

Redistribution of Intra-Budgetary Funds across Municipalities

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SUMMARY

Intra-budgetary redistribution of the Personal Income Tax is achieved by funnelling a percentage of tax revenue into the State Treasury, and reallocating it in order to bolster weaker municipalities. This tax revenue originates from the economically strongest municipalities.

In the majority of municipalities, redistribution equals to at least 20% of the total budget. In Alytus District, Neringa, and Kalvarija, redistribution takes up a one third of the municipal budget. This implies that weaker municipalities are heavily dependent on additional revenue from the Personal Income Tax redistribution.

There are only three donor city municipalities in Lithuania: Vilnius, Kaunas and Klaipėda. Therefore, it is estimated that in 2015 each of these municipalities will respectively lose 191, 10 and 8 million EUR of their Personal Income Tax revenue.

Intra-budgetary redistribution of the Personal Income Tax creates the following problems:

- After redistribution, donor municipalities face less favourable fiscal fortunes than the supported municipalities.
- The incentives for economically weaker municipalities to seek their own policies to improve their economic, financial and social situation are diminishing, because such an improvement may result in a loss of additional Personal Income Tax revenue from redistribution.
- The criterion of determination on the proportion of the Personal Income Tax allocation across municipalities is unclear and therefore, intra-budgetary redistribution is disproportionate.

INTRODUCTION

Intra-budgetary redistribution of the Personal Income Tax in Lithuania is aimed at providing financial support for economically weaker municipalities. Tax revenue from the largest and strongest municipalities is used to support the weaker ones. On the one hand, redistribution is beneficial for economically weaker municipalities that may use additional funding for performing its functions. On the other hand, however, redistribution creates problems for the donor municipalities that have to bequeath a significant part of the revenue from the Personal Income Tax and cannot use it for their own needs.

The present analysis is aimed at measuring level differences of intra-budgetary redistribution of the Personal Income Tax across municipalities as well as identifying the major problems created by this process.

I. What the redistribution of intra-budgetary funds is?

Redistribution is usually defined as a set of governmental measures aimed at levelling the income distribution in the society by using tax revenue collected from one group to bolster individuals and groups that cannot care for themselves. Thus a minimum level of subsistence is guaranteed. However, redistribution is not peculiar to people; it also applies to municipalities.

The European Charter of Local Self-Government stipulates that the protection of financially weaker local authorities (in this case – municipalities) calls for financial equalisation procedures designed to counteract the unequal distribution of potential sources of finance across municipalities.¹ Therefore, intra-budgetary redistribution is instituted in order to level territorial, social and economic differences.

The budgetary revenue system in Lithuania is based on the principle of tax revenue redistribution across municipalities. This means that the Personal Income Tax revenue is redistributed to support financially weaker municipalities. Redistribution of this kind is commonly known as intra-budgetary redistribution. This policy is aimed at levelling unequal distribution of financial resources across municipalities.

II. How is the redistribution of intra-budgetary funds achieved in Lithuania?

Specifically, intra-budgetary redistribution in Lithuania aims to level the Personal Income Tax revenue per capita and structural differences of municipal expenditure caused by demographic, social and other factors across municipalities. Redistribution consists of the proportion of the Personal Income Tax collected by different municipalities that is transferred to the State Treasury² by the Territorial State Tax Inspectorate. In other words, a part of the Personal Income Tax collected in economically stronger municipalities is transferred to the State Treasury and redistributed in order to support weaker municipalities.

The funding is aimed at the following:

1. Levelling municipal revenue from the Personal Income Tax differences across municipalities;
2. Levelling the structure of municipal expenditure across municipalities.

The first aim is achieved by allocating the tax revenue transferred into the State Treasury to municipalities whose factual Personal Income Tax revenue per capita for the past month was below average. Simply put, supported municipalities are those with below-average Personal Income Tax revenue even

¹ [The European Charter of Local Self-Government.](#)

² The State Treasury account is the entirety of the bank accounts in the Central Bank of the Republic of Lithuania in which all the monetary resources of the State are held.

after receiving the amount fixed under the Law on the Municipal Budgetary Revenue Estimation Methodology³ (hereinafter referred to as “the Law”). Such municipalities receive a sum equal to the difference between last month’s factual average Personal Income Tax revenue per capita of all municipalities and their reported Personal Income Tax revenue per capita.

The second aim is achieved by allocating funds to municipalities for levelling structural differences in municipal expenditure. These funds are allocated with regard to changes in, as well as the significance and the proportion of, certain demographic, social and other indicators⁴ of all municipalities that influence a shift in the objective structure of municipal expenditure. The calculation takes many factors into account, including the length of local roads and streets, total municipal size, the number of pensioners and children and the amount of developed land. Moreover, the calculation that determines this allocation only takes these factors into account for municipalities whose Personal Income Tax revenue is 100% under the Law.

Under the Law, Vilnius, Klaipėda and Kaunas municipalities do not receive 100% of the Personal Income Tax revenue. In 2015, these municipalities will respectively receive 48%, 86% and 94%⁵ of the Personal Income Tax revenue. Therefore, these municipalities do not receive funding for levelling structural differences in municipal expenditure. On the contrary, all 57 remaining municipalities receive 100% of the Personal Income Tax collected and get additional funding for levelling said differences.

Therefore, the absence of a clear criterion for a) the allocation of the municipal budgetary revenue from the Personal Income Tax; and b) differences in current proportions, prompt a number of questions. Moreover, there is no consideration that donor municipalities may end up in a less favourable financial situation as a direct result of intra-budgetary redistribution.

III. What are the levels of the redistribution of intra-budgetary funds across municipalities?

This section measures level differences of intra-budgetary redistribution across municipalities. Consequently, the proportion of the income from the Personal Income Tax revenue redistribution in municipal budgets will be estimated. The charts below reflect the composition of Vilnius, Kaunas and Klaipėda municipal income. These figures show Personal Income Tax revenue received from the

³ The basic act regulating intra-budgetary redistribution is the [Law on the Municipal Budgetary Revenue Estimation Methodology](#).

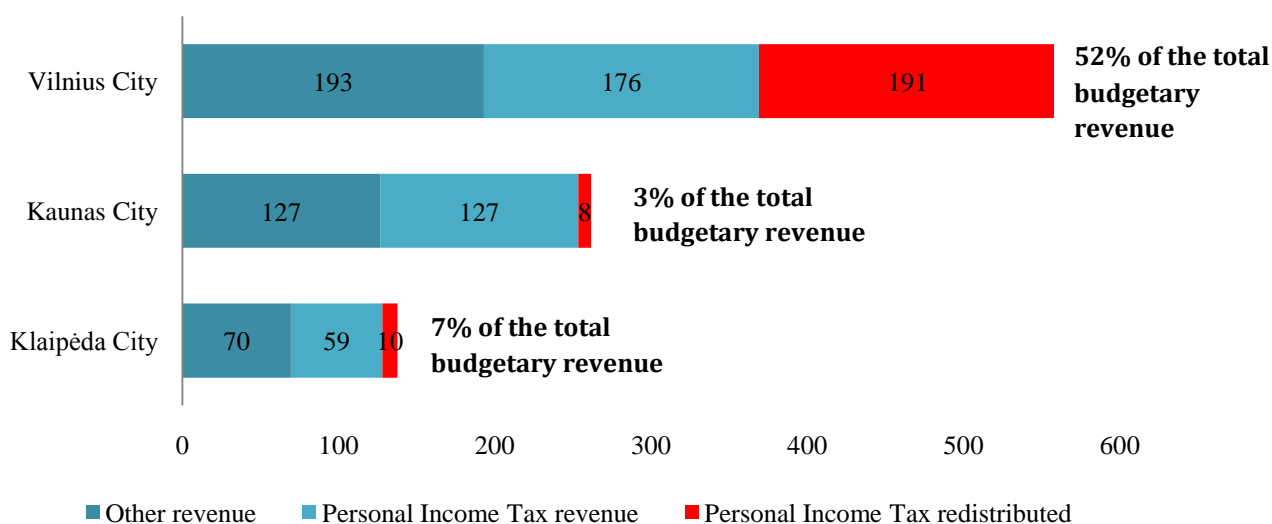
⁴ Indicators: 1) the length of local roads and streets; 2) the area of a municipality; 3) the number of pensioners; 4) the number of children from 7 to 17 years of age; 5) the number of children from 0 to 6 years of age; 6) a total useful floor area of municipality-funded educational institutions; 7) a total built-up area of a municipality; 8) a total territory of the living areas with the resort status in a municipality; 9) a total territory of the living areas with the resort territory status in a municipality (the Law on the Municipal Budgetary Revenue Estimation Methodology, 1997).

⁵ This proportion of the Personal Income Tax is calculated with regard to the remaining sum after transferring a part of income to the State budget, rather than the total tax revenue. In 2015 a total proportion of 72.8% of the Personal Income Tax revenue is allocated to municipalities.

State Tax Inspectorate, the said revenue transferred to the State Treasury, and other budgetary income (excluding EU aid).

According to data from the Ministry of Finance of the Republic of Lithuania, Vilnius City Municipality will transfer 191 million EUR of the Personal Income Tax revenue to the State Treasury for redistribution in FY 2015. This amount constitutes around 52% of the total tax revenue. Therefore, the contribution of Vilnius will be 24 times higher than that of Kaunas (8 million) and 19 times greater than that of Klaipėda. Moreover, in FY 2015, Personal Income Tax revenue will constitute around 46% of the total budgetary revenue of the Klaipėda City Municipality. Of this total, around 10 million (or 7% of the total revenue) will have to be redistributed.

Municipal revenue structure, million EUR



Source: derived from approved budgetary plans of municipalities for 2015

Additionally, Personal Income Tax revenue constitutes a significant part of the total budgetary revenue of district and small city municipalities. Although a part of this revenue is collected by the municipalities, a large portion is received as a result of intra-budgetary redistribution. A more detailed analysis of the Personal Income Tax revenue redistribution across municipalities shows that the biggest beneficiaries are the municipalities of Raseiniai (6.5 million or 22% of the total budget), Vilkaviškis (6.2 million or 17% of the total budget), and Telšiai (6 million or 17% of the total budget). In contrast, less money is allocated to the municipalities of Elektrėnai (1.2 million or 6% of the total budget), Visaginas (0.8 million or 5% of the total budget) and Birštonas (0.8 million or 10% of the total budget). The estimated average sum of the Personal Income Tax revenue redistribution per municipality in 2015 is 3.7 million EUR.

If calculated per capita, the major beneficiaries of intra-budgetary redistribution are the municipalities of Neringa (838 EUR), Zarasai (208 EUR) and Kalvarija (206 EUR). The lowest revenue per capita is observed in Panevėžys (33 EUR), Šiauliai (36 EUR) and Alytus (36 EUR) city municipalities.

However, when calculated in terms of the proportion to the total budget, the greatest redistribution is observed in Alytus District (28%), Neringa (28%) and Kalvarija (28%) municipalities. The least subsidised are Šiauliai (4%), Alytus (4%), Panevėžys (5%) and Visaginas (5%) city municipalities. The average proportion of Personal Income Tax redistribution to the total budget of municipalities is 16%.

The overall results suggest quite a significant redistribution of intra-budgetary funds across municipalities. In the majority of these areas, redistribution is equal to 20% of the total budgetary revenue. In some municipalities, redistribution garnishes as much as one third of the total income.

IV. What are the problems caused by the intra-budgetary redistribution of the Personal Income Tax?

1) After redistribution, donor municipalities face a less favourable financial situation than the supported municipalities.

The budgetary revenue per capita in Vilnius, Kaunas and Klaipėda city municipalities is much lower compared to the municipalities supported by them. In 2014, for instance, the average municipal budgetary income per capita was 769 EUR while the numbers were lower in all of the three donor municipalities: 733 EUR in Vilnius, 733 EUR in Kaunas and 775 EUR in Klaipėda. Moreover, in 2014, municipal budgetary expenditure per capita was as low as 674 EUR in Vilnius, 758 EUR in Klaipėda and 775 EUR in Kaunas city municipalities. This compares unfavourably to the countrywide average of 800 EUR (see appendices). Such detrimental situation is mostly felt in the Vilnius City Municipality, whose budgetary revenue per capita is lower than that of 58 other municipalities. Additionally, the municipality's budgetary expenditure per capita is lagging behind 54 of the supported municipalities. This implies lower than the average budgetary income and expenditure per capita in the donor municipalities. Moreover, since the expenditure per capita indicates the amount of public services supplied, the inhabitants of the donor municipalities receive fewer services as compared to the other municipalities. Therefore, the current system of redistribution is fundamentally flawed given that donor municipalities eventually end up in a less favourable financial situation with a below average level of both, budgetary income and expenditure per capita.

Secondly, the Personal Income Tax revenue is taken from financially weak municipalities. As of June 2015, the debt of the Vilnius City Municipality was 251 million EUR. The corresponding figures for Kaunas and Klaipėda were 51 million

EUR and 27 million EUR respectively. It is estimated that a donor city status will cost Vilnius 191 million EUR in 2015 while Klaipėda and Kaunas will respectively lose 10 million and 8 million. Although financially weak, these municipalities support the others by sharing a significant part of the revenue collected from the Personal Income Tax.

The data indicts a broken system that fails to evaluate whether the financial situation of the donor municipalities is better than that of the supported ones. Moreover, there is no consideration that donor municipalities may end up in a less favourable financial situation as a direct result of supporting other municipalities.

2) The incentives for economically weaker municipalities to forge their own path in improving their economic, financial and social conditions are diminishing.

Municipalities whose budgets are heavily dependent on redistribution have less incentive to seek additional sources of funding, increase the collection of the Personal Income Tax and take decisive measures that would help to improve their financial, economic and social situations. They also have a diminished incentive to attract investment, improve the business climate, optimise administrative, reduce unemployment levels, limit the number of social benefit recipients, etc. The incentives of the supported municipalities are diminishing because an improvement in the current situation might imply a decrease in funding from the donor municipalities.

Additionally, a high level of redistribution restricts the financial independence of municipalities. Since redistribution is centralised in some municipalities, their budget revenue and expenditures are heavily dependent on the decisions of the central government. Therefore, municipalities accept redistributive support at the high price of diminished independence, as municipal financing decisions are increasingly centralized.

3) The criterion for determining the proportion of the Personal Income Tax to allocate across municipalities is unclear.

On June 11, 2015, the Constitutional Court of the Republic of Lithuania ruled⁶ that some provisions of the Law on the Municipal Budgetary Revenue Estimation Methodology regulating the calculation and distribution of the Personal Income Tax revenue across municipalities run counter to the Constitution. The Constitutional Court ruled that the absence of a clear criterion for determining the proportion of the Personal Income Tax revenue to allocate across municipalities is against Articles 29, 120 and 121(1) of the Constitution.

⁶ [Ruling No KT17-N11/2015 of 11 June, 2015 of the Constitutional Court of the Republic of Lithuania on the compliance of the provisions of the Law on the Municipal Budgetary Revenue Estimation Methodology with the Constitution of the Republic of Lithuania.](#)

It was additionally determined that this ambiguity infringes on the principles of the rule of law and responsible governance.⁷

There are no specific legislative provisions regarding the criterion for the determination and changes in the proportion of Personal Income Tax revenue allocation across municipalities. There have been eight municipalities those Personal Income Tax revenue was transferred into the State Treasury for levelling financial differences: Vilnius, Kaunas, Klaipėda, Palanga, Panevėžys and Šiauliai city municipalities as well as Ignalina and Mažeikiai district municipalities. However, an increase in the proportion of the Personal Income Tax revenue allocation to 100% for these municipalities has left only three donor municipalities. Since 2014, the Vilnius City Municipality has received 48% of the Personal Income Tax revenue. Kaunas and Klaipėda have received 86% and 94% of the revenue respectively, since 2010. The remaining 57 municipalities receive 100% of the Personal Income Tax collected since 2010 (see Appendices).

The proportions used for calculating Personal Income Tax revenue allocation across municipalities have been modified in decisions regarding territorial changes, municipal debt payment, etc. However, there have never been legislative provisions regarding such modifications in the proportions *themselves*. Additionally, the Constitutional Court affirmed that, “a lack of such criteria does not allow an objective evaluation of the need to change the proportions of allocation across municipalities and its abilities to contribute to the support of financially weaker municipalities.” The Court stressed that such regulation creates prerequisites for the distortion of the levelling mechanism.

In conclusion, the current intra-budgetary redistribution creates a clash between the interests of two groups of municipalities. The current regime, in which some municipalities are denied a part of the Personal Income Tax revenue while the others receive 100%, is fundamentally unclear. In addition to interpretive issues, redistribution puts donor municipalities at a financial disadvantage since they have less revenue and expenditure per capita than the supported municipalities. This outcome suggests that the current redistribution of intra-budgetary funds across municipalities is distorted and fails to achieve its aim of levelling the revenue and expenditure across municipalities.

⁷ Under the rule of law, provisions laid down by law, regulation or administrative action shall be clear, comprehensible and unambiguous. Moreover, under the principle of responsible governance, the constitutional and other legal duties vested in the authorities and state officials shall be carried out properly.

CONCLUSIONS AND RECOMMENDATIONS

1. Intra-budgetary redistribution may be defined as a State funding aimed at levelling the distribution of financial resources across municipalities.
2. Intra-budgetary redistribution of the Personal Income Tax is achieved by funnelling a percentage of tax revenue into the state treasury, and reallocating it in order to bolster weaker municipalities. This tax revenue originates from the economically strongest municipalities (Vilnius, Kaunas and Klaipėda).
3. Intra-budgetary redistribution creates the following problems:
 - After redistribution, donor municipalities face less favourable fiscal fortunes than the supported municipalities.
 - The incentives for economically weaker municipalities to seek their own policies to improve their economic, financial and social situation are diminishing, because such an improvement may result in a loss of additional Personal Income Tax revenue from redistribution.
 - The criterion of determination on the proportion of the Personal Income Tax allocation across municipalities is unclear and therefore, intra-budgetary redistribution is disproportionate.
4. It is estimated that in 2015, due to the intra-budgetary redistribution, the Vilnius City Municipality will lose 191 million, Klaipėda – 10 million and Kaunas – 8 million EUR in budgetary revenue.
5. In the majority of municipalities, redistribution equals to at least 20% of the total budget. In Alytus District, Neringa, and Kalvarija, redistribution takes up a one third of the municipal budget. This implies that municipal finances are heavily dependent on additional income from redistribution, the financial status of the other municipalities as well as the decisions of the central government.
6. It is recommended to abolish unconstitutional provisions of the Law on the Municipal Budgetary Revenue Estimation Methodology and provide a clear method for the calculation of the Personal Income Tax revenue distribution across municipalities. This will ensure due functioning of the self-government as well as the financing which is necessary for the implementation of municipal activities.

SOURCES

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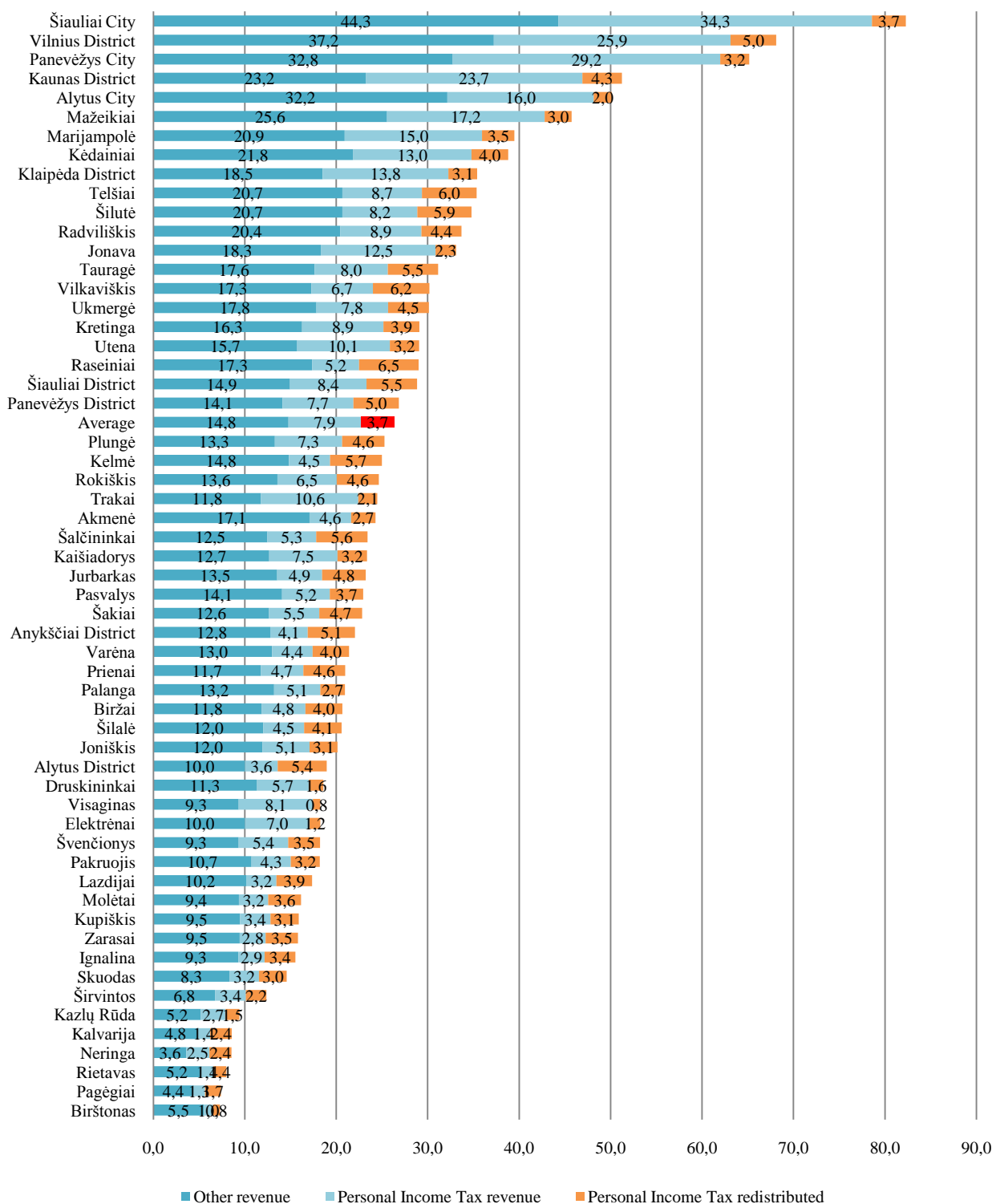
APPENDICES

Appendix 1. The proportion of the Personal Income Tax allocated to municipalities (%)

Municipality	2002	2003	2006	2010	2013	2014	An increase between 2002 and 2014 (%)
Vilnius	40	40	40	40	42	48	8
Kaunas	74	74	74	94	94	94	20
Klaipėda	64	64	64	86	86	86	22
Šiauliai	96	96	96	100	100	100	4
Panevėžys	84	84	84	100	100	100	16
Mažeikiai	55	55	90	95	99	100	45
Ignalina	78	100	100	100	100	100	22
Palanga	70	70	100	100	100	100	30
Other	100	100	100	100	100	100	-

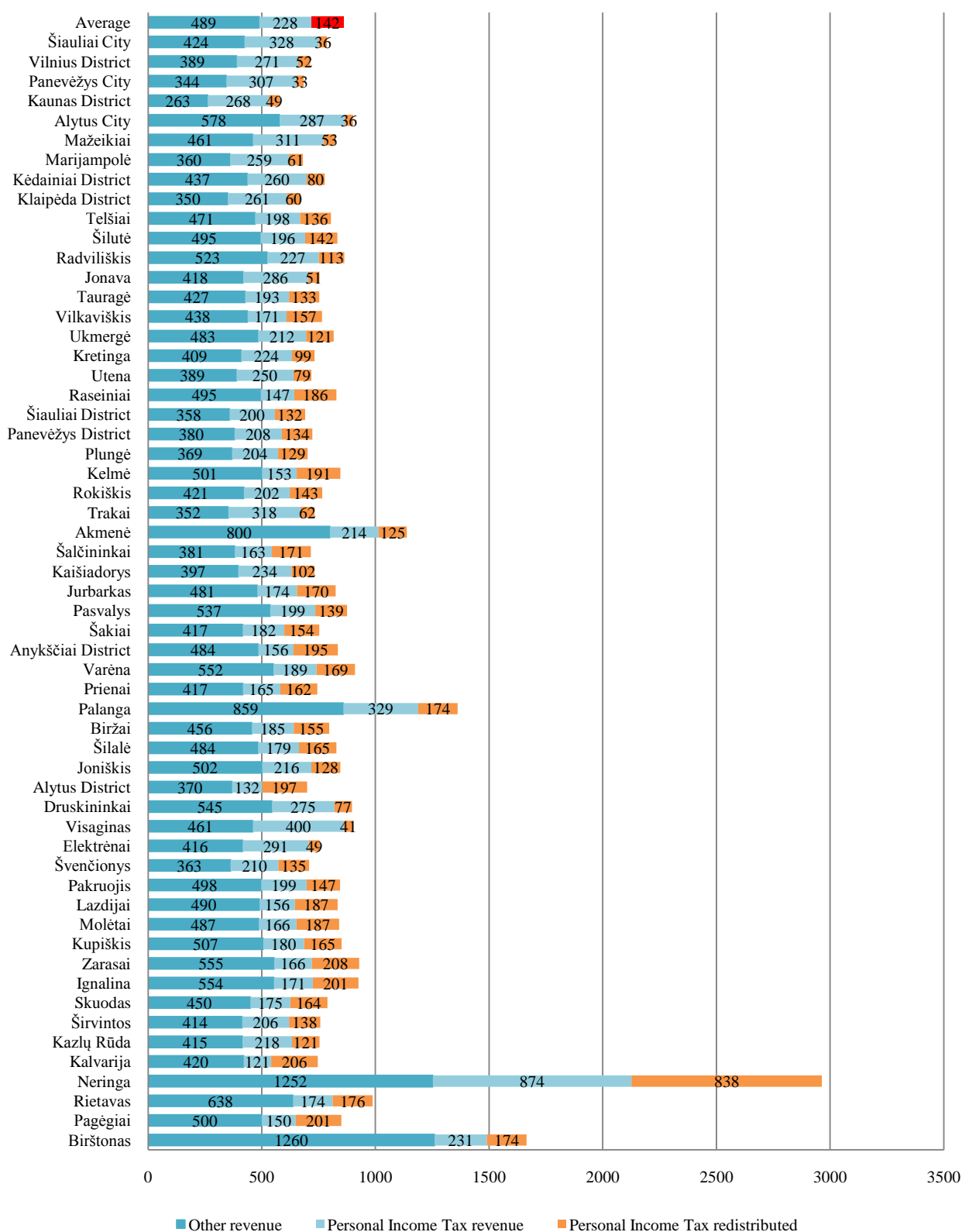
Source: the Law on the Municipal Budgetary Revenue Estimation Methodology

Appendix 2. The distribution of intra-budgetary funds across 57 supported municipalities in 2015, million EUR



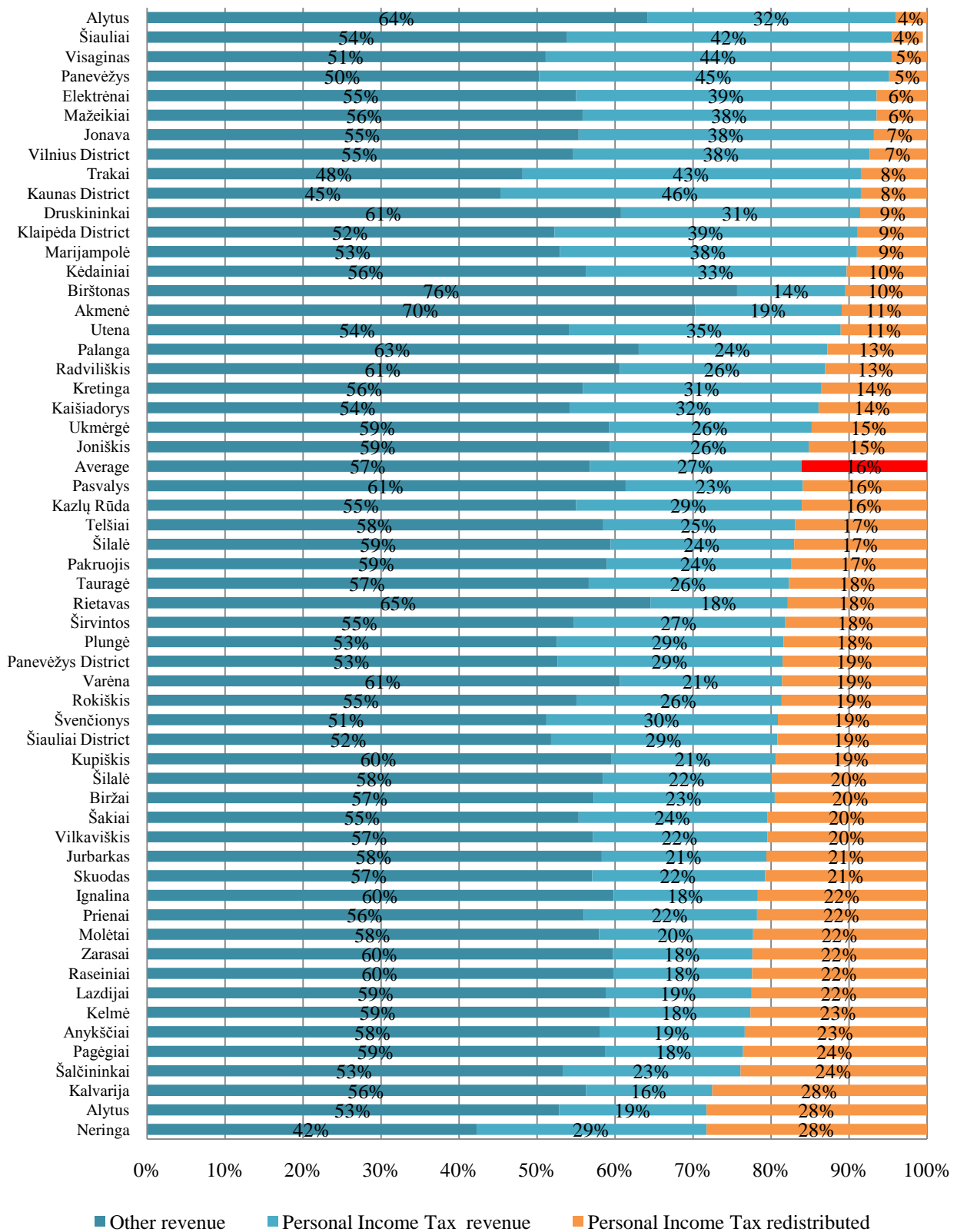
Source: calculated with regard to the approved budgetary plans of municipalities for 2015

Appendix 3. Intra-budgetary redistribution per capita (EUR) in the supported municipalities in 2015



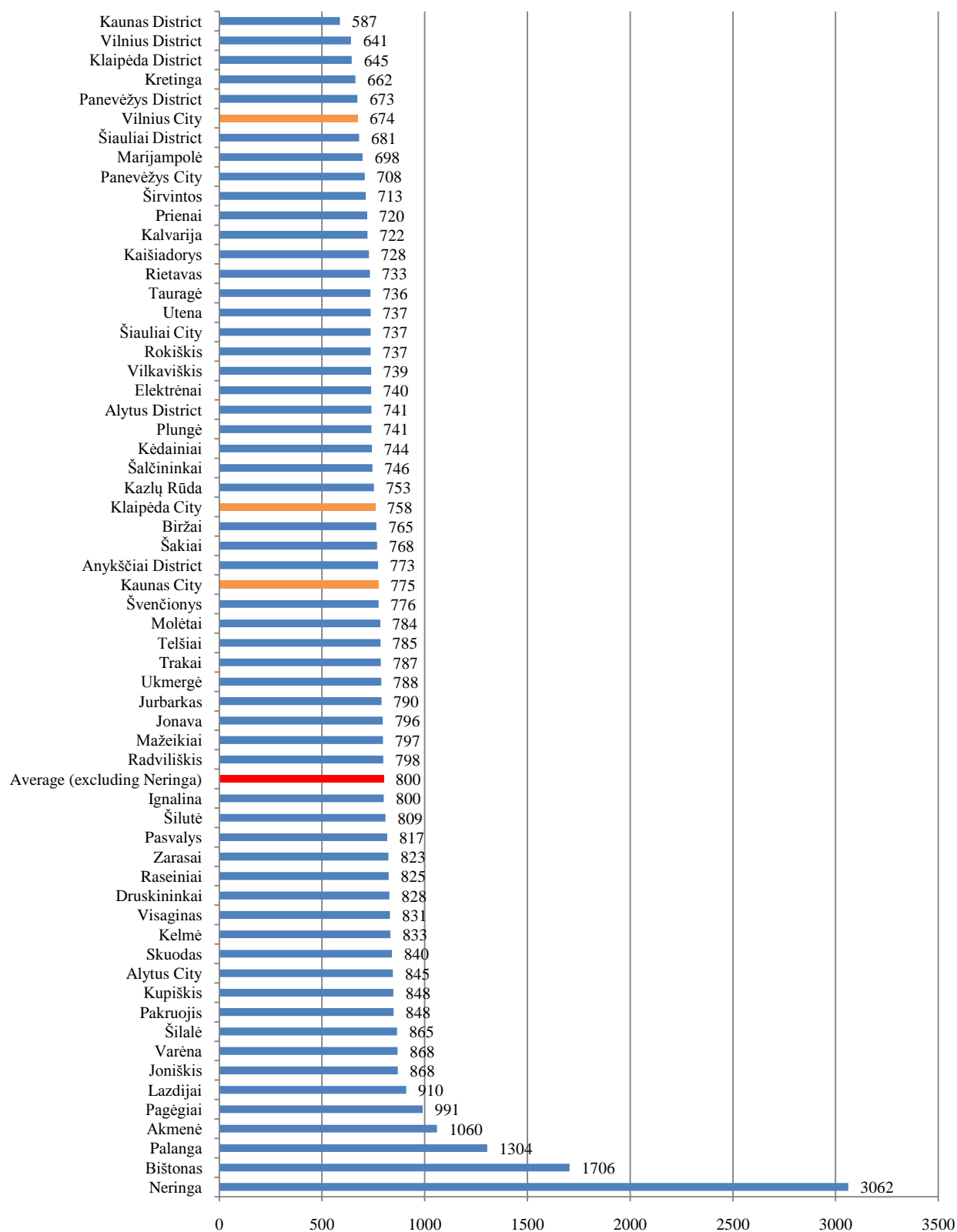
Source: calculated with regard to the approved budgetary plans of municipalities for 2015 and the data of Statistics Lithuania

Appendix 4. Redistribution of intra-budgetary funds across 57 supported municipalities in 2015 (%)



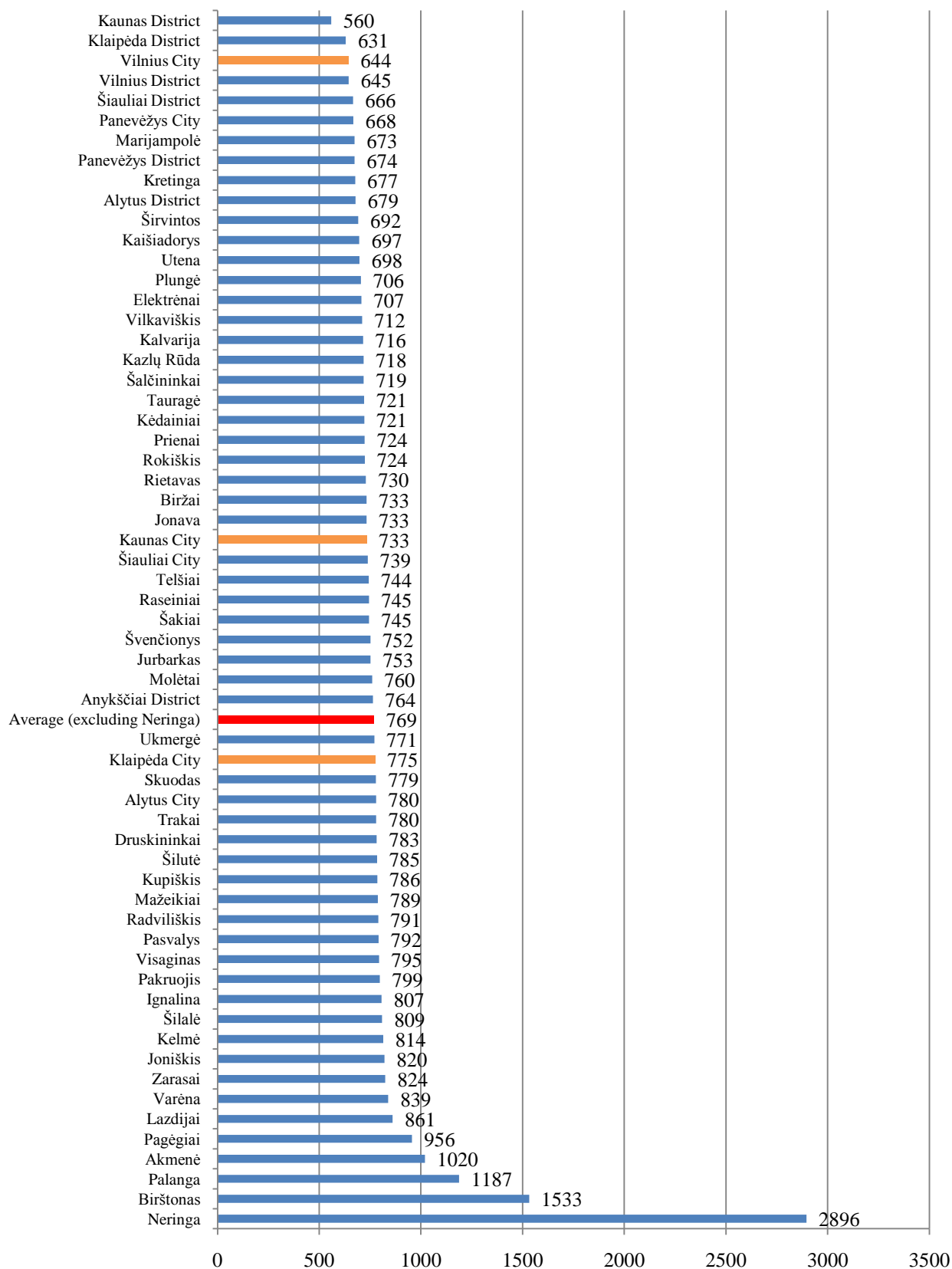
Source: calculated with regard to the approved budgetary plans of municipalities for 2015

Appendix 5. Municipal budgetary expenditure per capita (EUR) in 2014



Source: Statistics Lithuania

Appendix 6. Municipal budgetary income per capita (EUR) in 2014



Source: Statistics Lithuania