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Evaluation of financing of Lithuanian economic sectors: post 2020

Summary

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The evaluation was carried out according to the agreement for the provision of services, dated 31 July 2018, No. 14P-45 between the Ministry of Finance of the Republic of Lithuania and a group of economic entities UAB PricewaterhouseCoopers and UAB ESTEP Vilnius.

Evaluation goals, subject and methodology

The goal of the evaluation of financing of Lithuanian economic sectors post 2020 is to optimise public interventions in individual public policy areas in order to ensure sustainable growth of the society's quality of life in the medium-term and in the long-term perspective. Three tasks were set in the technical specification in order to achieve the goal:

- (1) To identify the structure and the extent of public interventions in the aforementioned public policy areas by type of intervention (regulation, financing, production, income support) and funding sources (state and municipal budgets, EU or other support funds) and to evaluate the relevance, sufficiency, coherence, and effectiveness of all types of interventions in achieving the public policy objectives.
- (2) To examine the coherence and relevance of the public interventions for achieving sustainable growth of quality of life in the medium-term and in the long-term perspective.
- (3) To identify the potential directions for decreasing the dependency on the EU Structural Funds (EU SF) in 2021-2027 and to assess the possibilities of replacing the EU SF investments with non-financial interventions by the state or private funds in order to sustain economic development and social welfare.

During the evaluation, in response to the evaluation questions set out in the technical specification for services, the needs for ongoing interventions and funding after 2020 in the following public policy areas were analysed: education; science, technology and innovations; business and tourism; energy; energy efficiency and home renovation; environmental protection; transport; the digital economy; healthcare; employment and social inclusion; demographics and migration; culture; public administration; regional development. The analysis and evaluation of each public policy area for all evaluation questions is presented in separate sectoral reports (annexes to the final report).

The aim of this evaluation was to improve public interventions implemented by the state and to seek consensus on the possibility of changing funding to other types of interventions, and therefore participatory evaluation involving representatives of public policymakers, experts and socio-economic partners has been implemented. During the evaluation, more than 30 intervention laboratories and focus group discussions supported by in-depth interviews were organised. The analysis of individual public policies was based on the results of the focus group discussions and the analysis of secondary sources. The latter included the analysis of academic literature, relevant research, evaluation, policy planning documents and legislation, evaluations performed by international organisations (EU, OECD, IMF), 2014-2020, analysis of EU Funds Investment Planning Documents (Partnership Agreement, 2014-2020, EU Funds Investment Operational Program (hereinafter – the OP), OP Priority Implementation Measures, Implementation Plans, Strategic and Annual Reports). In deciding on the optimisation of state interventions and their interoperability, in order to achieve sustainable growth in the society's quality of life, theoretical tools such as inclusive growth diagnostics (Hausman, Rodric, Velasco, 2005) have been used to identify the most growth-limiting factors and to identify priority trends for change, as well as economic state functions and theory of suitability of policy instruments (Musgrave, 1956, Tanzi, 2011).

Conclusions and recommendations of the analysis of the continuing relevance of public policy objectives

One of the main tasks of the evaluation was to examine whether the current state objectives are suitable for solving the existing and forecasted problems of the growth of the Lithuanian economy and the implementation of separate public policy areas post 2020. In this analysis, first of all, the main challenges for the sustainable growth of the quality of life in Lithuania were identified. The first challenge is the slowing down of economic growth due to the “middle income trap”. Lithuania has already used its potential for cheap labour and resource-based growth across sectors, suggesting the need to shift to innovation-based productivity and high value-added growth. This requires, in particular, removing restrictions on the creation and deployment of human, social capital and innovation. The second challenge is unsustainable growth and distribution of wealth occurring through inequality in income and regional disparities. The third challenge is unsustainable growth in relation to its environment.

In assessing the continuing relevance of the objectives of individual public policy areas and their compatibility with the general needs of the Lithuanian economy, sectoral trees of problems and their causes were formed, and then it was assessed whether the objectives set in the current planning documents are directed to the solution of these problems or their causes. The progress of the implementation of the sectoral objectives and targets was also assessed when analysing the achievements of the National Progress Program (NPP) indicators. Sectoral analysis has shown that in many areas of public policy, strategic goals are appropriate and aligned with each other in order to achieve a steady improvement in the society's quality of life. In addition, it is inappropriate to formulate (many) new targets in some sectors, as the old targets have not yet been reached. Business and innovation as well as social exclusion are a particularly good example. The following areas lack not new purposes but proper tools to achieve them. The main block of new goals, especially in comparison with the current NPP, is related to resource efficiency and circular economy (green dimension). However, the green dimension is more prominent in the newer strategic documents. The second important new element is the emphasis on the quality of public services, particularly in education, health and culture.

Taking into account the challenges of sustainable growth of the quality of life in Lithuania identified during the evaluation and the conclusions of the continuing suitability analysis of sectoral goals, three horizontal medium-term growth priorities for Lithuania's economy were formulated, categorizing the sectors into three target groups:

- (1) ***to overcome the middle income trap and ensure further economic growth*** (these goals are achieved through structural economic change and above all through the following public policies: R&I, business, digital economy, health and education);
- (2) ***to maintain and increase the number of skilled, working / healthy and motivated (happy) people / to increase the number of Lithuanian residents by enabling them to pursue their individual and social well-being*** (by pursuing these goals through the following public policy areas: employment and poverty, migration, education, healthcare and culture) (people));

- (3) *to create the conditions for sustainable and geographically balanced growth* (it is achieved by implementing transport, energy, environment, tourism and regional policy objectives).

Public administration could provide the basis for the formulation of the fourth priority – ***a strong and smart state***. It could also be applied to areas not covered by this evaluation, such as rule of law and justice, foreign policy and national defence.

The medium-term priorities and objectives for growth of the Lithuanian economy as outlined in the evaluation report are broadly in line with the recommendations of international organisations. Recommendations for Lithuania (European Semester, IMF, and OECD) highlight the problem of income inequality, low efficiency of redistribution of income, lack of labour force, which are not sufficiently reflected in Lithuanian strategic documents. The recommendations of the European Semester of recent years suggest improving tax compliance and broadening the tax base by including sources that are less damaging to the economic growth, addressing the problem of the adequacy of pensions, further developing the tax and social benefits system to cope better with the challenges of poverty and income inequality. These recommendations reflect not only the specifics of Lithuania or its changes (income inequality has long been characteristic of Lithuania) but also changes in global context and consensus on policy goals.

Conclusions and recommendations of state interventions review

An important task of the evaluation was to analyse the content of state interventions in pursuit of objectives in separate areas of public policy. In the course of the evaluation, each of the analysed public policy areas were covered by intervention maps, which can be found in the sector reports. The review of applied interventions shows that over the last twenty years, especially in the run-up to the EU accession, Lithuanian public policy area has expanded, production related interventions have decreased, they have been replaced by regulation, which has been substantially extended by EU law, and public investment, which has been significantly increased by the EU Structural Funds. Sectoral analysis and the use of investments of EU funds in this financial perspective have shown that there is a lack of clarity in key areas as to which interventions can help to achieve the objectives, for example in areas such as innovation (in particular the specific objective of encouraging business investment in R&D), poverty reduction and lifelong learning. In the field of innovation, policymakers are aware that progress in this area requires a set of interventions, aside from investment, it also requires tax incentives, and institutional tools such as agency mergers and one-stop shops, but the right parameters for this set are unclear. There is a need to calibrate the applicable tax incentives and to look for appropriate institutional measures. Another example is the importance of focusing on migration rules in order to attract talent in the development of innovation or the digital economy, but the appropriate mix of interventions is still being sought in this area. In some areas (such as employment, regional policy), the economic context and other interventions, such as regulation, are more important than investment. During the evaluation it was found that there is a lack of institutional incentives for combining different interventions, as public governance is organised on a sectoral basis. Another factor inhibiting combination of interventions is that the planning and management of the EU structural funds through a separate institutional system for managing EU structural funds is separated from that of general policy making. Other necessary interventions are not clearly identified in the planning and implementation of

the Operational Programme for the EU Funds' Investments. The ex-ante conditions for this financial perspective were limited exclusively to various strategic documents. They encouraged thinking about strategic goals and outcomes, but increased sectorial fragmentation and reduced incentives to look for appropriate interventions and to experiment with them.

In order to optimise public interventions, the following strategic suggestions and recommendations have been made in the evaluation report:

- 1) Given the limits on the size of the public sector, it is recommended to increase regulatory and communication interventions within the mix of interventions and to strengthen capacities. It is also recommended to pay more attention for testing of interventions, especially in the fields of innovation, lifelong learning, education and healthcare. A separate testing mechanism could be envisaged.
- 2) For successful interventions, it is recommended to increase the volume of interventions. This applies primarily to public service quality interventions in the fields of education, health, social security and culture.
- 3) The most important prerequisite for successful investment is the functioning institutions and administrative capacities. Investment progress is a good indicator of capacities. Therefore, the relevant institutions and their clusters should be identified as well as capacity-building measures and their funding should be foreseen. Among such institutions and clusters, it is worth mentioning institutionalisation of public administration improvement, institutions related to the digital economy and society, and the capacity of healthcare investment planning.
- 4) The most important enabling conditions should be non-investment type reform measures. Their number and content could be adjusted according to the Council recommendations of the National Reform Program of Lithuania.
- 5) Funding for new infrastructure is suggested to be organised on the basis of a public-private partnership (PPP). It is proposed to extend the application of this principle not only in order to reduce the dependency on EU funding, but also to achieve more efficient use of funds and faster implementation of the projects.
- 6) Upgrading of existing infrastructure and maintenance costs is proposed to be financed by infrastructure users (via tariff). This proposal is relevant to the fields of energy, energy efficiency and environmental protection.
- 7) Dependency on the EU structural funds would also be reduced by the increased use of financial instruments, which also reduces potential distortions of competition. It is recommended to additionally assess the establishment of separate infrastructure funds, where the funds of the EU structural funds, state, municipalities, private and institutional investors could be combined.

Reduction of dependency on the EU Structural Funds in 2021-2027

The evaluation covered the analysis of the extent of financing of separate public policy areas, based on the information provided by the Ministry of Finance via the State Budget Accounting and Payments

System (hereinafter referred to as VBAMS) on the state budget expenditures for the respective state functions and sources of financing of these expenditures, as well as on the data of the Lithuanian Department of Statistics and the Ministry of Finance, and data provided by municipal budgets for the analysed area. It was found that in 2011-2017, in the structure of the state budget expenditures, energy efficiency and housing renovation (97%), energy (96%), regional policy (95%), tourism (94%), business competitiveness and investment promotion (89%) and the digital economy (84%) were mainly financed by the EU funds. The medium level of dependency on the financing from the EU funds has been determined in the field of environmental protection (64%). In other areas of public policy, financing from the EU funds is less than 35% of all state budget allocations for a specific area.

The evaluation report states that financing from EU structural funds could be reduced for the following areas of public policy:

- (1) Where goals are achieved or are irrelevant due to external changes. Taking into account the current economic upturn (high employment and low unemployment), funding for active labour market policy measures which during the period of 2014-2020 were allocated over EUR 200 million, could be reduced. It is necessary to develop plan B in case of economic crisis however. At present, the overall level of entrepreneurship in Lithuania is among the highest in Europe, therefore the funding for the promotion of SME competitiveness can be directed to the start-ups having the highest potential. The need of funding for youth employment measures is diminishing, given the reduced size of the NEET youth problem. It is proposed to reduce the amount of funding for public childcare facilities by making better use of existing public infrastructure or by using shuttle services.
- (2) Where the need for infrastructure funding will diminish, as it will largely be generated from 2014-2020 EU funding period and previous funds. In addition, demographic challenges in the country will require more efficient use of available infrastructure. In the new financial period, it is forecasted that less money will be needed for the development of new infrastructure in the areas of employment and social inclusion, health care, education, culture and environment.
- (3) Where objectives can be achieved through alternative interventions (for example, economic instruments have a significant impact on the environment; the impact of EU investments in science, technology and innovation must be strengthened through regulatory measures; although communication is also costly, it is recommended that a larger share of EU SF funds be earmarked for marketing and communication) both by promoting the use of existing products, such as e-services as well as by replacing hard investments with them.
- (4) Where funded interventions do not generate the expected result, it is proposed to pilot interventions and analyse them more.

Four key criteria were used to formulate proposals to reduce dependency on EU Structural Funds in each public policy area:

- (1) If the problem for which financing at the current is period applied, is already solved or irrelevant due to external changes;
- (2) if funded interventions do not generate the expected result, or have failed;

- (3) if funding interventions can be replaced through regulatory measures (by imposition of obligations) or encouraging positive changes using communication tools (which also come at a cost but are cheaper), also
- (4) if conditions for private financing can be made, by applying the principle of public and private sectors partnership, by handing over to private funds, business or persons or by changing with other source of financing.

Specific proposals for reducing the EU funding in 2021-2027 are provided in sectoral reports. In conclusion:

- ***In the area of employment and social inclusion***, it is proposed to reduce the scope of measures targeting unemployed and aimed at strengthening the competences of the employed; and to direct it towards the problems of social exclusion. Housing problem (lack of supply of social housing) is proposed to be solved through the harmonisation of housing rental and coordination of social housing development, while reducing the volume of the illegal housing rental market. It is proposed to finance the development of social housing by combining the funds of the EU structural funds, state, municipalities and other institutional investors by managing them through a specialised fund.
- ***In the area of demography and migration*** it is proposed to focus the funding for public childcare facilities by making better use of existing public infrastructure or by using shuttle services. For solving the problems of older people, it is suggested to promote private and community services, as there is evidence that they may cost less. In order to increase the overall effectiveness of active labour market measures, it is suggested that they be directed to those with higher potential for employment.
- ***In health care***, it is proposed to reduce the funding of EU Structural Funds for infrastructure development and modernization, and to use PPPs to finance this need. Within the public policy area itself, it is proposed to increase funding for public health and disease prevention as well as primary health care. In the field of integrated (nursing-care) services development, it is worth considering combining the funds of the Compulsory Health Insurance, the Ministry of Social Security and Labour funds as well as allowances from municipalities and residents.
- ***In the area of education***, given the current situation and the recommended actions, it is not appropriate to reduce funding, but the investment priorities should be partly amended. It is recommended to reduce infrastructure investment at all levels of education, but the infrastructure should be adapted to pre-school and primary education: in rural areas, promoting the use of existing infrastructure (day centres, multifunctional centres, community homes, etc.) for educational purposes, creation of mobile kindergartens while renovating old or building new premises in the cities. The role of private funding could be greater in the area of vocational training, encouraging business to invest in apprenticeship and other programs together. Private funding can contribute more to the solving of problems of quality of schools and higher education.
- ***In the area of science, technology and innovation***, it is difficult to reduce dependency on the EU structural funds, especially when EU-wide financing for this area is to be increased, and

Lithuania's performance in the field of R&I is poor. The dependency on EU Structural Funds funding can be partly reduced by successful public procurement, thus changing public investment in demand-driven R&I growth.

- ***In order to promote business competitiveness and investments***, it is appropriate to move from grants to wider use of financial instruments. The same as in the operational program of 2014-2020, only small and medium-sized business subjects are offered financial interventions in order to concentrate business support funds. There are many examples of international practice where the FEZ and other industrial areas are developed by the private sector. It is proposed to carry out a feasibility study of private sector involvement in FEZ infrastructure development and development of new industrial territories, which would analyse the distribution of costs, benefits and risks between the public and private sectors in a comprehensive way.
- ***In the area of digital economy***, it is proposed to reduce the financing from the EU structural funds by making more effective use of the principle of public-business partnership, by adjusting educational programs and the legal environment of the digital economy by means of regulatory measures, and by using communication tools targeted at the target audience to achieve the set goals.
- ***In the area of public administration***, the need for financing related to the structural reforms in the country is proposed to be financed from the EU Reform Support Program; other important (horizontal) governance improvement initiatives, such as strengthening the level of managers, promoting the use of evidence in decision-making could be financed from the national budget.
- ***In the field of environmental protection***, it is proposed to reduce the financing from the EU Structural Funds for infrastructure deployment and modernization by making more effective use of PPPs, applying regulatory measures and focusing on public education, training and participation.
- ***In the area of energy efficiency***, it is proposed to increase the cost of energy for consumers through the introduction of energy-related taxation to improve the energy efficiency of housing as well as public buildings and infrastructure. In order to further reduce the cost of renovation, it is appropriate to develop quarterly renovation plans. In order to increase the energy efficiency of industry, it is proposed to exempt energy-intensive industries from the public service obligation related part of tariff in exchange for the implemented energy efficiency measures. There is a need for both public education and the creation of demand for goods that use sustainable energy-based technology or "green" energy. In the transport sector, increasing energy efficiency would be fuelled by the taxation of polluting vehicles and restrictions on entering city centres. The development of electric cars would be driven by both taxation of inefficient cars and a one-off subsidy for electric cars.
- ***In the energy sector***, in order to achieve energy security in the electricity sector without the EU structural funds, it would be necessary to increase the price of electricity in order to make the necessary investments in the electricity grid. Similar steps would be needed to modernise the gas network and connect it to Poland. The accelerated development of renewable energy without the EU Structural Funds investment in electricity could be driven by the taxation of electricity imported from third countries produced from fossil fuels as well as formation of the loan fund for the development of renewable energy. The development of cooling economy and

heating and cooling accumulation infrastructure could potentially contribute to both increased use of renewable resources in electricity generation (electricity price fluctuations will be reduced) as well as in heat production (facilities will work with fewer breaks).

- ***In the transport sector***, it is proposed to reduce the dependency on the financing from the EU Structural Funds through wider application of PPPs, for example, for the development of electric cars loading infrastructure, infrastructure upgrading, municipal ride hailing services and road maintenance. In the financing of road infrastructure, the need for the EU structural funds would be reduced by planned replacement of existing vignettes for freight transport by an electronically administered system that would charge a fee based on the distance travelled instead of driving time which should increase the funds collected for that purpose. It is also proposed to consider setting up a fund for infrastructure, including transport, which would be an additional barrier to political decision-making by attracting funds from other investors. It is proposed to reduce the negative impact on the quality of the environment by introducing new regulatory measures.
- ***In the field of tourism promotion***, changes could be related to a more even distribution of the country's tourism promotion costs, especially in the area of marketing, between the state, regions/municipalities and private business. Municipalities and businesses will have to assume greater responsibility and make their contribution through participation in tourist destination management organizations (DMO), where marketing is one of the main areas of activity. Municipalities, especially those who collect a "capitation tax", resort fees or local entry fees have a good mechanism for shifting the bulk of the burden on the tourists themselves, particularly taking into account that Lithuania is the world leader according to the price competitiveness.
- ***In the field of culture***, by the implementation of the 2014-2020 projects, the most pressing need for modernisation of the infrastructure of national cultural institutions will be solved, therefore, it would be possible to allocate the EU structural funds more to soft measures by promoting the demand, quality and accessibility of cultural services and the qualification of cultural workers. It is proposed to combine the measure for private owners of the Cultural Heritage Department with the EU Structural Funds for the use of the cultural heritage, to establish a cultural heritage fund for this purpose, to commit real estate developers to contribute to the management, to increase their abilities and knowledge.
- ***In the area of digital economy***, it is proposed to reduce the financing from the EU structural funds by making more effective use of the principle of public and private partnership, by adjusting educational programs and the legal environment of the digital economy by means of regulatory measures, and by using communication tools targeted at the target audience to achieve the set goals.
- Given the growing focus on ***regional development***, the increasing concentration of planned EU structural funds for sustainable urban development, no reduction in EU funding is proposed. However, the creation of an Urban Development Fund to mobilise private funds should also be considered.