1998	1999	2000
Total	125.7	162.3	237.2	160.8
Transfers from Government	61.4	77.4	82.5	67.1
Central Government Budget	61.4	77.4	0.0	2.1
Privatization Fund	0.0	0.0	82.5	65.0
Loans	61.8	67.0	108.3	59.7
State Onlending	61.8	35.4	36.7	7.1
State Guaranteed Loans	0.0	31.6	71.6	52.6
EU and Bilateral Grants[1/]	2.5	17.9	46.4	34.0

Source: Association of Local Authorities and Ministry of Finance
[1]includes miscellaneous other sources

3.15 **IFIs.** Part of the PIP is financed by Government-intermediated loans, both on-lent and guaranteed, provided by international financial institutions: the World Bank (IBRD), the European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB) and Nordic Investment Bank (NIB).[55] In the past four years, these institutions have signed loan agreements totaling Euro 106 million for municipal infrastructure. Three of these institutions (IBRD, EIB and NIB) have opened credit lines for municipal infrastructure of Euro 19 million, Euro 15 million and Euro 20 million, respectively. The EBRD has extended a Euro 17 million equivalent loan to the Kaunas Water Company in 1995.[56] In addition to its municipal credit line, the EIB has extended a Euro 6 million equivalent for Kaunas street upgrading.[57] Likewise, the IBRD has extended loans to water treatment facilities in Siauliai and Klaipeda totaling USD 13.2 million, a geothermal project in Klaipeda totaling 5.9 million, an energy efficiency rehabilitation in schools component totaling USD 5.2 million and provided a USD 4.9 million in a component of a transport project for city road repair and maintenance. Together with its current credit line, the IBRD has committed Euro 53.4 million equivalent for municipal infrastructure investments.

[55] One commercial bank loan has been onlent. Based on the last four years of the PIP, state on-lending or guarantees of non-IFI loans appears to be an exception based on the last four years.
[56] *Annual Report*, EBRD, 1995.
[57] *Annual Report*, EIB, 1999. The EIB extended a Euro 10.0 million loan for the Klaipeda port rehabilitation, but this is considered an investment in national infrastructure for the purposes of this report.

Box 3.2: Municipal Infrastructure Development Program

In 1998, the World Bank and Nordic Investment Bank agreed with the Ministry of Finance to place their credit lines for municipal infrastructure investments under a coordinated framework, operated by the Housing and Urban Development Foundation. The Governments of Denmark, Finland and Sweden provided technical assistance to build up a separately incorporated entity to manage flow of funds, assist municipalities throughout the project cycle and in particular appraise projects to ensure funds are used for economically beneficial projects. The donors also provide investment grant support. In addition to bilateral assistance, this Municipal Infrastructure Development Program is coordinated with EU grant initiatives in particular the ISPA. Thus far, investments have been made in wastewater, urban transport (street lighting) and education. Other eligible sectors are district heating, solid waste, and other urban renewal.

3.16 **EU and Bilateral Grants.** Over the past four years, foreign grants have steadily grown in proportion to other sources of financing in the PIP. Several donor countries provide investment grant financing in the municipal sector, particularly in environment. In addition, EU pre-accession funds since 2000 are becoming a predominant source of capital investment in the environment sector for municipalities. In 2000 84 percent of total foreign grants allocated for projects in the public investment program were for environmental investments. The EU pre-accession grants are deliberately focused on sectors where investment is required to ensure that Lithuania can comply with European environmental standards once it joins the EU, and on improving international transportation corridors. About Euro 25 million is available for environmental infrastructure under the EU Instrument for Structural Policies for Pre-Accession (ISPA). Most of this will be allocated to municipal investments.[58] Another source of financing is through the EC Phare program. It provides grant financing mainly for technical assistance but recently also for investment financing. Relevant eligible sectors are administrative reform and small and medium enterprise development.

3.17 **Road Maintenance and Development Program (Road Program).** The Road Program is an extra budgetary resource for municipal road construction and maintenance. It is managed by the Road Directorate of the Ministry of Transportation and until 2002 operated separately from the PIP process. (Starting in 2002 flows from the Road Fund will be included under the PIP framework.) Road Program allocations cannot be used for purposes other than those prescribed in the Road Maintenance and Development Law, i.e. for road and other transport-related investments.[59] The Road Program provides about 20 percent of total annual outlays for municipal road maintenance and construction. The Road Program Fund was financed from charges assessed through other transport taxes and, therefore, annual outlays depended on previous years' disbursements and collections, and was not included in the general Government Budget. Beginning in 2002,

Table 3.3: Road Fund Outlays to Municipalities (LTL millions)

	Total Road Fund	Municipalities[1/]
1998	683	137
1999	746	149
2000	527	105
2001	538	108

Source Government Decrees and Road Fund Law (2000)

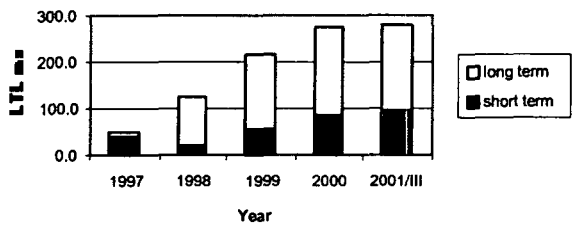
[1/] Local (municipal), forest and national park roads receive 20 percent of total planned receipts annually by law. 2001 figures represent new allocation system which makes allocations to municipalities more explicit. 19.2 percent is the set proportion for municipalities under the new system.

[58] Another Euro 25 million is available for transport. While most transport investments will be made for upgrading the *national* transport system, environmental investments will involve mainly municipal capital investments. Note that in the past the EU's Large Scale Infrastructure Facility program provided investment grant financing for mainly environmental projects in urban areas. See Republic of Lithuania, *National ISPA Strategy: Environmental Sector, draft Working Paper* (Vilnius: October 1999), p.3.

[59] Road Maintenance and Development Law (No. VIII-2032, October 12, 2000).

the Road Program has been incorporated in the General Budget, and is financed from general Government revenue. Road Program outlays to municipalities reached a peak of LTL 149 million in 1999 and then declined to LTL 108 million in 2001 (Table 3.3).

Figure 3.1: Commercial Bank Lending to Municipalities



3.18 **Commercial Loans** As noted earlier, commercial banks are a significant source of finance for local governments. The stock of commercial bank general obligation lending to municipalities totaled LTL 282 million in October 2001. Two thirds of this consisted of loans with maturities of over one year. Most of growth in commercial lending occurred in the late 1990s, when the majority of commercial banks were still owned by the Government. As shown in the chart below, the stock commercial debt increased from LTL 50 million in January 1998 to LTL 213 million in January 2000. Since the banks have been privatized, the growth rate has tapered off. Between January 2000 and October 2001, the stock of outstanding loans to municipalities increased by only LTL 69 million. (Due to data constraints, the maturities of this debt and the proportion of it that was explicitly used to finance capital works is unknown). While the growth rate of general obligation lending has slowed, some banks have started to lend to revenue-generating projects, particularly for district heating.[60] In 2000, a Bank of Lithuania statement reported loans to non-financial state and municipal enterprises recorded the fastest growth in lending, jumping to 17 percent of total loans granted from 14.5 percent in the previous year.[61]

3.19 **Other Sources.** Lithuanian municipalities have not issued bonds and the legal framework for this source of financing remains yet untested. Other non-recourse or limited recourse project financing schemes are still at an early stage of development for municipal services. Off-budget municipal funds capitalized mainly from sales of municipal assets, rents of public space, or environmental pollution penalties (redistributed by the central authorities) have been used as supplemental financing sources. While these amounts are nowhere aggregated, it is generally accepted that they are small relative to the main capital financing sources. Investment financing from privatization concessionaires is also only at an initial stage. As noted above, private firms are already operating some district heating concessions. Privatization is being considered for municipal maintenance companies which provide property administration and maintenance services to residential buildings.

[60] Interviews with World Bank mission, November 2001.

[61] News Release, "Credit Institution Operations in 2000", Bank of Lithuania (January 30, 2001). Note that this may be a skewed view as it also includes lending to the social security fund, (SODRA), which alone comprises about 5 percent of the portfolio. Unfortunately, neither the Ministry of Finance nor the Bank of Lithuania disaggregate this category further to provide details on lending to municipal enterprises.

Issue 1: Donor Terms and Government Vetting Process

3.20 The fiscal straightjacket that applies to current financing also applies to the financing of capital investment. To the extent that local priorities differ from national ones, projects of local interest have difficulty finding financing. The system of project selection is largely determined by the priorities of the National Government. In the past few years as the Government prepared for EU accession, it has steered new projects toward maximizing the use of EU grant funds. The Order of the Minister of Finance (Nr. 201 of the Government of Lithuania, dated July 4, 2001) lists the PIP priorities in order of importance (i) EU financed projects and NATO related; (ii) emergency reconstruction; (iii) projects tied to decisions of Seimas or Government; (iv) projects tied to obligations under legal acts and are partially state funded; (v) projects that could be completed in 2002; (vi) uncompleted projects (previously financed from state funds).[62] In reality state-obtained funds appear to focus on projects that have been identified for EU pre-accession funds. These projects in turn consume not only the EU funds but also discretionary resources of the Government. The EU funds require between 25-50 percent of counterpart contributions. As a result, the government uses its discretionary capital financing resources (including borrowing and proceeds from the privatization fund) to match these financing gaps.

Table 3.4: Correspondence of Pre-Accession funding and Municipal Responsibilities

Municipal Functions	Pre-Accession Fund Eligibility
Heat and Hot Water	Not Eligible
Water and Wastewater	Eligible (ISPA)
Solid Waste	Eligible (ISPA)
Public Buildings	Not Eligible
Rural Infrastructure	Eligible (SAPARD)
Urban Roads	Not Eligible
Urban transport	Not Eligible

3.21 While there is some correspondence between the sectors eligible for pre-accession funds and the sectoral responsibilities of municipalities, it is far from complete. Table 3.4 compares EU pre-accession funding eligibility (excluding Phare) with municipal functions requiring capital expenditures. As shown, three major municipal responsibilities--district heating and educational and health facilities--do not fall within the list of Pre-accession fund eligibility. (In addition, ISPA has a minimum project size requirement that is above the size of most of the subprojects put forward by small municipalities. Recently, "packaging" of smaller subprojects has been approved which could help to reduce favoring larger municipalities).[63]

3.22 Table 3.5 provides a breakdown of planned PIP resource allocations for municipalities by sector in 2000. As shown, roughly half the resources go to water and sewerage. Education receives only six percent; district heating, two percent. Sectors that are not eligible require additional efforts by municipalities to access state-obtained funds.[64] In theory, municipalities could use their own current account savings to finance local priorities. But, but as noted earlier, the present level of current savings is extremely low. Likewise, municipal enterprises are not in a

[62] Order of Minister of Finance *Confirming Public Investment Planning Methodology*, No. 201, dated July 4, 2001.

[63] It is important to note that upon acceding to the EU, Lithuania will be able to access funds from the Regional Development Fund, an EU Structural Fund, that is able fund local initiatives and other projects that currently are not favored by the system.

[64] The exception is the urban road sector which obtains approximately $50 million per annum for urban road construction and maintenance. The Road Fund is allocated by law according to norms, but is disbursed centrally by the National Road Directorate and not by municipalities.

position to finance new investment out of current savings, due to their weak financial position. Under these circumstances, mayors have difficulty matching financing to local priorities.

3.23 There are also problems in the vetting process itself. The PIP preparation process in a given year consists of two sets of reviews.[65] The first reviews candidate projects for inclusion in the PIP. The second reviews projects for financing with state obtained loan funds. Under the first review, candidate projects are submitted by municipalities formally to the Ministry of Finance--but only after they are reviewed and agreed upon by line ministries.[66] After projects are selected, the Ministry of Finance reviews the availability of financing. The financing envelope is determined by fiscal deficit targets as well as investment targets for strategic sectors which the Ministry of Economy develops with inputs from line ministries.[67] If projects require foreign loans they are reviewed by a State Foreign Loan Committee. If the project is accepted, a Government Decree is issued for each loan guaranteed or on-lent by the Government to a municipality.[68]

Table 3.5: Public Investment Program for Municipal Investments by Sector and Source of Funds, Plan 2000 (Percent of total by source)

		Transfers and Grants			Loans		
	Own Resources	State Budget	Privatization Fund	Foreign Grants	State Guaranteed Loans	State Onlending	Total
Total	100%	100%	100%	100%	100%	100%	100%
Agriculture	0%	0%	0%	0%	30%	0%	11%
Culture	0%	100%	6%	11%	12%	0%	8%
District Heat	0%	0%	0%	1%	1%	9%	2%
Education	50%	0%	21%	5%	0%	0%	6%
Environment	50%	0%	48%	84%	51%	48%	56%
Water	0%	0%	2%	9%	22%	15%	14%
Wastewater	0%	0%	43%	67%	26%	18%	35%
Solid Waste	50%	0%	3%	8%	3%	0%	4%
Health	0%	0%	25%	0%	1%	0%	6%
Transport	0%	0%	0%	0%	0%	15%	3%
Other	0%	0%	1%	0%	5%	27%	8%
SME	0%	0%	0%	0%	1%	27%	6%

[65] See, *Decree on Public Investment, Planning, Adjustment, Use, Accounting and Control, Nr. 478, dated June 26, 2001; Order of Minister of Finance Confirming Public Investment Planning Methodology, No. 201, dated July 4, 2001; Decree on the Distribution of Capital Investments to Assignment Managers and Investment Projects for 2001 in the Public Investment Program 2001-2003, Nr. 359, dated March 30, 2001 and amended in Decree Nr. 1090, dated September 12, 2001.* Note Decree No. 478 is recommended, but not mandatory, for projects financed from municipal own-source revenues.

[66] Government of the Republic of Lithuania, *Decree on Public Investment, Planning, Adjustment, Use, Accounting and Control,* (No. 478, June 26, 2001), Annex "Procedures to be followed in Planning, Adjusting, Using, Accounting for and Controlling Public Funds Allocated for Public Capital Investments", paragraphs 8, 10 and 11.

[67] This is the new procedure as of April 26, 2001 under Government Decree No. 478. In the past, the Ministry of Economy played the central role of vetting projects with line ministries and coordinating with the Ministry of Finance on financing questions. The responsibility for preparing the Public Investment Program was passed to the Ministry of Finance in 2000.

[68] Government of the Republic of Lithuania, *Decree on Public Investment, Planning, Adjustment, Use, Accounting and Control,* (No. 478, June 26, 2001), Annex "Procedures to be followed in Planning, Adjusting, Using, Accounting for and Controlling Public Funds Allocated for Public Capital Investments", paragraphs 8, 10 and 11.

3.24 The process of project preparation and evaluation provides ample opportunity for political input – for good or ill. As shown in Table 3.6, the average time for a project to be go from the initial preparation phase to the signing of contracts for major works is over two years.[69] Of these 25 months, 11.5 months involve external or internal approval procedures after appraisal. (This excludes the initial time it takes municipalities to identify donor financing or mobilize other resources to identify and prepare feasibility studies for their infrastructure projects). While this table provides the experience of a subset of projects managed through the Municipal Development Project (see paragraph 93), it is said to be generally true that the entire project cycle—from identification through implementation—takes too long.

Table 3.6 PIP Project Cycle for Projects Financed with Government- Obtained Loans (Municipal Development Project)*

Step	Primary Responsibility	Months
Preparation of Feasibility Study	Municipality	7
Appraisal	Line Ministry/MoF	3
External Source Approval	IFIs, EU, Donors, Commercial Banks	1.5
Investment Project Expert Commission Approval	Inter-ministry	1
State Foreign Loan Committee Approval	MoF	1
Government Decree	Government	2
Sub-loan Signing	MoF	6
Signature of Major Works/Goods Contract	Municipality	4
Average from Receipt of Proposal to Signature of Contract		25.5

Source: Housing and Urban Development Foundation, Mid-term Review, November 2001
* Average time to complete step in the process under the Municipal Infrastructure Development Program

3.25 Although attempts have been made to increase the technical content of the selection process, Government political priorities appear to prevail. Order No. 201 sets out guidelines for project preparation, namely setting out how projects that fit within national priorities would be selected.[70] Paragraph 30 attaches priority to those municipal projects which (i) contain at least 20 percent of own resources (including borrowed or from other sources); (ii) reduce operating expenditures or (iii) create new jobs. The Order also sets out how municipalities are to look at their investment: they are to present a situation analysis, tying in their plan to national and municipal development priorities, a capital expenditure and maintenance plan for the new investment, a cost/benefit analysis, sensitivity analysis, procurement and disbursement plan, and it asks the municipality to calculate the net present value of the investment. The EU accession process has helped to improve linkages between official criteria and selection.[71] It is said that municipalities can nevertheless improve their chances of obtaining state funding by directly approaching the Government and the Parliament.[72]

[69] Some PIP projects were transferred to the MDP from another agency. Therefore, the numbers are not meant to represent any criticism of the MDP and its implementing agency.
[70] Ministry of Finance, *Order of Minister of Finance Confirming Public Investment Planning Methodology* (No. 201, dated July 4, 2001), Parts II – VIII and Annexes 3-12.
[71] For example, the Ministry of Environment is finalizing a series of papers which outline the rationale, priorities and financing strategies for high priority investments in the environment sector.
[72] Decree Nr. 201, dated July 4, 2001 (see above). Although paragraph 19 lists priorities as summarized above, paragraph 20 clarifies that the order of priorities for projects may be changed by decisions of the Seimas or the Government.

Issue 2: Stop-and-Go Disbursements

3.26 Once a project is selected, it has no assurance of timely financing. Although the PIP is designed as a triennial investment program, funding allocations are made annually through the process outlined above. PIP project managers are allowed to sign contracts for either partial works or for the entire activity schedule.[73] Funding, however, may be conditional upon the proceeds of specific revenues sources, such as privatization receipts.

Table 3.6 Public Investment Program for Municipal Investments by Sector and Implementation Record 2000 Actual

	Plan	% Total	Paid	% Total	Work Completed	% Total
Total	354,398		160,690		140,125	
Agriculture	38,000	11%	0	0%	0	0%
Culture	29,360	8%	8,850	6%	7,919	6%
District Heat	8,640	2%	6,440	4%	2,054	1%
Education	20,660	6%	17,561	11%	15,716	11%
Environment	196,932	56%	91,156	57%	80,594	58%
o/w: Water	48,020	14%	5,315	3%	8,471	6%
Wastewater	124,722	35%	72,414	45%	65,946	47%
Solid Waste	12,490	4%	1,739	1%	1,727	1%
Coastal	11,700	3%	11,688	7%	4,450	3%
Health	20,992	6%	19,509	12%	16,668	12%
Transport	12,200	3%	16,753	10%	16,753	12%
Other	27,614	8%	421	0%	421	0%
o/w: SME	22,006	6%	0	0%	0	0%
Power	140	0%	140	0%	140	0%
Safety	358	0%	281	0%	281	0%
Other	5,110	1%	0	0%	0	0%

3.27 As a result, project financing in a given year depends less on the disbursement plan and more on the availability of funds. Project implementation therefore proceeds on a stop-and-go basis, halting when funding runs out and resuming when it becomes available. This is evident in the gap between planned and actual disbursements in the PIP. As shown in Table 3.6, in 2000 less than half of total planned outlays were implemented and paid. These delays can drive up the costs of public works significantly, as municipalities are forced to compensate contractors for mobilization and demobilization, and pay interest and security costs on projects that are temporarily sidelined.

[73] Government of the Republic of Lithuania, *Decree on the Distribution of Capital Investments in 2001 by Allocation Managers and Investment Projects in the 2001-2003 Public Investment Program*, (No. 359, March 30, 2001), paragraph 2. Also, Decree Nr. 478 (April 28, 2001), para. 5.

Issue 3: The Financing Gap

3.28 The third problem is that funding may be running out. In recent years, 34-40 percent of the PIP has been provided by the privatization fund. But the privatization of major state assets is nearing completion. The State Agriculture Bank was sold in 2001. The privatization of Lietuvos Dujos is set to be finalized in 2002. In addition, claims on privatization fund resources are not diminishing. In particular, privatization fund resources are earmarked for the restoration of personal savings lost during the 1995 banking crisis. According to interviews conducted by the Bank in November 2001, allocations from the Privatization Fund to the PIP are expected to decline sharply to LTL 35 million in 2003 from 227 million in 2001 (Table 3.7).[74] Over the long term, more sustainable sources of PIP financing--central government current savings (the excess of current revenue over current expenditures) and central government borrowing would be expected to finance most of the PIP. But in the short term, the absence of privatization proceeds will be missed.

Table 3.7 State Funds for Public Investment Program, 2001-2004 (in LTL millions)

	2001	2002	2001-02	2003	2002-03	2004	2003-04
			%		%		%
	LTL	LTL	Change	LTL	Change	LTL	Change
Total	1269.0	1156.9	-9%	1148.6	-1%	1064.5	-7%
State Budget[1/]	313.3	627.5	100%	713.9	14%	763.9	7%
Privatization Fund	227.0	200.0	-12%	35.0	-83%	30.0	-14%
Loan Funds	728.7	329.4	-55%	399.7	21%	270.6	-32%
o/w Guaranteed	410.0	148.2	-64%	149.7	1%	120.6	-19%
Onlent	318.7	181.2	-43%	250.0	38%	150.0	-40%

Source: Ministry of Finance
1/Road Fund is included in the PIP as of 2002. The projected Road Fund amount in 2002 is approximately LTL 114 million.

Recommendations

3.29 Upon EU accession, several of the sectoral problems will diminish. The financing gap may narrow, as EU grant funds partly compensate for the decline in privatization receipts. On accession, Lithuania will be eligible for grants from the cohesion fund and four structural funds: the regional development fund, the European Social Fund, the European Agricultural Guidance and Guarantee Fund, and the fisheries fund. Under the terms of present agreements, Lithuania will receive a flow of EU cohesion and structural funds equal to 4% of GDP or about LTL 137 per capita.[75] Non-municipal sectors will, of course, make claims these resources. In addition, the Ministry of Environment estimates that by 2010, LTL 2.5 billion will have to be spent just to meet EU environmental directives. EU funding is also subject to counterpart funding requirements ranging from ten to fifteen percent. Municipalities' ability to access EU funds may therefore be limited by their ability to generate counterpart funding. Ironically, while there will be pressure to reduce expenditures to meet EU macroeconomic criteria for accession (i.e., deficit targets), there will be pressure to increase capital spending in order to meet EU sectoral directives.

[74] At the time of writing, the Government was considering a proposal to increase the 2003 allocation to LTL 150 million, contingent upon the planned sales of state assets.

[75] The investment estimate assumes a 80% co-financing rate from the EU and includes the corresponding counterpart contributions. An 80% co-financing rate would amount to LTL 1.9 billion in gross investment. Source: Commission of the European Communities, *Communication from the Commission: Information Note, Common Financial Framework 2004-2006 for the Accession Negotiation*", Brussels, January 30, 2002, p. 5-6.

3.30 While EU funding will help solve the financing gap in the medium term, it will still leave the Government with the need to (1) improve the allocation of Government-mediated investment resources (including EU and other sources); (2) improve the flow of multi-year project funding and (3) supplement EU financing with alternative sources of investment financing. To address these problems, this report recommends a two part strategy. The first would focus on reforms in the Government's public investment program, simplifying the project vetting procures, while strengthening local capacity to prepare good projects. The second would focus on mobilizing alternative sources of financing.

Reforming the PIP

3.31 **Simplify and De-Politicize the Project Vetting Procedure**. The project vetting process should be compressed and improved by removing the number of legislated reviews carried out annually by the Government. This would reduce the opportunities for ad hoc political interventions, and instead focus the Government's efforts on setting strategic goals and monitoring their achievement. The PIP contains several investments that have been inserted through political initiatives, some of which come from dialogue with donor institutions. A better approach would be to broaden the number of eligible sectors and define explicit evaluation criteria for each sector. At the same time, project appraisal could be outsourced to other agencies. This would bring more technical expertise into the process and provide an independent view of project merits.

3.32 As preparation for EU Structural Funds, Lithuania is currently developing a National Development planning process. In principle, this strategic programming tool should temper the influence of political initiatives. While a preliminary national development plan has been written, the process is still in flux and the connection between the PIP and NDP is still under discussion with the Government.[76]

3.33 **Strengthen Municipal Capacity to Prepare Projects**. At the same time, municipalities need training in project preparation and the rules of the funding game to permit them to understand the likelihood of success or failure in their efforts to compete for funding. Some such training already exists. EU Phare funds focus on building local capacity to learn about these new rules and how to maximize access to these new funds. Another measure adopted by the Government to address municipal capacity is the implementation of the Municipal Development Program whereby the Housing and Urban Development Foundation, the implementing agency of the MDP for the Finance Ministry, offers free of charge advice on project preparation, training and investment sources. It also provides a coordinated framework for IFI lending, linking it to EU pre-Accession and other donor grants, for municipalities.

3.34 In part, the speed with which Lithuania will be able to meet its accession targets will depend on how quickly local governments are able to prepare projects. As part of a broadened local capacity building effort, the municipalities should receive support in developing projects that would successfully meet the selection criteria. The delivery of this support could take several forms, and ideally the support in preparation should be delivered by entities separate from those which conduct project evaluation and selection. The municipal capacity building

[76] Based on interview with Ministry of Finance, November 2001.

effort could be improved by strengthening the incentives for municipalities to use investment funds effectively. The current changes undertaken in the Public Investment Program which ask municipalities to undertake strategic planning and capital budgeting is a good first step. However, the plans will lose their value unless municipalities feel they will have an even chance of realizing these plans.

3.35 There may be still be significant institutional questions that will arise when implementing some of the EU-driven reforms in the municipal sector. Questions such as who will supervise a river basin management system, or who will borrow and repay to implement a regional solid waste management scheme will face municipalities and central authorities alike. More information and training, perhaps lead by the Association of Local Authorities, for municipalities on upcoming changes, EU sources of funding and state-of-the-art municipal services delivery would help to develop ownership of the reforms at the local level and help them to plan their investment programs carefully.

Box 3.3: Monitoring, Evaluating and Disseminating Outcomes

A significant shortcoming in the PIP and, generally, in municipal capital investments is the lack of adequate monitoring and evaluation of intended outcomes of the investments. Intended outcomes of each investment are expected to have an impact on national development and sector improvement objectives. The current PIP requirements call for a series of analyses with intended outcomes. This analysis should be accompanied by a reasonable set of quantifiable indicators which are to be reviewed and reported upon to appropriate line ministries. A triennial report on the achievements of the PIP could be produced. The report could outline how the PIP helped to achieve objectives on a national level, on the municipal level (is the municipality performing better?) and at the sector level (is the sector performing better?). Currently, Decree 478 requires the Statistic Department to produce quarterly reports on the use of public funds for capital investments and semi-annual reports on the implementation of the program of capital investments. The MOF also requires quarterly reporting and has introduced some output monitoring. The reports would be strengthened if they could relate more comprehensively the uses of public funds with the expected and actual benefits of the investment.

The Ministry of Finance confirmed the PIP resources are audited annually by the State Controller. It would be useful to include in the scope of the audit, the sources and uses of the entire project. Procedures should be drawn up to ensure that deficiencies identified in the audit report be corrected in a timely manner. Municipalities are required to report on the use of funds to the Statistics Department. With a full project audit, these reports should help to ensure the reliability of these reports.

3.36 **Cancel Old Uncompleted Projects**. To address the problem of stop-and-go financing, the Government should cancel old uncompleted projects. There is a mismatch between the investment requirements of the projects in the PIP and the financing envelope. The Government has started a process of setting priorities for allocations to address this problem. The current criteria are outlined as follows: (i) drop projects that were started between 1984 and 1994 which are less than 50 percent complete, need more than LTL 10 million to complete or which did not receive financing from 1995-2000; (ii) finance projects by 2004 that have been partially completed and fit within national and regional economic and social development plans and concentrate on those projects which require less than LTL 1 million to complete.[77] The working

[77] Government of the Republic of Lithuania, *Protocol of Government Session* (No. 33, July 11, 2001), paragraphs 3.1.1 through 3.1.9.

group that has been set up to reduce the number of projects in the list is encouraged to complete its job quickly. The focus on unfinished construction is also appropriate in light of EU regulations that strictly discourage the financing of uncompleted construction out of EU Structural Funds.

3.37 Projects already in the PIP should be given financing priority in subsequent years over new projects. Imposing this constraint should help to further reduce the list of projects and accommodate the upcoming counterpart financing demands of EU fund-financed projects. Disbursement plans should be monitored and updated annually to calculate the amount of "headroom" available for new commitments each year. However, updates should not mean that commitments are to be breached over the three year period.

3.38 **Alternative Sources of Financing: Increase Reliance on Current Savings**. There is a strong argument for increasing the use of current savings to finance capital works. This would have three benefits. First, it would address the impending financing gap without requiring the Government to increase borrowing. Second, it would provide municipalities with an independent source of capital financing, thus reducing the influence of central government priorities on local capital spending decisions. Third, it would provide local governments with a cushion of flexible expenditures that could used to meet fixed expenditures in the event of a downturn in revenues.

3.39 The opportunities for increasing current savings were discussed in Chapter 2. In large part they rely on increasing local control over revenues and expenditures. But municipalities' would have little incentive to use their new found ability to run current surpluses if it means a reduction in capital funding from the Government. PIP allocations should therefore be at least neutral with respect to current savings. There is, in fact, an argument for using PIP allocations to encourage current savings. Access to capital grants and concessional loans under the PIP could be linked to achievement of a minimum current surplus for example.

3.40 **Increase Private Sector Participation**. Private sector participation may also be a means of generating resources for capital investment independently of the PIP. As noted earlier, private participation in municipal services is a relatively recent phenomenon, and is largely confined to district heating. Municipalities and national government entities should work together toward introducing private management and improving the climate for investment in municipal enterprises. A good first step would be to recruit reputable business people to sit on supervisory boards.

3.41 Several methods of private sector participation could be explored. (See Table 3.8.) Lessons from early experiences suggest municipalities require assistance in designing arrangements and regulatory mechanisms that maximize value for the customer, municipality and the private sector partner. In many cases, for example, investment is set as an objective in the contract rather than performance objectives that set the service requirements which municipalities expect the private lessee to deliver in a given period of time.

Box 3.4: Preparing for Private Sector Participation in Municipal Services

As a local government sets out to find a suitable private sector partner, it needs to sort through a series of issues that would help it determine which private sector arrangement maximizes its value to the local government, to the company and to the customer. Among the first questions to ask for a local government are:

What problems does it hope to solve? A common mistake in designing lease or concession contracts is the tendency to specify the size of the investment to be undertaken. Rather, the arrangement should be designed around objectives with time bound performance standards designed to meet this objective. Some of these performance measures could be the number of complaints in a year, the average time to resolve to complaints, and technical measures in district heating for example, the ability to maintain system temperature, and reduction of water and heat losses. A starting point in determining objectives is to analyze the state of the existing utility.

Which private sector options offer the best solutions to these problems? Another common tendency is for the local government to rush into an arrangement so as not to miss an window of opportunity. A pre-contract analysis that looks at the problems in the sector, and which private arrangements are affordable and politically acceptable is needed to avoid costly misunderstandings down the road. The following is a table that distinguishes private sector participation arrangements by how they allocate responsibility for functions such as asset ownership and capital investment between public and private sectors. Pre-contract analysis should identify key stakeholders and determine the degree to which they are committed or opposed to private sector participation.

Do existing legal and regulatory arrangements support private sector involvement? An analysis of legal and regulatory arrangements should not be left until after decisions have been made on the type of private participation arrangements. While a detailed analysis of a regulatory environment is not needed for each case, the decision makers should take stock in the compatibility of the regulatory regime with private sector participation. Importantly, the assessment should take into account the regulatory needs and costs, i.e. their regulatory capacity, so that important arrangements to protect customers from monopolistic pricing and to enforce health, environmental and safety standards would be effectively executed under the new arrangement. In addition, subsidy systems should also be evaluated so that they target the right customers and achieve the intended objectives under the new arrangement.

Adapted from Cowen, Penelope et .al., "Toolkit 3: What a Private Sector Participation Arrangement Should Cover," (World Bank: 1997)

3.42 Concessions are one promising option. This option is impeded by a legal ambiguity in Article 3 of the Concession Law which sets out that (only) "objects and companies under municipal ownership, which are not foreseen for privatization during the concession period" are eligible for concession. There appears to be a legal ambiguity in this definition that prevents municipalities from using the concession law for utilities that are special purpose joint stock companies under Lithuanian Company Law and whose shares are owned by municipalities. Thus, lease arrangements have been used, but features of a concession are written into the contracts. It would be more straightforward to adjust the legal framework so that municipalities can be guided by a uniform code for concessions.

Table 3.8: Privatization Options

Option	Asset Ownership	Operations	Capital Investment	Commercial risk	Duration
Service Contract	Public	Public and private	Public	Public	1-2years
Management Contract	Public	Private	Public	Public	3-5 years
Lease	Public	Private	Public	Shared	8-15 years
Concession	Pubic	Private	Private	Private	25-30 years
BOT/BOO*	Private and Public	Private	Private	Private	20-30 years
Divestiture	Private or Private and Public	Private	Private	Private	Indefinite

* BOT: Build/operate/transfer BOO: Build/operate/own

Source: Adapted from Cowen, Penelope et .al., "Toolkit 3: What a Private Sector Participation Arrangement Should Cover," (World Bank: 1997).

3.43 In principle, commercial borrowing would be another promising alternative to the PIP. Loans from private banks can supplement resources from the PIP, while providing local governments with a means of financing project that reflect their own priorities. And borrowing—unlike current surpluses--allows municipalities and their enterprises to leverage future revenues to finance projects, rather than confining the level of capital spending to what can be financed from current income. As noted earlier, borrowing, however, raises a number of risks to the Government—particularly the risk that the Government may come under pressure to assume the debt obligations of distressed municipalities—and does not appear to be a promising substitute for PIP-intermediated funds, at least until the fiscal straightjacket is loosened and debt regulation is strengthened.

4. FINANCIAL REPORTING

4.1 Municipal finance policy making and the management of individual municipalities now rests on extremely shaky financial information. The Government needs to know what is going on at the municipal level in order to work out transfer policy. The municipal governments need to know in order to plan expenditures and evaluate financial risks. The banks need to know in order to assess creditworthiness. But at present, the financial strength or weakness of municipalities and districts is complicated and difficult to assess accurately. There are three major reasons.

4.2 **Financial Statements Fail to Separate Current and Capital Accounts** The arcane budget system disguises the financial position of a municipality. Municipalities are required to present a balanced budget by showing that receipts from all sources (including possible draw downs of cash balances) equal total payments. The 2000 budget for Vilnius municipality, for example, shows receipts and disbursements balanced at Lt. 455 million. Money- in consists of receipts from all sources including tax revenues collected by the state, local revenues collected by the municipality, grants, state subsidies, sales of assets, and proceeds from loans. Money- out includes disbursements for operating expenses, social services, capital additions and loan repayments. But there is no separation of recurrent revenues from extraordinary revenue; nor of fixed expenditure obligation from flexible; no tradition of matching current revenues with ordinary expenses to calculate an operating surplus (or a current surplus) from which the municipality may finance capital additions or repay loans. There is no balance sheet.

4.3 Recasting the cash flows into two statements, an operational statement and a statement of non-operational receipts and disbursements should be an important process for every municipality. Operational receipts would exclude grants, sales of assets and proceeds from loans; operational expenses would exclude capital additions, debt repayment and extraordinary disbursements. Recasting Vilnius municipality's accounts on this basis would reveal an ever-decreasing margin of revenues less expenses from 1997-2000 and that the capital addition program was financed primarily by borrowing and not from Vilnius's own operating surplus.

4.4 **Cash Basis Accounting Clouds Financial Position** The municipalities by law record transactions on the cash basis. Revenue is not recorded until collected and expenses are not recorded until paid. Conservative accounting would concur with a regulation that forbids recording of revenues before it is collected. The temptation to puff up income with uncollected taxes would be irresistible. This restriction is therefore appropriate. However, conservative accounting would treat expenses differently.

4.5 Expenses should be recorded when incurred. The present accounting regulations forbid a municipality to record the cost of a service until it is paid in cash. This amounts to a license to fog and distort financial statements through a simple omission to record a service. For instance, the razor thin 1.7 percent operational margin of Vilnius would disappear and convert to a deficit if Vilnius had recorded its payables which increased from Lt 91 million US$ 23 million) to Lt 173 million (US$ 43 million) from 1997 to 2000. In fact this increase in payables would have converted all of the operating margins into deficits for the entire 1997-2000 period. Unfortunately, almost all municipalities have increased their unpaid but incurred expenses to a point where the diminishing operational margin would vanish if municipalities were required to

record all unpaid items in their annual financial statements. In short, the financial statements currently prepared by all districts and municipalities are misleading if unpaid services are excluded.

Table 4.1: Reporting Sources of Municipal Capital Spending in Lithuania

	Included in Budget Reports?
Budget Sources	
Tax revenues	Yes
Non tax revenues	Yes
Non-budget Municipal Sources	
Municipal Privatization Fund	No
Municipal Environment Fund	No
Municipal Special Funds	No
Central Sources	
National Privatization Fund	No
National Road Fund	No
EC Funds	No[1/]
Bilateral Grants	No
IFI Loans	No[1/]

4.6 **Finances of Special Funds and Enterprise are not Reported** Municipalities finance a significant part of expenditures from special funds. As noted earlier, these include the Road Program and the Environment Fund, as well as their own privatization funds, and special-purpose funds.[78] Although these funds are major sources of investment for capital finance, they do not appear in the municipal annual financial statements. Table 4.1 gives an overview of the sources of municipal capital investment finance showing those that are--and are not--reported in the quarterly budgetary reports provided to the Ministry of Finance. As shown, eight of the ten financing sources do not appear in the accounts. As a result, capital spending—other than that financed from current account savings—is grossly underreported.

4.7 Municipalities also lack adequate financial data on their enterprises. As noted earlier, municipalities own and operate a variety of enterprises. Some are large scale public utilities, including companies providing district heating and cold- and hot-water supply. The revenue of the Vilnius district heating company, for example, are nearly as large as those of the municipality itself. Some are smaller enterprises engaged in a variety of service and retail activities. Most of the larger municipalities, for example, own building maintenance companies that are charged with the upkeep of formerly state-owned housing. Some own municipal bus companies. Some own bakeries and grocery stores. Vilnius and Kaunas municipalities each own and operate over 100 such enterprises.

4.8 To varying degrees, these enterprises cover their operating costs from fees and charges. Political pressures to keep tariffs down, combined with weak administration and arrears by the municipalities themselves have resulted in significant levels of losses, however. Lengthy delays in the payment of heating bills have been a feature of the Vilnius District Heating Company ever since tariffs started to move towards the cost recovery level, for example.[79] Over the last three years total customer receivables have risen from LTL 31 million to LTL 75 million in October 2000; a figure is equivalent to 31 percent of the company's sales. (Vilnius municipality is, itself, the company's largest delinquent account). In some cases, these losses are covered by cross-subsidies from profitable activities. The Vilnius District Heating Company, for example, finances its losses on heating sales from profits from the sale of electricity. The Kaunas building maintenance companies finance their operating losses by running up arrears to the municipality's district heating company. Others receive explicit subsidies from the municipal budget. Kaunas,

[78] As noted earlier, the Road Program was incorporated in the General Budget as of the 2002 budget program.
[79] Kelly, Peter, 2001, "Vilnius City Municipality Review of Accounts Payable to Vilnius District Heating Co.", mimeo

for example, subsidizes its loss-making bus lines directly from the municipal treasury. It finances its loss-making retail enterprises from the municipal privatization fund.

4.9 At present, municipal financial statements do not reveal the extent of transactions with enterprises or the amount of subsidies, hidden or transparent, that are needed to keep these enterprises operating. Better information on municipal enterprises would help municipal officials decide what to do with them. It would also provide a more accurate picture of municipalities' financial condition. Until municipalities recast their financial statements to include the accounts of the special funds and enterprises, their true financial position, healthy or otherwise, will not be known.

Recommendations

4.10 **Separate Current from Capital Accounts in Financial Statements** Four reform measures are recommended. First, financial reports should separate the current and capital accounts. Current revenue, including taxes, fees and recurrent transfers should be aggregated separately from capital receipts. Current expenditure—including recurrent spending on personnel and benefits, equipment and supplies, subsidies to enterprises, and transfers to households, should be reported separately from non-recurrent capital receipts such as borrowing, capital grants, and proceeds from privatization.

4.11 **Adopt Accrual Accounting for Expenditures** Second, the Government should regulate an immediate and modest improvement in municipal accounting standards that would require municipalities to record all payables in the accounting records. Pending full adoption of internationally recognized accounting standards, the state can regulate a partial accrual accounting. Revenues should be recorded on a cash basis but disbursements should be accrued when incurred.

4.12 **Consolidate Reporting of Special Funds and Municipal Operations.** Third, to more fully appreciate municipal operations, all special funds should be consolidated, at least quarterly. Since these special funds are an important source of state funding of capital improvements, municipalities should consolidate fund operations into one consolidated fund report and then further consolidated with municipal financial statements. The Government is considering reforms that would require the municipalities to record fund operations in the municipal accounting records. Until this disposition becomes law, and fund operations become a part of the accounting records, municipalities should be required to consolidate these funds in a special report for its own management and government officials. These reporting dispositions should take immediate effect, even before current plans to incorporate some of these funds into municipal accounting records become definite.

4.13 Municipalities should also be required to disclose more financial information on the operations of their controlled enterprises. Improving municipal vigilance over municipal operations could begin with the following: (a) council approval of all enterprise budgets including a consolidation of enterprise budgets; (b) periodic consolidation of enterprise operations divided into sub-groups (maintenance companies, road repair companies, etc.); (c) quarterly reports of enterprise operations prepared by the managers with explanations for variance from the budget; (d) quarterly consolidation of municipal operations including a

statement of operations and a balance sheet; (e) reports that summarize significant transactions with the enterprises, their indebtedness to banks, other municipal enterprises and to the municipality.

4.14 **Inventory Public Enterprises** Finally, the municipalities should study and analyze their enterprises to determine how many are really needed and which could be sold to private enterprise. A thorough study of the need for each enterprise might reveal opportunities to sell them to owners who would provide more consistent and hands on management that could lead to efficient and profitable operations.

4.15 **Strengthen Municipal Financial Management Capacity** More training in public accounting and financial management practices would help to implement these reforms. Municipalities have the latitude within the existing framework to work out better ways of managing their finances. With few exceptions, they do not do so. In addition to training, the creation of a professional association of public accountants, or some other professional forum with contacts to international public accounting organizations, would help to build up a critical mass of experience and knowledge needed to independently make improvements.

5. PRIORITIES

5.1 In the short period since the restoration of independence, Lithuania has undergone a series of major reforms in the fiscal relationship between central and local governments. There is a strong argument for avoiding further drastic changes. There is an argument for slowing the cycle of reforms to allow time for officials—particularly at the municipal level--to become familiar with the existing rules and learn to make them work. During the time this report was under preparation, there was only one issue that justified immediate action by the Government: an impending short term debt crisis. As noted earlier, the total stock of municipal arrears and short term debt in late 2001 totaled roughly LTL 632 million. This equaled 20 percent of revenues. More importantly, it exceeded municipal current surpluses by a factor of 3. Municipalities did not have the resources to meet these obligations.

5.2 This crisis was resolved prior to final publication of this report through a Government—backed refinancing program. But more fundamental problems with the fiscal system will need to be addressed to avoid a recurrence. As detailed in previous sections of this report, these would include:

- relaxing controls on personnel spending, including job protection for certain categories employees and central control on the level of salaries (para 2.49);
- increasing revenue autonomy, preferably by permitting municipalities to adjust the rate of the PIT retained within their jurisdictions (para 2.51);
- assisting municipal governments with high-per-pupil education costs to bring these costs into line with 'education basket' targets (para 2.44); and
- adopting a firm policy against rolling over debts to the Treasury, bailing out municipal debt to commercial banks, or permitting the accumulation of PIT arrears (para 2.56).

5.3 At the same time, the Government should work to improve municipal service delivery, particularly by improving the allocation of capital expenditure. This would include:

- simplifying and reducing central government political discretion over the PIP funding process (para 3.31);
- strengthening municipal capacity to prepare projects (para 3.33);
- encouraging greater reliance on current savings to finance capital works (para 3.38);
- encourage private participation in the financing (as well as management) of revenue generating municipal services (para 3.34); while
- toughening regulation of commercial lending to municipal governments (para 2.56).

5.4 Finally, the Government must begin to improve the quality of financial information on municipalities and their enterprises on which policy and management decisions are made, including the separation of current from capital accounts, the adoption of accrual accounting for expenditures, and the consolidation of fund and enterprise operations.

5.5 While some of these recommendations can be implemented piecemeal, the most fundamental reforms in the intergovernmental relationship cannot be. The Government cannot

expect to impose a hard budget constraint on municipalities while at the same time denying them any control over their own revenues and expenditures. Reforms on these two fundamental aspects of the intergovernmental relationship must therefore proceed simultaneously.

ANNEX 1

Annex 1.1: Summary Statistics of Municipalities, 2000

	Revenue	Expenditure	Deficit/Revenue	Population	Rev/Cap
Akmenė	33,778	33,946	-0.5%	33.3	1,014
Alytus	65,320	67,444	-3.3%	77.6	842
Alytus	31,765	31,026	2.3%	33.6	945
Anykščiai	34,311	34,199	0.3%	37.3	920
Birštonas	12,529	12,154	3.0%	6.1	2,054
Biržai	35,328	34,770	1.6%	37.8	935
Druskininkai	26,577	26,411	0.6%	28.9	920
Elektrėnai	18,019	17,930	0.5%	31.6	570
Ignalina	28,542	28,282	0.9%	25	1,142
Jonava	47,790	48,080	-0.6%	55.5	861
Joniškis	34,109	34,163	-0.2%	34.2	997
Jurbarkas	36,612	36,716	-0.3%	40.4	906
Kaišiadorys	34,561	34,320	0.7%	37.7	917
Kalvarija	10,101	9,432	6.6%	15	673
Kaunas	66,680	65,937	1.1%	86.1	774
Kaunas	319,687	316,493	1.0%	409.7	780
Kazlų Rūda	9,162	8,214	10.3%	15.8	580
Kėdainiai	59,054	58,644	0.7%	70.9	833
Kelmė	39,691	40,542	-2.1%	42.9	925
Klaipėda	169,692	165,172	2.7%	201.8	841
Klaipėda	43,696	44,042	-0.8%	45.8	954
Kretinga	39,896	40,311	-1.0%	47.5	840
Kupiškis	28,483	27,421	3.7%	26	1,096
Lazdijai	29,533	29,024	1.7%	28.4	1,040
Marijampolė	61,247	60,302	1.5%	74	828
Marijampolę raj.	15,427	15,427	0.0%		
Mažeikiai	63,838	67,844	-6.3%	69.9	913
Molėtai	27,420	26,708	2.6%	26.1	1,051
Neringa	15,962	15,883	0.5%	2.8	5,701
Pagėgiai	7,843	7,882	-0.5%	12.6	622
Pakruojis	32,346	31,919	1.3%	30.7	1,054
Palanga	29,964	25,132	16.1%	19.6	1,529
Panevėžys	111,838	111,098	0.7%	133.6	837
Panevėžys	40,091	39,924	0.4%	41.6	964
Pasvalys	34,834	34,579	0.7%	36.2	962
Plungė	44,415	45,342	-2.1%	45.9	968
Prienai	33,029	33,996	-2.9%	36.7	900
Radviliškis	49,491	50,078	-1.2%	54	917
Raseiniai	41,655	44,636	-7.2%	46.3	900
Rietavas	7,442	6,831	8.2%	11.5	647
Rokiškis	42,392	46,081	-8.7%	44.9	944
Šakiai	38,059	38,147	-0.2%	40.7	935
Šalčininkai	35,554	39,835	-12.0%	39.4	902
Šiauliai	121,433	121,436	0.0%	146.2	831
Šiauliai	48,832	47,753	2.2%	53.0	921
Šilalė	36,988	36,569	1.1%	33.4	1,107

Annex 1.1: Summary Statistics of Municipalities, 2000 (continued)

Šilutė	53,825	55,509	-3.1%	57.7	933
Širvintos	22,966	22,637	1.4%	21.5	1,068
Skuodas	31,250	29,505	5.6%	27.6	1,132
Švenčionys	33,801	34,186	-1.1%	35.2	960
Tauragė	49,206	48,794	0.8%	56.0	879
Telšiai	51,352	54,704	-6.5%	61.4	836
Trakai	44,309	43,790	1.2%	38.2	1,160
Ukmergė	45,161	46,271	-2.5%	50.9	887
Utena	48,881	48,029	1.7%	53.3	917
Varėna	33,032	33,173	-0.4%	33.5	986
Vilkaviškis	45,641	47,755	-4.6%	52.5	869
Vilnius	70,379	70,212	0.2%	89.9	783
Vilnius	488,698	479,127	2.0%	589.2	829
Visaginas	35,424	35,069	1.0%	33.1	1,070
Zarasai	25,332	25,051	1.1%	24.6	1,030