Executive summary of the public audit report

ACTIONS TAKEN BY PUBLIC ESTABLISHMENTS AND INSTITUTIONS IN ATTRACTING DIRECT FOREIGN INVESTMENT

27 September 2017, No. VA-2017-P-20-6-16

Full audit report in Lithuanian available on website
of the National Audit Office:
www.vkontrole.lt

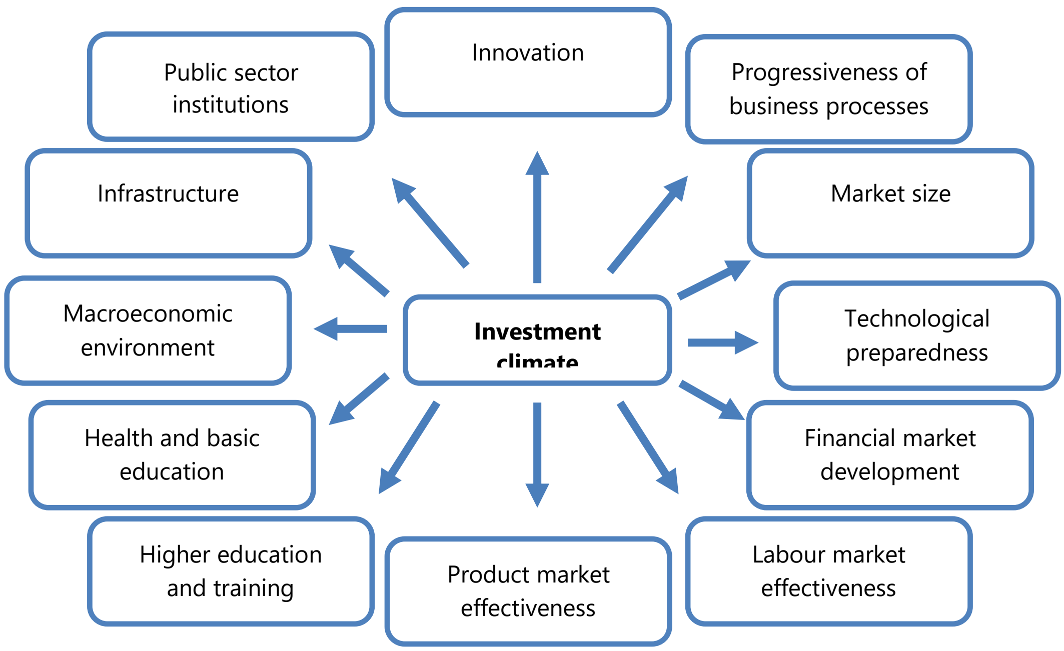
SUMMARY

The Importance of Audit

Broadly, direct foreign investment (DFI) refers to the investment of foreign capital for the purposes of establishing new or purchasing already functioning local companies, where the foreign investor[1] is granted the right to no less than 10 percent of the company's authorised capital. Small-scale transactions at the local stock exchange do not fall under direct foreign investment. In Lithuania, foreign investment is allowed into all legitimate commercial-economic activities, except those which are prohibited or limited due to public interests. These consist of not only primary investment, but also of later transactions. This is an important element, which often leads to more rapid economic growth, opens up foreign markets, promotes the growth of export, creates jobs, fosters competition, encourages progressive management, and establishes a safer environment for the state.

The investment climate is commonly understood to mean the actions of the state, as well as all other factors which fall beyond the operators of business (Picture no. 1).

1 pav. Components of investment climate



Source – the National Audit Office in accordance with the indicators of the Global Competitiveness Report

When deciding on which country to enter, foreign investors first take note of the business environment and the conditions for growth, and then make comparisons between different countries. There are two universally recognised annual studies, designed to compare individual countries and rate them according to their business climate – the Doing Business study conducted by the World Bank (which encompasses 190 countries) and the Global Competitiveness Report conducted by the World Economic Forum (encompassing 138 countries).

[1] According to Part 4, Article 2 of the Law on Investment of the Republic of Lithuania, these are foreign countries, international organisations, and foreign legal and natural persons, which, following the procedure specified in legislation, invest own or borrowed assets, or assets owned and used in accordance with trust law.

According to the Doing Business study conducted in 2017, Lithuania is currently at number 21 in the world (and number 11 in the EU) in terms of business climate, taking over such European countries as Poland, the Czech Republic, Holland, France, Slovenia, Switzerland, Belgium, etc. In terms of competitiveness, in 2016 Lithuania was number 35 (number 14 in the EU), taking over Poland, Italy, Latvia, and Slovenia.

Regardless of the relatively high comparative results in terms of investment climate, Lithuania is currently at the very bottom of the list of EU countries in terms of attracted direct foreign investment. Even though Lithuania enjoys a number of successful foreign-owned companies, which chose to develop their business here, as well as an increasing number of successful foreign investment projects, in terms of the aggregate DFI from GPD, we had been number 25 of 28 EU countries in 2015, and number 22 in 2014. In terms of aggregate DFI, we are currently number 26, ahead only of Romania and Greece. All of this leads Lithuania, which has a number of advantages and is attractive to business (especially in certain areas), to lag behind other countries of the EU due to its geopolitical environment, insufficiently consistent policy (including investment policies), and passive practices in many areas.

Even though Lithuania had joined the EU 13 years ago, the experiences of neighbouring countries indicate that better results in this area were indeed possible. For instance, Latvia, which is lower on the list than Lithuania in terms of investment climate, is currently at number 20 in terms of aggregate DFI from GDP, and Estonia is number 12. Malta, which had jointed the EU at the same time as Lithuania, is currently number one. It can therefore be presumed that improvements to the indicators of the investment climate does not have any direct impact on the growth of DFI, but rather creates the necessary conditions for it.

Furthermore, there had been changes to the structure of Lithuania's DFI. Comparing the structure of the country's DFI between 2011 and 2015, manufacturing had shrunk by 5.5 percent, wholesale, retail, and vehicle repair – by 2.3 percent, and the supply of electricity and gas, as well as other areas by 3.4 percent. The largest positive change (8 percent) was seen in finance and insurance, and real estate operations – 3.27 percent. However, investment into these areas largely comes on its own, without any significant effort on the part of the state. Currently, these areas account for almost 42 percent of all investment which finds its way to Lithuania, whereas in 2011 it accounted for 30 percent. Meanwhile, other areas of DFI, which are generally prioritised in other states, are shrinking.

Based on the experience of other countries, the quality and attraction of DFI are decisively impacted by the long-term, consistent and sustainable public vision, as well as decisive actions taken by public establishments and institutions in attracting DFI. Market effectiveness depends on regulatory institutions, which set operating conditions for investors, specifying costs and the accessibility of information, which, in turn, determine the success of the investors' business. Direct foreign investors consider effective and predictable institutions to be one of the host country's potential advantages. This is the aspect of our study we had chosen for the present audit.

The Goal and Extent of the Audit

The audit was designed to assess the following: whether the state manages to clearly articulate its strategic goals, and the effectiveness and consistency of public establishments and institutions in attracting direct foreign investment.

The key questions of the audit:

- is the regulatory environment of the state oriented towards successful attraction of DFI?;
- are the means of attracting DFI applied by public institutions and municipalities managed and employed effectively?

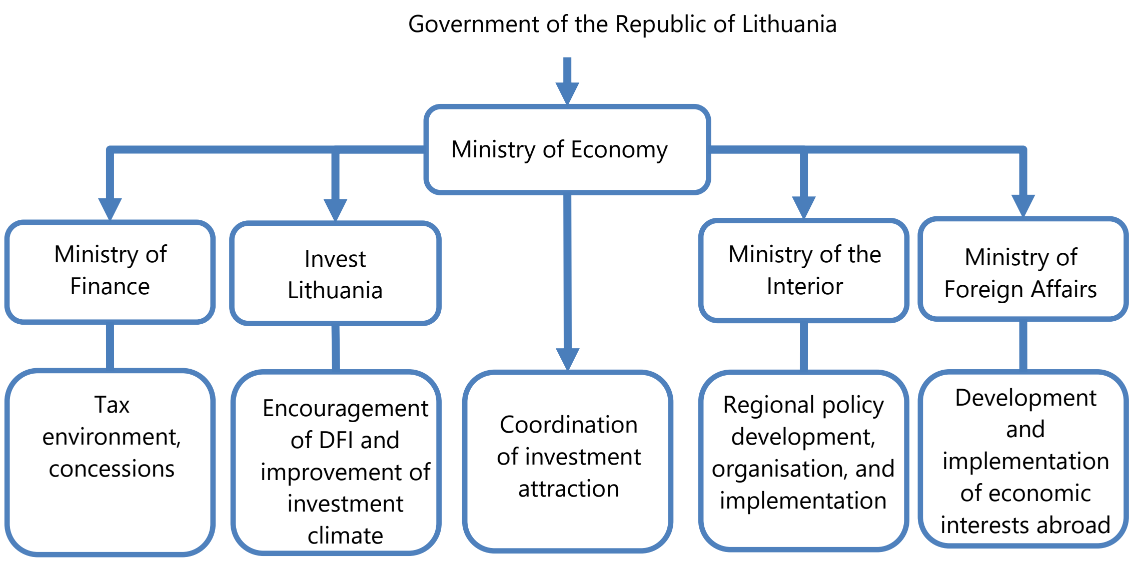
The subjects of the audit:

- the Ministry of Economy, which is responsible for the implementation of policies related to the economy and the increase in competitiveness, including the attraction of investment. The public establishment Invest Lithuania, operating under the Ministry, is responsible for attracting investment into the industrial and service sectors, emphasising investment with a high potential for creating added value.
- the Ministry of the Interior, which is responsible for the development of public policy in the area of local self-government, thereby contributing to the development of a favourable investment climate in the regions of Lithuania.
- the Ministry of Finance, which is responsible for ensuring that the municipal budget revenue planning and distribution system attracts local and foreign investment.

The audited period: 2013–2016. In some cases, when it relates to EU funding, the financial aid period of 2007-2013, as well as the preparedness for the implementation of the 2014-2020 EU financial measures, related to the attraction of direct foreign investment were also assessed.

Public sector participants, operating in the area of DFI attraction, and related in terms of subordination and coordination, operate in accordance with the principles of public administration, and the documents regulating their activities. In order to make progress in the area of attracting DFI, the public sector must operate effectively, employing its relevant resources efficiently, and strive for positive outcomes at the lowest possible cost. Institutional action determines not only whether an investor decides to make an investment in the country, but also the most favourable and beneficial place (a region or municipality) for doing so. The operation of public sector establishments must have clearly defined responsibilities, and specific functions differentiated in terms of areas of operation, without any redundancies (Picture 2).

2 pav. Members of the DFI attraction system of the public sector, and their key functions



Source – the National Audit Office in accordance with legislation

Having assessed the areas of responsibility set for ministries and establishments, we had analysed the implementation and impact of said measures for attracting direct foreign investment to Lithuania (Picture 3).

3 pav. Direct DFI attraction measures managed by public establishments and institutions

Direct DFI attraction measures managed by the Ministry of Economy

- Aid to investment development (57.7 million Eur for financial investment ecouragement measures)
- Industrial parks and FEZ (40 million for FEZ infrastructure and land purchase)

Direct DFI attraction measures managed by Invest Lithuania Invest Lithuania

Direct DFI attraction measures managed by the Ministry of the Interior

- Regional development and attraction of investment to them. Coordination of regional activities of institutions responsible for the attraction of investment
- Encouragement of investment attraction to regions using EU aid funds of 2007-2013 and 2014-2020 (848.9 million Eur and 1.194 million Eur)

Measures managed by the Ministry of Finance, which have an impact on the attraction of DFI

- Tax concessions applied exclusively to investors
- Encourgement of municipalities to attract investors by redistributing the budgetary revenue of municipalities

Source – the National Audit Office in accordance with the areas of responsibility set for ministries and establishments

The audit was carried out in accordance with public audit requirements and international supreme audit institution standards. The extent and methods of audit are provided in Annex 1, "The Extent and Methods of Audit" (p. 46).

The Key Outcomes of the Audit

The strategies of the state and regions have no clear, sustainable and integrated vision for attracting DFI, and the planning of the operation of public institutions and municipalities fail to encourage the attraction of DFI.

The National Progress Programme for 2014–2020, the Investment Encouragement and Industrial Development Programme for 2014–2020, and other public and municipal management action programmes fail to ensure an integral and consistent approach to DFI.

Programme objectives and criteria related to the attraction of DFI are uncoordinated, and, in some cases, mutually contradictory.

Public institutions are not being encouraged to use their resources effectively. There is also a lack of cooperation between the ministries of economy and the interior in attracting DFI to regions, specifying directions of attraction, and the intensity of financing using the funds of the EU.

The only reason for the growth of DFI per person by approximately 1.2 percent during the period between 2010 and 2016 was depopulation.

The Implementation of Financial Incentives for the Attraction of DFI Lack Traceability

According to the documents provided to us by Invest Lithuania, the process of project selection, preliminary assessment, decisions regarding whether to inform investors of possible financing, and proposals made to the Ministry of Economy regarding the funding of projects are untraceable.

The preliminary project proposal of Invest Lithuania was evaluated without an examination of its public value. There is also no set threshold where a project would be deemed disadvantageous.

To the Ministry of Economy, responsible for decisions regarding the funding of projects, Invest Lithuania submits unjustifiably inflated indicators of the public value of projects.

Part of the justifications of qualitative criteria (i.e., those related to public value) provided in applications are vague, redundant, and fail to oblige investors to comply with them.

An effective system for the monitoring and control of the assessment of project expenditure is not ensured.

Publicity requirements are set only for projects related to the promotion of business, which are financed through EU structural funds, but not for measures funded via the state budget, even though their goals and supported activities are similar.

The State Fails to Use PEZ to its Full Potential for Attracting Foreign Investors

Even though the state had invested over 40 million EUR into the infrastructure of 7 PEZs, 74 percent of the territory assigned for PEZ-related activities is still underutilised.

The Ministry of Economy had failed to take all necessary actions to ensure that municipality-owned infrastructure, granted to the management company of PEZ to manage and utilise under tenancy rights, be appropriately developed and prepared for use in a timely manner.

The operation of the public commission responsible for the monitoring of PEZ is not ensured; the representation of public interest in PEZ management boards is inappropriate; and the monitoring of state aid and the activities of PEZ are insufficient.

Municipalities Fail to Consistently Apply Measures for the Attraction of Foreign Investment

10 of the major cities of Lithuania (Vilnius, Kaunas, Klaipėda, Panevėžys, Telšiai, Utena, Šiauliai, Marijampolė, Alytus, and Tauragė) had attracted most of the country's DFI (88 percent). A comparison of the major cities reveals Vilnius to be the leader in this regard.

Municipalities rarely apply fiscal measures of promotion, which could help attract investment, because, in their view, said measures are ineffective and financially damaging to the municipalities themselves. Approximately 88 percent of municipalities fail to employ fiscal advantages to promote the attraction of investors, claiming they are ineffective and inefficient. 77 percent of municipalities fail to employ "soft" investment facilitation measures, cooperate with investors, and help them by providing consultations.

The use of EU Funds in Regions Fails to Promote the Development of a Favourable Investment Climate

Structural EU funds (848.8 million EUR) allocated to regions during 2007–2013 had failed to develop sustainable jobs and a favourable climate for DFI.

The Ministry of the Interior had chosen to allocate the EU structural funds for 2014-2020 (1.194 billion EU) for measures very similar to those chosen during the period between 2007 and 2013, namely: the improvement of public management and service quality in municipalities, the modernisation of infrastructure important to local communities, and the improvement and protection of the environment.

Having assessed the collected evidence, we present the outcomes of the public audit. Appropriate implementation of the provided recommendations could ensure more effective functioning of the public sector in attracting direct foreign investment.

The Municipal Budgetary Revenue Planning and Allocation System Fails to Promote the Attraction of DFI

Even though active attraction of DFI within regions requires both financial and human resources, the allocation of PIT between public and municipal budgets fails to consider the functions carried out by municipalities, as well as their outcomes and extent.

The Law on the Methodology for Setting Municipal Budget Revenue lacks criteria for setting and amending the part of PIT received by municipalities. Donating municipalities are specified, and funds for redressing the differences between the structures of expenditure calculated without considering municipal activity indicators.

CONCLUSIONS

Attraction of direct foreign investment in Lithuania is insufficiently effective. The management and use of investment attraction measures applied by public institutions and municipalities lack efficiency and effectiveness necessary to achieve the aim of making every effort to attract such foreign investment, specified in the National Progress Strategy "Lithuania 2030", because of the following:

1. The policy of attracting direct foreign investment, as well as its implementation, lack a clear, sustainable, and integrated vision and goals, and fail to prioritise the development of certain business sectors, which have an impact on using the country's investment climate to its full capacity (Subsection 1.1).
2. In some cases, public sector institutions fail to appropriately implement their assigned functions related to the attraction of DFI. Their operation is insufficiently coordinated and lacking in cooperation, which complicate the process of making the most important decisions for the state and its regions (Subsection 1.2).
3. The potential of measures for attracting investors, funded from the public budget, is not being used to its full capacity: project selection lacks traceability, the results of their public value assessments are unjustifiably inflated, and the possibility of assessing the real value of investment projects is limited due to commitments to maintain the confidentiality of information (Subsection 2.1).
4. The management, monitoring, coordination, and representation of PEZs at their management companies fail to ensure that activities they perform would meet public expectations. Inappropriately fulfilled public sector obligations, specified in PEZ framework agreements, allow PEZ management companies to neglect their obligations (Subsection 2).
5. Municipalities fail to use fiscal, infrastructural, and "soft" measures for attracting direct foreign investment to their full capacity, claiming they are unattractive (Subsection 2.3.1).

6. EU funds (848.9 million EUR) allocated to promoting the development of regional economies and the attraction of investors during the period between 2007 and 2013 were used not to attract investors or create sustainable jobs, but for measures to improve the environment, which only had an indirect impact on the volume of investment. The planning of EU aid (1.194 billion EUR) allocated to regions during the period between 2014 and 2020 had failed to consider the shortcomings of implementing the aid provided during the previous period (Subsection 2.3.2).
7. The municipal budget planning and allocation system, which has been modified many times since 1997, still fails to encourage municipalities to attract investment and make decisions which might lead to an increase in budgetary revenue and the growth of regional economies (Subsection 1.3).

Recommendations

Considering the legislation regarding the improvement of legal regulation, and the planned measures in this area specified in the government programme, as well as striving for the attraction of direct foreign investment to also ensure more effective operation of the public sector, which would encourage the growth of the national and regional economies by making use of the attracted direct foreign investment, we recommend the following:

To the Government

1. Develop a DFI attraction policy based on a clear vision and consistent goals, and prioritise certain business sectors for development (Conclusion 1)
2. Ensure that the long-term direct foreign investment attraction policy be consistently implemented in the short- and medium-term public and municipal strategic planning documents, and that the strategic planning system provides the conditions necessary for integrating the processes of territorial and regional planning (Conclusions 1 and 2)

To the Ministry of Economy

3. Improve the administration process of the DFI attraction measure, such that project selection and assessment would be traceable, the implementation monitoring – consistent, and the projects and their implementation publicised (Conclusion 4).
4. Specify measures for ensuring the operation of a system for the public management and monitoring of PEZs, and the discharge of public sector obligations to the PEZ management companies (Conclusion 5).

To the Ministry of the Interior

5. Ensure the specialisation of regions in accordance with the attraction of priority investment, and their compatibility with public strategic and land planning documents (Conclusion 1).
6. Improve the fiscal, infrastructural, and “soft” measures applied by municipalities, such that they would attract foreign investors more effectively (Conclusion 6).
7. Revise the methodologies used for developing the regional development plans, and the development programmes for integrated territories, specifying measures necessary for the regional EU funds for the period between 2014 and 2020 to be used for the improvement of the investment climate and the creation of sustainable jobs, which are more significant in the long-term (Conclusion 7)

Measures and terms for the implementation of recommendations are provided on page 43 in, "The Plan for the Implementation of Recommendations".