OECD Economic Surveys
LATVIA

FEBRUARY 2015

OECD

OECD Economic Surveys: Latvia 2015

OECD
BETTER POLICIES FOR BETTER LIVES

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

Please cite this publication as:
OECD (2015), *OECD Economic Surveys: Latvia* 2015, OECD Publishing, Paris.
http://dx.doi.org/10.1787/9789264228467-en

ISBN 978-92-64-22845-0 (print)
ISBN 978-92-64-22846-7 (PDF)

Series: OECD Economic Surveys
ISSN 0376-6438 (print)
ISSN 1609-7513 (online)

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Photo credits: Cover © Knivinis/Shutterstock.com.

Corrigenda to OECD publications may be found on line at: *www.oecd.org/about/publishing/corrigenda.htm*.

Table of contents

Thematic chapters

Tables

Figures

On 29 May 2013, the OECD Council decided to open discussions with Latvia on accession to the Organisation and, on 15 October 2013, an Accession Roadmap, setting out the terms, conditions and process for accession was adopted [C(2013)122/FINAL].

In the Roadmap, the OECD Council requested a number of OECD Committees to provide it with a formal opinion. The Economic and Development Review Committee was requested to provide a formal opinion evaluating Latvia's policies and practices as compared to OECD best policies and practices. In light of the formal opinions received from OECD Committees and other relevant information, the OECD Council will decide whether to invite Latvia to become a member of the Organisation.

The present Economic Survey was prepared for the purposes of the accession review of Latvia. The draft report was discussed by the Economic and Development Review Committee on 18 December 2014, revised in the light of the discussions and finalised on 22 January 2015. The draft report was prepared for the Committee by Caroline Klein and Zuzana Smidova under the supervision of Andreas Wörgötter. It also benefitted from consultancy work by Robert Price. Research assistance was provided by Corinne Chanteloup. Heloise Wickramanayake formatted and produced the layout of the document.

This is the first OECD Economic Survey of Latvia. It is published on the responsibility of the Secretary-General of the OECD.

More information about how Surveys are prepared is available at www.oecd.org/eco/surveys.

BASIC STATISTICS OF LATVIA, 2013

(Numbers in parentheses refer to the OECD average)[a]

LAND, PEOPLE AND ELECTORAL CYCLE

Population (millions)	2.0		Population density per km²	31.5	(34.8)
Under 15 (%)	14.6	(18.3)	Life expectancy (years, 2012)	74.1	(80.2)
Over 65 (%)	18.9	(15.7)	Men	68.9	(77.5)
Foreign-born (%, 2011)	14.5		Women	78.9	(82.9)
Latest 5-year average growth (%)	-1.6	(0.6)	Latest general election	October	2014

ECONOMY

Gross domestic product (GDP)			Value added shares (%)		
In current prices (billion USD)	30.9		Primary	4.9	(2.5)
In current prices (billion EUR)	23.2		Industry including construction	25.1	(26.8)
Latest 5-year average real growth (%)	-0.9	(0.8)	Services	70.0	(70.2)
Per capita, (000 USD PPP)	23.0	(38.1)			

GENERAL GOVERNMENT

Per cent of GDP

Expenditure[b]	35.7	(42.5)	Gross financial debt (2012)	32.3	(110.4)
Revenue[b]	34.8	(36.8)	Net financial debt (2012)	8.1	(69.9)

EXTERNAL ACCOUNTS

Exchange rate (EUR per USD)	0.752		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	0.503		Manufactured goods	18.8	
In per cent of GDP			Machinery and transport equipment	18.6	
Exports of goods and services	59.4	(53.4)	Crude materials, inedible, except fuels	13.1	
Imports of goods and services	62.6	(49.4)	Main imports (% of total merchandise imports)		
Current account balance	-2.3	(- 0.1)	Machinery and transport equipment	23.0	
Net international investment position	-67.6		Mineral fuels, lubricants and related materials	15.8	
			Manufactured goods	13.9	

LABOUR MARKET, SKILLS AND INNOVATION

Employment rate for 15-64 year olds (%)	65.0	(65.0)	Unemployment rate, Labour Force survey (15 and over) (%)	11.9	(7.9)
Men	66.8	(73.1)	Youth (age 15-24) (%)	23.2	(16.2)
Women	63.4	(57.0)	Long-term unemployed (1 year and over) (%)	5.7	(2.7)
Participation rate for 15-64 year-olds (%)	74.0	(71.1)	Tertiary educational attainment 25-64 year-olds (%, 2012)	29.2	(31.5)
Average worked hours per year	1928	(1 771)	Gross domestic expenditure on R&D (% of GDP, 2012)	0.7	(2.4)

ENVIRONMENT

Total primary energy supply per capita (toe, 2012)	2.2	(4.2)	CO_2 emissions from fuel combustion per capita (tonnes, 2012)	3.4	(9.7)
Renewables (%, 2012)	37.4	(8.6)	Water abstractions per capita (1000 m^3, 2013)	0.12	
Fine particulate matter concentration (urban, PM10, µg/m^3, 2013)	34.2	(24.4)	Municipal waste per capita (tonnes, 2013)	0.31	

SOCIETY

Income inequality (Gini coefficient, 2011)[c]	0.360	(0.308)	Education outcomes (PISA score, 2012)		
Relative poverty rate (% below 50% of median income, 2011)	13.4	(11.2)	Reading	489	(497)
Median equivalised household income (000 USD PPP, 2010)[c]	8.2	(20.4)	Mathematics	491	(494)
Public and private spending (% of GDP)			Science	502	(501)
Health care (2012)	6.0	(9.2)	Share of women in parliament (%, September 2014)	25.0	(26.7)
Pensions (2011)	8.2	(8.7)	Net official development assistance (% of GNI, 2011)	0.08	(0.37)
Education (primary, secondary, post sec non tertiary, 2011)	3.0	(3.9)			

Better life index: *www.oecdbetterlifeindex.org*

a) Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exists for at least 29 member countries.

b) 2012 for the OECD.

c) For Latvia, OECD Secretariat calculations from EU-SILC – preliminary results.

Source: Calculations based on data extracted from the databases of the following organisations: OECD, International Energy Agency, Eurostat, World Bank, International Monetary Fund Eurostat and Inter-Parliamentary Union.

Executive summary

- *Main findings*
- *Key recommendations*

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Main findings

Latvia has made rapid progress in adjusting its economy since the economic crisis, as illustrated by its successful entry to the euro area at the beginning of 2014, and has implemented wide-ranging structural reforms. The recovery has been strong with record-high growth rates. However, the economy is volatile and GDP is still below its pre-crisis level. It is challenging to replace unsustainable and loan-financed domestic demand generated by the real estate bubble before 2008. Unemployment has come down considerably, but long-term unemployment and emigration remain issues. Latvia has a tradition of providing "bridging" services between East and West and attracts non-resident deposits mainly from countries outside the EU. It is important to acknowledge the volatile character of a business model based on non-resident resources, not least because of the geopolitical instability of the region.

Raising productivity and ensuring robust convergence

The economic recovery slowed as the global economic environment deteriorated. The vulnerability of the economy to external developments highlights the need to improve resilience and to move domestic production and exports up the value chain. Despite significant improvement, informality, entry barriers and red tape, notably linked to the complexity of the permits and licenses system, still undermine Latvia's attractiveness for manufacturing investors and the productivity of exporters. Public involvement in the economy is extensive and poses regulatory and competition challenges. Governance of state-owned enterprises could improve with the Public Persons Enterprises and Capital Shares Governance Law adopted in October 2014, but room for improvement remains. Energy security is fragile, reflecting high energy intensity and lack of interconnected supply networks. The vocational education and lifelong learning systems are critical to moving up the global value chains but do not yet fully provide the skills students and employers need.

Improving public sector efficiency for more inclusive growth

Latvia is one of the most unequal societies when compared with OECD countries and a high share of the population is at risk of poverty. The social safety net is underdeveloped and not well targeted at those most in need. The tax structure is skewed towards distortive taxes on labour, with relatively low property and environmental taxes. In particular, the tax wedge is high for low-income earners and contributes to the elevated level of long-term unemployment. The efficiency of tax administration and collection stands well below international standards, not least due to a prevalent grey economy. In the long term, there is a risk that spending allocated to key public services (education, health, pensions) will prove inadequate in view of desired outcome improvements.

Limiting the risk of repeated boom-bust cycles

Latvia experienced a boom-bust cycle between 2004 and 2009. Since 2007, macro-prudential policies have been implemented to reduce the risk of instability in the financial sector. Major improvements in the fiscal framework have also been achieved with the introduction of a structural budget balance rule, medium-term budgeting, binding expenditure ceilings, a restriction on expenditure growth and oversight by a fiscal council. Nevertheless, cases of extreme market turbulence may generate access barriers to international financial markets, thereby hampering the implementation of countercyclical fiscal policy. Also, some risks related to features of the financial sector, such as the large share of non-resident deposits, might be difficult to eliminate.

Key recommendations

Raising productivity and ensuring robust convergence

- Make regulation more competition-friendly by reducing entry barriers.
- Continue reducing red tape, by simplifying the permits and licenses system and tax payments.
- Bring the governance of state-owned enterprises further in line with the OECD Guidelines on Corporate Governance of State-Owned Enterprises.
- Continue improving the connectivity of energy networks with the rest of the European Union.
- Proceed with the reform of vocational education and training, including the planned extension of work-based learning.
- Encourage lifelong learning and training by improving information about training opportunities and adult learning while ensuring the portability of skills.

Improving public sector efficiency for more inclusive growth

- Strengthen efforts to tackle tax fraud and improve tax collection.
- Evaluate the current benefit system and make universal social benefits more targeted at low-income households.
- Gradually withdraw benefits targeted at low-income earners when they take up a job.
- Decrease the labour tax wedge for low-income earners.
- Raise additional revenues by increasing property and environmentally related taxes.

Limiting the risk of repeated boom-bust cycles

- Reinforce countercyclical liquidity buffers.
- Continue using leverage ratios, together with risk-weighted capital ratios, for gauging the strength of bank balance sheets.
- Continue monitoring non-resident banking businesses to identify and address financial stability risks at an early stage.

Assessment and recommendations

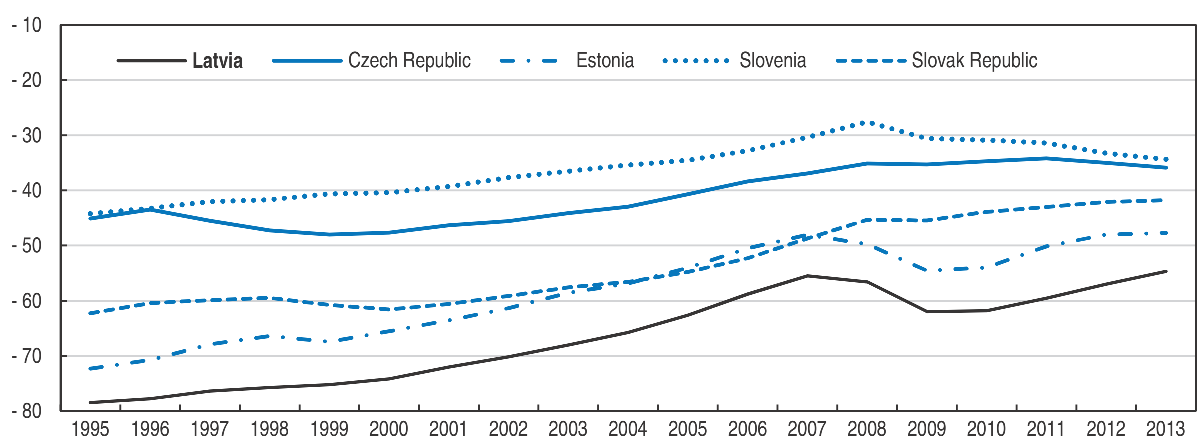
- *A volatile economy*
- *Strong recovery clouded by weakening regional prospects*
- *Limiting the risk of repeated boom and bust cycles*
- *Improving public sector efficiency for more inclusive growth*
- *Raising productivity and ensuring robust convergence*

Latvia is a small open economy with a population of around 2 million that has made significant progress in catching-up to the income levels of the more advanced economies over the past twenty years. After re-gaining its independence in 1991, Latvia joined the WTO in 1999, the European Union (EU) in 2004 and most recently the euro area in January 2014. Since 2011, economic growth has been one of the highest in Europe. Nevertheless, there remains a large convergence potential both in terms of income and well-being. In 2013, GDP per capita was 55% below the best performing OECD countries (Figure 1). Were the current speed of convergence to be maintained, 1½ generations would be needed to catch up with the above average performing OECD countries. However, population ageing and migration constrain future growth prospects. The working age population has already started to shrink and will fall by 16% by 2060 according to long-term projections ('no policy change' scenario, European Commission, 2012). Much of the remaining catching-up thus needs to come from productivity increases.

Latvia lags behind the OECD and its regional peers in a number of social and economic dimensions measuring the quality of life (Figure 2). While the employment rate and the level of skills is close to the OECD average, life expectancy and life satisfaction are relatively low even when compared with countries with similar income levels. Around 35% of the population is at risk of poverty (vs. 24.5% in the EU) and the level of income inequality ranks as one of the highest when compared with OECD countries. The environmental quality in urban areas is also a concern, notably air pollution, with a level of particulate emissions exceeding the OECD average by around 40%.

Figure 1. **The gap in GDP per capita remains wide**

Gap to the upper half of OECD countries,[1] %

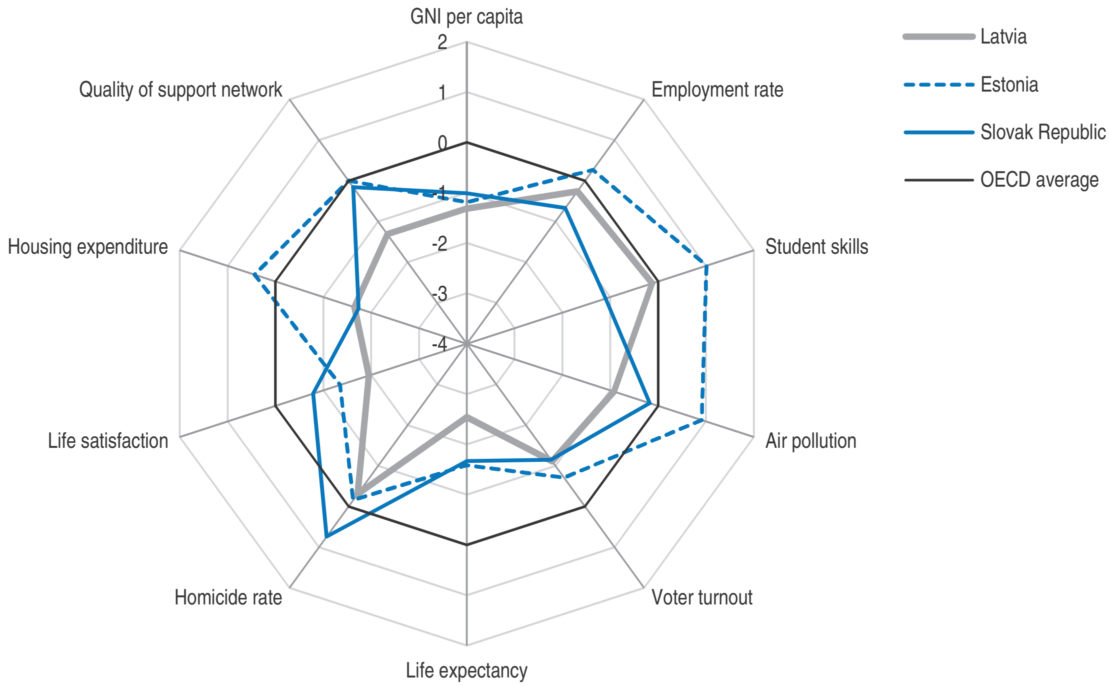


1. Percentage gap with respect to the simple average of the highest 17 OECD countries in terms of GDP per capita (in constant 2005 PPPs).

Source: OECD National accounts database and World Bank, WDI database.

StatLink http://dx.doi.org/10.1787/888933183569

Figure 2. **Well-being indicators suggest a large scope for catching up**



Note: These indicators are not comparable with the OECD How's Life's? well-being indicators. The figure shows the difference between the values of the variable for the country with respect to the average of OECD countries, normalised by the standard deviation. A positive difference means that the country does better than the average of OECD countries in terms of this variable. When a variable measures a negative component of well-being (air pollution, homicide rate and housing expenditure), the difference has been multiplied by -1.

Source: OECD National accounts database, Eurostat database, World Development Indicators Database, OECD Labour Force Statistics database, OECD PISA 2012 database, International Institute for Democracy and Electoral Assistance (IDEA) database, OECD Health Statistics database, Central Statistical Bureau of Latvia, WHO Mortality database and Gallup World Poll.

StatLink http://dx.doi.org/10.1787/888933183572

Policymaking in recent years has been marked by substantial reform activity in response to the legacy of the 2009 global crisis. The macroeconomic framework has been improved substantially: new medium-term based fiscal rules and macro-prudential tools have been adopted. A number of reforms are in the pipeline concerning social spending, the judiciary, vocational education and training.

Nevertheless, further reforms are needed to address structural vulnerabilities, to maintain a high and sustainable pace of convergence and to make the economy more resilient. The *Survey* finds that main priorities should be directed at the following policy areas:

- To prevent a repeat of the build-up of internal and external imbalances, Latvia has introduced a prudent counter-cyclical fiscal policy framework as well as strong financial sector supervision. Nevertheless, fiscal liquidity buffers should be reinforced to address adverse future macroeconomic shocks. Also, the existence of foreign-owned branches and non-resident deposits in the banking sector could pose challenges for financial sector oversight.
- The composition of public spending and the taxation system should be revised to reduce the high level of inequality and structural unemployment. Social benefits should be better targeted and barriers to low-wage employment, in particular the high tax wedge, should be reduced.

- To make the most of Latvia's openness, growth has to be underpinned by a better business environment and enhanced human capital accumulation. These require a reduction in red tape, the elimination of entry barriers and an improvement in the competition environment. Lifelong learning should be further supported to ensure jobseekers and low-productivity workers obtain the skills needed on the labour market.

The annex provides an overview of Latvia's ranking for some indicators with respect to OECD countries and its peers. OECD policy indicators suggest that Latvia has still some way to go to catch up with OECD best performing policies. This is to some extent related to the heritage from several decades of central planning. The focus of this accession review is therefore not so much on documenting gaps, but more on the assessment of policy settings with respect to supporting the process of catching-up with more advanced countries.

A volatile economy

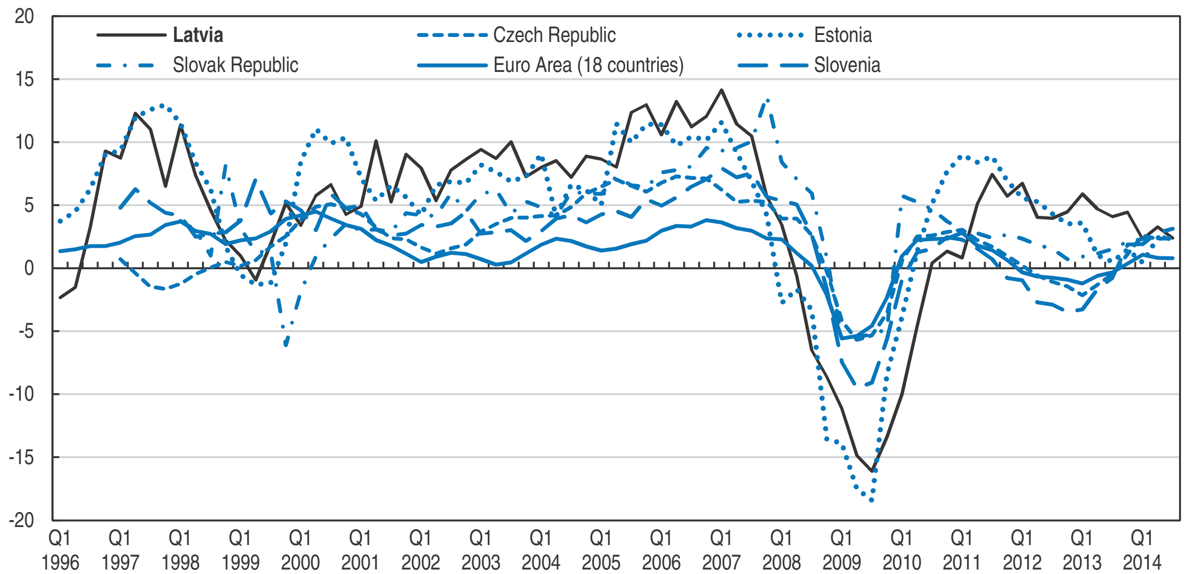
The economy is marked by high volatility (Figure 3). In recent years, Latvia passed through four major economic downturns: the collapse of the central planning system in 1991; the local banking crisis in 1995; spill-overs of the Russian financial crisis in 1998, and the most recent boom-bust episode starting with the EU accession in 2004 and bursting in the late 2000s. The macroeconomic aggregates, including GDP, inflation, unemployment rates, have displayed particularly large fluctuations in the last decade.

- Between 2000 and 2007, annual GDP growth reached 10% on average. Low interest rates, an inflow of cheap credit and a belief in fast convergence led to a rapid expansion of the financial sector and of non-financial sector indebtedness accompanied by high current account deficits (Blanchard et al., 2013). Banking sector assets grew from 57% to 150% of GDP and the private sector debt from 35% to 116% of GDP. The economy experienced an inflationary spiral, with a doubling of unit labour costs and a real estate bubble.
- Between 2007 and 2010, the bursting of the domestic demand bubble coincided with the international financial crisis, leading to a decrease in GDP by about a fourth. Credit growth came to a halt by 2009 and in the context of the international financial crisis a sudden stop in capital flows put a strain on the banking system. As a result of a maturity mismatch, Parex, the second largest bank in the country with a significant business in non-resident services, was nationalised in 2008 after being subject to a bank run.

The economy adapted swiftly to these macroeconomic shocks. Most of the imbalances accumulated during the boom years, including the excessive increase in private sector indebtedness, unsustainable current account deficits and oversized public spending programmes, were addressed, backed by an international financial assistance programme (EUR 7.5 billion, i.e. 30% of GDP, of which 4.5 billion was used). Latvia maintained the currency peg with a view to joining the euro area. Thus, a significant internal devaluation was implemented to rebalance the economy. The budget deficit was reduced significantly within four years by implementing austerity measures amounting to 17% of GDP (Ministry of Finance, 2014). Consolidation was made mainly on the expenditure side, including a 20% decrease in public sector wages, thus only moderately increasing the tax burden. Internal devaluation came also from productivity increases stemming from labour shedding. Unit labour costs decreased, restoring external competitiveness and supporting an export-led recovery.

Figure 3. **The economy is highly volatile**

GDP, Growth rate compared to the same quarter previous year, sa, %



Source: OECD Quarterly national accounts database.

StatLink http://dx.doi.org/10.1787/888933183589

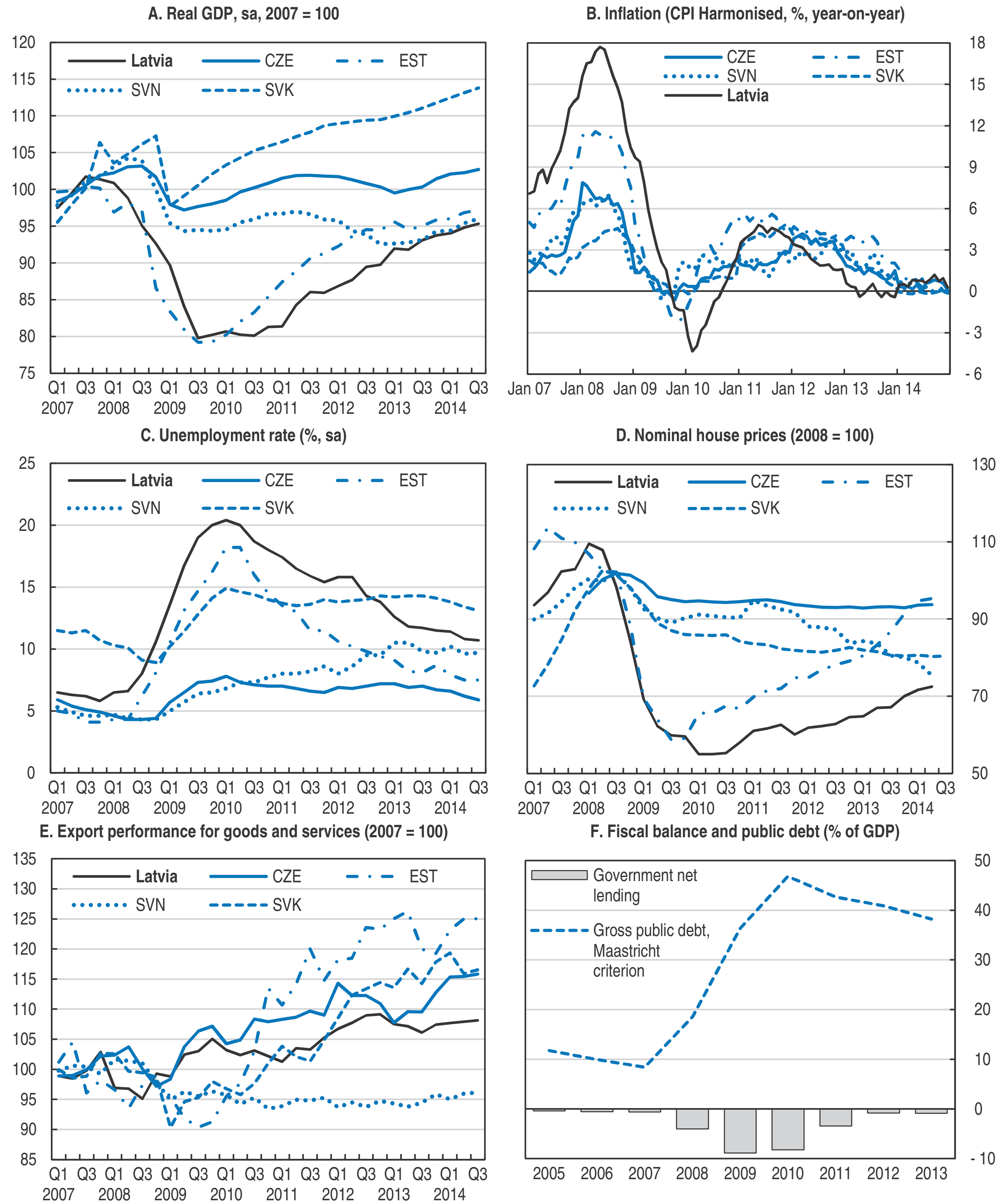
The adjustment has been rapid and impressive, but has come at a cost. Empirical studies suggest that high volatility reduces trend growth and welfare, notably by restraining investment in physical and human capital and raising economic insecurity (OECD, 2012). A significant part of the adjustment in Latvia happened through massive emigration flows, depriving the economy of qualified resources. On average 30 000 people left every year during 2008-13 and the country lost some 8% of its population, mainly of working age. The emigrants have been disproportionally young and relatively well educated (OECD, 2013a). Despite the strong recovery since 2011 and recent overall economic improvements, the legacy of the bust, in the form of bank credit contraction and high long-term unemployment, still needs to be addressed.

Latvia is particularly exposed to external shocks because of its small size and tight links with volatile neighbouring economies. Energy intensity is high and energy supply largely depends on imports from Russia. The banking sector is mostly foreign-owned (mainly by companies of Nordic origin) and around a third (35%) of banking assets come from non-resident deposits, exposing the financial sector to risks linked to a volatile client base. Furthermore, Latvia lags behind in terms of its integration into global-value chains, investment in knowledge-based capital and innovative capacities. It exports mostly goods with a low technological content (agricultural, food, wood, metals products). This is a concern as productivity gains will be essential to move up the value chain and secure robust convergence.

Strong recovery clouded by weakening regional prospects

GDP growth reached 4.2% in 2013, the highest rate in the EU (Figure 4, Panel A). It was mainly driven by private consumption on the back of improved labour market developments. The unemployment rate has decreased significantly from its peak of 20% at the beginning of 2010, reaching 10.7% in the third quarter of 2014 (Figure 4, Panel C).

Figure 4. **Main short and medium-term economic indicators**



Source: Central Statistical Bureau of Latvia, Eurostat, OECD National accounts database, OECD Main Economic Indicators database, OECD Housing prices database and OECD Economic Outlook 96 database.

StatLink http://dx.doi.org/10.1787/888933183593

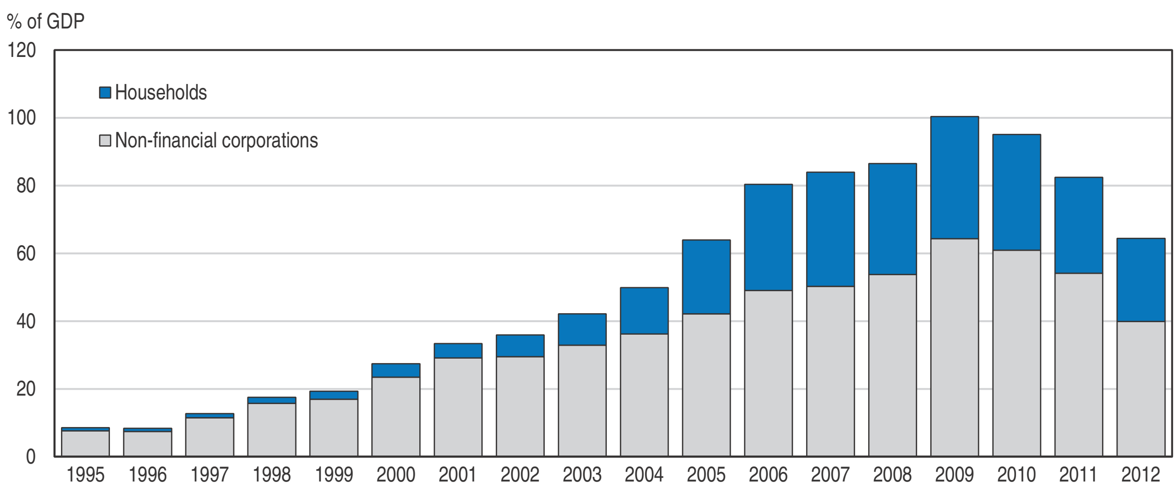
Increases in net wages, from low levels, amounting to around 5% on average over the past two years, supported household purchasing power. As the government deficit declined to below 1% of GDP and the Medium-Term Objective was reached, fiscal consolidation softened, decreasing the tax burden of households (Figure 4, Panel F).

Growth was also stimulated by the housing sector recovery. In 2012 and 2013, a new policy providing temporary resident permits to investors attracted EUR 505 million (over 2% of GDP). House prices recovered to around 70% of their pre-crisis level (Figure 4, Panel D). Despite large increases in wages and house prices, inflation remained low, mainly driven by falling global commodity prices and changes in indirect taxes and administered prices (European Central Bank, 2013). The adoption of the euro at the beginning of 2014 did not have much of an impact (Eglitis et al., 2014).

By contrast, productive investment (excluding housing) remained subdued as a consequence of the significant on-going debt reduction and tightened credit conditions. Private sector debt increased substantially during the boom years, with the credit-to-GDP ratio more than doubling between 2000 and 2010 to 60% GDP for non-financial corporations (Figure 5). After the bust, domestic loan portfolio continuously diminished (Figure 6, Panel B), with an annual decline of around 5% over the past two years (Figure 6, Panel A). Non-performing loans (NPL) have been declining steadily and stood at 7.5% in June 2014.

Figure 5. **Debt is being significantly reduced**

Private sector debt



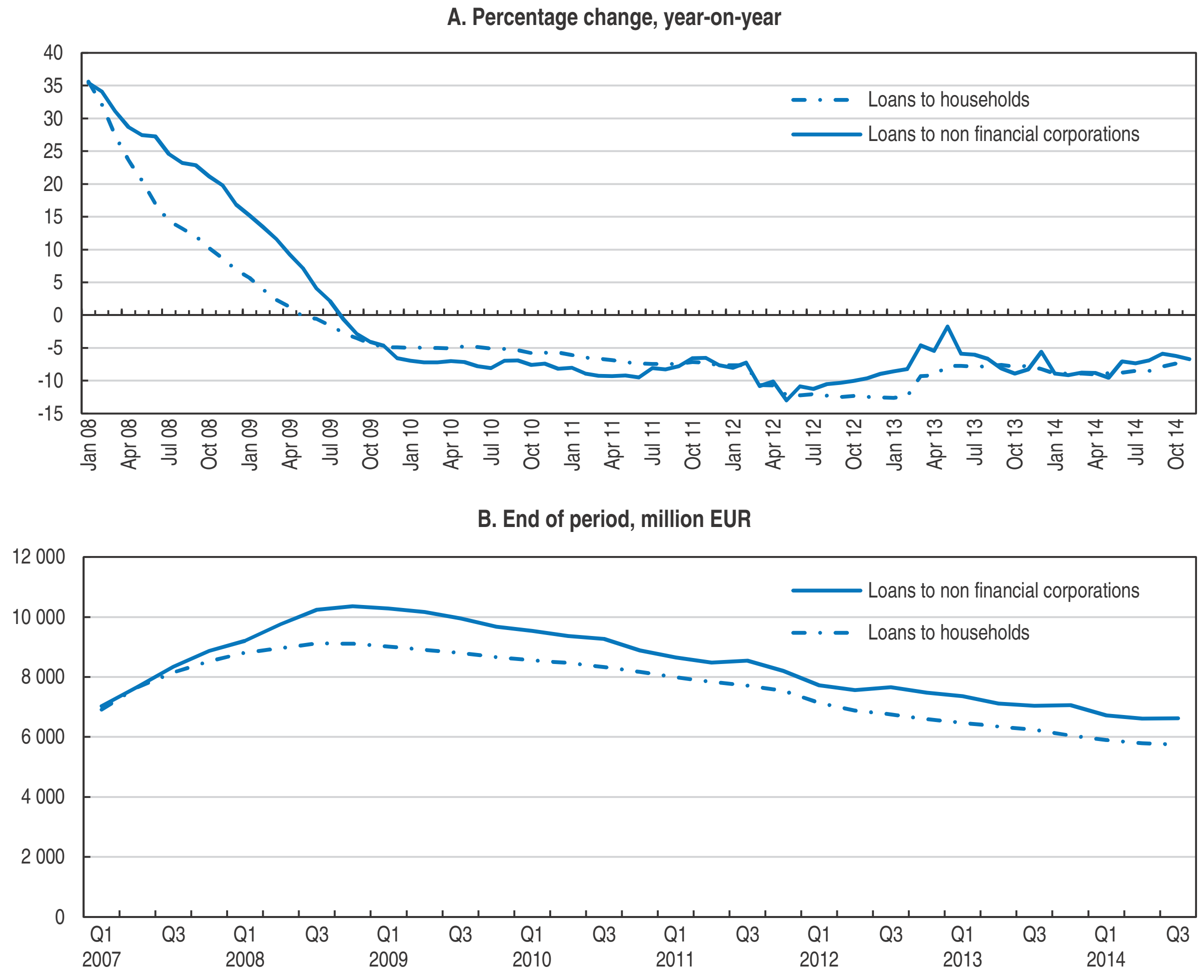
Note: The private sector debt is the stock of liabilities held by the sectors non-financial corporations and households and non-profit institutions serving households. The instruments that are taken into account to compile private sector debt are securities other than shares, excluding financial derivatives and loans.

Source: Eurostat database.

StatLink http://dx.doi.org/10.1787/888933183602

In 2014, economic growth slowed and is estimated to have fallen below 3% (Table 1). The deterioration of the global environment, in particular growing regional geopolitical tensions and their indirect impact on the outlook of the EU and Russia (which account respectively for around 70% and 10% of total Latvian goods exports) has reduced external demand and weaken business confidence. The direct impact of sanctions imposed by Russia on the economy is limited, as the share of banned goods in total exports is low (around 0.5% of total goods exports). Also, Latvian exporters have shown an ability to

Figure 6. **Credit is falling**



Source: Bank of Latvia.

StatLink http://dx.doi.org/10.1787/888933183617

diversify their export markets and increase their export market shares in the unfavourable external environment. Nevertheless, the slowdown of the Russian economy, the falling transit of goods to and from Russia, increasing competition on the food market and heightened uncertainty will all weigh significantly on short-term growth prospects.

The recovery is projected to gain momentum in 2015 and 2016, assuming improving exports prospects and a rebound in investment (Table 1). Capacity utilisation has already reached historical highs (at around 72%). In the absence of a further deterioration in the regional economic environment, business confidence should progressively firm over the next two years. Financial conditions are set to gradually improve supported by an accommodative monetary policy. Credit should also benefit from the positive confidence effect of euro adoption, the progressive reduction in non-performing loans and the decrease in the debt burden in the private sector. Economic activity will also be sustained by household spending, though less than in the past. Private consumption growth should soften as the improvement of labour market outcomes will moderate. After a sharp recovery from relatively low levels, wage growth is projected to slow as firms will have to limit the rise in labour costs to preserve competitiveness. Fiscal policy is expected to

Table 1. **Macroeconomic indicators and projections**

	2011	2012	2013	2014	2015	2016
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	20.3	4.8	4.2	2.5	3.2	3.9
Private consumption	12.7	3.0	6.2	2.7	3.0	3.7
Government consumption	3.7	0.4	-4.2	2.7	2.8	2.8
Gross fixed capital formation	4.5	14.5	-5.2	2.4	2.7	5.2
Stockbuilding[1]	0.4	-2.6	1.8	-0.8	0.4	0.0
Total domestic demand	21.3	2.3	3.4	1.8	3.2	3.8
Exports of goods and services	11.7	9.8	1.5	1.9	3.1	5.2
Imports of goods and services	12.7	5.4	0.3	1.7	3.2	5.0
Net exports[1]	-1.0	2.3	0.7	0.1	-0.1	0.0
Memorandum items:						
GDP deflator	-	3.6	1.1	1.7	1.8	2.4
Harmonised index of consumer prices	-	2.3	0.0	0.8	1.9	2.3
Unemployment rate	-	15.0	11.9	10.9	9.7	8.8
General government financial balance[2]	-	-0.8	-0.9	-1.3	-1.0	-0.8
General government debt, Maastricht definition[2]		40.9	38.2	40.2	36.8	35.0
Current account balance[2]	-	-3.3	-2.3	-2.3	-2.3	-2.2

1. Contributions to changes in real GDP, actual amount in the first column.
2. As a percentage of GDP.

Source: OECD EO96 database.

remain relatively accommodative, in line with the Medium Term Objective (structural balance at 1% of GDP in 2015 and 0.9% 2016). Inflation should progressively increase and exceed 2% in 2016, due to the deregulation of electricity prices for households in 2015 and wage growth.

The growth outlook is increasingly clouded by ongoing geopolitical tensions, the uncertainty surrounding the recovery in the euro area and the economic outlook in Russia. Risks are mainly on the downside and relate to an intensification of regional tensions and subsequent lower growth in regional trading partners. A further decline in confidence could lead to delays in investment, tightened credit conditions and increasing precautionary savings. A long-lasting disruption of imported energy supply would significantly affect the economy. Persistent stagnation and declines in inflation expectations in the euro area could also cut growth significantly as it is a destination for around a third of exports. A lower share of exports is destined to Russia (around 10%), but the deterioration of the Russian economic outlook might also reduce growth prospects in Latvia, by affecting the transport sector in particular. The steep fall in oil prices aggravated by the limited access to international financial market will lead to a decline in the Russian economic activity and the depreciation of the rouble will further curb imports. According to recent estimates by the Bank of Latvia, a 10% decline in Russia's imports would reduce Latvian GDP growth by 0.66 percentage point, but these estimates do not take into account the positive impact of the fall in oil prices on GDP.

Growth could also surprise on the upside. Should the accommodative monetary policy in the euro area become more effective with the progressive move towards banking union and should planned structural reforms be implemented swiftly in the euro area, the recovery could accelerate more than expected with positive spill-overs to Latvia. A restart of steel production at *Liepajas Metalurgs,* a large industrial conglomerate and employer, in 2015 could also result in higher growth.

Limiting the risk of repeated boom and bust cycles

To limit the risk of repeated boom and bust cycles, Latvia should ensure fiscal and financial policy settings are leaning against the wind. Pro-cyclicality of the financial sector and fiscal policy played an important role in the volatility of the economy over the previous decade. The fiscal policy response to overheating during the boom years was limited. The currency peg encouraged borrowing in euro with short-term refinancing rates close to the low European Central Bank lending rate, while increases in reserve requirements had a limited impact (Blanchard et al., 2013). Following the bust, the currency peg was maintained – avoiding large capital losses on loans denominated in euro – and the adjustment was made through internal devaluation and fiscal austerity reducing domestic demand by about one third.

The macroeconomic policy framework has been improved

The fiscal and financial stability policy frameworks have undergone significant improvements in recent years. Tools available now should allow the authorities to manage a more sustainable growth path and make the economy more resilient. Yet, the effectiveness of the framework remains to be tested. The authorities need to remain vigilant to limit the risk of repeated boom and bust cycles.

Improved counter-cyclicality and sustainability of fiscal policy

In 2013, a rules-based fiscal framework was adopted based on structural budget balance, three-year budgeting, binding expenditure ceilings, a restriction on expenditure growth (to not exceed potential growth) and oversight by a fiscal council. This institutional set-up should be an effective means of keeping public expenditure growth consistent with fiscal sustainability and of avoiding the slippages that occurred in previous upturns. In 2013, at 38% of GDP the government debt ratio (Maastricht definition) was one of the lowest when compared to OECD countries and the fiscal deficit declined below 1% of GDP. Having achieved the short-term goals of consolidation, the challenge now is to lock in the gains.

Latvia, as a volatile economy, needs a precautionary buffer to cope with adverse domestic and international shocks. Since during extreme turbulences borrowing at reasonable costs may be restricted, a fiscal reserve should be made available. With the accession in the euro area, Latvia can benefit from the European Stability Mechanism, a permanent crisis resolution mechanism, which can issue loans and other forms of financial assistance to euro area countries with severe liquidity problems or threatened by them. Also, the establishment of a banking union should limit the impact of banking crises on public finances. The Single Resolution Mechanism (SRM) backed by a Single Resolution Fund has introduced resolution tools that involve private bank investors and the banking sector as a whole in covering bank losses before involving public finances (OECD, 2014a).

Nevertheless, there is scope to build-up additional fiscal liquidity buffers over time, not least because Latvia's exposure to external shocks is higher than in the average EU country. The Fiscal Discipline Law introduced two counter-cyclical reserves. The first one, the Long-Term Stabilisation Reserve, is set to accumulate government budget surpluses, i.e. saving in good times in order to soften budget constraints in bad times, but no resources have actually been accumulated yet. The second one, the Fiscal Security Reserve, has been established to mitigate the negative impact of small adverse macroeconomic developments on the budget and fiscal risks (e.g. risks related to loans repayments, loan guarantees, public-private partnerships). The size of this reserve is set annually; it shall not fall below 0.1% of GDP from 2017 onward.

Strengthened macro-prudential oversight

Euro adoption in January 2014 followed the peg to the euro since 2005 and to the Special Drawing Right since 1993. In the early 2000s an excessive credit cycle developed, which created severe distortions and involved large costs to the economy and society. There is thus a case for the timely use of macro-prudential tools. The evolution of international regulatory frameworks (Basel III, the European Systemic Risk Board, and the Capital Requirements Directive and Regulation) has increased awareness and mainstreaming of such tools. In Latvia, a newly set up Macro-prudential Council with all the main stakeholders, including the Central Bank, the Ministry of Finance and the Financial and Capital Market Commission, meets at least twice a year.

The three above-mentioned local institutions are charged with financial stability and macro-prudential policies. The Central Bank is assigned overall responsibility for macro-prudential oversight and the Financial and Capital Markets Commission (FCMC) is tasked with micro-prudential tools and is designated authority for macro-prudential tools. The Macro-prudential Council, chaired by the Governor of the Central Bank, has a consultative role and the power to issue non-binding recommendations on the principle of "comply or explain".

Banking sector assets have fallen from a peak in 2010 of 172% of GDP to 124% at the end of 2013, well below the EU average of around 300% of GDP. Capital adequacy and liquidity ratios are above the minimum requirements and a 2.5% capital conservation buffer has been applied (FCMC, 2014). The recent asset quality review and stress tests carried out by the European Central Bank did not identify capital adequacy problems for the three Latvian banks covered (ABLV Bank, Swedbank, and SEB; European Central Bank, 2014). A new counter-cyclical buffer, mandated by the EU by 2016, is likely to be set at zero. Leverage ratios are also monitored to gauge the strength of bank balance sheets, and have to be disclosed by banks since January 2015. Taxes are also used, including a tax on capital gains from real estate transactions and an increase in property taxes rates (that remain modest though). A 90% ceiling of the loan-to-value ratio on housing loans has been introduced to limit the build-up of imbalances in the banking and real-estate sectors. It will have to be seen whether these tools will discourage retail real estate investments betting on perceived capital gains.

Following the bursting of the credit boom, banks tightened lending standards (IMF, 2014). Risk aversion has increased; the banks now rely more on collateral-based lending with loans of short maturity and personal guarantees are common (World Bank, 2012). Micro-enterprises can have difficulties providing adequate collateral. Moreover, there seems to be a lack of strategic interest by lenders for this segment as well as deficiencies in credit information (World Bank, 2012). The capital market in Riga is small, with few trades and listings: currently some 30 companies are listed with a market capitalisation equivalent to just under 4% of GDP in 2012. An alternative capital market, First North, is operational under the Nasdaq Baltic stock exchange, but only one Latvian company is listed. A public credit information registry, run by the Central Bank, exists with a relatively high coverage in terms of population. Standard credit bureaus will be developed, as a new legislation allowing for this was passed in September 2014. The authorities provide public guarantees and other instruments to ease access to credit. To improve access to finance further, micro-finance institutions could provide services for micro-enterprises (World Bank, 2012). Currently such institutions exist only in limited consumer credit markets (providing loans to their members). Before developing institutions for business-oriented loans, the necessary regulatory changes and risks would have to be carefully considered.

Supervision adapted to the particular features of the financial sector

The Latvian financial sector is dominated by banks. There are two distinct business models in the banking sector, the first focused on Latvian clients and the second on non-resident banking services. Just over a half (54%) of banking sector assets are held by foreign banks, most of them of Nordic origin. The parent banks tend to rely on short-term financing, and while during the 2009 downturn, they maintained funding and absorbed losses, maturity mismatches have been increasing in their Latvian operations. It poses a potential risk that requires further monitoring (Bank of Latvia, 2014). Cooperation between the home and host authorities on cross-border financial stability, crisis management and resolution is in place as part of the Nordic-Baltic Cross-Border Stability Group that includes supervisory colleges.

In the wake of the 2009 global crisis, supervisory powers of EU host authorities were strengthened. The host regulator is now involved more closely in the supervision of so-called significant branches. There is a mandatory reciprocity for countercyclical capital buffers (it must be recognised up to 2.5% in all EU member states and can be recognised also above that) and a possibility for recognition of a systemic risk buffer rate set by the other member state. The authorities need to ensure that supervision and application of macro-prudential tools is not compromised by the banking structure. Whether this is achieved by unilaterally imposing specific regulation on systemically important branches or whether enhanced co-operation with mother-bank supervisory institutions is the right approach should depend on how to best protect financial sector stability while preserving capital mobility and the freedom of providing financial services within the EU.

Another policy challenge, both in terms of supervision and financial sector stability, arises from the relatively high share of non-resident deposits in the banking sector. They amount to 40% of GDP and account for just under a half of all bank deposits. Estimates of the contribution of this sector to the domestic economy vary between 0.8% and 1.5% of GDP (KPMG, 2014). The recent global financial crisis was a reminder of the potential burden of a financial sector dependent on foreign deposits which can be very mobile. Most non-resident deposits in Latvia are short-term and invested in short-term high-quality liquid assets abroad.

The nature of the non-resident deposits business is to be less transparent, requiring well-developed supervision and enforcement of ’know-your-client’ policies. Responding to this challenge the authorities have strengthened such measures. Also, banks focusing on business with non-residents face stricter prudential capital and liquidity requirements under Pillar II of the Basel framework. Individual minimum capital requirements range up to 20% depending on the share of non-resident deposits, loans to non-residents and growth rates of these indicators, with liquidity ratios up to 60% (as compared to 30% of regulatory minimum) depending on the share of non-resident deposits (Table 2). According to the authorities, the business model of these banks is to a large extent separated from the domestic economy and thus should not pose a threat to the stability of the domestic financial sector. Nevertheless, the authorities should continue to monitor this sector carefully.

Table 2. **Main prudential indicators in the Latvian banking sector**

September 2014

	Banks focused on residents (%)	Banks focused on non-residents* (%)
Capital adequacy ratio	21.94	18.8
Liquidity ratio	45.9	81.8
Total core tier 1 capital to exposure	12.6	6.4

* Banks with a share of non-resident deposits above 20% of the bank assets, excludes banks under state-ownership (i.e. Citadele bank).

Source: FCMC.

Recommendations to limit the risk of repeated boom-bust cycles

Key recommendations

- Reinforce countercyclical liquidity buffers.
- Continue using leverage ratios, together with risk-weighted capital ratios, for gauging the strength of bank balance sheets.
- Continue monitoring non-resident banking businesses to identify and address financial stability risks at an early stage.

Other recommendations

- Continue coordinating the supervision of systemically important branches with the supervisors of mother banks.

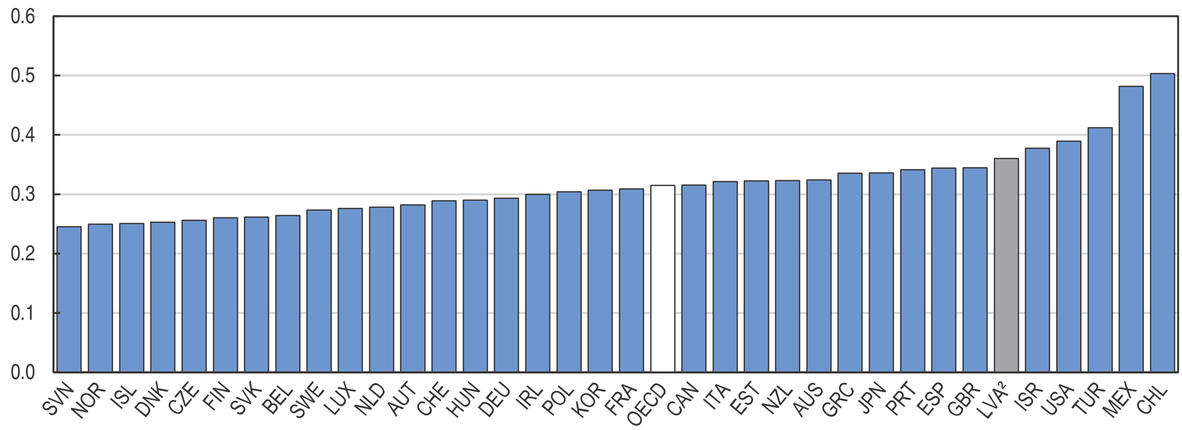
Improving public sector efficiency for more inclusive growth

Despite significant improvements since its independence, Latvia still lags behind the average OECD or EU economy in a number of dimensions. It is one of the most unequal economies when compared with OECD countries (Figure 7) and it stands out in terms of poverty risks. In 2013, according to Eurostat, some 19% of population lived on less than 60% of the national median disposable income, and over 35% were at risk of poverty or social exclusion, more than 10 percentage points above the EU average. Despite some progress in this area, life expectancy remains low, as does the accessibility of healthcare in particular for low-income earners (Figure 2, World Health Organisation and European Observatory of Health Systems and Policies, 2012). The proportion of long-term unemployed has decreased but remains elevated (42.4% of total unemployment in the third quarter of 2014), with large geographical disparities. The impact of socio-economic background on educational outcomes results has increased, suggesting the role of education in reducing inequality has diminished (OECD, 2013c). Pupils with learning difficulties are placed in special schools, undermining their chances to succeed in higher levels of the education system.

At the same time, a significantly smaller proportion of GDP is allocated to core public programmes (social protection, health care) than in the European OECD countries on average. Spending on social protection and health is also smaller as a share of total public spending (Table 2). In addition, the degree of income redistribution ensured by the tax-benefit system is among the lowest in the EU (BICEPS, 2014). A low level of public spending is not necessarily undesirable, but its prioritisation and efficiency should be questioned when the policy outcomes are poor.

Figure 7. **Income inequality is among the highest compared with OECD countries**

Gini coefficient of equivalised household disposable income, scale from 0 "perfect equality" to 1 "perfect inequality", 2011[1]



Note: The Gini index is a measure of income inequality. A Gini index of 0 represents perfect equality, while an index of 1 implies perfect inequality. Equivalised household disposable income refers to income after tax and transfers adjusted for household size.

1. 2009 for Japan, 2010 for Belgium, 2012 for Australia, Finland, Hungary, Korea, Mexico, Netherlands and the United States.
2. OECD Secretariat calculations from EU-SILC – preliminary results.

Source: OECD Income Distribution database and OECD calculations.

StatLink http://dx.doi.org/10.1787/888933183624

Table 3. **Components of public spending, 2012**

	General public services	Economic affairs	Health	Education	Social protection	Other[3]
			Percentage of total			
Latvia	**12.3**	**14.5**	**10.7**	**15.1**	**30.7**	**16.7**
Peers[1]	12.0	10.3	15.4	12.6	33.8	16.0
OECD Europe[2]	**14.1**	**9.5**	**14.1**	**11.9**	**38.1**	**12.2**
			Percentage of GDP			
Latvia	**4.5**	**5.3**	**3.9**	**5.5**	**11.2**	**6.1**
Peers[1]	5.1	4.4	6.5	5.4	14.4	6.8
OECD Europe[2]	**6.8**	**4.6**	**6.8**	**5.7**	**18.3**	**5.8**

1. "Peers" is an average of Czech Republic, Estonia, Slovenia, and Slovak Republic.
2. OECD Europe includes all European OECD countries except Turkey.
3. "Others" includes defence, public order and safety, environmental protection, housing community amenities, recreation, culture and religion.

Source: Eurostat.

Improving public sector efficiency requires developing strategic and evaluation capacities. The new three-year expenditure planning framework is an important step towards greater policy continuity. The establishment of a new planning unit under the authority of the Prime Minister, the Cross-Sectoral Coordination Centre (PKC), should improve strategic co-ordination and counteract the prior tendency to strong ministerial silos and policy fragmentation. The PKC's mandate is to produce mid- and long-term planning documents, such as the National Development Plan, and to ensure that policies are effective and appropriate. The body can also be engaged in the early planning phase of new policies, and has been tasked with analysing transversal issues, such as evaluating the management of state-owned enterprises, demographics or income disparities. However, the PKC is not properly resourced to meet line ministries' demands and has no possibility to engage outside expertise on specific substantive issues.

Increasing the efficiency of public spending in the short and long term

Social spending

The level of spending allocated to protect the most vulnerable is low, with social spending amounting to only about 15% of GDP, compared with an EU average of 28% of GDP. Certain spending programmes were increased during the downturn (e.g. on labour market policies, social safety net) and helped to cushion its impact. Nevertheless, this spending was generally from a very low base, often temporary and with patchy coverage. It is crucial to ensure limited resources are used in an efficient way to make growth more inclusive and reduce the poverty risk.

A guaranteed minimum income benefit – the main poverty-targeted tool – more than tripled during the downturn in real terms, but still reached only about 14% of the poor in 2010 because of restrictive eligibility criteria and limited financing (World Bank, 2013). The benefit has been scaled back since then. A reform of the social benefit system is currently under discussion and would introduce a new minimum income threshold of 40% of national median income by 2017. It will be important to pay attention to the incentive effects of increasing social benefits. The German labour and social assistance reforms, which managed to combine an increase in labour force participation and fiscal efficiency gains, are a good example to be followed (Hüfner et al., 2013).

A number of important benefits are universal (state family benefit, child care benefit, child birth grant) and the degree of income redistribution is relatively low. Less than 20% of all social benefits go to the poorest quintile, the richest quintile receives almost 27%. In the EU, the poorest quintile received on average more than 40%, while the richest less than 10% (World Bank, 2013). This suggests the need for better targeting.

At the same time, a large proportion of employees have salaries close to the minimum wage and targeting social benefits can create disincentives to take-up a formal job for low-income earners. This trade-off needs to be balanced carefully. A planned gradual withdrawal of certain social benefits (guaranteed minimum income and housing benefit) is welcome and would significantly increase the income gain of taking a low-paid job in the formal economy (BICEPS, 2014). Given the widespread underreporting of salaries (Putnins and Sauka, 2014), this measure needs to be coupled by further actions against undeclared work.

Active labour market policies

The elevated level of poverty is closely linked with the relatively high long-term unemployment rate, which exceeds the OECD average by 8 percentage points. A recent World Bank study shows that men in particular are affected by persistent labour market difficulties, often those poorly educated and/or disabled (World Bank, 2013). During the downturn, mothers at home with small children also became at risk of unemployment or low-paid unstable jobs. Meanwhile, some 13% of youths were not in employment, education or training in 2013. Young men seem to be at a higher risk of so-called scarring (i.e. failing to form a labour market attachment early on in their working life), as they are over-represented among early-school leavers and have lower higher education attainment. Minorities also encounter difficulties on the labour market. For instance, their unemployment rate in 2012 was 6 percentage points higher (Lehmann and Zaiceva, 2015, *forthcoming*). This could be partly related to the uneven distribution of the unemployment rate across the country, being higher in the eastern part of the country with a larger proportion of minorities.

The labour market is quite flexible and characterised by a high level of informality, notably an under-reporting of salaries (Putnins and Sauka, 2014). While, according to OECD indicators, employment protection legislation (EPL) is stricter than OECD average, it did not impede adjustment through massive layoffs during the 2009 downturn. The unemployment rate rose by 14 percentage points in two years (from 6% in 2007 to 20% at the beginning of 2010) and then decreased below 11%. However, recent increases in the minimum wage are likely to be a barrier to the employment of low-productivity workers in the formal sector, as a large share of workers are already officially paid at the minimum wage level (Lehmann and Zaiceva, 2015, *forthcoming*).

Active labour market policies targeted at at-risk groups can contribute to reducing under-employment. In Latvia, a number of measures were recently implemented to improve the public employment service (e.g. profiling of jobseekers) but spending on labour market programmes remains low by international comparison. In 2011, with a 16% unemployment rate, overall spending on labour market policies was only 0.7% of GDP. Ireland, which had a similar level of unemployment at the time, spent five times more. Participation in active labour market programmes is also below OECD standards, although Latvia performs better than its Baltic neighbours (IMF, 2014). Countries with a relatively successful labour market performance during the crisis, like Germany and Austria, have a high level of spending on such programmes and could provide some inspiration for policy changes.

Ageing-related spending

According to current long-term projections, Latvia's public finances do not face strong ageing-related spending pressures (European Commission, 2013c). This is mainly because replacement rates are projected to remain modest which ultimately raises the risk of future spending pressures. Regular reporting on long-term spending trends and the adequacy of social programmes such as pensions and healthcare should be introduced. In addition, spending efficiencies will be needed to achieve stated objectives in terms of health and education.

- The share of old-age population at risk of poverty is high by international comparison (34% in 2012, around 15 percentage points more than the EU average) suggesting that the pension system does not contribute enough to old age poverty prevention (European Commission, 2013c). Recent pension reforms improve long-term financial sustainability and the adequacy of the pension system by increasing the statutory retirement age and minimum contributory period for old-age pension rights as well as changing pension indexation rules. Nevertheless, it is unclear how much improvement this will bring in terms of eliminating poverty risks. The replacement ratio of the public system is set to decline and will remain among the lowest in the EU (43.6% in 2050). Unless private pensions expand significantly, old age poverty may not be properly addressed, and future political pressures may force higher pension spending than currently foreseen.
- Health care spending is among the lowest when compared with OECD countries (6% vs. 9.3% of GDP in 2012). Funding by the public sector is also well below the OECD average, as out-of-pocket payments account for 40% of spending. Tight public resources have led to queuing and privately funded treatment. Life expectancy is among the lowest by OECD standards and the quality of care is not well perceived. Reforms are improving efficiency by shifting from expensive hospitals to less costly ambulatory care and

putting a higher priority on primary care. However, only a small increase in public health care resources (around 0.6 percentage point of GDP) has been factored into fiscal sustainability calculations. At the same time, improvements in life expectancy to levels above those currently seen in any OECD member country are expected.

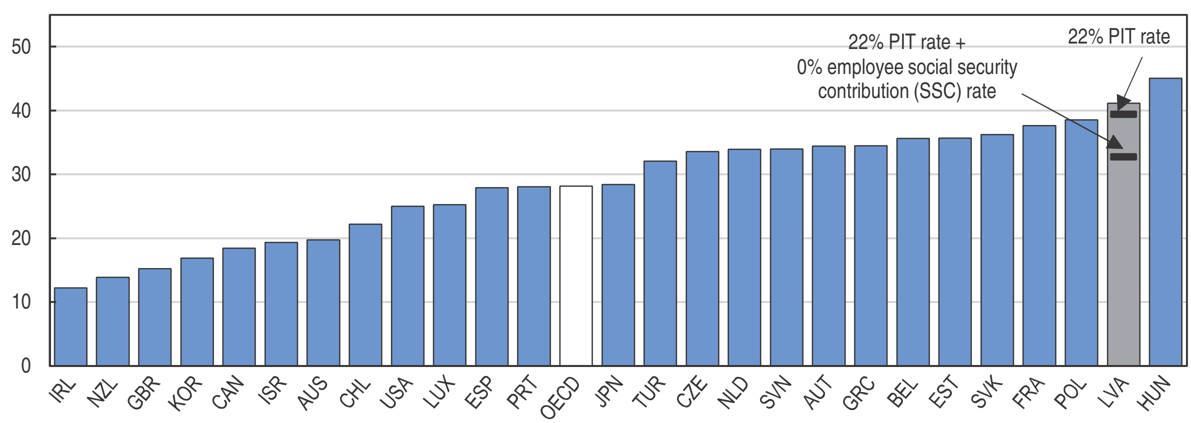
- Vocational and tertiary education needs to continuously improve in order to ensure it meets the requirements of a catching-up economy. Any efficiency-enhancing reforms will be difficult without far-reaching interventions, like implementing a new financing model that rewards quality and strengthens links with market needs and research institutions. Achieving this in a revenue-neutral way will be a challenge.

Making the tax system more progressive and employment friendly

The tax system is skewed toward labour taxes and is relatively regressive. In particular, it is characterised by a relatively high tax wedge for low-income earners which undermines their employability in formal jobs. The labour tax wedge stems from high social security contributions: the combined employer and employee contribution rate is 34.09%, while the personal income tax is flat (23%). The tax wedge was recently reduced for low-income earners with children (European Commission, 2014a). The tax allowance for dependants was increased in 2014 and the personal income tax rate is gradually decreasing by one percentage point annually to 22% in 2016. Despite these measures, the tax wedge is projected to remain significantly above the OECD average, in particular for single earners (Figure 8). Moreover, a ceiling on the base for social security contributions reintroduced in 2014 effectively increases the regressivity of the tax system.

Figure 8. **The tax wedge on low-income earners is set to remain high**

Minimum Wage, single person without children, % of total labour compensation, 2013



Note: The figure shows the impact on the tax wedge for a single person without children of planned reform of the personal income taxation (PIT) in 2016, i.e. the reduction of the PIT tax rate to 22%, and of this reform combined with social security contribution paid by employees set to zero.

Source: OECD Tax-Benefit Models (2013 provisional).

StatLink http://dx.doi.org/10.1787/888933183633

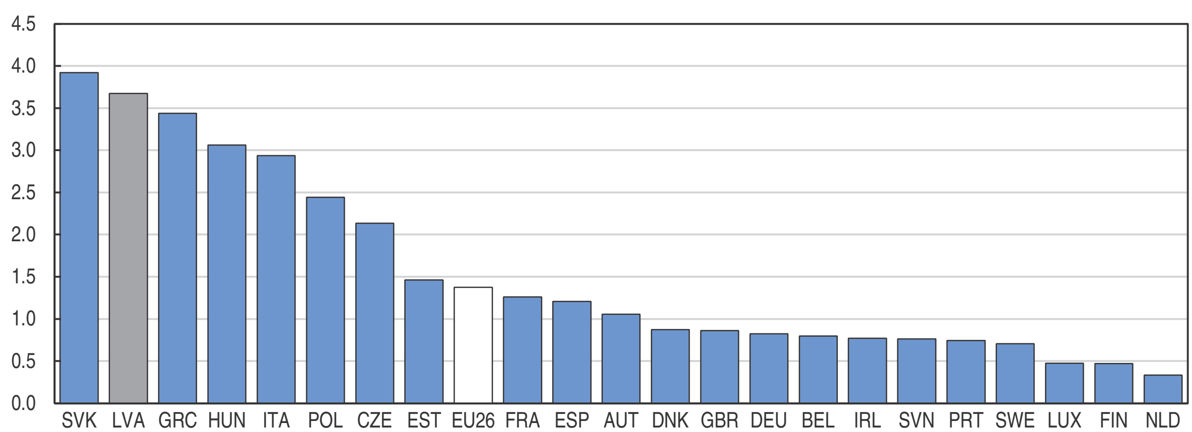
The tax wedge is one of the main factors behind the elevated structural unemployment rate in Latvia (IMF, 2014). The policy issue now is how to reduce the labour tax wedge further, in particular for low-income earners. In this vein, one possibility would be to decrease social security contributions on low wages. Such measure has been implemented in 14 OECD countries, with a generally positive impact on the employment of low-skilled workers (OECD, 2011a). To avoid increases in the share of low paid jobs and associated deadweight costs, the decrease could be targeted at particular groups (such as low skilled workers, long-term unemployed, first-time job applicants). At the same time, tax enforcement should be strengthened. The reduction in the social security contribution rate should not lead to a reduction in already low social coverage (e.g. pension replacement rates). Another possibility, already on the agenda of the authorities, is to increase the personal income tax allowance, which ideally should be phased out for higher incomes.

Revising the tax mix requires additional revenues. They should come from better tax collection in the first place. Tax evasion is substantial and the economy is marked by informality, with estimates of the shadow economy reaching some 24% of GDP (Putnins and Sauka, 2014). This is well above the levels estimated for Estonia and Lithuania, though measuring unreported activity is inherently difficult and results depend on the source and the method used. Underreporting of business profits and salaries is particularly pronounced, while firms state that approximately 10% of their revenue is spent on bribery (Putnins and Sauka, 2014). Hidden activity should be tackled as it reduces tax revenues and excludes part of the population from the social security system, contributing to the high level of inequality and increasing poverty risks.

Evidence of entrenched tax evasion can also be found in the high "VAT compliance gap" (Figure 9). The efficiency of the VAT system has been greatly affected by the 2009 downturn and there is significant scope for improvement as the economy recovers, in particular if supported by policy action to improve tax collection. The potential revenue that could be collected if tax collection improved is quite large, amounting to around 3.5% of GDP (European Commission, 2014b). While the issue has been on the agenda of the authorities for some time, it is not clear whether sufficient resources are being allocated for measures against tax fraud.

Figure 9. **Improved tax collection offers revenue potential**

2012, VAT gap,[1] % of GDP



1. The VAT Gap is the difference, in any given year, between the VAT Collections (as recorded by Eurostat) and the amount theoretically due, i.e. VTTL (VAT Total Tax Liability). The latter is the total amount of estimated VAT payments on the basis of national accounts aggregates and the existing structure of rates and exemptions.

Source: European Commission, "2012 Update Report to the Study to quantify and analyse the VAT Gap in the EU-27 Member States", September 2014 and Eurostat database.

StatLink http://dx.doi.org/10.1787/888933183649

Another potential revenue source is the better pricing of environmental externalities. New passenger cars in Latvia have the highest CO_2 emissions per kilometre in the EU (Dreblow et al., 2013) and high levels of particulate matter (PM10) have been recorded along some busy roads in Riga (European Commission, 2014a). 84% of municipal waste is landfilled two and a half times more than the EU average. Environmentally-related taxation has been extended. In 2010, a registration tax for passenger cars differentiated by CO_2 emissions per km and an annual tax on vehicles depending on the capacity and volume of engine were introduced. This has led to a decrease in the average emissions of new cars but it would be more effective if applied to all motor vehicles. There is also some evidence of tax evasion through car registration in neighbouring Estonia, which could be remedied by tax harmonisation. A new road toll tax (so-called euro vignette) for trucks using the highways was introduced in July 2014.

Nevertheless, fuel taxes are among the lowest in the EU and do not reflect the relative negative impact of fuel consumption on the environment. There are also tax exemptions or reductions on fuels for agriculture and for heat generation. An 80% VAT tax deduction is applied on corporate passenger cars, which are often used for private purposes, on both purchase price and operating costs (e.g. fuel, Lamine and Lohmuste, 2014). These environmentally harmful subsidies should be phased out. To preserve the competitiveness of sectors exposed to international competition, time-limited cash transfers compensating for the cost of taxation but not linked to energy consumption could be provided. Despite recent increases, taxes related to waste management are not effective enough to divert waste from landfill to recycling (European Commission, 2014a) and should thus be revised.

Property taxes, which are low by international standards, could be increased. In 2013, local governments were given more leeway to adjust the rates within a pre-defined bracket of 0.2-3%. However, they are not motivated to do so, as they compete for taxpayers. According to recent estimates, doubling the residential and land tax rates could increase revenues by around EUR 100 million, i.e. 0.4% of GDP (BICEPS, 2014). By contrast, there is little need to increase the value added tax rate, which is already 21%, comparable to the levels in high-income countries, and brings a large portion of revenues, although potentially large revenue increases could be reaped by reducing the VAT gap.

Recommendations to improve public sector efficiency

Key recommendations

- Strengthen efforts to tackle tax fraud and improve tax collection.
- Evaluate the current benefit system and make universal social benefits more targeted at low-income households.
- Gradually withdraw benefits targeted at low-income earners when they take up a job.
- Decrease the labour tax wedge for low-income earners.
- Raise additional revenues by increasing property and environmentally related taxes.

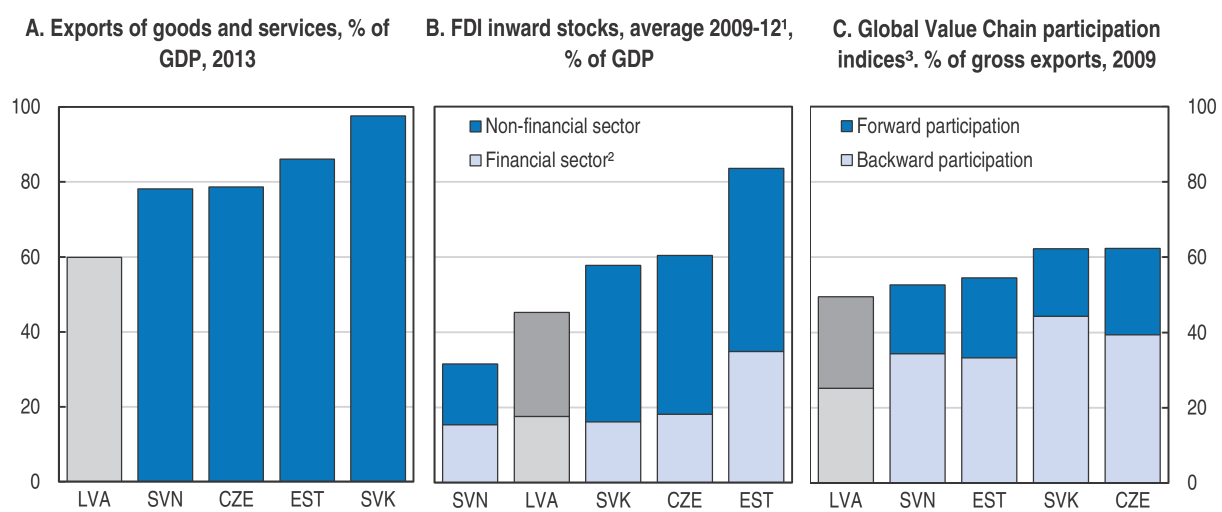
Other recommendations

- Allocate adequate staff and resources to the Cross-Sectoral Coordination Centre.
- Phase out environmentally harmful fuel subsidies.
- Introduce regular reporting on long-term spending trends and the adequacy of social programmes, such as pensions and healthcare.

Raising productivity and ensuring robust convergence

The gap in productivity *vis-à-vis* the top OECD performers is substantial, which means that much of the catching-up in incomes needs to come from productivity increases. For a small open economy, a competitive domestic environment is key to securing a competitive position internationally. Domestically, strong competition would stimulate a reallocation of resources and raise productivity. Yet, Latvian firms do not perform as well as their peers. Exports as a share of GDP, foreign direct investment inflows and participation in global value chains are all lower than in other open catching-up economies, such as the Czech Republic, Estonia and the Slovak Republic (Figure 10). Moreover, according to a survey of managers reported in the World Economic Forum's Competitiveness Report, Latvia ranks 34th worldwide with respect to perceived competition. To better identify and build support for solutions to domestic productivity challenges effective coordination of the various bodies dealing with productivity issues (i.e. the Large and Strategically Important Investments Coordination Council, the National Economy Council) is necessary. Some countries have established an independent advisory body tasked with reviewing these issues regularly (such as the Australian Productivity Commission), have set up a government co-ordination unit or found other ways to ensure a whole-of-government approach.

Figure 10. **Latvia is less competitive than its peers**



1. Average 2009-11 for Czech Republic and Slovak Republic.
2. Financial sector refers to financial and insurance activities and real estate activities.
3. Backward participation shows the use of foreign intermediates in a country's exports and forward participation the use by other countries of a country's inputs in their exports.

Source: OECD Economic Outlook database, Eurostat database and OECD Global Value Chains indicators – May 2013.

StatLink http://dx.doi.org/10.1787/888933183654

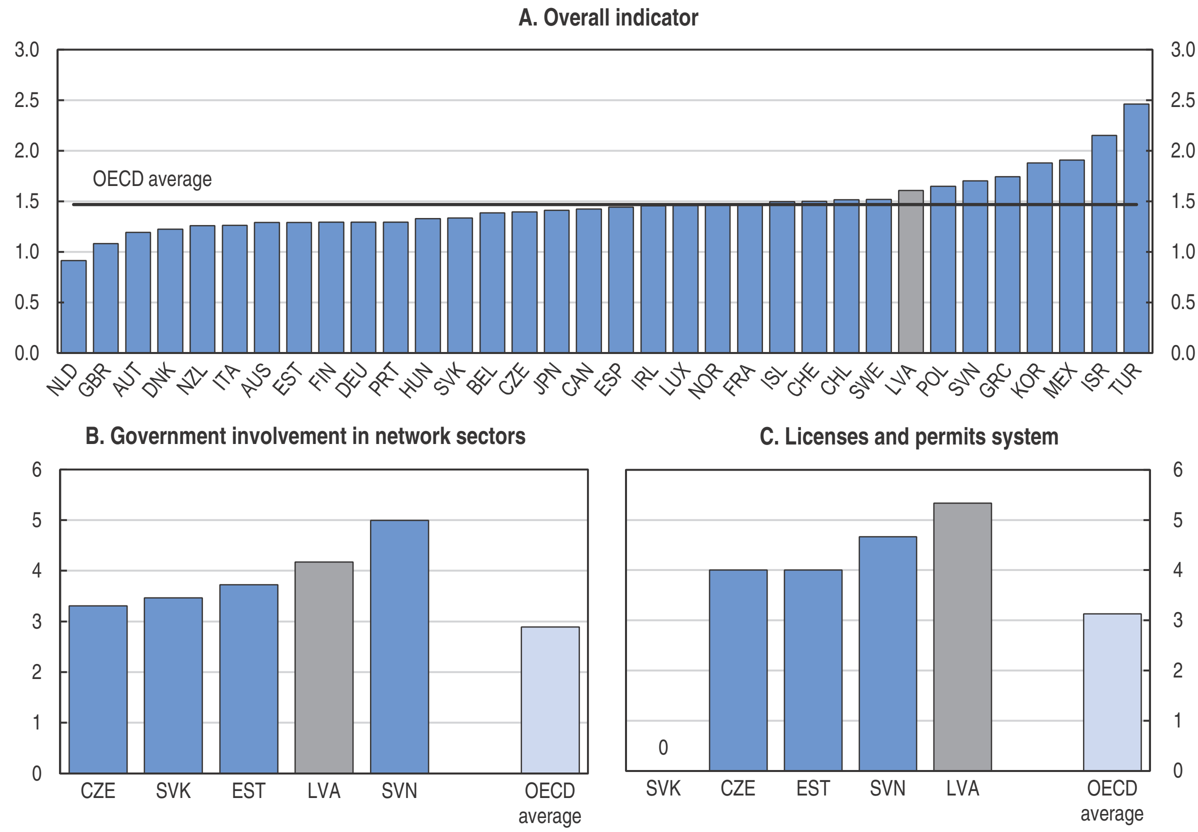
The following section looks at the main aspects of the business environment: the regulatory burden, competition, the judiciary and access to finance. It concludes by exploring the potential for innovation and the deepening of skills.

Cutting red tape

Regulation can hamper competition and investment. Overall, product market regulation (PMR) in Latvia is not very pro-competitive. *De jure*, businesses face red tape, as regulatory procedures seem complex, notably in terms of permits and licenses (Figure 11).

Figure 11. **Product Market Regulation is more restrictive than in the average OECD country**

2013, index scale of 0-6 from least to most restrictive



Source: OECD (2013), Product Market Regulation database.

StatLink http://dx.doi.org/10.1787/888933183661

State involvement in the economy is considerable, notably in the network sectors. The administrative burden on start-ups, sole proprietors and corporations is above the OECD average. The cost of tax compliance is relatively high, in part because of time-consuming tax filing (PWC and World Bank, 2014). Furthermore, there are barriers to foreign direct investment, in particular in areas of agriculture and forestry, real estate investment and financial services (OECD, 2015a *forthcoming*). Latvia ranks 23th in the 2015 World Bank's Doing Business survey measuring *de facto* ease of the business environment across the world. Though this is a good position, it lags behind Estonia and ranks just above Lithuania, with whom it ultimately competes for foreign investment.

An annual exercise, whereby the public can signal burdensome regulations, is in place and based on its outcomes the authorities prepare an action plan for the following year. Also, regulatory impact assessments, essential for effective policy evaluation, are being strengthened. At present the scope of investigation is often restricted to financial, budgetary, and administrative costs. Procedures can often be fast-tracked by ministries and there are no specific sustainability checks. Moreover, there is no threshold test for the preparation of more in-depth analyses of legislative and policy proposals with significant economic, social or environmental impacts. Such a test would help the public administration to prioritise resources better and to conduct more robust in-depth assessments for those proposed policies and laws that are likely to have the greatest costs and benefits for the economy.

Transparency in administrative procedures and integrity in administration both contribute to good business environment. Latvia is making important progress in tackling corruption and has one of the lowest levels of administrative corruption in the transition region (EBRD, 2011 Life in Transition Survey). To limit conflicts of interest in public procurement, innovative tools to streamline and centralise procurement procedures have been introduced. Local governments are obliged to use centralised procurement for a range of services and publish small contracts online. The share of published calls for public tenders is one of the highest in the EU. The "one-stop-shop" principle for the provision of state and local government services is also being developed. Nevertheless, there have been cases of insufficient follow up by the procuring agencies and ensuring the independence and capacity of the KNAB, the agency in charge of preventing and combating corruption, remains a challenge.

Strengthening competition enforcement

The competition framework is sound but the independence of oversight and enforcement with respect to the Competition Law need strengthening. Competition enforcement lies with the Competition Council, which is independent in its decision-making, but administratively falls under the Ministry of Economy. Subject to the Civil Servants Law, the government can interfere with the operations of the Council by transferring civil servants. By this, it can also effectively by-pass an open-selection process for appointments to the Council, undermining its independence. To secure full independence, the Competition Council should be made financially independent and government involvement in transferring civil servants should be minimised.

Large public involvement in the economy poses regulatory challenges and a number of state-owned enterprises have been involved in competition cases. More than 6% of total dependent employment is in state-owned enterprises (SOE), which would rank Latvia just after Norway, France and Slovenia, the OECD countries with the highest shares of employment in public companies. SOEs have sub-par governance structures, not least because boards of directors for all SOEs were – with a few exceptions – abolished in 2009. The state enterprise ownership function is decentralised and the separation between ownership and other functions is blurred, making oversight and ensuring a level playing field challenging. No regular aggregate reporting is in place and monitoring mechanisms are weak (OECD, 2015b *forthcoming*). Some SOEs are "strategic", i.e. not to be privatised (e.g. Riga airport authority, Latvian Post, Latvian Railways). They maintain a monopoly position and are prone to abuse it, as illustrated in rulings of the competition authority.

A legislative package of reforms of SOEs that came into force this year ("Public Persons Enterprises and Capital Shares Governance Law") goes some way towards addressing these shortcomings. Notably, it reintroduces boards to the biggest SOEs; establishes an entity coordinating state enterprise ownership (the Coordination Institution) and requires annual aggregate reporting. Nevertheless, the implementation of the new SOE corporate governance function will be key (OECD, 2015b *forthcoming*). Besides, in line with the *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, boards of directors should be re-introduced for all commercially-oriented companies, with clear selection and nomination procedures; annual aggregate reporting should become the norm, and large or listed SOEs should adhere to high quality internationally recognised accounting and auditing standards.

Competition issues in the network industries mainly result from poor connectivity of the infrastructure and incumbents that continue to dominate the market. Most of the network sectors remain concentrated and have a high degree of public ownership (Karnitis and Virtmanis, 2011), but progress is being made:

- In the electricity sector, liberalisation resulted in the legal separation of generation and distribution from the network operator. Most of electricity is produced by a state-owned incumbent *Latvenergo,* which owns the biggest distributor. Business customers and households that decided to become market participants have been able to choose their suppliers since 2007, while for other customers, in fact majority of the households, market opening started this year. Recently, the country has been connected to Nord Pool Spot, the Nordic- Baltic electricity exchange, and there are 12 electricity traders active in the domestic market. Yet, prices for businesses remain higher than for Nordic customers. This can be mainly explained by insufficient transmission capacity and limited connectivity.
- In the gas sector, a privatisation deal made in the late 1990s resulted in a vertically integrated monopoly. Third-party access to the network became legally possible in 2014 and supplier choice for end-users will be allowed in 2017, or as soon as the natural gas system is directly connected to the interconnected system of any EU member state other than Estonia, Lithuania and Finland, or as soon as the share of the main supplier of natural gas is less than 75% (at the moment, 100% gas is supplied by Russia).

Effective competition in both the electricity and gas sectors is conditional on improving infrastructure connectivity and this will take time. Nevertheless, to strengthen the competitive environment in the near term, non-discriminatory access to the natural monopoly elements of the industries is needed. Moreover, the risk that vertically integrated firms will engage in strategic under-investment in infrastructure in order to circumvent access obligations needs to be considered (OECD, 2011b). If on-going breaches of competition rules are linked to a vertically integrated market structure, and regulation alone proves inefficient, ownership unbundling should be considered.

Competition in other markets is often marked by a rural-urban divide. The broadband telecom market is a case in point. A true digital divide exists both in terms of coverage and access to broadband services. While a plethora of data providers compete in urban areas, in the countryside only 44% of population is covered by the standard broadband coverage, one of the lowest in the EU. A publicly funded development of the next generation network is underway in rural areas, carried out by the public broadcaster. It will establish local broadband connection points that will allow third-party access once it is completed. The Competition Council has raised issues in waste management, where some local governments use an in-house procurement exemption to provide these services, resulting in a market that is closed to new entrants.

Improving judicial processes

An inefficient judiciary can diminish competition, firm growth, investment and specialisation by hampering the reallocation of resources and raising capital costs. A comprehensive reform of the judiciary is being implemented and includes reorganisation of judicial districts, a bigger role for court presidents in managing the case-flow and wider use of electronic record keeping. Some of the measures are starting to bear fruit, as the length of proceedings and the clearance rate are improving. Yet, efficiency indicators for civil and commercial cases are starting to stall. Out-of-court settlements, an alternative to the overburdened judiciary, have not worked well, because the arbitration institutions have not been seen as independent (FILC, 2012). Reforms of laws on mediation and arbitration have been passed. Both aim at tightening qualification requirements, thereby rebuilding the effectiveness of these tools.

The insolvency regime, which is crucial for an efficient reallocation of resources as well as for the cost of credit, has undergone a substantial overhaul in recent years. Discharge of debt is now possible within one year following the sale of assets and an US-style walk-away clause for mortgages has been recently introduced. Announced personal insolvencies increased following the reforms but completion is still a challenge. Corporate insolvencies have also picked up, though they appear to have peaked in 2009/2010. It remains to be seen whether the recent slowdown is because of improved economic environment or due to the introduction of a deposit (EUR 640) to be paid by the insolvency applicant. Restructuring is possible also via protected out-of-court settlements, but these have been infrequent, with only 4 cases concluded out of over 100 initiated in 2013.

Reducing energy intensity and dependency

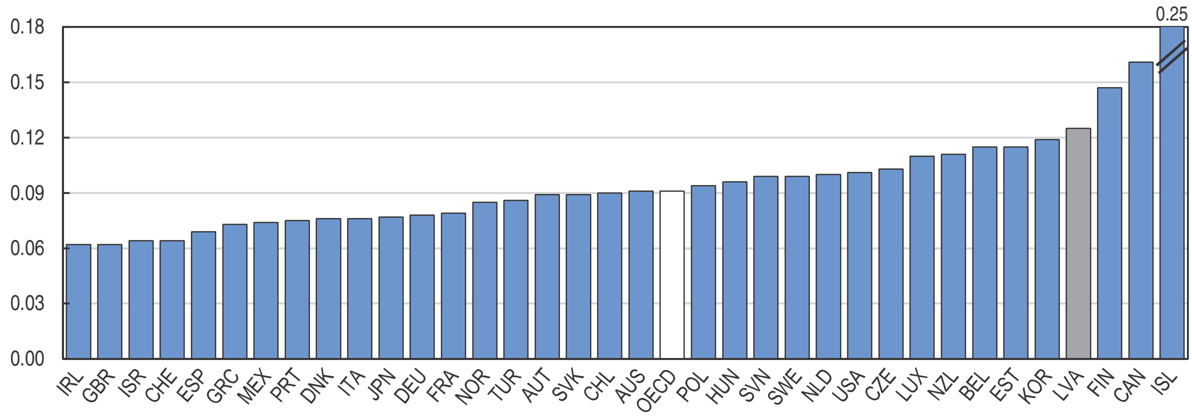
Latvia is an energy intensive economy when compared with other OECD countries (Figure 12). This is worrisome, as the economy is vulnerable to supply disruptions: gas accounts for a large share of energy supply and is provided by one supplier. Also, the relatively high level of energy consumption per unit of GDP has an impact on the greenhouse gas emission intensity of the economy. This is only partly compensated by a favourable energy mix which includes a large share of low-carbon energy sources.

Greenhouse gas (GHG) emissions have decreased significantly since 1990, and the country's GHG profile is unique since, thanks to large forest areas, it has negative absolute emissions. However, abstracting from the natural endowment (i.e. excluding negative emissions from land use, land-use change and forestry) Latvia ranked among the ten most GHG intensive economies when compared with OECD countries in 2010 (Figure 13). As defined by the EU Effort Sharing Decision, Latvia should not increase GHG emissions from sectors not covered by the EU Emissions Trading System by more than 17% by 2020 compared to 2005. Reaching this target will be a challenge and additional measures are planned to limit non-ETS emissions increase to 14.5% by 2020. Given expected increases in carbon prices in the long term, ensuring competitiveness and sustainable growth requires reducing energy intensity.

Transport and the household sector are the biggest energy users, with industry playing a smaller role. In the transport sector there is scope for improved pricing of environmental externalities as fuel taxes are among the lowest in the EU (OECD, 2015c *forthcoming*). In the household sector, energy intensity reflects a large stock of inefficient housing and centralised heating systems. Recent evidence suggests that households' propensity to invest in clean energy technologies depends mainly on home ownership, income, social context and households' information (Ameli and Brandt, 2014). Latvia has a high home-ownership but income levels are low, which could explain part of the under-investment in energy efficiency. A number of initiatives have been launched to improve the energy efficiency of buildings. In 2013, the government introduced building energy certification rules in order to facilitate comparisons of energy efficiency. Subsidies and public guaranties for loans were also offered for improving housing insulation, energy-efficient lighting and replacing fossil fuel heating systems with renewable energy heating systems.

Figure 12. **Energy intensity is high**

Total final energy consumption per unit of GDP (toe per thousand 2005 USD of GDP calculated using PPPs), 2012

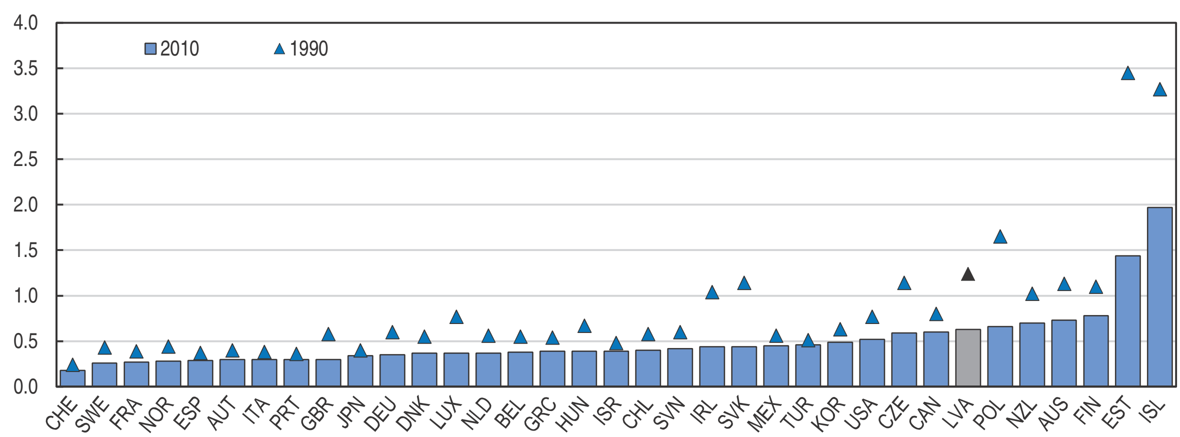


Source: IEA (2014), World Energy Statistics and Balances database.

StatLink http://dx.doi.org/10.1787/888933183675

Figure 13. **Greenhouse gas emissions intensity is above the OECD average**

Tonnes CO_2 eq per 1000 USD, including positive emissions from LULUCF[1] sources



1. Land use, land-use change and forestry; i.e. including sources of GHG emissions and excluding removals/sequestration of greenhouse gas. Regarding what emissions from LULUCF are included and which ones are not, the model used is EDGAR.

Source: OECD/IEA Energy database.

StatLink http://dx.doi.org/10.1787/888933183685

Energy-efficient investment in housing should be further supported. To increase the efficiency of these programmes, subsidies should be directed to credit-constrained households. Energy efficiency in district heating also remains a challenge. The regulation of heat networks should provide stronger incentives to improve efficiency, for instance by defining stricter requirements for heat supply systems.

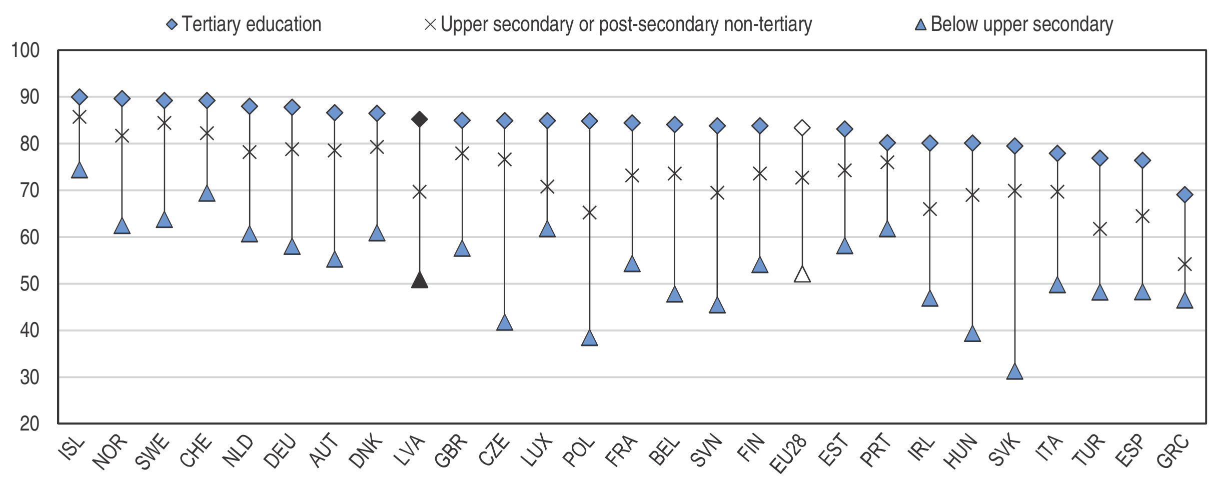
With good natural conditions for hydropower and biomass, renewable energy sources accounted for 36.3% of total primary energy supply in 2012, one of the highest shares in the EU (Central Statistical Bureau of Latvia). Renewables reduce dependency on foreign energy suppliers and mitigate GHG emissions. Nevertheless, developing them further from the currently high level could be costly and the cost-effectiveness of the policy tools used to reach renewables targets should be carefully assessed. Feed-in tariffs are in place to promote renewable energy in the electricity sector, but as in many OECD countries they have not been adapted to developments in electricity market price or to falling investment costs. The generosity of the scheme was reduced in January 2014 with the introduction of a tax on subsidised electricity production. The feed-in tariffs were suspended for new entrants in 2011 and are currently under revision. A cost-benefit analysis of the scheme should be carried out as they entail generally the highest costs for abating carbon emissions (OECD, 2013b). If the scheme is continued, feed-in tariffs should be adjusted to electricity market prices and technology developments on a regular basis.

Deepening skills and innovation

Educational attainment and skills have a strong influence on labour market outcomes and effective investment in youth skills determines the capacity of countries to face various shocks and to get the most out of globalisation, technological changes and innovations. The education system has undergone significant reforms during the transition and Latvian students perform relatively well by international comparison. PISA results show that literacy, numeracy and science scores are close to the OECD average. Overall, the population is well educated: 80% of the working-age cohort has upper secondary education or higher; tertiary education attainment has been increasing over the years to 27% in 2013, with more women attaining degrees than men: 34% versus 20%. Employment rates of tertiary education graduates are comparable to the top OECD performers. Yet, graduates of lower levels of education lag behind (Figure 14).

Figure 14. **Employment rates differ widely by educational level**

Employment rates among 25-64 year-olds, 2013, %



Source: Eurostat database.

StatLink http://dx.doi.org/10.1787/888933183697

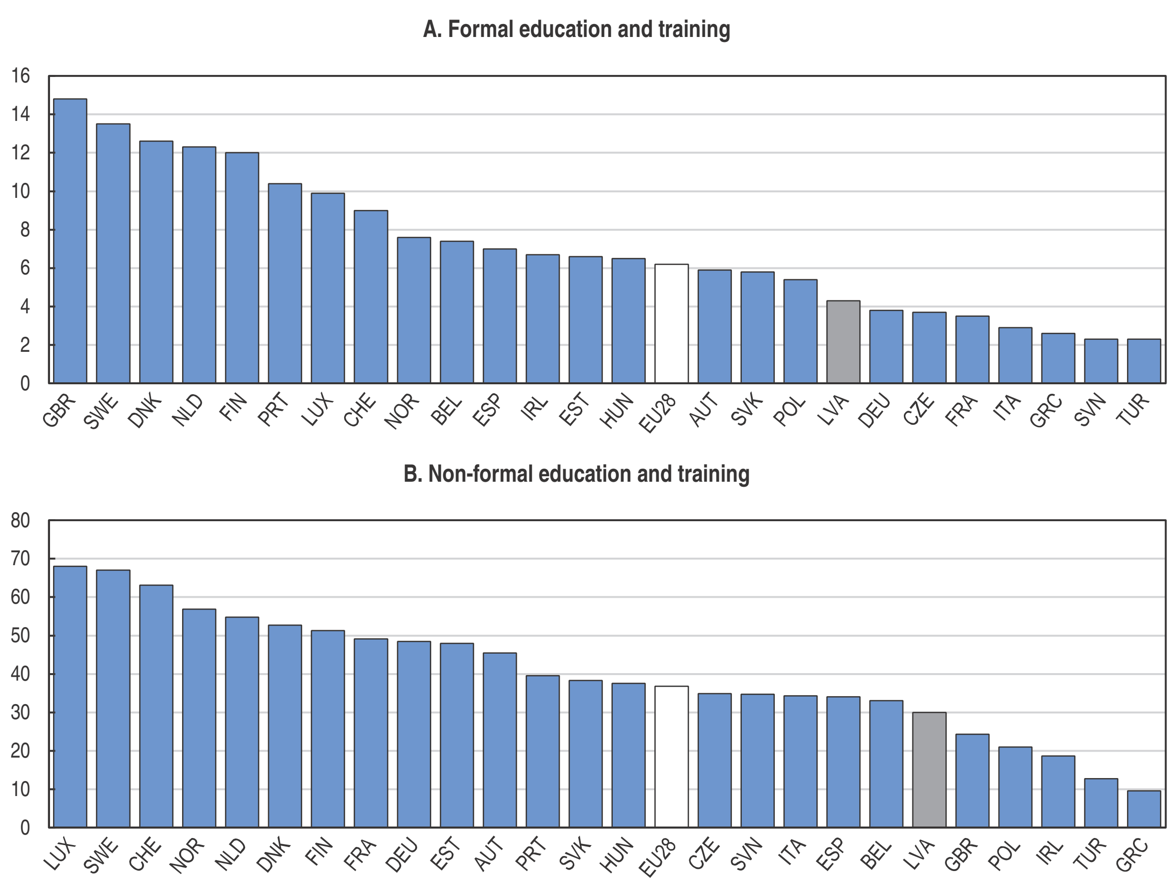
Vocational education and training (VET) is to play an increasing role. The authorities aim is for half of students to attain VET and half a general education by 2020; the current share being 40 to 60. To date, the VET has not had a particularly good image; the share of those who consider that VET provides high-quality learning was well below the EU average (Eurobarometer, 2011). A comprehensive reform is currently under way that includes consolidating VET institutions; creating so-called multi-functional competence centres; setting up new occupational standards in cooperation with employers; and revising school programmes and teaching methods. A pilot programme of work-based-learning, inspired by the German, Austrian and Swiss apprenticeship models is also being developed.

This reform is welcome, as it covers many important aspects of a well-balanced skills strategy, but could go even further in some areas. Four ministries are involved in VET, though most of the schools fall under the Ministry of Education, and in addition some municipalities have taken over smaller VET institutions. Coordination across these bodies should therefore ensure that national standards are enforced in order to reach the same quality of education. While modular programmes that can also serve the purpose of lifelong learning are being developed in the VET, it is important that there are also modules for enhancing basic literacy and numeracy skills.

The participation of the working-age population in both formal and non-formal forms of education and training is low (Figure 15). According to the Programme for the International Assessment of Adult Competencies (PIAAC) survey, in most OECD countries, adults with already-high levels of literacy and numeracy are much more likely to participate in further adult education and training. In combination with generally lower employment rates, this means that involving the low-skilled should be a priority. Minorities were hit by the downturn in terms of employment, suggesting that these groups should also be in the policy focus. Factors behind these outcomes have not yet been fully identified but a relatively lower educational level and the lack of Latvian language skills certainly play a role.

Figure 15. **Participation in lifelong learning is low**

Participation rate in formal or non-formal education and training, 25-64 years-olds, 2011, %



Note: Based on the adult education survey (AES). The reference period for AES is the 12 months before the interview. 2007 data for Turkey.
Source: Eurostat database.

StatLink http://dx.doi.org/10.1787/888933183705

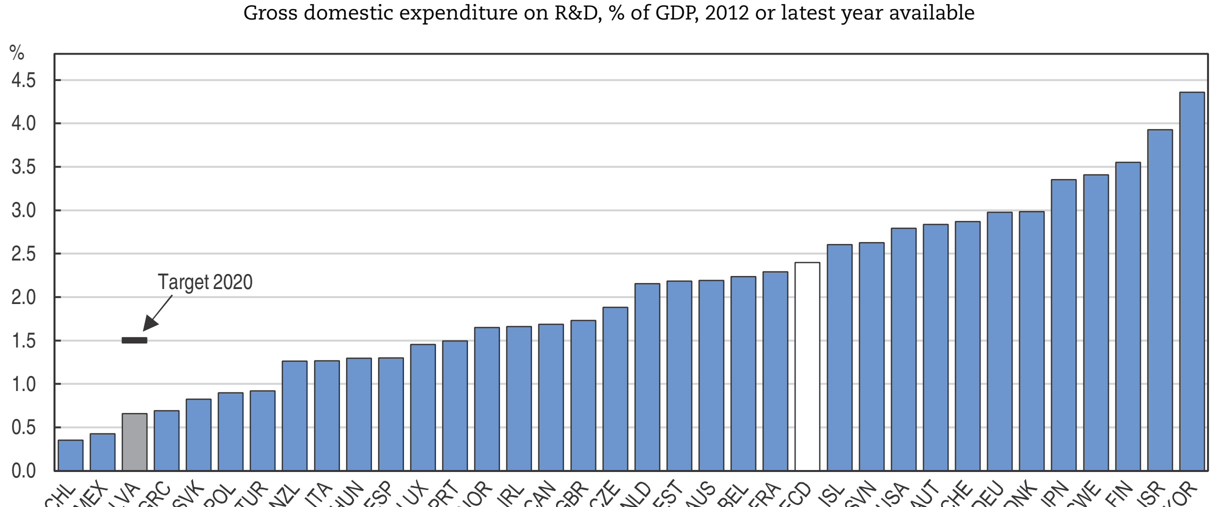
Insufficient public supply of general and professionally oriented Latvian language courses for the adult population was identified as one of the barriers to better integration of the ethnic minorities (Hazans, 2011). Language training is now offered by the public employment service, as well as for employed under risk of job-loss as a part of lifelong learning programmes. Efforts to help minorities to acquire the skills needed on the labour market should continue, combined with professionally-oriented Latvian language courses.

Current measures to support lifelong learning, including a deduction from personal income tax for employees, might not be sufficient to develop adult education and training. As part of the ongoing VET reform, the authorities plan that selected VET institutions will play a bigger role in the provision of lifelong learning, once the new curricular and modules are in place. Labour unions and employers are currently involved in discussions about the settings of the occupational standards under the so-called Sector Expert Councils. This is welcome, as experience of countries like France, Finland, Austria and Germany shows that involvement of social partners is useful in designing the content of training and supervision of the provision (Bassanini et al., 2005). Nevertheless, as with VET, policy responsibility is fragmented: ten different institutions are involved in implementing lifelong learning. The authorities have an important role to play in improving information about training opportunities, adult learning and ensuring the portability of skills. In addition, improving access to good quality education and preventing poor educational outcomes in the first place should increase training and adult learning demand in the long run.

Innovation activity has been limited. Only about a third of local enterprises were innovative prior to the 2009 global economic crisis, one of the lowest shares in the EU (Eurostat, 2013). The share of high-technology products in exports is small; and Latvia lags behind its neighbours in patenting and commercialisation of research (Cunska et al., 2013). Furthermore, overall spending on research and development (R&D) is low, both in terms of public and private expenditure. The authorities have an ambitious goal of more than doubling the R&D spending, from current 0.6 to 1.5% of GDP by 2020 (Figure 16). Though a number of policies have been developed to this end, it will be a challenging task.

Figure 16. **R&D expenditure is among the lowest compared with OECD countries**

Gross domestic expenditure on R&D, % of GDP, 2012 or latest year available



Note: 2011 for Iceland, New Zealand and Mexico. 2010 for Australia. 2008 for Switzerland.
Source: OECD Main Science and Technology Indicators database and Eurostat database.

StatLink http://dx.doi.org/10.1787/888933183711

The R&D policy framework involves both direct and indirect support measures. A number of direct support measures, such as business incubators are available, largely subsidised by the EU structural funds. A new tax incentive has been recently introduced to stimulate investment in research, development and innovation. It allows decreasing corporate income tax liability by three-times the costs of purchased intangibles with no cap. The impact of such measures should be carefully assessed. In particular, there is a risk that the tax incentives will not influence innovative activities in young firms. Tax incentives that do not involve immediate cash refunds are less favourable to new market entrants, which do not typically make much profit in their early years and so are not able to benefit from tax concessions.

A consolidation of the existing public research infrastructure is under way. With some exceptions, existing research activities are not very well tuned to business needs and Latvian research lags behind in terms of internationalisation. The ongoing comprehensive reform includes cutting down the number of research institutions and units, bringing research into the tertiary education sector and improving links between the research and business sectors. This could help local enterprises to become more innovative and productive. At the same time, incentives for international cooperation in local research and innovation activity are needed, as well as a regular external evaluation exercise.

Recommendations to raise productivity and ensure robust convergence

Key recommendations

- Make regulation more competition-friendly by reducing entry barriers.
- Continue reducing red tape, by simplifying the permits and licenses system and tax payments.
- Bring the governance of state-owned enterprises further in line with the OECD Guidelines on Corporate Governance of State-Owned Enterprises.
- Continue improving the connectivity of energy networks with the rest of the European Union.
- Proceed with the reform of vocational education and training, including the planned extension of work-based learning.
- Encourage lifelong learning and training by improving information about training opportunities and adult learning, while ensuring the portability of skills.

Other recommendations

- Strengthen the independence of the Competition Council and enforcement of competition policy by giving it more financial and administrative autonomy.
- Ensure that feed-in tariffs for renewable energy production are cost-effective.
- Offer financial support to foster energy efficiency gains in the housing sector, in particular to credit-constrained households.
- Provide stronger incentives to improve efficiency in district heating.
- Continue helping minorities to acquire skills needed on the labour market.
- Continue offering programmes enhancing basic literacy and numeracy skills.

Recommendations to raise productivity and ensure robust convergence *(cont.)*

- Carry out coordinated and regular assessment of productivity challenges as an input for regulatory reform.
- Reinforce regulatory impact assessments by reducing fast-tracking, establishing specific sustainability checks and introducing threshold tests for the preparation of more in-depth analyses.
- Evaluate the newly reformed tax incentives for R&D, also in view to reaching young firms.
- Develop incentives for international cooperation in local research and innovation as well as a regular external evaluation exercise.

Bibliography

Ameli, N. and N. Brandt (2014), "Determinants of Households' Investment in Energy Efficiency and Renewables: Evidence from the OECD Survey on Household Environmental Behaviour and Attitudes", *OECD Economics Department Working Papers*, No. 1165, OECD Publishing.

Bank of Latvia (2014), *Financial Stability Report 2013/2014*, Bank of Latvia.

Baltic International Centre for Economic Policy Studies, (2014), "Tax Reform in Latvia", BICEPS, Riga.

Bassanini A., A. Booth, G. Brunello, M. De Paola, E. Leuven (2005), "Workplace training in Europe", *IZA Discussion Paper* No. 1640, June 2005.

Blanchard O., M. Griffiths, and B. Gruss (2013), "Boom, Bust, Recovery Forensics of the Latvia Crisis". *BPEA paper*, Economic Studies at Brookings.

Cunska, Z., C. Ketels, A. Paalzow and A. Vanags, (2013), *Latvia Competiveness Report*, Stockholm School of Economics in Riga and Baltic International Centre for Economic Policy Studies.

Dreblow, E., M. Duwe, T. Wawer, L. Donat, E. Zelljadt, A. Ayres, I. Upatniece (2013), "Assessment of climate change policies in the context of the European Semester, Country Report: Latvia", Ecologic Institute, eclareon, June.

Eglitis G., R. Krastev and C. Weise, (2014), "Latvia: benefiting from the euro, facing new challenges", *ECFIN Country Focus*, European Commission, Vol. 11, Issues 12, November 2014.

Eurobarometer (2011), Attitudes towards vocational education and training, Special Eurobarometer 369, European Commission, Brussels.

European Bank for Reconstruction and Development (2011), *Life in Transition Survey*, EBRD Publications.

European Central Bank (2013), "Convergence report June 2013".

European Central Bank (2014), "Aggregate Report on the Comprehensive Assessment", October 2014.

European Commission (2012), 2012 Ageing Report: Economic and budgetary projections for the EU27 Member States (2010-60), EC, Brussels.

European Commission (2013a), "EC Staff Report from the Third Post-programme Surveillance Mission", Brussels.

European Commission (2013b), "Member States' Energy Dependence: An Indicator-based Assessment", *Occasional Papers No 145*, Brussels.

European Commission (2013c), "Adequacy and Sustainability of Pensions", *European Commission paper*.

European Commission (2014a), "Assessment of the 2014 National Reform Programme and Stability Programme for Latvia", *Commission staff working document*, Brussels.

European Commission (2014b), "2012 Update Report to the Study to quantify and analyse the VAT Gap in the EU-27 Member States", September 2014.

Foreign Investors' Council in Latvia (FILC) (2012), Position paper on proposals for the improvement of the Insolvency process, Riga.

Hazans M. (2011), Labour market Integration in Latvia, in M. Kahanec and K.F. Zimmermann, *Ethnic Diversity in European Labour Markets*, Edward Elgar Publishing.

Hüfner F., A. Wörgötter, and C. Klein (2013), "The German Labour Market in the Great Recession, Lessons for Other Countries", in *Learning from the World : New Ideas to Redevelop America*, edited by Joe Colombano and Aniket Shah.

IMF (2014), "Republic of Latvia: 2014 Article IV Consultation, International Monetary Fund".

Karnitis E., A. Virtmanis (2011), Multi-sectoral regulation of services of general economic interest – Ten year experience of Latvia, Public Utilities Commission of Latvia, Riga.

KMPG (2014), "Estimated Macroeconomic Impact on the Non-resident Segment of the Banking Sector on the Latvian economy", KMPG, Riga.

Lamine B. and E. Lohmuste, (2014), "Do the Baltics States need to tax passenger cars more", ECFIN Country Focus, Vol. 12, Issue 11, November 2014.

Lehmann H. and A. Zaiceva (2015), Key Labour Market Trends in Latvia, *forthcoming*.

OECD (2011a), *Taxation and Employment, The Taxation of Low-Income Workers,* OECD Publishing.

OECD (2011b), "Report on Experiences with Structural Separation", OECD Publishing.

OECD (2012), *OECD Economic Surveys, Estonia*, OECD Publishing.

OECD (2013a), *Migration Outlook*, OECD Publishing.

OECD (2013b), *Effective Carbon Prices*, OECD Publishing.

OECD (2013c), *PISA 2012 Results: Excellence through Equity Giving Every Student the Chance to Succeed,* Vol. II, PISA, OECD Publishing.

OECD (2014a), *OECD Economic Surveys: Euro Area 2014*, OECD Publishing.

OECD (2015a), *Market Openness Review*, OECD Publishing, *forthcoming*.

OECD (2015b), *Review of Latvia's position relative to the OECD guidelines on corporate governance of state-owned enterprises*, OECD Publishing, *forthcoming*.

OECD (2015c), "Climate Change Mitigation in Latvia", *Technical background paper,* OECD Publishing, *forthcoming*.

Putniņš T.J. and A.Sauka, (2014), "Shadow Economy Index for the Baltic countries, 2009 – 2013", The Centre for Sustainable Business, SSE Riga.

PWC and World Bank (2014), *Paying taxes 2015: The Global Picture*, World Bank, Washington.

World Bank (2012), Financial Sector Assessment – Republic of Latvia, June 2012, World Bank, Washington.

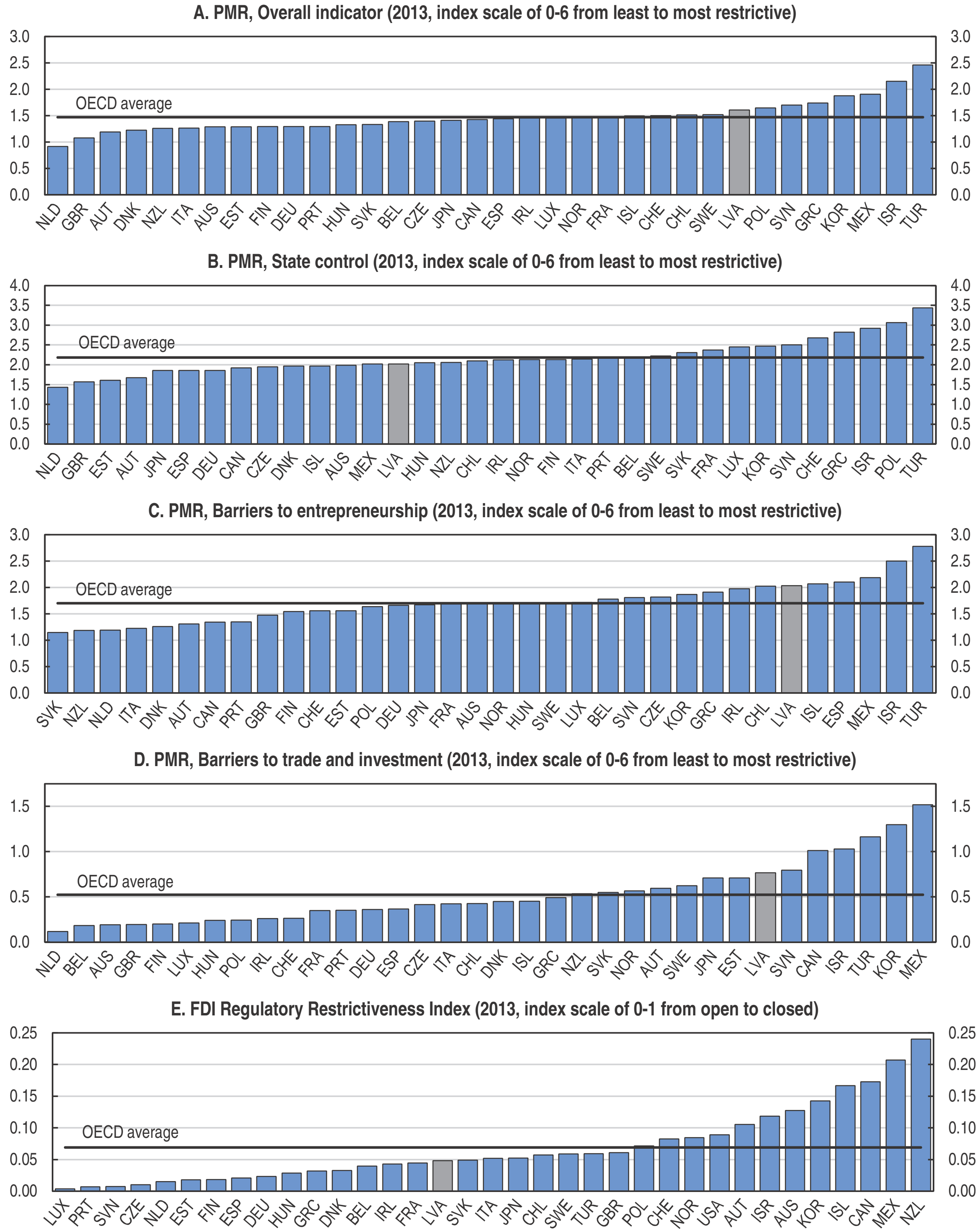
World Bank (2013), "Latvia: Who is Unemployed, Inactive or Needy? An Assessment of Post-Crisis Policy Options", World Bank, Washington.

World Health Organisation and European Observatory of Health Systems and Policies (WHO and EOHSP) (2012), *Latvia: Health System Review*, Health systems in Transition, Vol. 14, No. 8.

ANNEX

Selected policy indicators

Figure A1. **Product Market Regulation (PMR) and FDI Regulatory Restrictiveness Index**

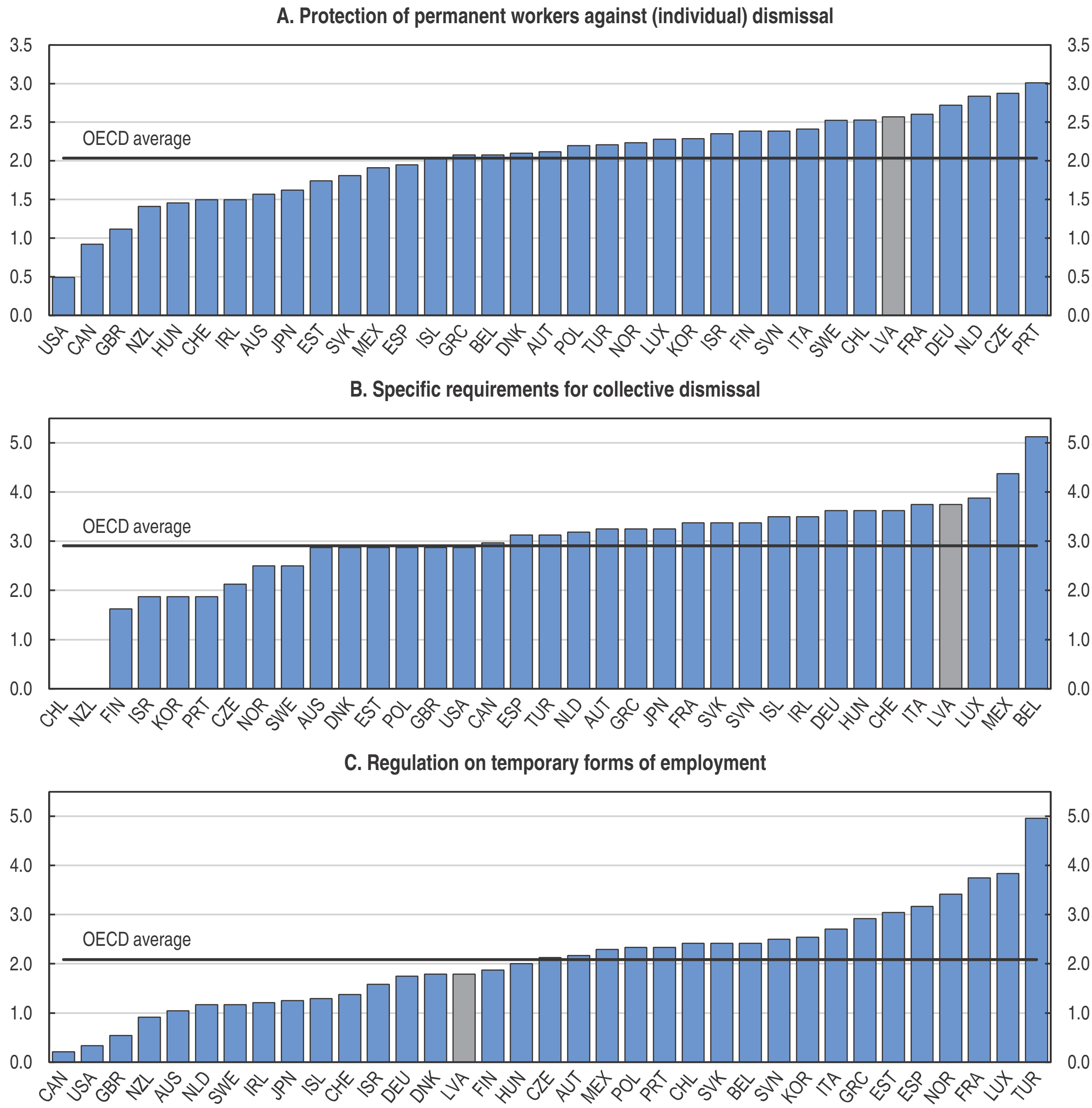


Source: OECD (2013), Product Market Regulation Database and *www.oecd.org/investment/index*.

StatLink http://dx.doi.org/10.1787/888933183725

Figure A2. **OECD indicators on Employment Protection Legislation (EPL)**

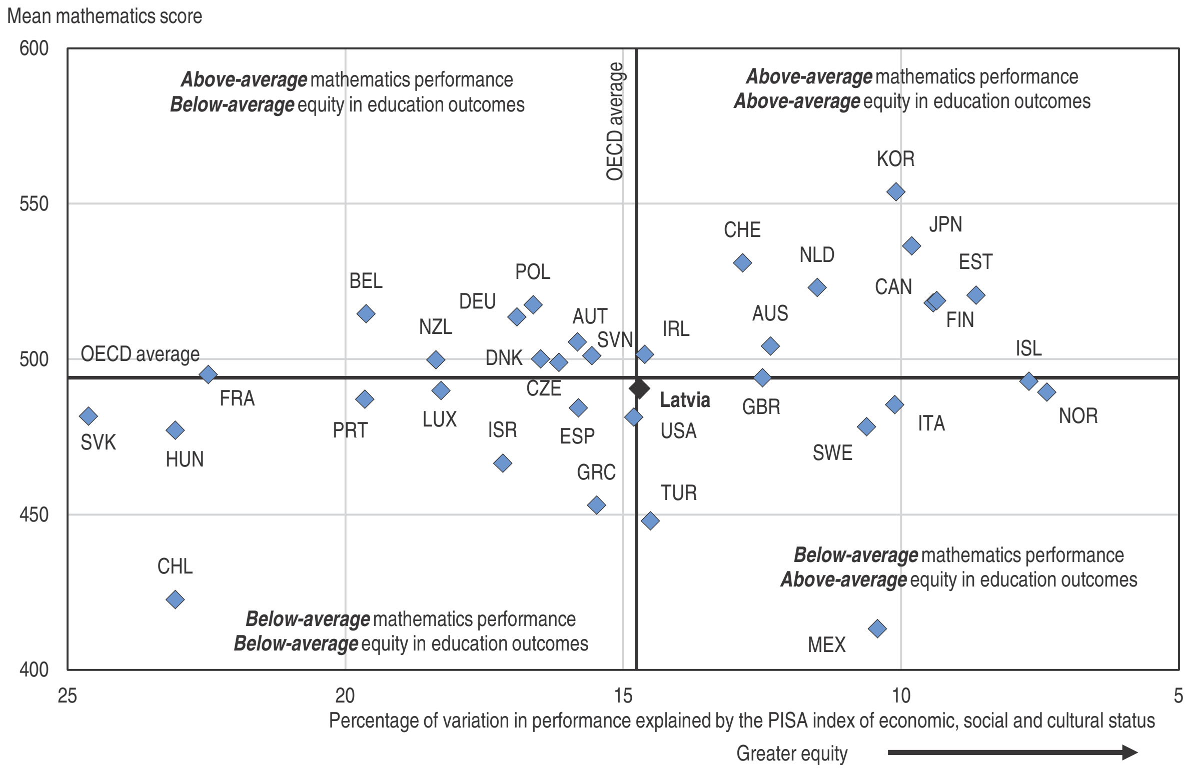
2013, index scale of 0-6 from least to most restrictive



Source: OECD Employment Protection Database, 2013 update.

StatLink http://dx.doi.org/10.1787/888933183731

Figure A3. **Student performance and equity**

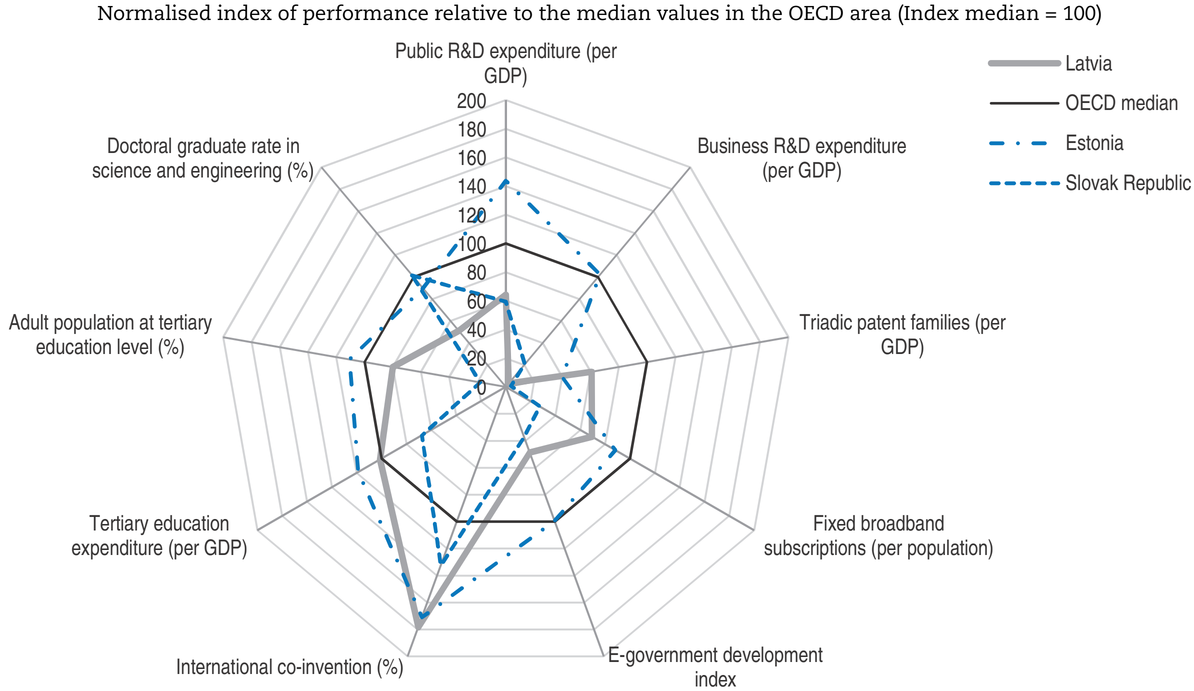


Source: OECD (2014), Education at a Glance, Chart A9.4.

StatLink http://dx.doi.org/10.1787/888933183742

Figure A4. **Science and innovation indicators**

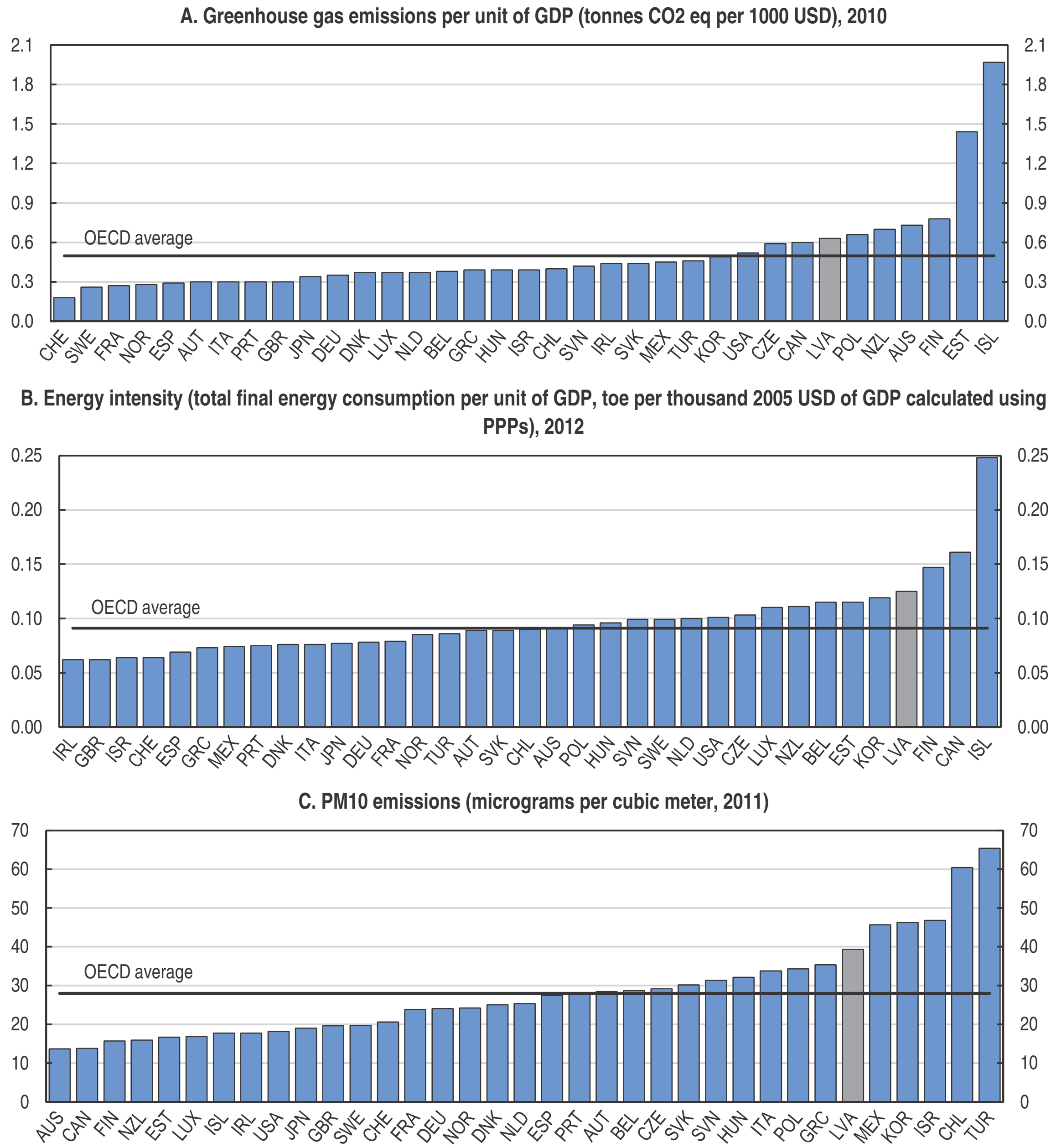
Normalised index of performance relative to the median values in the OECD area (Index median = 100)



Source: OECD (2014), OECD Science, Technology and Industry Outlook.

StatLink http://dx.doi.org/10.1787/888933183751

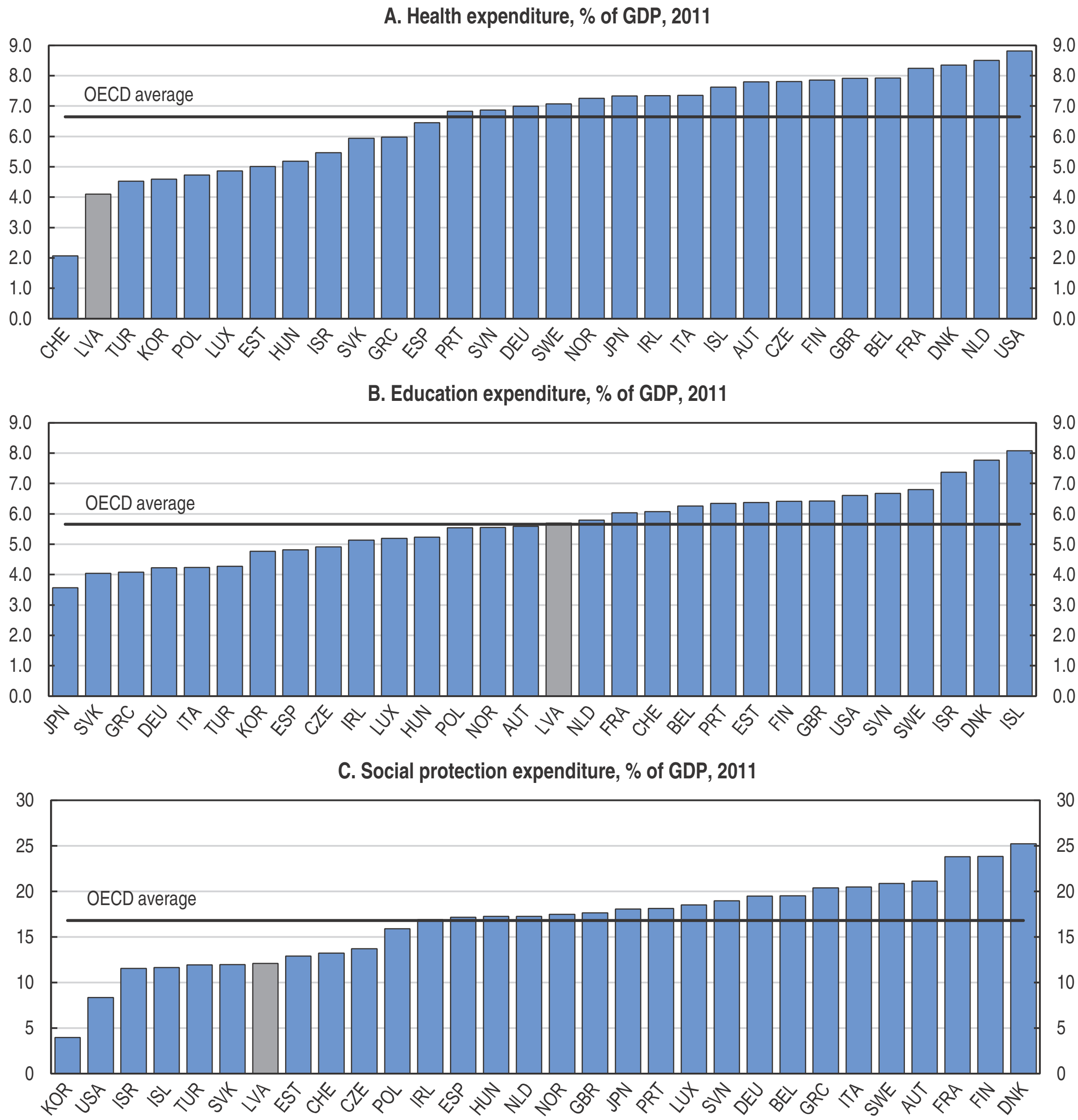
Figure A5. **Environmental indicators**



Source: OECD/IEA Energy database and World Bank, WDI database.

StatLink http://dx.doi.org/10.1787/888933183762

Figure A6. **Public spending**

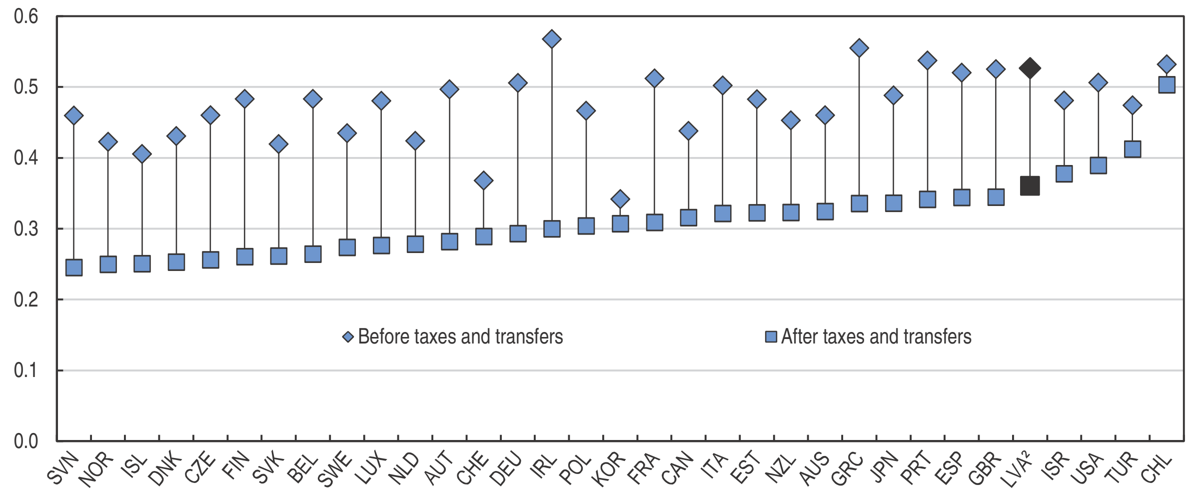


Source: OECD National Accounts at a glance database and Eurostat database.

StatLink http://dx.doi.org/10.1787/888933183778

Figure A7. **Income redistribution**

Gini coefficient, scale from 0 "perfect equality" to 1 "perfect inequality", 2011[1]



1. 2009 for Japan, 2010 for Belgium, 2012 for Australia, Finland, Korea, Netherlands and the United States.
2. OECD Secretariat calculations from EU-SILC – preliminary results.

Source: OECD Income Distribution database and OECD Secretariat calculations.

StatLink http://dx.doi.org/10.1787/888933183782

Thematic chapters

Chapter 1

Improving public sector efficiency for more inclusive growth

Improving public sector efficiency is a priority in a catching-up and ageing economy such as Latvia, where spending needs are large. Ensuring that spending allocated to core services (e.g. education, healthcare) is adequate to achieve convergence of policy outcomes to OECD upper standards is challenging. Efficiency gains in the tax system could bring additional revenues. The tax base should be expanded by reducing informality, strengthening tax administration and increasing property and environmentally related taxes, which are low by international standards. To reduce unemployment and income inequality, the tax-benefit system should also be revised as it is now relatively regressive and the tax wedge on low-income earners is high. Enhancing analytical, monitoring and assessment capacities should help to rein in wasteful expenditure and improve the prioritisation of spending. The reform of human resource management, public procurement, and state-local relations is also needed to deliver higher-quality and more cost-efficient public services.

Introduction

This chapter explores ways for improving public sector efficiency in Latvia. Efficiency is broadly defined. There is a budgetary dimension, determined by the rules, planning processes and institutional framework necessary to achieve long-run growth and budget sustainability. The second element relates to output efficiency, which depends on the effectiveness of spending and programmes and taxation in achieving welfare (growth and distributional) objectives. The third element is cost efficiency, which relates to the management and organisation of expenditure programmes and tax systems, the latter including policies to combat the hidden economy. The budgetary framework conditions for long-run growth and fiscal sustainability are discussed in section I. Section II looks at the structure and administration of the tax system, in terms of the potential to reduce the inefficiencies caused by the tax composition and the need to improve tax collection processes. Section III discusses issues of institutional co-ordination, programme management and administration.

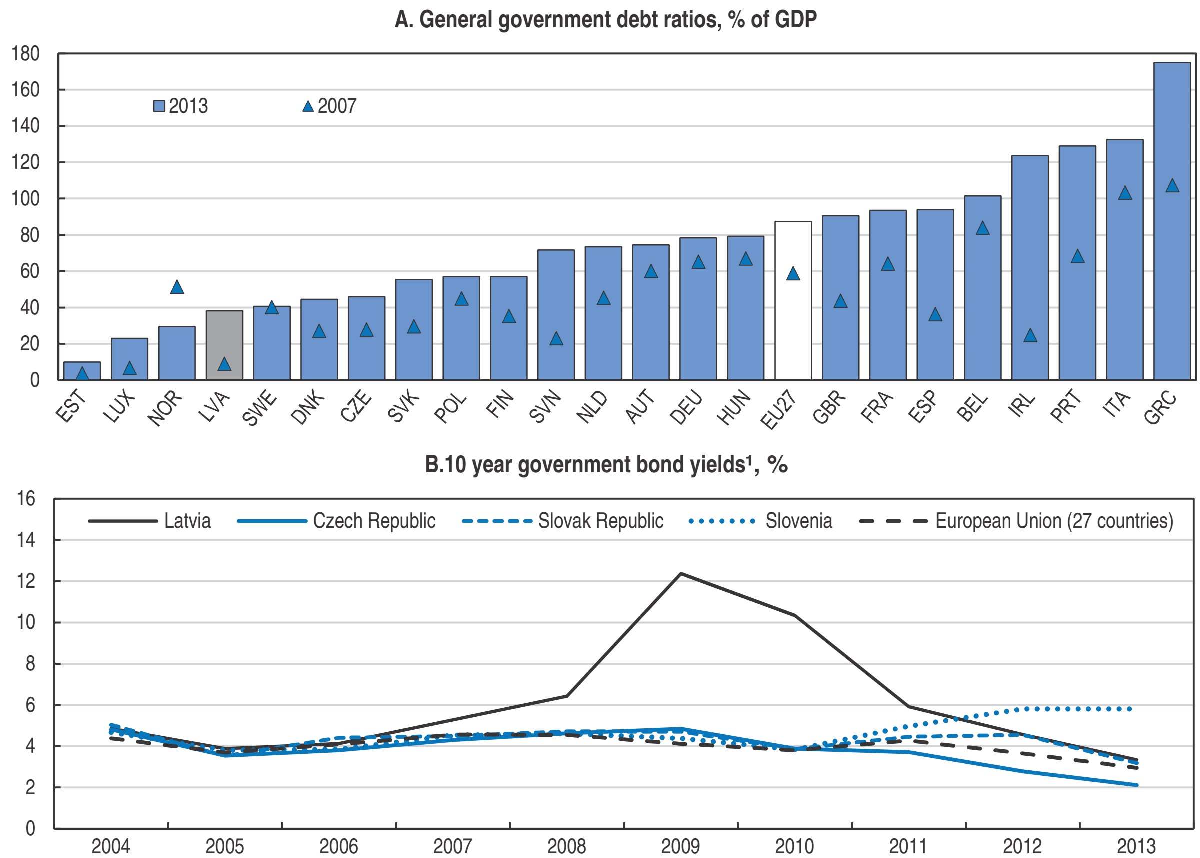
The main findings of the chapter are:

- The fiscal framework has been improved significantly and should ensure long-term sustainability of public finances. However, there is a risk that spending allocated to key public services (healthcare, poverty, infrastructure) will prove inadequate in view of desired outcome improvements.
- Addressing the high levels of inequality and informality is priority. Public spending should be better targeted at those more in need. The tax system should be made more progressive and the tax burden on labour reduced. Additional revenues should be raised by increasing property and environmentally related taxes. Strengthening actions against tax fraud is also crucial.
- The reliability and proficiency of the public sector can be improved by reinforcing strategic and monitoring capacities of in-charge institutions, by modernising human resource management, and by strengthening transparency in public procurement. Ensuring that local governments are sufficiently resourced and autonomous is also key to enhancing the quality of public services.

Establishing a budget framework for long-run growth and stability

Latvia has a stronger fiscal position than most OECD economies, the general government deficit being projected to gradually improve under current policies from around to slightly below 1% of GDP by 2017. The government debt ratio is one of the lowest in the OECD, at 38% of GDP at the end of 2013 (Figure 1.1, Panel A), and bond yields are just above average levels in the European Union (EU) (Figure 1.1, Panel B). Even allowing for uncertainty about the rate of potential growth, such a low deficit should ensure that without policy changes and further consolidation measures the debt ratio trends down for the rest of the decade to around 30% of GDP. Nevertheless, future spending pressures will pose challenges to budget discipline.

Figure 1.1. **General government debt and bond yields**



1. EMU convergence criterion bond yields.
Source: Eurostat database.

StatLink http://dx.doi.org/10.1787/888933183797

Ensuring effective rules-based budgeting

Fiscal rules can contribute to that budget discipline. In the past, the fiscal framework in Latvia has lacked mechanisms to limit expenditure growth during cyclical upturns. Latvia ratified and fully implemented the Fiscal Compact through a *Fiscal Discipline Law* which entered into force in March 2013 (Box 1.1). The main principles of the Fiscal Discipline law are:

- A budget balance rule, which requires that the general government structural deficit shall not exceed -0.5% of GDP.
- An automatic correction mechanism inspired by the Swiss debt break, which triggers an automatic improvement in structural balance if the cumulative deviation from the annual targets for the structural balance falls below -0.5% of GDP.
- Medium-term expenditure ceilings and restrictions on net expenditure growth (deflated by the GDP deflator) are not to exceed average potential GDP growth.

The annual Medium-Term Budgetary Framework Draft Law defines maximum permissible spending by setting the general government structural budget balance in accordance with the structural balance rule and determining expenditure growth consistent with the defined structural balance and the expenditure growth rule.

Box 1.1. **Fiscal Discipline Law and Fiscal Council**

The *Fiscal Discipline Law* stipulates the underlying principles of sound budget practice: the efficient use of available resources; the counter-cyclicality of fiscal policy; the pursuit of economic growth and financial stability; the maintenance of a sustainable general government debt level; inter-generational mutual responsibility; inter-governmental solidarity and transparency.

Fiscal Rules

The Law stipulates that the general government structural balance in the Medium-Term Budgetary Framework Draft Law shall not be lower than -0.5 percentage of GDP. In the event of significant deviation from the national medium-term objective, it provides for an automatic adjustment mechanism, which registers deviations of the actual structural balance (+/-) from its planned targets in a specific notional account. If the cumulative deviation is negative and higher than 0.5% of GDP, a correction is triggered automatically by improving structural balance in the next Medium-Term Budgetary Framework Draft Law by an extra 0.5% until deviation is fully compensated. In addition, the Law stipulates that draft laws submitted to the Parliament and legislation adopted by the Cabinet (with some exceptions) which breach the budget expenditure ceiling or reduce state budget revenues need to be compensated by equivalent expenditure or revenue adjustments elsewhere.

The Fiscal Council

The *Fiscal Discipline Council* was established on 1 January, 2014 and consists of six members of which three are nominated under the joint proposal of the Governor of the Bank of Latvia and the Minister of Finance and three by the Parliament. Members cannot be re-elected more than twice consecutively. The Council performs regular monitoring of compliance with the requirements of the Fiscal Discipline Law and prepares an annual report which is submitted to the Parliament together with the Medium-Term Budgetary Framework Draft Law. The Council is also required to prepare an Irregularity Report if any violation of the Fiscal Discipline Law is discovered. The first report was issued in March 2014, relating to the draft amendments to the State Pension Law.

Sanctions

The *Stability and Growth Pact* stipulates that non-compliance with either the preventive or corrective arms of the Pact can lead to the imposition of sanctions. In the case of the corrective arm, this can involve annual fines for the euro area member states and, for all countries, possible suspension of Cohesion Fund financing until the excessive deficit is corrected.

Stabilisation Reserve

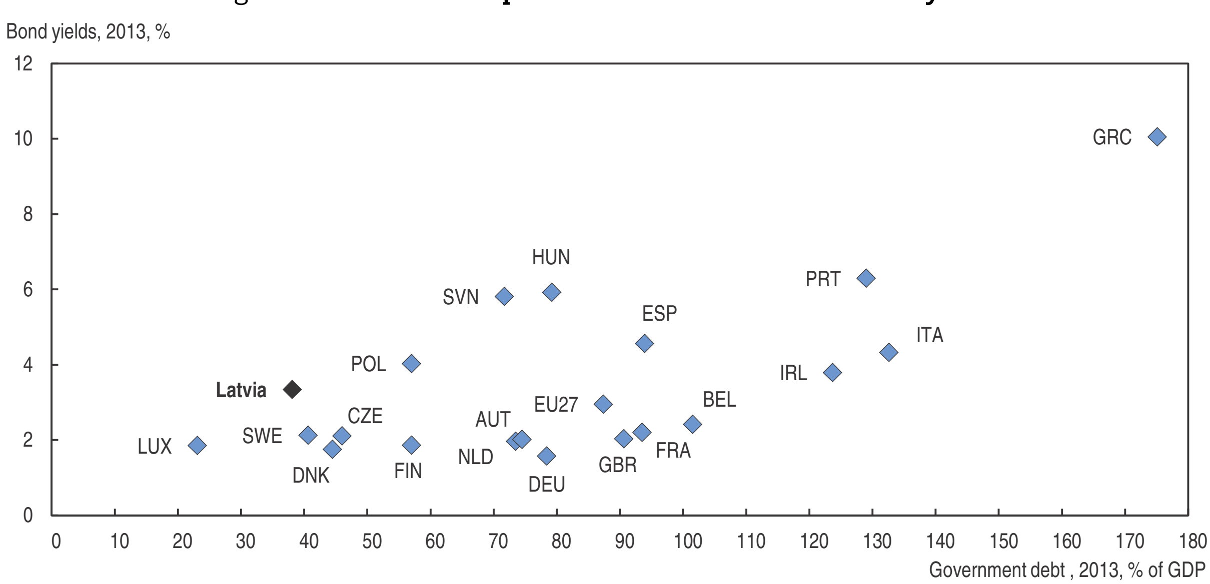
The *Long-Term Stabilisation Reserve Law*, in force since May, 2014, stipulates that government budget surpluses should be accumulated in a reserve account, for use in the event of financing difficulties. Financial resources that are allocated to the reserve cannot be used for financing budgetary needs (e.g. new policy initiatives and other priority measures), or to pay down debt. Accumulated funds will ensure that the country has resources to fund itself if it is impacted by a significant and unexpected adverse event or does not have access to financial resources at a sustainable price. Currently, no resources have been accumulated in the reserve and no assessment of its optimal size has been carried out.

The Fiscal Council, established on 1 January 2014, oversees the implementation of fiscal rules (Box 1.1). This independent institution reports annually to the Parliament about the consistency of the Medium-Term Budgetary Framework Draft Law and the Annual State Budget Draft law with the fiscal rules. If any breach is observed, it issues a report including recommendations to address the identified deviations. The council is a key institution for achieving transparency and is a safeguard against political pressures undermining the credibility of fiscal rules. At the same time, its effectiveness is reinforced by the fiscal rules, which are designed to prevent medium-term deviations from programmed expenditure paths. In Latvia a programme-based budget format with a three-year perspective has been applied since the 2008 budget, but before 2013 the framework only indicated the ceilings of the State budget for total central government expenditure over the medium term. The new system embeds the annual budget process in a broader three-year framework with ceilings for line ministries which have a legally binding force.

A combination of a budget balance objective and medium-term expenditure ceilings is acknowledged as best practice from a political economy point of view and most effective in locking in consolidation gains (Price, 2010). Framing the rule in terms of structural balance, rather than actual balance, ensures the operation of the automatic stabilisers, thereby reducing the risks of discretionary policy intervention. However, the last decade has demonstrated accurate calculation of output gaps and structural deficits is difficult, raising the possibility that under some circumstances budgets will prove unintentionally pro-cyclical.

The low debt level – which stands well below the Maastricht ceiling – does not offer Latvia extra fiscal flexibility, since it has relatively higher debt-financing rates compared to OECD countries with similar debt levels (Figure 1.2) and during extreme turbulences borrowing at reasonable costs may be restricted. With the accession in the euro area, Latvia can benefit from the European Stability Mechanism, a permanent crisis resolution mechanism, which can issue loans and other forms of financial assistance to euro area

Figure 1.2. **Relationship between debt ratios and bond yields**



Source: Eurostat database.

StatLink http://dx.doi.org/10.1787/888933183807

countries in or threatened by severe liquidity problems. Also, the establishment of a banking union should limit the impact of banking crisis on public finances. The Single Resolution Mechanism (SRM) backed by a Single Resolution Fund introduced resolution tools that involve private bank investors and the banking sector as a whole in covering bank losses before involving public finances (OECD, 2014a).

There is, nevertheless, scope to build-up additional fiscal liquidity buffers over time, not least because Latvia's exposure to external shocks is higher than in the average EU country. The Fiscal Discipline Law introduced two counter-cyclical reserves. The first, the Long-Term Stabilisation Reserve, is set to accumulate government budget surpluses, i.e. saving in good times in order to soften budget constraints in bad times, but no resources have actually been accumulated yet. The second, the Fiscal Security Reserve, has been established to mitigate the negative impact of smaller adverse macroeconomic developments on the budget and fiscal risks (e.g. risks related to loans repayments, loan guarantees, public-private partnerships). The size of this reserve is set annually and should not fall below 0.1% of GDP from 2017 onward.

There is a question mark over the long-term optimality of the public debt profile: there is no official debt target, but the long-run debt ratio implied by a structural deficit of 0.5% would be 10% of GDP or below (depending on the long-run growth rate), which would be very low for a catching-up economy. To ensure robust convergence, such economies need to invest relatively more in growth-enhancing areas (e.g. infrastructure, education, health). As experience with the new fiscal framework accumulates, the authorities may wish to adjust fiscal rules to permit more debt financing of needed investment expenditures, though the settings of the rules will always have to conform to EU fiscal requirements.

Policies for longer-term fiscal sustainability

Latvia appears to be in a better position than most OECD economies to meet future demographic challenges, and hence to ensure long-run fiscal sustainability, notably because commitments to pension and healthcare recipients are lower. Latvia currently allocates a significantly smaller proportion of GDP to the public sector than the European OECD countries (respectively 36.5% and 45.6% in 2012) and, within this total, the composition of public spending differs from the average largely with respect to the smaller proportion of GDP spent on social protection and health (Table 1.1). The

Table 1.1. **Components of public spending, 2012**

	General public services	Economic affairs	Health	Education	Social protection	Other[3]
			Percentage of total			
Latvia	**12.3**	**14.5**	**10.7**	**15.1**	**30.7**	**16.7**
Peers[1]	12.0	10.3	15.4	12.6	33.8	16.0
OECD Europe[2]	**14.1**	**9.5**	**14.1**	**11.9**	**38.1**	**12.2**
			Percentage of GDP			
Latvia	**4.5**	**5.3**	**3.9**	**5.5**	**11.2**	**6.1**
Peers[1]	5.1	4.4	6.5	5.4	14.4	6.8
OECD Europe[2]	**6.8**	**4.6**	**6.8**	**5.7**	**18.3**	**5.8**

1. "Peers" is an average of Czech Republic, Estonia, Slovenia, and Slovak Republic.
2. OECD Europe includes all European OECD countries except Turkey.
3. "Others" includes defence, public order and safety, environmental protection, housing community amenities, recreation, culture and religion.

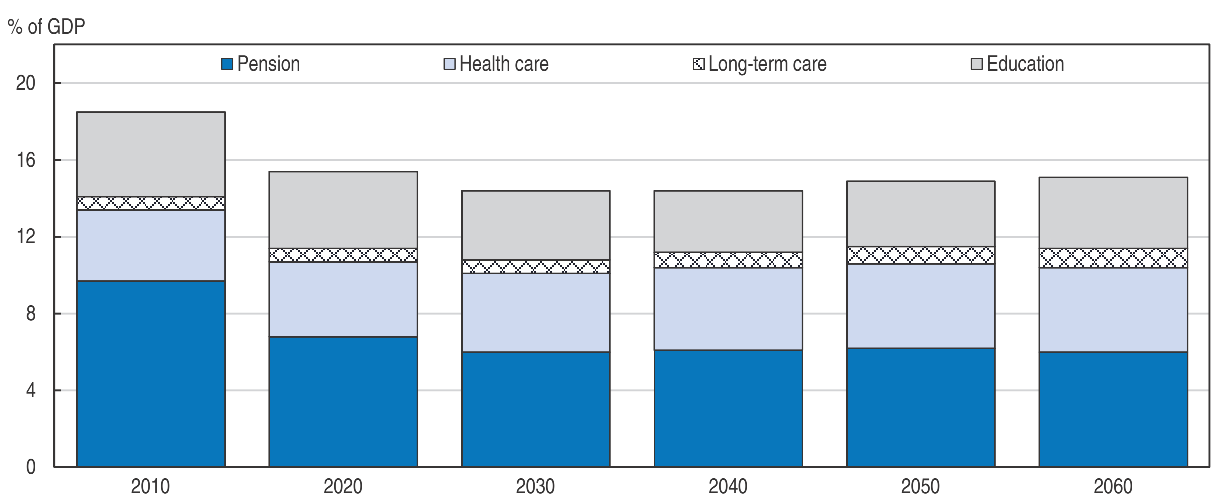
Source: Eurostat.

problem is that health, poverty and inequality outcomes currently are relatively low, suggesting that associated spending is insufficient (World Bank, 2014). The prospective convergence in GDP levels would be expected to reduce the differences between Latvia and the OECD-average outcomes. But an issue arises as to whether the current long-run sustainability assumptions are compatible with a full convergence of health and social outcomes.

On the basis of underlying demographic projections and policy parameters, Latvia's long-term age-related liabilities seem to be contained relative to the OECD average, with age-related public spending projected to decrease in the period 2010 to 2060 by almost 3½ per cent of GDP (Figures 1.3 and 1.4). These projections assume, however, that the private sector will take on greater responsibility for pension and health provision and that the efficiency of health and education provisions will increase. Past pension reforms imply a long-term fall in spending (Figure 1.4). The planned decline in the replacement ratio of the notional defined contribution public pension system (from 48% to 15%) more than offsets the projected increase in the dependency ratio (European Commission, 2012). The statutory pension age is being increased from 62 to 65 years between 2014 and 2025 and mandatory contributions to the funded pension scheme are being increased gradually from 2% of gross wages to 6% in 2016. However, the combined scheme amounts to very low pension payments. The total replacement rate is set to remain among the lowest in the EU at 43.6%. This carries a long-term risk that the adequacy of future pensions would need to be revised and pensions made more generous.

Latvia's expenditure on social assistance may also be unsustainably low, non-contributory social assistance programmes accounting for only about one fifth of total social protection spending (World Bank 2014a). Social assistance is mostly delivered in the form of cash transfers rather than targeted on the basis of need, and is largely composed of universal family and child allowances. Conversely, poverty-targeted programmes represent only 10% of the total spending on social assistance which is relatively low. Even after its recent expansion, expenditure on the Guaranteed Minimum Income (GMI)

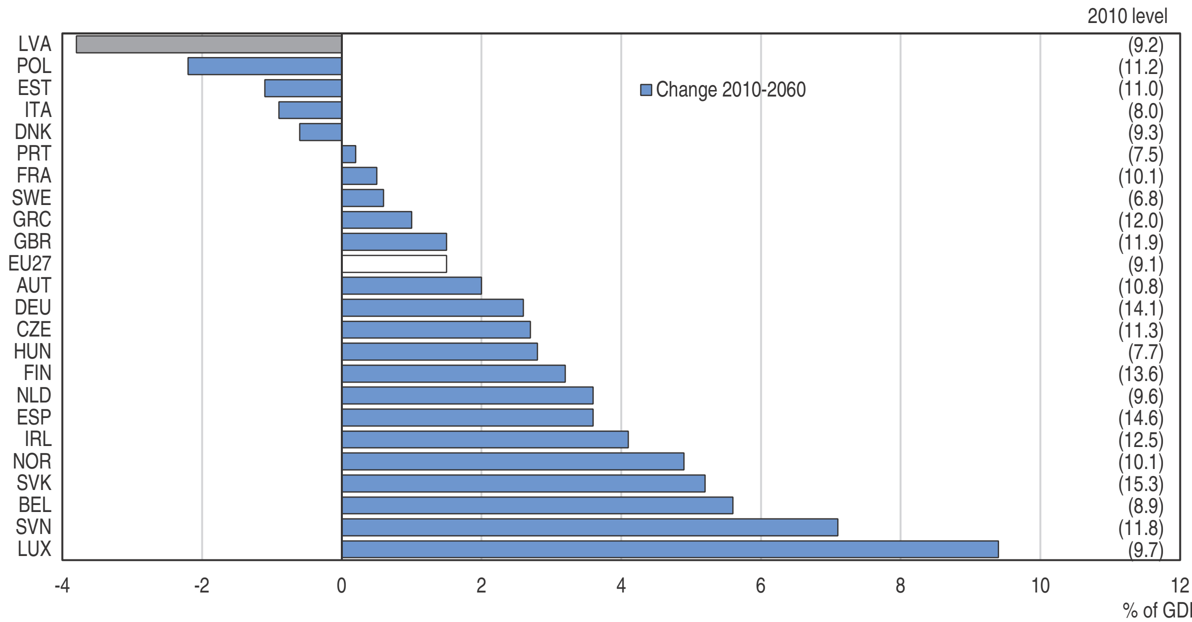
Figure 1.3. **Ageing-related spending is projected to decrease**



Source: European Commission (2012); Government of Latvia (2013).

StatLink http://dx.doi.org/10.1787/888933183816

Figure 1.4. **Public pension expenditure is set to decline significantly**



Source: European Commission (2012); Government of Latvia (2013).

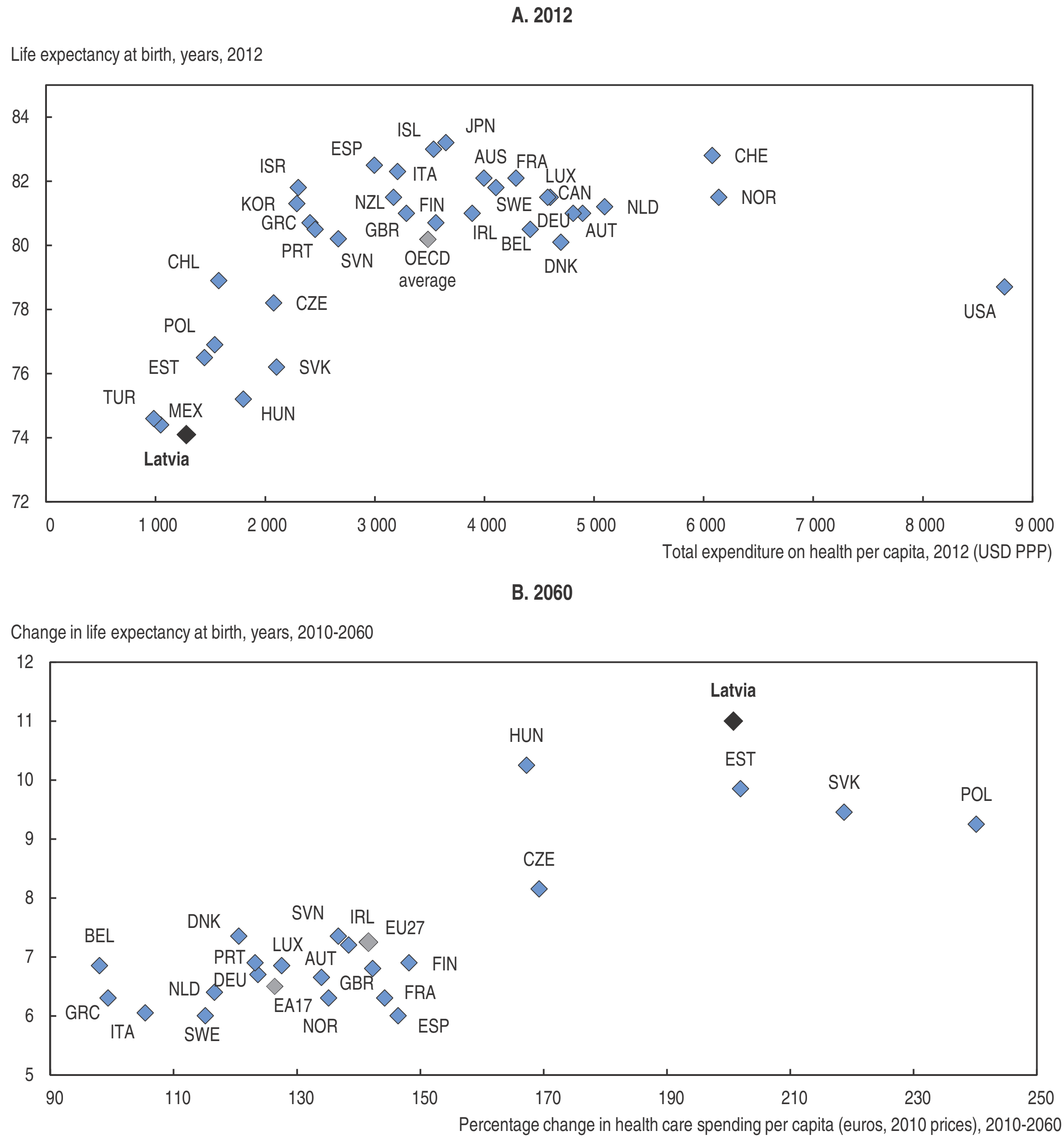
StatLink http://dx.doi.org/10.1787/888933183820

program, which is the main poverty-targeted program in the country, remains very moderate compared to other EU countries (0.16% of GDP in 2011). The distributional impact of the tax system is among the lowest in the EU (BICEPS, 2014) probably due to the universal, untargeted nature of the benefit system and the effectiveness of policies in reducing poverty and inequality is perceived as ineffective (WEF, 2014). This suggests the need for better targeting universal social benefits at low-income households. Inequality tends to be higher in economies on a fast catch-up path, where opportunities for high income are a key incentive for investors and entrepreneurs to achieve the necessary upgrading of the economy, but Latvia's level of income inequality is high even by the standards of other countries at the same level of economic development. To the extent that the benefits system as a whole is not sufficient to have a meaningful impact on poverty and inequality, the catching up process could bring the need for resources allocated to this sector to be increased.

The need to resource health spending

Total healthcare spending amounts to 6% of GDP and is well below the OECD average of around 9% of GDP. Of this, only 3.8% of GDP is public spending, the rest being private out-of-pocket payments. Demographics are expected to push public spending to around 4.5% of GDP by 2060 (see Figure 1.3). Currently, life expectancy is also among the lowest in the European OECD countries, reflecting a low level of spending (Figure 1.5, Panel A). Mortality rates for men, women and infants are higher than in most other EU countries. According to European Commission survey data, 66% of citizens evaluate the overall quality of health care as bad (2011), and 65% believe that the quality of care in Latvia is worse than in other EU member states (2010). The Euro Health Consumer Index 2012 puts Latvia near the bottom of its ranking index.

Figure 1.5. **Resource inputs and outcomes in the healthcare sector**



Source: OECD Health Statistics, World Development Indicators database, Eurostat database and European Commission (2012), "The 2012 Ageing Report".

StatLink http://dx.doi.org/10.1787/888933183836

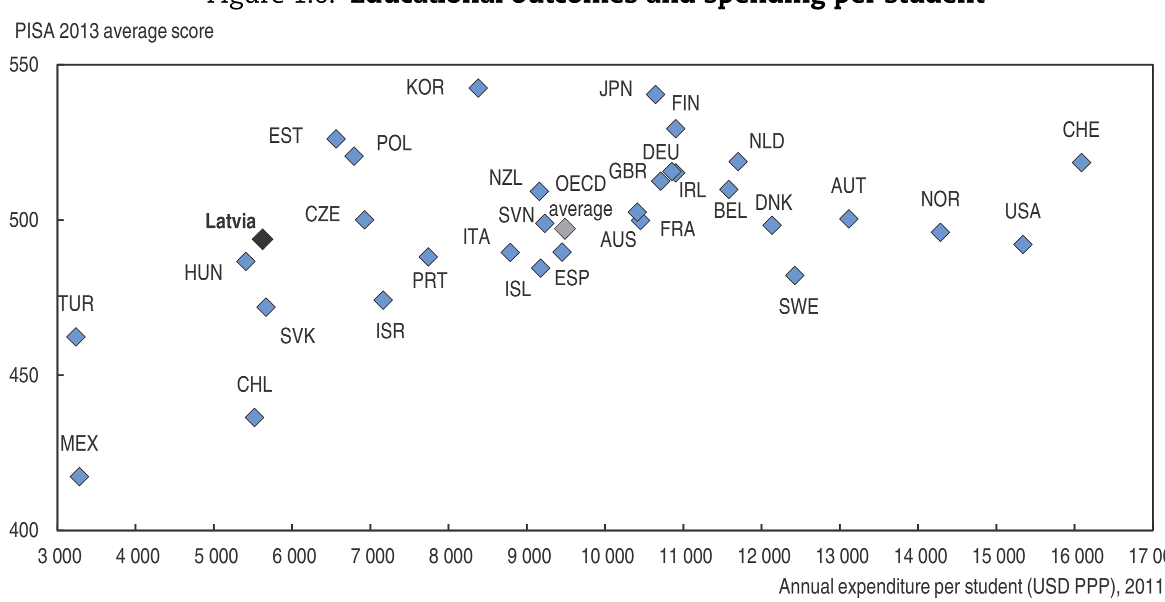
The economic crisis, having resulted in a decrease in financial resources for health care, created a new impetus for structural reforms aimed at reducing costs. As a result, the allocation of resources among different providers is improving – shifting from expensive hospital care to less costly ambulatory care, and putting a higher priority on primary care (WHO and EOHSP, 2012). However, the large co-payment presents barriers to lower-income groups. Financial constraints focus public monies on the provision of emergency care, creating long waiting times for other care.

There is substantial scope to improve cost efficiency, reduce waiting lists, give more attention to chronic conditions and focus more on preventable lifestyle diseases. Latvia should continue to catch up with average OECD performance in terms of health outcomes. However, although only a small increase in public healthcare resources (0.6% of GDP) has been factored into long-run fiscal sustainability calculations, the planned improvement in outcomes – life expectancy is projected to increase by more than 10 years up to 2060 – exceeds the achievements in any other OECD member country for the same prospective level of public inputs (see Figure 1.5, Panel B). The share of resources allocated to health care are thus likely to be inadequate, as pointed out in the 2012 *Health System Review* (WHO and EOHSP, 2012). The implication is that health spending may need to rise by more than allowed for in the long-run fiscal sustainability scenario. Private co-payments could increase, but that could exacerbate current health coverage problems. Reforms are envisaged to link health entitlements to those who regularly pay income tax and socially vulnerable people, whom the state will insure. Convergence in health outcomes could well need an increase in the public health spending/GDP ratio beyond that provided for, again requiring increased tax revenues.

Meeting education requirements

Public education expenditure, benefiting from demographic trends, is projected to decline from 4.4% of GDP to 3.5% of GDP by 2050 (European Commission, 2012). Up to the secondary level, Latvia's educational performance, as measured by PISA scores, is slightly above average for the resources committed (Figure 1.6). Efficiency savings in the education system, such as increases in the teacher to student ratio, have been part of the recent budgetary consolidation. Funding allocation is now tied to pupil enrolment, which has resulted in consolidation and efficiency gains, but also to unequal access and uneven quality, the latter being associated both with demographic changes and staffing problems inherited from the Soviet era (Terauda et al., 2014). Efforts to improve educational quality need to build on the attractiveness of educational careers, strengthening the links between teacher pay and performance (Sutherland et al., 2007 and OECD, 2014).

Figure 1.6. **Educational outcomes and spending per student**



Source: OECD, PISA 2012 Database and OECD (2014), Education at a glance, table B1.1a.

StatLink http://dx.doi.org/10.1787/888933183845

Latvia is currently performing less well in vocational and higher education. To date, the VET has not had a particularly good image; the share of those who consider that VET provides high-quality learning was well below the EU average (Eurobarometer, 2011). Survey evidence shows that employers believe vocational education institutions are failing to supply students with the skills needed on the labour market. The policy aim is to increase the quality of vocational education to ensure it meets the requirements of market, while promoting a more efficient use of available resources, notably by optimising and differentiating the number and location of vocational education and improving infrastructure in vocational education institutions with the support of the European Regional Development Fund (Chapter 2).

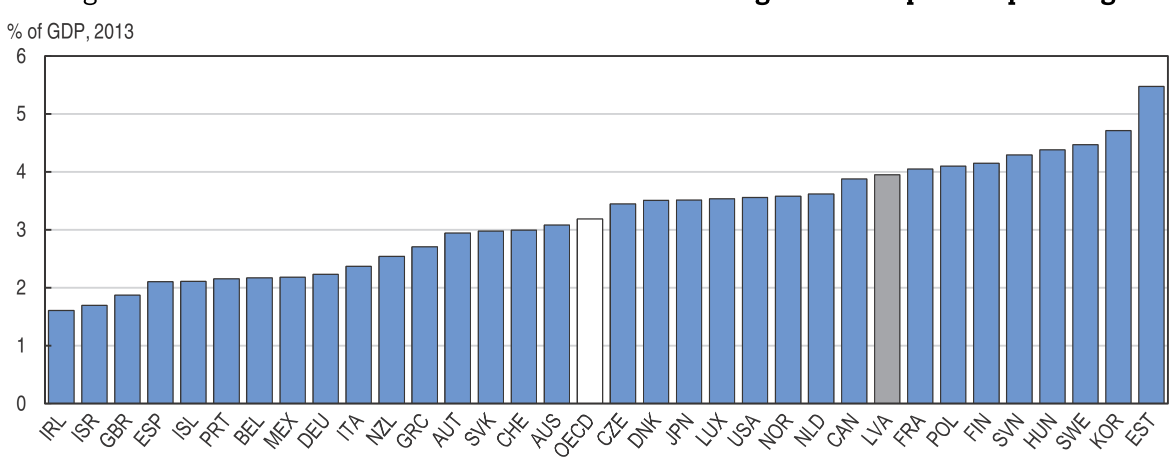
Higher education also needs modernising. At the tertiary level, Latvia reached the EU 2020 educational target of 40% of 30- to 34-year-olds having university-level qualifications in 2013, from a ratio of 26% in 2009. Nevertheless, the higher education system is dominated by social sciences, where there are too many institutions given the population, which results in low entrance requirements and thinly distributed academic resources (Terauda et al., 2014).

Longer-run efficiency gains depend closely on the success of structural reforms, *inter alia*, by implementing a new financing model that rewards quality, strengthens links with market needs and research institutions, and avoids fragmentation of budget resources. This would have efficiency benefits in terms of outcomes as well as better match of skills to labour market requirements. However, these reforms might be difficult to implement. Reform attempts undertaken between 2011 and 2013 have been met with substantial resistance from educational institutions themselves.

Ensuring adequate public investment

Public investment accounts for a relatively high share of government spending (Figure 1.7) although it has been significantly cut in the 2009-12 period (Traidase, 2014). Over the medium term, the proportion of investment in public spending and GDP will have to increase, since public investment is needed to maintain convergence. However,

Figure 1.7. **Government investment accounts for a large share of public spending**



Source: OECD Economic Outlook 96 database.

StatLink http://dx.doi.org/10.1787/888933183851

allocating sufficient resources to public investment under the fiscal rules is challenging and might require increasing tax revenues. In the meantime, though, Latvia should make the most of the resources at its disposal, which involves the effective use of EU structural funds, and resort to private finance where there is the possibility of effectively using public-private partnerships (PPPs).

The amount of public funding provided for R&D is the lowest of any EU member state and the lack of public funding is identified by the Ministry of Education as a major factor slowing down scientific progress in the country. Expenditure for scientific research in the business sector in 2010 was 0.22% of GDP, placing Latvia significantly below the average EU27 rate of 1.23% of GDP. Annual fluctuations in funding for research institutions produce uncertainty, inducing young scientists to look for opportunities abroad. There is a persistent lack of state funds for participation in international research and infrastructure projects. The Innovation Union Scoreboard study ranks Latvia second to last in terms of innovation performance among 27 surveyed EU countries (European Commission, 2014b). Designing and implementing an effective research and innovation policy which upgrades infrastructure and rationalises research institutions while encouraging companies to innovate is likely to have additional resource implications.

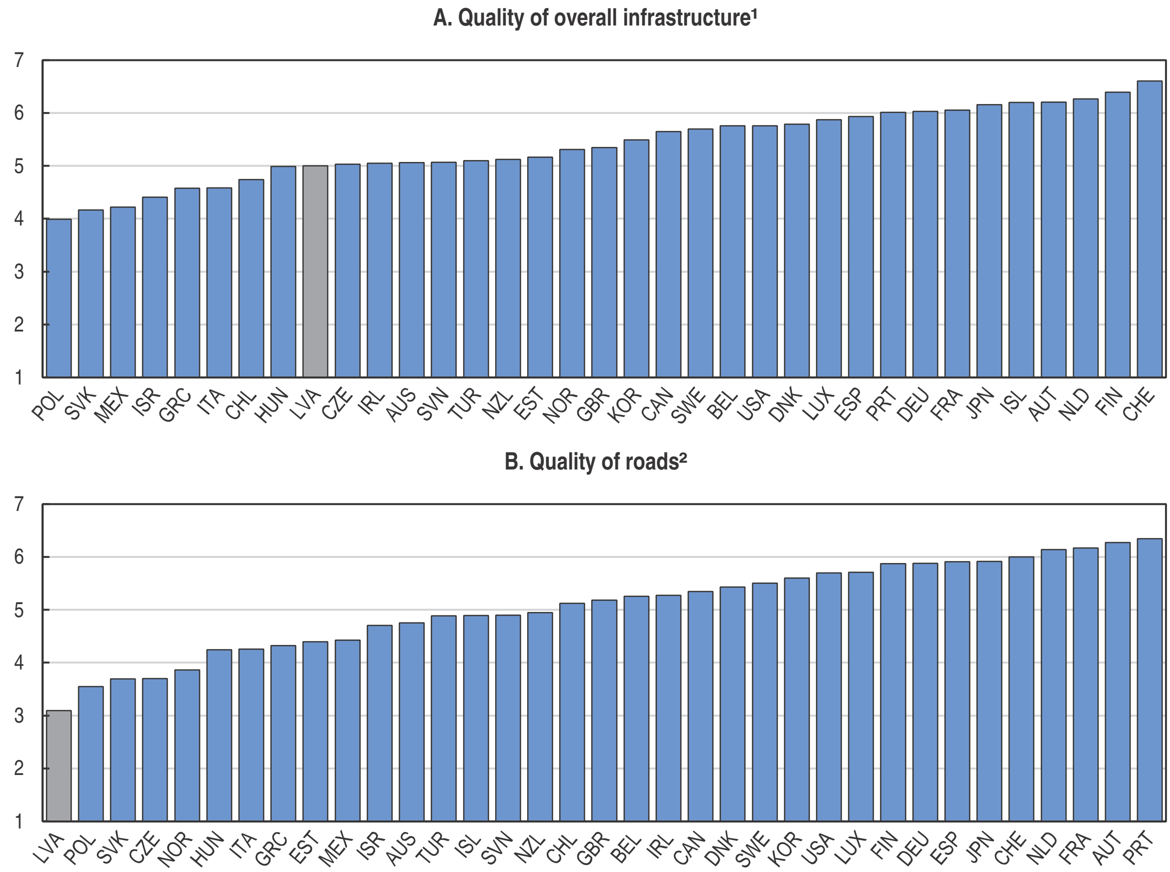
Public infrastructure is one of the most important public contributors to a favourable business environment and hence to growth potential. Considerable resources are required in this respect. The overall quality of logistical infrastructure in Latvia is perceived as relatively low (Figure 1.8, Panel A). The main problem is road infrastructure. Even though a large number of important roads cross Latvia, they suffer from insufficient investment in maintenance and construction. Data from Latvian State Roads show that more than 50% of roads and bridges are in bad or very bad condition, and that there are almost no roads that are of high quality throughout their entire length. The Global Competitiveness Index also suggests that roads in Latvia are the worst of all Central and Eastern European (CEE) countries except Poland (WEF, 2014a). Moreover, the perceived quality of Latvian roads decreased between 2005 and 2010, while it increased in Lithuania and Estonia.

Using EU structural funds effectively

The EU structural funds have been an important funding source, in particular during the global financial crisis. Funding covers infrastructure, human capital, R&D, ICT and technical assistance. It is not used to finance stand-alone projects, but rather is based on operational programmes managed and implemented by the national authorities. In the 2007-13 programming period, Latvia was one of the largest structural fund recipients (Figure 1.9, Panel A). For the next programming period (2014-20), similar amounts are allocated (EUR 4.51 billion, i.e. around 2.8% of GDP per year). Projects are always co-financed by the national budget and therefore depend on the availability of national resources and institutional governance structures for implementation. Latvia has managed these challenges relatively well (Katsarova, 2013 and Figure 1.9, Panel B). Nevertheless, a new legislation has been adopted, which clarifies the division of responsibilities of the various managing authorities. In particular, it is planned to ease the procedure for evaluating draft submissions, which will be approved only by the Supervisory Committee of the EU Funds, without the need for additional Cabinet approval. Also, a clear procedure is being laid down for the settlement of disputes and a one-stop agency principle applied in order to reduce the administrative burden on funding recipients and submitters of projects.

Figure 1.8. **Infrastructure quality is perceived as relatively low**

Global Competitiveness Index, score (1-7 scale)



1. The responses are to the question: "How would you assess general infrastructure (e.g. transport, telephony, and energy) in your country? [1 = extremely underdeveloped-among the worst in the world; 7 = extensive and efficient-among the best in the world]".
2. The responses are to the question: "In your country, how would you assess the quality of roads? [1 = extremely underdeveloped-among the worst in the world; 7 = extensive and efficient-among the best in the world]".

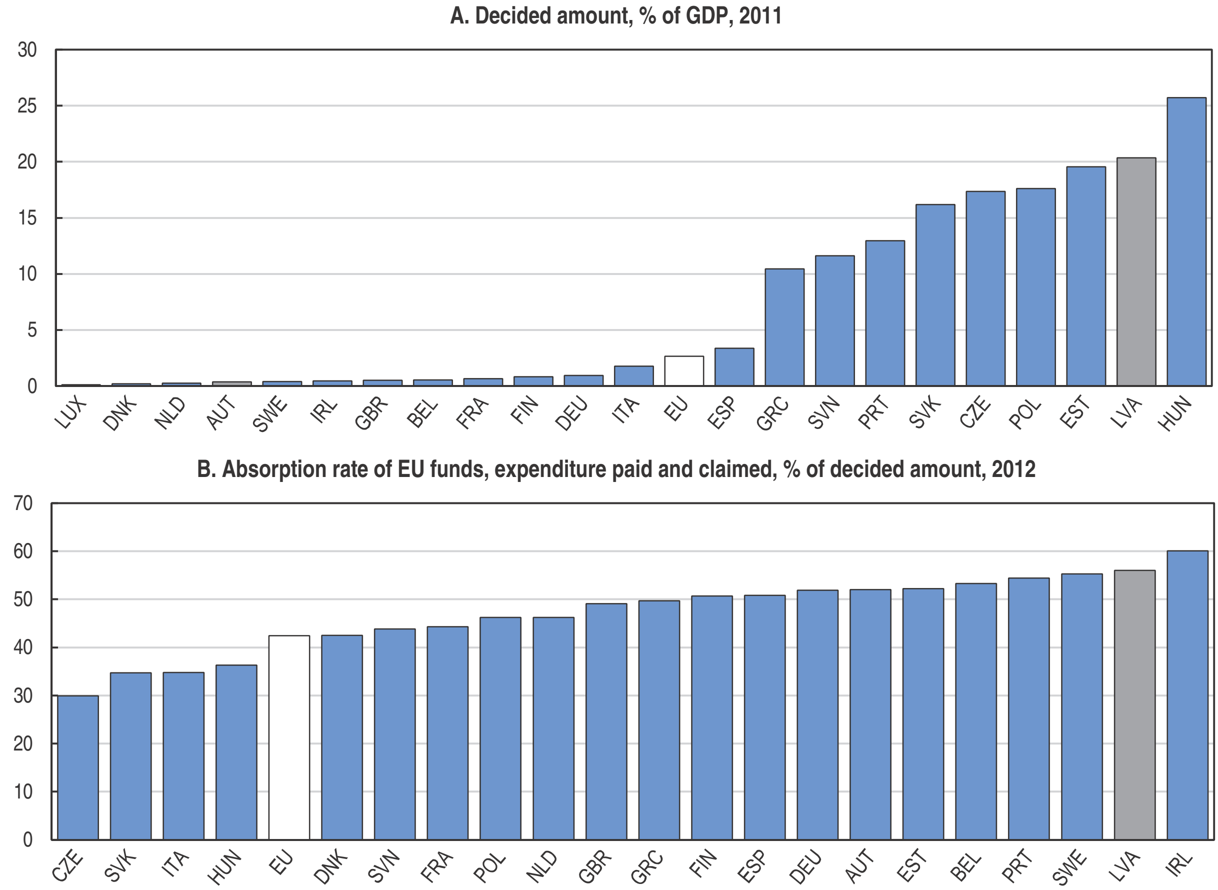
Source: The Global Competitiveness Index Historical Dataset, 2005-14 World Economic Forum.

StatLink http://dx.doi.org/10.1787/888933183860

Extending the role of private finance

PPPs could also be used to fund public infrastructure. They have been actively promoted in Latvia since 2004. In 2005 a "Policy Framework for Promotion of Public-Private Partnerships" identified number of loopholes including the inadequacy of the legal framework with EU standards, a lack of institutional co-ordination, a disconnection between PPPs and public investment planning, and a lack of tools available to ministries to support PPP evaluation (Ministry of Finance, 2014). The Latvia Investment and Development Agency (LIDA) also started the preparatory work on five PPP pilot projects to create a template for good practice and evaluate possible obstacles in PPP implementation. On the basis of the pilot projects and the obstacles identified, a new Law on PPP was adopted in 2009. To further promote the use of PPPs, the government has established an inter-ministerial action plan and working group, generating scope for co-operation between the Baltic States (Ministry of Finance, 2014).

Figure 1.9. **Absorption of EU structural funds**



Source: European Commission.

StatLink http://dx.doi.org/10.1787/888933183879

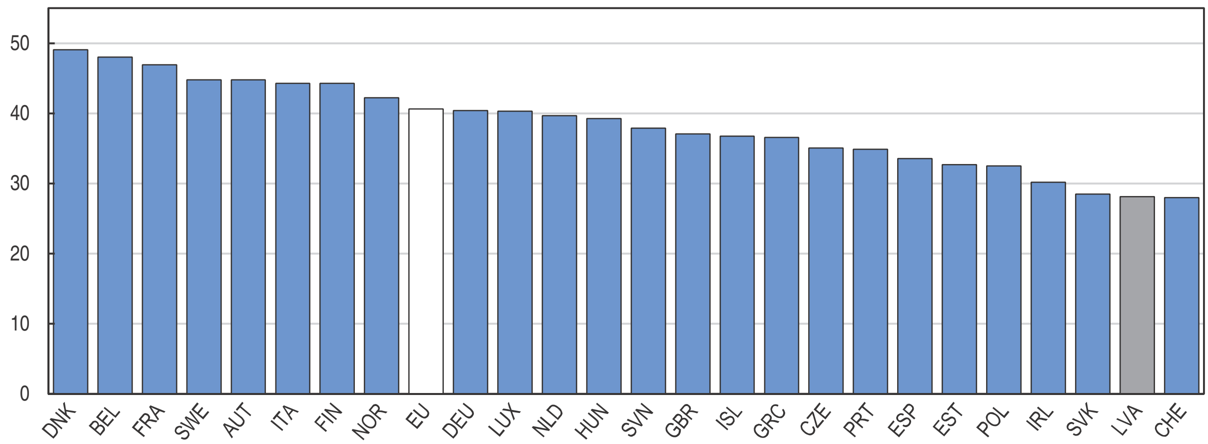
The governance of PPP poses challenges, however, as some EU countries discovered in the wake of the global financial crisis. In particular, projects financed by PPP should be subject to the same cost-benefit analyses as those that would be financed by the budget. In addition, the present and future cost of the PPPs should be transparently accounted for in the budget documents. Experience from other countries indicates that i) a prudent and rigorous approach to Value For Money assessment, ii) a track record of successfully implemented projects, iii) a credible pipeline of future projects and iv) international assurance as to the quality, reliability and capacity of public administration and institutions, are essential ingredients for the PPP model to be sustained and developed. These are all elements on which the Latvian authorities will need to maintain their focus into the medium term.

Improving the efficiency of the tax system

Latvia has the competitive advantage of having one of the lowest tax-to-GDP ratios in the EU, at 28% of GDP (Figure 1.10). However, the overall low tax burden conceals a number of structural distortions which inhibit employment growth and reduce revenue efficiency by driving activity underground. The main challenge facing tax policy is to break the link between high marginal rates on labour activity and the erosion of the tax base; the one now

Figure 1.10. **The tax burden is among the lowest compared with OECD countries**

Tax revenue in % of GDP, 2012



Source: Eurostat.

StatLink http://dx.doi.org/10.1787/888933183885

reinforces the other. Also, given the current and future spending pressures, improving efficiency in the tax system is crucial. The two instruments for achieving this are shift in marginal income tax rates away from rate-sensitive labour income and improved tax compliance. Tackling these distortions would raise revenues by expanding the tax base, while supporting economic growth and reducing inequality.

Reducing labour taxes

The composition of taxes is skewed towards the taxation of labour, the combination of income tax and social security contributions accounting for 53% of total revenues (as opposed to 50% in the OECD area) (Table 1.2). The labour income tax burden is relatively high, averaging 50% of earnings (vs. 40% in the EU). In January 2014, the combined employer and employee social security contribution rate was reduced by one percentage point to 34.09% but remains high by international standards.

Moreover, the tax wedge for low-income earners is one of the highest in the OECD (Figure 1.11). This contributes to the low employment rate of 51% among the low-skilled, which is below the EU average and almost 35 percentage points lower than that of high

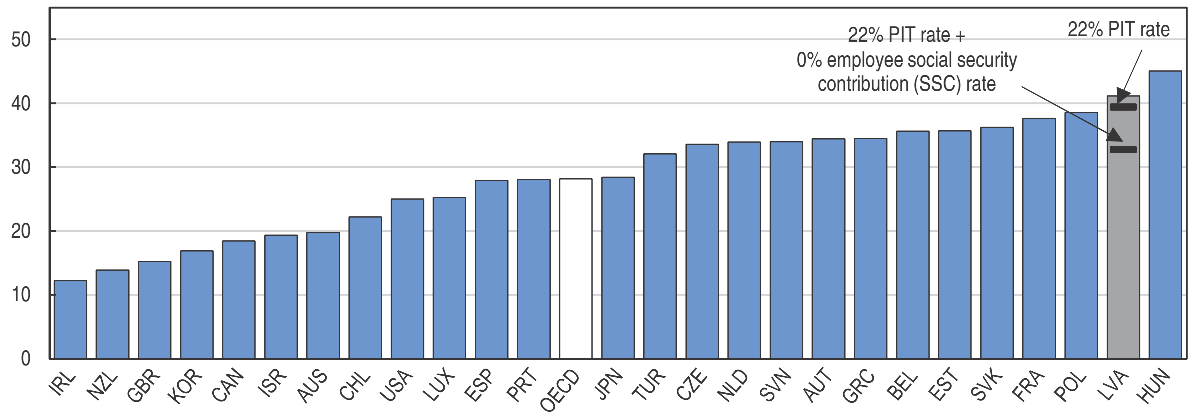
Table 1.2. **Composition of taxation, 2013**

	OECD	Latvia	Difference
Personal income tax	24.1	20.1	-4.0
Corporate income tax	8.7	5.5	-3.2
Social security contributions	26.2	32.9	6.7
Payroll taxes	1.1	-	-1.1
Property taxes	5.4	2.6	-2.8
General consumption taxes	20.3	25.2	4.9
Specific consumption taxes	10.7	11.0	0.3
Other taxes[1]	3.4	2.7	-0.7
Total	**100.0**	**100.0**	**0.0**

1. Including certain taxes on goods and services (heading 5200) and stamp taxes.
Source: OECD Revenue Statistics, Ministry of Finance.

Figure 1.11. **The tax wedge on low-income earners is set to remain high**

Minimum Wage, single person without children, % of total labour compensation, 2013



Note: The figure shows the impact on the tax wedge for a single person without children of planned reform of the personal income taxation (PIT) in 2016, i.e. the reduction of the PIT tax rate to 22%, and of this reform combined with social security contribution paid by employees set to zero.

Source: OECD Tax-Benefit Models (2013 provisional).

StatLink http://dx.doi.org/10.1787/888933183633

skilled workers, which, at 85%, exceeds the EU average. The elasticity of demand and supply of labour with respect to wages is generally higher for lower-income workers, so these disincentives impinge especially on them. Labour taxes are also perceived as having important disincentives to work, or conversely to participate, in the formal economy in Latvia (Table 1.3). To the extent that high tax rates are regressive and are both a deterrent to labour market participation (contributing to the large hidden economy via a "participation tax rate") and to formal employment, economic efficiency and equity would be improved by concentrating tax reduction efforts on low-income groups.

Table 1.3. **Perception of tax disincentives and social policy**

Global and Europe 2020 Competitiveness Indexes, score (1-7 scale)

	Latvia	Lithuania	Estonia	Slovak republic	Czech Republic
Extent of taxation on incentives to invest[1]	3.8	3.1	4.9	3.2	3.3
Extent of taxation on incentives to work[2]	3.3	2.9	4.3	2.9	3.1
Social safety net protection[3]	3.8	3.6	4.1	3.8	4.4
Government effectiveness in reducing poverty and inequality[4]	2.9	2.9	3.5	3.0	3.0

Scores based on the answer to the following questions:

1. In your country, to what extent do taxes reduce the incentive to invest? [1 = significantly reduce the incentive to invest; 7 = do not reduce the incentive to invest at all].
2. In your country, to what extent do taxes reduce the incentive to work? [1 = significantly reduce the incentive to work; 7 = do not reduce incentive to work at all].
3. In your country, to what extent does a formal social safety net provide protection from economic insecurity in the event of job loss or disability? (1 = not at all; 7 =provides full protection).
4. In your country, how effective are the government's efforts to address income inequality? (1 = not effective at all; 7 =extremely effective).

Source: World Economic Forum, Global competitiveness Report, 2014 -2015 and Europe 2020 competitiveness Report, 2014.

Latvia has already begun to reduce taxes on labour and further steps in this direction are planned by 2016. A tax allowance for dependants was increased in 2014 and the personal income tax rate is to be gradually decreased, by one percentage point annually to 22% in 2016. A ceiling on the base for social security contributions was reintroduced in 2014. According to recent OECD estimates, the recent and planned measures will not reduce significantly the tax wedge of low-paid workers which is set to remain above the OECD average (Figure 1.11). Reducing the social security contribution rates on low wages would have a higher impact, even if large cuts in these rates would be needed to reduce the tax wedge to the OECD average level (Figure 1.11).

One option to further reduce the labour tax wedge is to cut social security contributions on low wages. Such a policy has been implemented in 14 OECD countries with generally a positive impact on the employment of low-skilled workers (OECD, 2011a). To avoid increases in the share of low paid jobs and associated deadweight costs, the decrease could be targeted at particular low-income groups (such as young workers, long-term unemployed, first-time job applicants) and tax enforcement should be strengthened. The reduction in the social security contribution rate should not lead to a reduction of social coverage (e.g. pension replacement rates) which, as noted above, is low by international standards. Another possibility, already on the agenda of the authorities, is to increase the personal income tax allowance, phased out for higher incomes.

A carefully designed and integrated tax and transfer reform will also be important to ensure that effective marginal tax rates are low for those transitioning into employment. In Latvia, the financial gain from moving into work is particularly low for low-income earners because of the way means-tested benefits are withdrawn as income rises (BICEPS, 2014). The planned gradual withdrawal of certain social benefits (guaranteed minimum income and housing benefit) is welcome and would significantly reduce the marginal effective tax rates for those taking a low paid job. Given the widespread underreporting of salaries (Putnins and Sauka, 2014), this measure needs to be coupled with further actions against undeclared work.

Simplifying business taxation

Corporate income tax and property tax constitute a much smaller proportion of the total tax take than the OECD average (see Table 1.2). Nevertheless, surveys record a negative impact of taxation on investment (Table 1.3) which might be due to the administrative burden of compliance. Paying tax involves a low number of payments (7 per year vs. 13 on average in the EU). The time firms spend complying with tax legislation in Latvia has been significantly reduced over the past few years mainly thanks to the introduction of an electronic declaration system and a simplified declaration filling process. Nevertheless, it remains higher than in the EU on average (193 hours vs. 176 hours) and in regional peers (81 hours in Estonia, 175 hours in Lithuania, PWC and World Bank, 2014). Over complication, which are likely to be associated with larger informal sectors, more corruption and less investment, should be removed.

Expanding the scope of property and environmentally related taxes

The proportion of property taxes in overall taxation, at 2.6%, is around a half of the OECD average, with revenues from the taxation of land and buildings amounting to only 0.8% of GDP in 2013 (see Table 1.2). Coverage of the property tax has recently been increased and since early 2013 local governments have some flexibility in choosing appropriate tax rates within a pre-defined bracket of 0.2-3%. However, the municipalities have been reluctant to increase property taxes as they compete for taxpayers.

There is no clear model for property taxation to be copied from OECD countries: cross-country variation in property tax collection is substantial and variation actually increases sharply with national income level (Norregaard, 2013). Nevertheless, property taxes are widely regarded as an efficient and equitable means of raising revenue. Its potential for maintaining overall revenues in the face of necessary cuts in the tax burden on labour should be exploited. A property tax reform would by itself not have a significant effect on poverty and inequality but could be an important facilitator of poverty-reducing reform, depending on its design. Substantial property tax reform would raise important political economy problems, as in many other OECD economies. In this light, it is difficult to be precise about how much a 'realistic' reform of property taxes could raise. According to recent estimates, doubling the residential and land tax rates could increase revenues by EUR 100 million, i.e. 0.4% of GDP (BICEPS, 2014).

There is scope for better pricing environmental externalities. The indicators relating to waste management and air quality suggest that the taxation rates in place may not be conducive enough to environmentally friendly behaviour. 84% of municipal waste is landfilled two and a half times more than the EU average. Newly registered passenger cars in Latvia have the highest CO_2 emissions per kilometre in the EU (Dreblow et al., 2013) and high levels of particulate matter (PM10) have been recorded along some busy roads in Riga (European Commission, 2014).

Environmental taxation has been recently extended. In 2010, a registration tax for passenger cars differentiated by CO_2 emission per km and an annual tax on vehicles depending on the engine capacity and volume were introduced. This has led to a decrease in the average emissions of new cars but would be more efficient if it applied to all vehicles. A new road toll tax (the so-called euro vignette) for trucks using the highways was also created in July 2014. In addition, the tax rates on landfilling construction, industrial, and municipal waste were increased (for municipal waste from 1.78 EUR/tonne in 2009 to 12 EUR/tonne in 2015).

Nevertheless, the implicit tax rate on energy – measuring energy taxation per unit of energy – is among the lowest in the EU. Fuel taxes do not reflect their relative negative impact on the environment. Furthermore, there are tax exemptions or reductions on the use of fuels in agriculture, for heat generation and heating energy. An 80% VAT tax deduction is applied to corporate passenger cars, which are often used for private purposes, on both purchase price and operating costs (e.g. fuel; Lamine and Lohmuste, 2014). A wider application of environmentally related taxes, including pollution and energy sources, as well as a progressive increase of the existing landfill tax, would help achieve environmental goals, while allowing taxation to be shifted away from low-income earners. In particular, the fuel tax rates should be increased and set at a rate that better reflects their carbon content, while environmentally harmful subsidies should be phased out.

Improving tax compliance and the efficiency of tax collection

The shadow economy is relatively large. Estimates of unreported activity are inherently difficult to make and tend to vary depending on the source and the method used, but according to survey evidence, the informal economy accounts for around 24% of GDP, 8-9 percentage points higher than in Estonia or Lithuania (Putnins and Sauka, 2014). Schneider (2013) also finds that Latvia has one of the largest informal economies among EU countries, amounting to around 25.5% of GDP. Behind this aggregate figure, the degree of underreporting of business profits and salaries ("envelope" wages) is particularly marked, being approximately twice as large as the underreporting of the number of employees, while bribes constitute approximately 10% of firms' revenue (Table 1.4). According to surveys, the tolerance of tax evasion is more entrenched in Latvia than in Estonia or Lithuania and firms are more dissatisfied with the tax system and the government, which is a factor behind high informality (Putnins and Sauka, 2014).

Table 1.4. **Measures of the shadow economy**

	Business profits	Number of employees	Salaries	Level of bribery
	(% of actual profits)	(% of actual employees)	(% of actual salaries)	(% of revenue spent on payments "to get things done")
Estonia	10.3	8.1	17.1	4.7
Lithuania	11.8	6.4	15.5	10.3
Latvia	**19.9**	**10.3**	**25.2**	**10.5**

Source: Putniņs J. and A. Sauka, (2014).

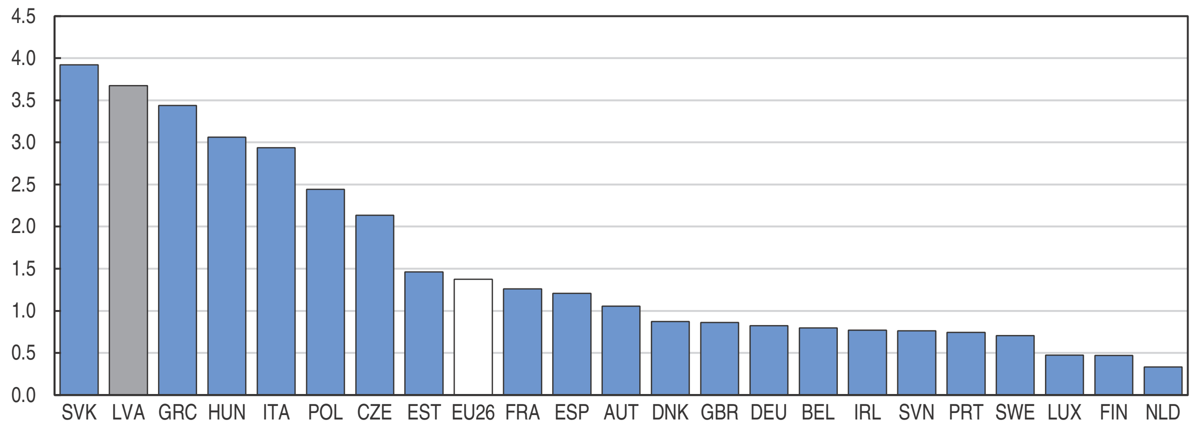
The high level of informality reduces tax collection efficiency. Correcting poor tax compliance is important, as it leads to resource misallocation, by diverting resources into unproductive uses and reducing the transparency needed for the efficient functioning of capital markets. It can also have severe budget effects, eroding the tax and social security bases, causing increases in tax rates and/or budget deficits, while distorting official statistics such as GDP, which are important signals to policy makers. Finally, it excludes part of the population from the social security system, contributing to the high level of inequality and increasing the poverty risks.

The VAT compliance gap, the difference between the amount of VAT effectively collected and the amount theoretically due, increased substantially during the crisis, leaving the country with one of the highest registered gaps in the EU (3.5% of GDP, Figure 1.12). Measures to increase revenues were taken during the crisis, when the standard VAT rate was increased from 18% to 22%, the reduced rate rose from 5% to 12%, and the scope of its application was narrowed. However, these crisis-related rate increases were not reflected in VAT revenues or in the implicit tax rate on consumption. The compliance gap could be due to fraud, delayed payments, collection of past debts, changes in refund patterns, underreporting, or failure to register. While it is difficult to determine how best to cope with the problem and how to assess the effectiveness of the tax administration, the indication is that the efficiency of the VAT system has been greatly affected by the economic crisis and there is significant scope for improvement as the economy recovers, in particular if supported by policy action to improve tax collection.

Tackling the problem of tax non-compliance requires a broad-based approach to reduce the administrative burden, ensure the efficient operation of controlling authorities, impose sanctions and support honest businesses. In 2010, an "*Action Plan to Combat Shadow Economy and Promote Fair Competition in 2010 – 2013*" was prepared, which encompassed a wide range of measures, including, for example, the proscription of cash transactions in wholesale trade and improved registration procedures for businesses. In parallel, several policy decisions have been or are being adopted in order to reduce the stock of tax arrears and to limit their accumulation in the future. The *Strategy of the State Revenue Service 2014-16* sets a strategic target of simplifying existing services, improving the range

Figure 1.12. **Improved tax collection offers revenue potential**

2012, VAT gap[1], % of GDP



1. The VAT Gap is the difference between the VAT Collections (as recorded by Eurostat) and the amount theoretically due, i.e. VTTL (VAT Total Tax Liability). The latter is the total amount of estimated VAT payments on the basis of national accounts aggregates and the existing structure of rates and exemptions.

Source: European Commission (2014c), "2012 Update Report to the Study to quantify and analyse the VAT Gap in the EU-27 Member States", September 2014 and Eurostat database.

StatLink http://dx.doi.org/10.1787/888933183649

of electronic services and simplifying the tax and customs fees payment process. Greater emphasis on facilitation should help taxpayers to fulfil their obligations, including those who have accumulated tax debts, while heavier penalties should help deter deliberate tax evasion.

There is, however, a question mark as to whether sufficient resources are being allocated to fight tax fraud. The State Revenue Service of Latvia (SRS) is an integrated state governmental institution responsible for tax, excise and customs administration, including crime detection and prevention in tax and customs area. One of the targets set in the Strategy of SRS for 2014-16 is "to increase the efficiency and effectiveness of using the SRS's resources". However SRS plans to meet this target without increasing the number of staff. Moreover, the allocated resources for salaries would not seem sufficient and may not ensure that salaries are competitive or staff sufficiently motivated. SRS staff turnover is on a growing trend and staffing is a problem especially for auditors, investigators, lawyers – key positions for tackling tax fraud. Without the allocation of additional resources, the foreseen improvement in revenue collection for the period 2013-16 is in danger of not being achieved.

Improving institutional and administrative efficiency at the central and local level

Overall, Latvia has a well-structured budgetary framework but ranks poorly on the WEF Global Competitiveness scale for political institutions and governance, with opinions about the wastefulness of government spending being particularly poor (Table 1.5). Given the need to increase the amount of resources committed to the core public programmes discussed above, an essential part of the policy response thus needs to be on improving the allocative and cost efficiency of public spending, which demands an analysis of efficiency at three levels: i) planning and prioritisation of spending, ii) coordination between levels of government, iii) programme management.

Table 1.5. **Institutional quality rankings, selected indicators**

	Latvia	Lithuania	Estonia	Russia
Social Infrastructure and Political Institutions (SIPI)	57	48	27	86
Political institutions	87	61	24	91
Public trust of politicians	99	92	37	57
Wastefulness of government spending	97	88	33	65
Favouritism in decisions of officials	72	44	26	79
Rule of law	54	47	27	100
Ethical behaviour of firms	78	61	30	94
Control of Corruption (WB)	43	46	29	108

Note: Ranking over 151 countries.
Source: The Global Competitiveness Index Historical Dataset, 2005-14, World Economic Forum.

Towards more reliable medium-term planning

Ensuring effective prioritisation

During boom years, budgeting involved in-year adjustments with at least one supplementary budget and additional expenditures each year (Kraan et al., 2009). In part, this has been due to the instability of governments and the availability of additional cyclical revenues. Medium-term budgeting coupled with a target for the budget balance could correct this deficiency. The new budget system includes multi-annual estimates of spending at the line-item level. This can help to better prioritise spending. This medium-term approach should also be an effective means to avoid pro-cyclical and wasteful spending. However, current medium-term expenditure plans assume the discontinuation of a wide range of existing programmes and do not take fully into account the cost of measures that are envisaged for the next three years (e.g. expanding the social benefit system, reforming the healthcare sector). This undermines the credibility of the medium-term budget and increases the risk of underestimating future spending needs.

Improving strategic capacity

Strategic capacity has also been improved with the establishment of a new central-government planning unit, the Cross-Sectoral Coordination Centre (PKC). The PKC's mandate is to produce long-term planning documents and to ensure that policies are effective and appropriate to attain long-term goals. To date, the PKC has produced the National Development Plan, monitored progress toward Latvia's long-term development plan (Latvia 2030), and carved out an active role in the decision-making process. The body can also be engaged in the early planning phase of new policies. It has been tasked with analysing transversal issues, such as evaluating the management of state-owned enterprises, demographics or income disparities.

However, the PKC is not well staffed enough to meet line ministries' demands and it has no financial capacity to engage outside expertise on specific substantive issues. Additional allocations of human resources would enable the government to build on success of the PKC, further consolidating its role in the policy-planning process and enabling it responds to ministries seeking to engage with the Centre in the early stages of policy planning.

Reinforcing regulatory impact assessment

The regulatory impact assessment process is quite rigorous and all draft legislation has to undergo an assessment. Introducing new regulations requires justification and the process includes notably an assessment of the budgetary impact and compliance with the Latvia 2030 Strategy. In practice, though, the quality of analysis varies widely from detailed, evidence-based analysis to a simple pro forma cover sheet providing a brief summary of intent. The scope of investigation is often restricted to financial, budgetary, and administrative costs. Sustainability checks are not carried out and short-, medium- and long-term analyses are not required.

There is no threshold test for the preparation of more in-depth impact analyses of legislative and policy proposals with significant economic, social or environmental impacts. Such a test would help the public administration to prioritize resources better and to conduct more robust in-depth assessments for those proposed policies and laws that are likely to have the greatest costs and benefits for the economy.

In theory, government decision-making processes involve a large panel of stakeholders. Draft laws are published and non-governmental entities can provide inputs. In practice, however, the usual procedures for gathering cross-sectoral and expert input can be circumvented at the request of a minister, putting coordination and analytical quality at risk. In 2011 and 2012, a third of all issues before cabinet were fast-tracked, which appears excessive.

Developing performance budgeting

To ensure monitoring as well as promote control over budget use, performance budgeting is being developed at the programme level. Ministries and other state central institutions set goals, performance results and performance indicators characterising the degree of achievement for budget programmes and sub-programmes. Line ministries and other state central institutions submit quarterly reports on the budget execution process to the Ministry of Finance, including an overview of performed and non-performed actions and information about finance management improvement activities. As from the 2012 budget, the procedures for planning and reflecting operational level results and performance indicators in budgetary requests of ministries and other central state institutions have been improved. This information is included in the annual State Budget Law, thus provided to the parliament and public. Nevertheless, incentives for public bodies to conduct critical evaluations to identify fiscal space remain limited, suggesting evaluation capacities should be strengthened.

Improving co-ordination in state-local relations

Efficiency can be improved at all government levels. The Strategic Development Plan for 2010-13 envisages greater centralisation and harmonisation as one means of increasing efficiency, including a reduction of the size of central government administration and the unification of personnel management, procurement systems and digitalisation of government services. On the other hand, the 2014 National Reform Programme envisages an enhanced role for local authorities. Combining the benefits of decentralisation with the efficiency aims of the central government is bound to be a challenge.

Reforms of local governments aim at both strengthening local democracy by involving the population in decision-making processes, and increasing efficiency and effectiveness by using updated methods of management. The principles of local government reforms in Latvia are based on the principles of the European Charter of Local Self-Government, the core of which being territorial reorganisation of administration. The aim of the reform, via amalgamation, has been to establish administrative territories (regions) capable of promoting economic development in association with local governments that would ensure high quality provision of services. This has resulted in a consolidation of municipal governments and an intermediate level of government which consists of five planning regions (indirectly elected regional governments). Yet, the disparity in local government sizes poses challenges in terms of capacity and resources. There is an efficiency argument for a further reduction of the number of local governments by means of merging. There could also be a case for an extra administrative subdivision (e.g. a region) for some sectors such as education, as some issues are too complex to be handled at the local level.

The functions of local governments in Latvia outstrip their financial resources. In principle, local governments enjoy a high degree of autonomy and perform a wide range of tasks (Box 1.2). But, in its 2011 report on Latvia's adherence to the European Charter of Local Self-Government, the Council of Europe concluded that local authorities have inadequate access to independently raised resources, and urged Latvia to increase local authorities' financial autonomy. The Latvian Association of Local and Regional Governments has persistently complained about the growing gap between actual revenue and the service obligations prescribed by law. In primary and secondary education, for example, the funding system changed, tying allocations to pupil enrolment. As mentioned above, this resulted in a rationalisation of the school network but also contributed to unequal access and quality at the local level (Terauda et al. 2014). The medium-term budget-planning process adopted in 2012 envisages a three-year budget cycle for local government, but for this to be effective and for stability to be restored to Latvian local finances an improved balance needs to be achieved between local spending responsibilities and local resources. One option is to increase property taxes perceived at the local level, but as noted above, local governments are reluctant to do so as they compete for taxpayers.

Box 1.2. **State-local relations**

Tasks – The local government share of public expenditure is 27% (2010), slightly above the EU average of 24%. Local authorities are responsible for education (43% of expenditures) as well as sharing provision of general public services (housing, utilities, recreation, culture, religion). Local governments have autonomous tasks, delegated tasks and legally mandated tasks. Each type of task is meant to be accompanied by a funding source.

Finance – Latvian municipalities rely mostly on tax revenues, grants from the central government and fines they are empowered to impose. The most important shared taxes are the individual income tax (around 80%, negotiated annually) and the real estate tax (100%).

Fiscal rules – The fiscal rule for local governments focuses on the right of municipalities to borrow and issue guarantees. Annual borrowing cannot exceed 20% of the current budget revenues of a municipality, excluding earmarked grants and contributions to the Equalisation Fund. If local governments do not comply with their debt repayment obligations, the Treasury is entitled to apply sanctions and in case of financial problems, local governments are placed under supervision.

A better matching of local resources with obligations would still leave the problem of the equalisation system, which is implemented to balance substantially different tax capacities and service obligations of municipalities. Marked disparities in the level of socio-economic development of sub-central governments- notably between Riga and rural areas – imply extensive differences in tax revenues. An Equalisation Fund distributes resources between municipalities but the compensation system was set aside in 2009 because the central government was not able to guarantee payments to the local level in the difficult circumstances of the financial crisis. Financial equalisation can be justifiably regarded as one of the key instruments of regional development (in addition to the EU Structural Funds) and its functioning needs to become more efficient.

Almost all grants from the central government to the local level are earmarked. Such grants concern, notably, the remuneration of teachers and trainers, the salaries of medical staff, any increase in the minimum wage, investment projects, road maintenance and construction. The only non-earmarked grant is the equalisation transfer. In the longer term, the Latvian authorities may consider incorporating more financial incentives – for instance, by moving away from earmarked grants (which stimulate both federal and regional authorities to shift spending patterns in the direction of subsidised services) towards fixed non-earmarked grants, while ensuring that high-quality public services are provided.

Increasing administrative efficiency

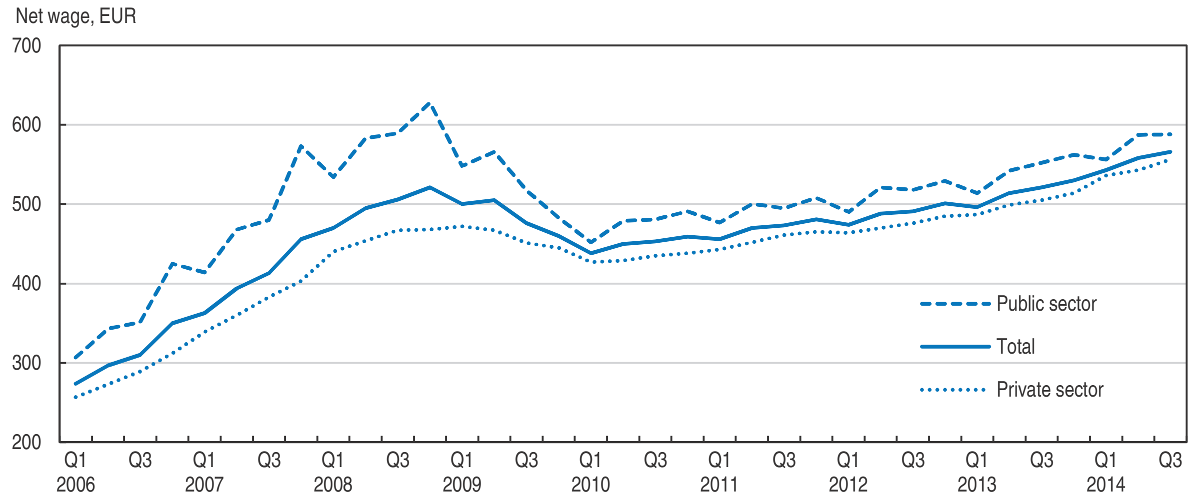
Bureaucracy and administrative inefficiency have plagued the Latvian economy. According to the OECD Product Market Regulation (PMR) indicators, businesses face a high degree of red tape, as regulatory procedures seem overly complex, notably in terms of permits and licenses (see Chapter 2). The administrative burden on start-ups, sole proprietors and corporation is above the OECD average. The objective as defined in the Public Administration Development Guidelines for 2014-20 is now to build an efficient, motivated, accessible and innovative public administration, providing citizens and businesses with quality and affordable public administration services, as well as reducing administrative obstacles and burdens.

Improving human resource management

Government wages have been very volatile in the past few years. From 2004 to 2008, public sector wages significantly outpaced private sector wages, to reach a level about 30% higher; but as a result of fiscal consolidation the gap narrowed substantially to around 10% in 2010 (Figure 1.13). This fluctuation has not come without costs in terms of disruption and motivation of employees in the public sector, as evidenced by the fact that many high qualified specialists have left the government service.

The wage cuts have left the public sector with a significant challenge in attracting, retaining and motivating talent. The lack of continuity in public pay, employment and productivity raise questions about how human resources management may be improved pointing to the need to avoid future boom-bust cycles in public resources and to look further at human resources (HR) practices. Increasing practices such as "flexible job descriptions", "realistic job previews", "regular appraisals" and "regular feedback on performance" would increase efficiency in the Latvian public sector (Lobanova and Ozola, 2013). Annual assessment of work performance is currently one of the criteria for determining wages and employees may receive a bonus once a year according to the

Figure 1.13. **Wages in the public sector have been volatile**



Source: Central Statistical Bureau of Latvia.

StatLink http://dx.doi.org/10.1787/888933183892

results of annual assessment. Further developing results-oriented pay and training would improve employee motivation, giving a motivational tool to heads of institutions and improving the retention of professionals in the public sector. Particular attention should be given to teacher remuneration, which is unlikely to be high enough to retain a quality and motivated workforce (OECD, 2014).

Achieving greater efficiency in public procurement

Achieving greater value for money from procurement spending is an important element in public sector efficiency (OECD 2013). This could be achieved by investing in innovative tools to streamline procurement procedures. For example, many central governments in the OECD have invested in e-procurement systems and almost all OECD member countries use framework agreements to take advantage of economies of scale. Latvia has made important progress in this area: the State Regional Development Agency passed framework agreements and central government institutions have since 2010 been obliged to use e-Catalogues based on these agreements. The State Agency for Internal Affairs and the State Agency for Defence Properties of the Ministry of Defence also act as central purchasing bodies. The government also modified regulations on centralised electronic procurement, widening the circle of buyers.

Ensuring that procedures are transparent is also key. The share of calls for tender published in the Official Journal as a percentage of total expenditure on public works, good and services was 87.2% in 2011, the highest percentage in the EU. Nevertheless, according to the 2013 *Eurobarometer on businesses' attitudes towards corruption in the EU,* 66% of Latvian respondents consider that corruption is widespread in procurement managed by national authorities (vs. 56% in the EU on average; Eurobarometer, 2013). The Procurement Supervision Bureau has noted cases in which procuring agencies failed to make documentation available to bidders, provided unclear or disproportionate requirements for bidders and subcontractors (for instance in terms of qualification). Risks also arise from the decentralised procurement of a range of standardised goods and services (such as internet services), despite the existence of a centralised e-procurement system.

A set of measures is in place to prevent conflicts of interest and corruption in public procurement. Amendments made to the Public Procurement Law in 2013 include an obligation for local governments to use centralised procurement for a range of services, stricter consequences for suppliers who fail to deliver according to procurement contracts, and the requirement to publish small procurement contracts online. Amendments to the Code of Administrative Violations also make it possible to sanction officials for procurement violations which do not amount to criminal offences. This progress needs to be consolidated by protecting the administration in charge of preventing and combatting corruption, the KNAB, from political interference, by strengthening the ability of the judiciary to handle corruption cases, and by providing practical guidance on conflicts of interest.

Ensuring a transparent decision-making process

The State Audit Office (SAO) plays an integral part in developing a fair and transparent decision-making process. With respect to external audit, the SAO is reputed to meet international standards and annually produces a large number of financial and performance audits of high quality. Its recommendations are generally followed up. However, in response to the financial crisis, the staff was reduced by 15% and there is some doubt as to whether it now has adequate resources. The SAO is financed from the budget and its budget request can be amended by the Cabinet of Ministers, possibly generating a conflict of interest. There is thus an on-going discussion on strengthening its budgetary independence.

Financial audits are performed annually and cover the correctness of the preparation of annual financial statements by all ministries and other central state institutions. Since this is the primary function of the SAO, a substantial share of its resources is channelled to this objective. Compliance and performance audits are planned in accordance with available resources. During 2013 a total of only 13 compliance or performance audits were performed as opposed to 28 financial audits. As from 2014, a budget provision is being made for ad hoc audits in cases where the SAO's expertise and opinion are needed to resolve contentious issues. This might improve the SAO's flexibility of response but still leaves funding below the pre-crisis level.

Interfacing with the public

Measures have been taken to improve the effectiveness of public administration processes by providing better access to public services for citizens and companies. The 2011 "E-governance Development Plan 2011-13" aims at improving the operation and availability of the national information system, introducing complete electronic data and document transfer between institutions, consolidating and centralising national IT services. In 2013, the government approved the Information Society Development Guidelines 2014 – 2020 to further support the development of e-government. As a result, individuals and companies should have access to public administration services in a simpler, faster and remote manner. Public accessibility would also benefit from the introduction of the "one-stop agency" principle for the provision of state and local government services. This would improve local government service delivery by developing service access points, both personally and electronically and create common standards for local government services.

Recommendations to improve public sector efficiency

Fiscal policy

- Reinforce countercyclical liquidity buffers.

Medium-term planning

- Allocate adequate staff and resources to the Cross-Sectoral Coordination Centre.
- Introduce regular reporting on long-term spending trends and adequacy of social programmes such as pensions and healthcare.

Institutional and administrative efficiency

- Reinforce regulatory impact assessments by reducing fast-tracking, establishing specific sustainability checks and introducing threshold tests for the preparation of more in-depth analyses.
- Ensure that local governments are sufficiently resourced and autonomous by increasing their tax revenues, reducing the share of earmarked revenues, and improving the equalisation system.
- Modernise human resource management by further developing results-oriented pay.
- Strengthen the transparency of public procurement by ensuring the independence of institutions in charge of combating corruption and by providing practical guidance on conflicts of interest.
- Restore the funding of the State Audit Office to at least pre-crisis levels.

Tax and benefit system

- Strengthen efforts to tackle tax fraud and improve tax collection.
- Evaluate the current benefit system and make universal social benefits more targeted at low-income households.
- Gradually withdraw benefits targeted at low-income earners when they take up a job.
- Decrease the labour tax wedge for low-income earners.
- Raise additional revenues by increasing property and environmentally related taxes.
- Increase energy tax rates, making them depend on their relative carbon content.
- Phase out environmentally harmful subsidies.
- Continue to reduce the complexity of tax compliance.

Bibliography

Baltic International Centre for Economic Policy Studies (BICEPS) (2014), *Tax Reform in Latvia, Final Report.*

Dreblow, E., M. Duwe, T. Wawer, L. Donat, E. Zelljadt, A. Ayres, I. Upatniece (2013), "Assessment of climate change policies in the context of the European Semester, Country Report: Latvia", Ecologic Institute, eclareon, June.

Eurobarometer (2011), Attitudes towards vocational education and training, Special Eurobarometer 369, European Commission, Brussels.

Eurobarometer (2013), *Businesses' attitudes towards corruption in the EU*, Flash Eurobarometer 374, European Commission, Brussels.

European Commission (2012), *2012 Ageing Report: Economic and budgetary projections for the EU27 Member States (2010-60)*, EC, Brussels.

European Commission (2014a), "Assessment of the 2014 National Reform Programme and Stability Programme for Latvia", *Commission staff working document*, Brussels.

European Commission, (2014b), *Innovation Union Scoreboard 2014*, European Commission

European Commission (2014c), "2012 Update Report to the Study to quantify and analyse the VAT Gap in the EU27 Member States", September 2014.

Kraan D-K, J. Wehner, J. Sheppard, V. Kostyleva and B. Duzler, (2009), "Budgeting in Latvia", *OECD Journal on Budgeting*, Vol. 2009/3.

Katsarova I. (2013), "The (low) absorption of EU Structural Funds", *Library Briefing,* Library of the European Parliament, 01/10/2013.

Lamine B. and E. Lohmuste, (2014), "Do the Baltics States need to tax passenger cars more", ECFIN Country Focus, Vol. 12, Issue 11, November 2014.

Lobanova L.and I. Ozolina-Ozola (2013), "Comparative evaluation of the practical areas of human resource management in Lithuania and Latvia", *Contemporary Issues in Business, Management and Education 201,* Procedia – Social and Behavioral Sciences, 110(2014).

Ministry of Finance, Republic of Latvia (2014), *PPP Policy*, *www.fm.gov.lv/en/s/ppp/ppp_policy/*.

Norregaard J (2013), "Taxing Immovable Property Revenue Potential and Implementation Challenges", *IMF Working Paper WP/13/129*.

OECD (2011), *Taxation and Employment, The Taxation of Low-Income Workers,* OECD Publishing.

OECD (2013), *Principles for Integrity in Public Procurement: Progress in OECD Countries*.

OECD (2014), *Teacher remuneration in Latvia: an OECD perspective*, OECD Publishing.

Price R.W.R. (2010), "The Political Economy of Fiscal Consolidation", *Economics Department Working Papers* No. 776.

Putniņš T.J. and Sauka, A. (2014), "Shadow Economy Index for the Baltic countries, 2009 – 2013", The Centre for Sustainable Business, SSE Riga.

PWC and World Bank (2014), *Paying taxes 2015: The global Picture*, World Bank, Washington.

Schneider F. (2013), "Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2013: A Further Decline", *www.econ.jku.at/members/Schneider/files/publications/2013/ShadEcEurope31_Jan2013.pdf*.

Sutherland, D., R. Price, I. Joumard and C. Nicq (2007), "Performance and Indicators for Public Spending Efficiency in Primary and Secondary Education", *Economics Department Working Papers*, No. 546, OECD Publishing.

Terauda V. A., A. Reetz, D. Jahn (2014), *Latvia Report, Sustainable Governance Indicators*, Bertelsmann Stiftung.

Traidase B. (2014), "Latvia`s Experience with Fiscal Adjustment", Bank of Latvia, Eighth meeting of the Network of public finance economists in public administration, February 11, 2014.

World Bank (2014), "Who Is Unemployed, Inactive Or Needy? Assessing Post-Crisis Policy Options"**,** Scientific Research: Latvia.

World Economic Forum (WEF) (2014a), *Global competitiveness Report, 2014 -2015*.

World Economic Forum (WEF) (2014b), *The Europe 2020: Competitiveness Report*, *Building a More Competitive Europe*.

World Health Organisation and European Observatory of Health Systems and Policies (WHO and EOHSP) (2012), *Latvia: Health System Review*, Health systems in Transition, Vol. 14, No. 8, 2012.

Chapter 2

Raising productivity and ensuring robust convergence

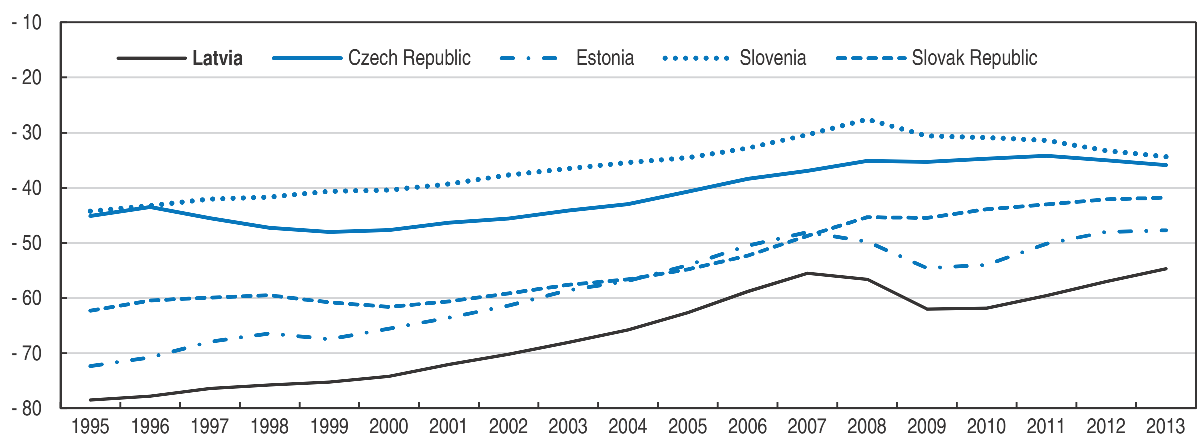
Much of the convergence of the Latvian economy needs to come from productivity increases. To achieve this, policy makers can do more to facilitate the integration of the economy into global trade and promote the competitive business environment, both of which should help in increasing productivity. This can be achieved by decreasing the regulatory burden even further, by removing trade and investment barriers, by strengthening the competitive environment and by continuing with improvements in the judiciary. To reap the full benefits of globalisation and to increase the capacity to face shocks, human capital accumulation is crucial. In this vein, the reform of the vocational education and training system, of lifelong learning and of policies for research and development have yet to deliver.

Introduction

Latvia has made great progress in catching-up over the past ten years. Nevertheless, convergence has still a way to go as the gap in GDP per capita *vis-à-vis* average of the upper half of the OECD remains large (Figure 2.1). Historical international experience shows that much of growth will have to come from multi-factor productivity, which can be understood as diffusion of technological frontier knowledge to the domestic economy (Johansson et al., 2013). This is often channelled via international trade, integration into global-value chains and investment in knowledge-based capital. Framework conditions for trade and investment, efficient re-allocation of resources, improving educational outcomes and developing innovative and absorptive capacities for knowledge transfers are thus important.

Figure 2.1. **The gap in GDP per capita remains wide**

Gap to the upper half of OECD countries[1], %



1. Percentage gap with respect to the simple average of the highest 17 OECD countries in terms of GDP per capita (in constant 2005 PPPs).

Source: OECD National accounts database and World Bank, WDI database.

StatLink http://dx.doi.org/10.1787/888933183569

A number of reforms have been carried out recently and more is in the pipeline, addressing many of structural weaknesses of the Latvian economy. Yet, to reap full benefits of openness and maintain competitiveness, more can be done to improve the business environment and incentivise human capital accumulation. Such reforms will help to put the economic growth and convergence path on a sustainable and more resilient foundation.

Latvian income convergence is undermined by a shrinking labour force. The working-age population has started to decline already and the severity of the downturn prompted many well-educated and skilled to look for a job elsewhere. Recent emigrants have been disproportionately young and more educated than those who have remained (OECD, 2013a). Potential output estimates show that growth was driven mainly by a foreign-financed investment boom (IMF, 2013), yet it is far from obvious that this will continue. Unless kept in line with productivity improvements, rising wage levels can further undermine the competitiveness of Latvian firms and the attractiveness to foreign direct investment (FDI).

While productivity growth has slowed in many OECD countries following the financial crisis, leading to an international debate on the future productivity prospects in countries at the technological frontier (Gordon, 2012), Latvia is still far from the frontier (Figure 2.4, Panel A). Some policy-makers point to the risk of a middle-income trap according to which slow growth episodes are disproportionately likely to occur in middle-income countries (Shekhar et al., 2013). At around 15 000 USD per capita, the country's income is indeed close to one of the thresholds of the middle-income trap identified by Eichengreen et al. (2013). They also find, however that the slowdowns are less likely in countries with relatively high level of secondary and tertiary education attainment, as is the case in Latvia.

In this context, the chapter reviews recent trends and market outcomes in terms of trade and productivity. It then examines regulatory and competition framework and practices, general business environment, including the judiciary and access to finance. The final sections look at incentives for R&D and innovation as well as human capital accumulation, all of which matter for solid productivity growth. The main findings of the chapter are:

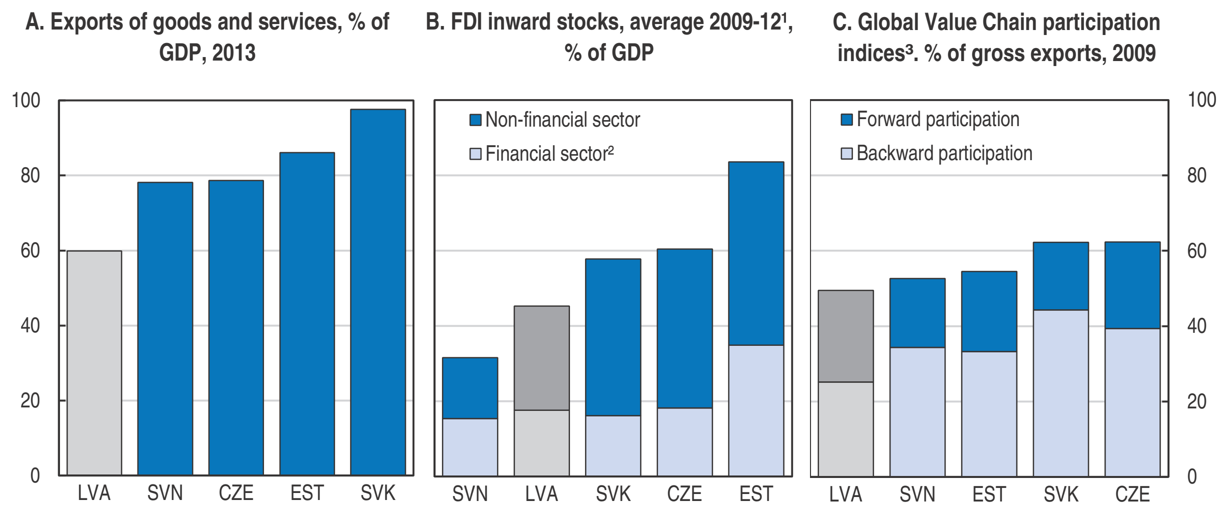
- Policy makers can do more to facilitate integration of the economy to global trade and promote the competitive business environment, both of which should help in increasing productivity. This can be done by decreasing regulatory burden even further, by removing trade and investment barriers, by strengthening the competitive environment and by continuing with improvements in the judiciary.
- To reap full benefits of the globalisation and increase the capacity to face shocks, human capital accumulation is crucial. In this vein, reform of the vocational education and training system, of lifelong learning as well as of policies for research and development have yet to deliver.

Improving integration to global trade

Exports are at around 60% of GDP, which is well below Estonia and Lithuania and other catching-up economies in the Central and Eastern Europe (CEE) region. Latvia's integration into the global value chains is also lagging behind these peer countries (Figure 2.2). Goods represent some two thirds of the Latvian exports, with metal, wood and agricultural products being the most important articles. The rest, one third, is exports of services, mainly freight transport of the ports. Only 10% of the exports could be characterised as high-technology and 15% of medium-high technology in 2010 (Government of Latvia, 2012). Almost a half of the trade is done with the other Baltic and Nordic countries and 16% with countries of the former Soviet republics, the Commonwealth of Independent States (CIS).

The Latvian economy is service-oriented (Figure 2.3). Unlike some of its transition peers in the CEE region, manufacturing plays a smaller part in the economy. In this vein the authorities have adopted a strategy to increase its role in the economy and foster productivity increases in the sector (Box 2.1). Manufacturing is dominated by low technology firms while productivity as well as labour costs are modest (Government of Latvia, 2012).

Figure 2.2. **Latvia is less competitive than its peers**



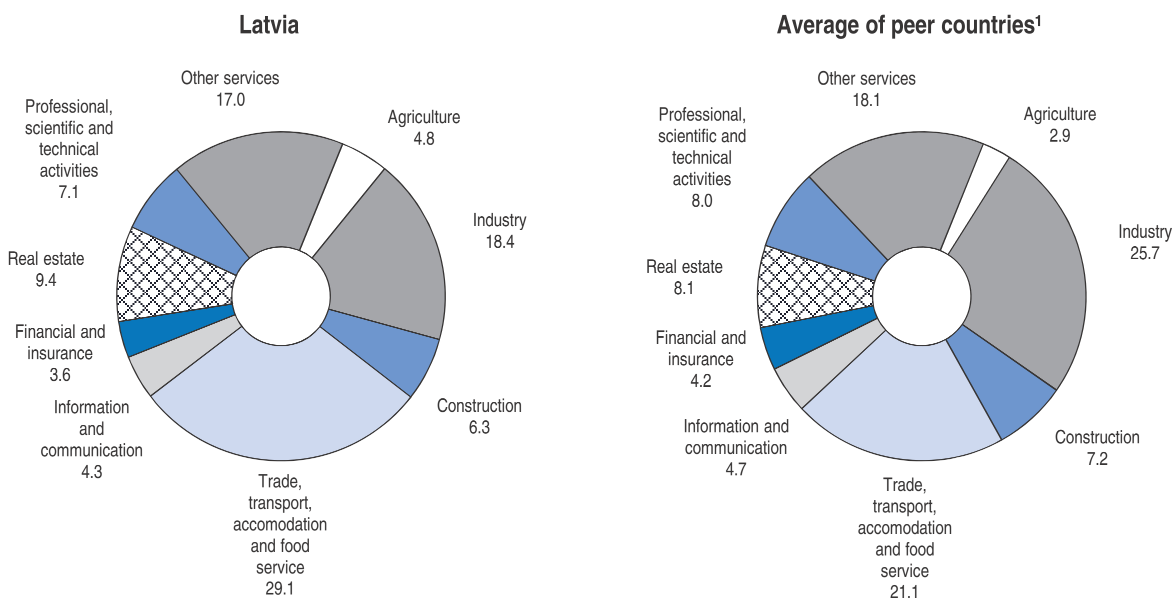
1. Average 2009-11 for Czech Republic and Slovak Republic.
2. Financial sector refers to financial and insurance activities and real estate activities.
3. Backward participation shows the use of foreign intermediates in a country's exports and forward participation the use by other countries of a country's inputs in their exports.

Source: OECD Economic Outlook database, Eurostat database and OECD Global Value Chains indicators – May 2013.

StatLink http://dx.doi.org/10.1787/888933183654

Figure 2.3. **Services play an important role in the economy**

Average 2009-13, % of total value added



1. Average of Czech Republic, Estonia, Slovenia and Slovak Republic.

Source: Eurostat database.

StatLink http://dx.doi.org/10.1787/888933183907

Box 2.1. **Shaping the future of Latvian economy– New Industrial Policy and Smart Specialisation Strategy**

Two policy documents address the need for changing Latvian economic structure in order to secure future growth. Firstly, in the framework of applying for EU's regional policy, the Latvian authorities produced a smart specialisation strategy. The second initiative is the National Industrial Policy, adopted in 2012 as a reflection on the pre-crisis sources of growth. Both aim at increasing the role of the exports, notably manufacturing, and productivity in the sector.

The Latvian Smart Specialisation Strategy focuses on effective coordination between knowledge specialisation and capabilities of industries, increasing the knowledge pool, policies promoting absorption of knowledge and knowledge transfer as well as social innovation at all levels of government and society in general. The following areas have been identified as priorities for the country's future growth:

- Knowledge intensive bio-economy
- Biomedicine, medical technologies, bio-pharmacy and biotechnology
- Smart materials, technology and engineering
- Smart energy
- ICT

Effectively, this means that a significant share of the EU structural and cohesion funds (EUR 4.51 billion or 19% of GDP) allocated to Latvia for the 2014-20 financing period will be directed towards these areas. The Smart Specialisation Strategy also aims at increasing funding for R&D to 1.5% of GDP with private sector financing about a half (23% in 2012) and increasing R&D personnel by 40% by 2020.

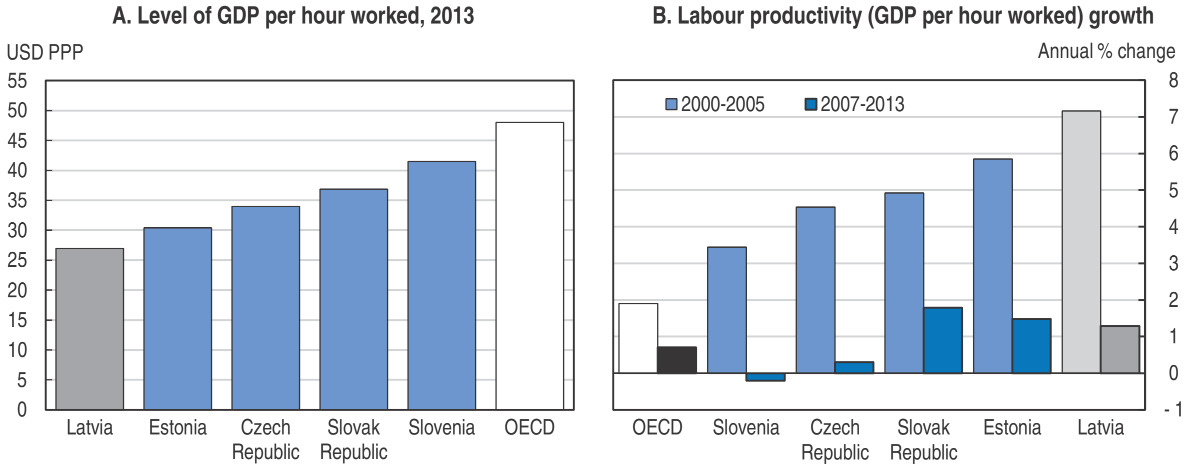
Covering the same period, the National Industrial Policy (NIP) and its Guidelines have been developed with a goal to diversify sources of growth away from real estate and financial sector that was at the heart of the boom-bust experience. This should be done by boosting role of the manufacturing sector in the economy. The stated policy goal is to increase the share of manufacturing in the economy from 14% in 2011 to 20% in 2020. Also, productivity in the manufacturing sector, currently that is below the overall productivity, should rise.

According to Soms (2013) industrial policy has been applied over past 20 years mainly via a number of the state owned enterprises. The recent NIP proved useful mainly as a cooperation tool between the public and private sectors to identify constraints that prevent new economic activities and discuss policy tools for overcoming these. While favouring horizontal tools – such as taxes, financial instruments, promotion of knowledge and skills and innovation and entrepreneurship, some selectivity is applied, notably the focus on manufacturing.

Source: Guidelines on National Industrial Policy for 2014-20 (2013); Soms (2013): Industrial Policy: Pros and Cons – a literature review; Kiopa (2014): External dimensions of Latvian Smart Specialisation Strategy.

Latvia experienced considerable productivity increases in the pre-bust period of 2000-06 (Figure 2.4, Panel B). Moreover, an important part of the crisis adjustment happened through productivity improvements, via labour shedding (Blanchard et al., 2013). Unit labour costs relative to Western Europe fell by 22% during 2008-12, the biggest decline among the Baltic countries (IMF, 2014). A revival of export on the back of wage restraint and productivity gains was instrumental in pulling the country out of the

Figure 2.4. **Scope for catching up in labour productivity**



Source: OECD Productivity database and OECD National Accounts database.

StatLink http://dx.doi.org/10.1787/888933183914

deep crisis and restoring external balance (IMF, 2014). Latvian exporters managed to increase their market share and non-price factors contributed to this (Benkovskis, 2012). More recently, with the recovery unit labour costs have increased on the back of strong wage inflation. Should wage growth continue to outpace productivity improvements, past competitiveness gains could be lost.

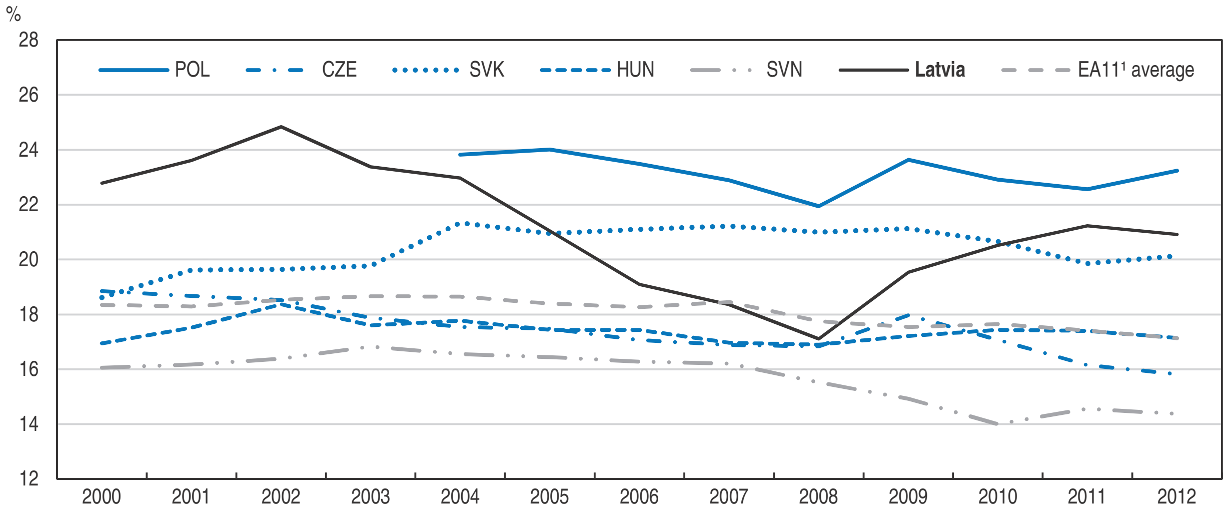
A number of authorities in OECD countries consult independent advisory bodies on microeconomic policy reforms and their impact on productivity. While in Denmark a temporary commission had been set up recently, in Netherlands and Australia these bodies have a permanent status and have a well-established role in the policy making dialogue (CPB and Productivity Commission respectively). In Latvia, an ad hoc Competitiveness Report has been produced in 2012 by a group of academics (Cunska et al., 2013) and many analytical inputs for the National Industrial Policy had also come from external experts. To better identify and build support for solutions to domestic productivity challenges effective coordination of the various bodies dealing with productivity issues (i.e. the Large and Strategically Important Investments Coordination Council, the National Economy Council) is necessary. Coordinated and regular assessment of productivity challenges as an input for regulatory reform should be carried out.

Promoting a competitive business environment

For a small open economy such as the Latvian one a competitive domestic environment is a precondition for securing a strong competitive position internationally. It boosts consumer welfare through lower prices and greater choice. Firms benefit from lower intermediate input prices and are forced to accelerate product and process innovation (Aghion et al., 2001). A more intense competitive environment will also stimulate reallocation of resources. These factors have positive effects on productivity growth, thereby increasing competitiveness and stimulating long-term income growth.

Relatively high Latvian price-cost margins suggest less intense competitive pressures than in other European Union (EU) countries (Figure 2.5). Increasing wages and the economic slowdown after 2007 reduced margins to levels comparable with those prevailing

Figure 2.5. **Price-cost margins are above those of peer economies**



Note: Price-cost margins (PCMs) are adjusted for self-employment except in the agricultural sector. Self-employed are assumed to earn the average wage in the sector.

1. Excluding Ireland.

Source: OECD calculations based on Eurostat database.

StatLink http://dx.doi.org/10.1787/888933183925

in other countries, however, they have since returned to higher levels. In sectors that are not exposed to foreign competition, the degree of competition is determined by domestic regulation. Such regulation typically aims at establishing the 'rules of the game' to improve the functioning of markets. However, when such regulation becomes intrusive and stifling, it reduces competition, weakens resource allocation and lowers productive efficiency (Nicoletti et al., 2000).

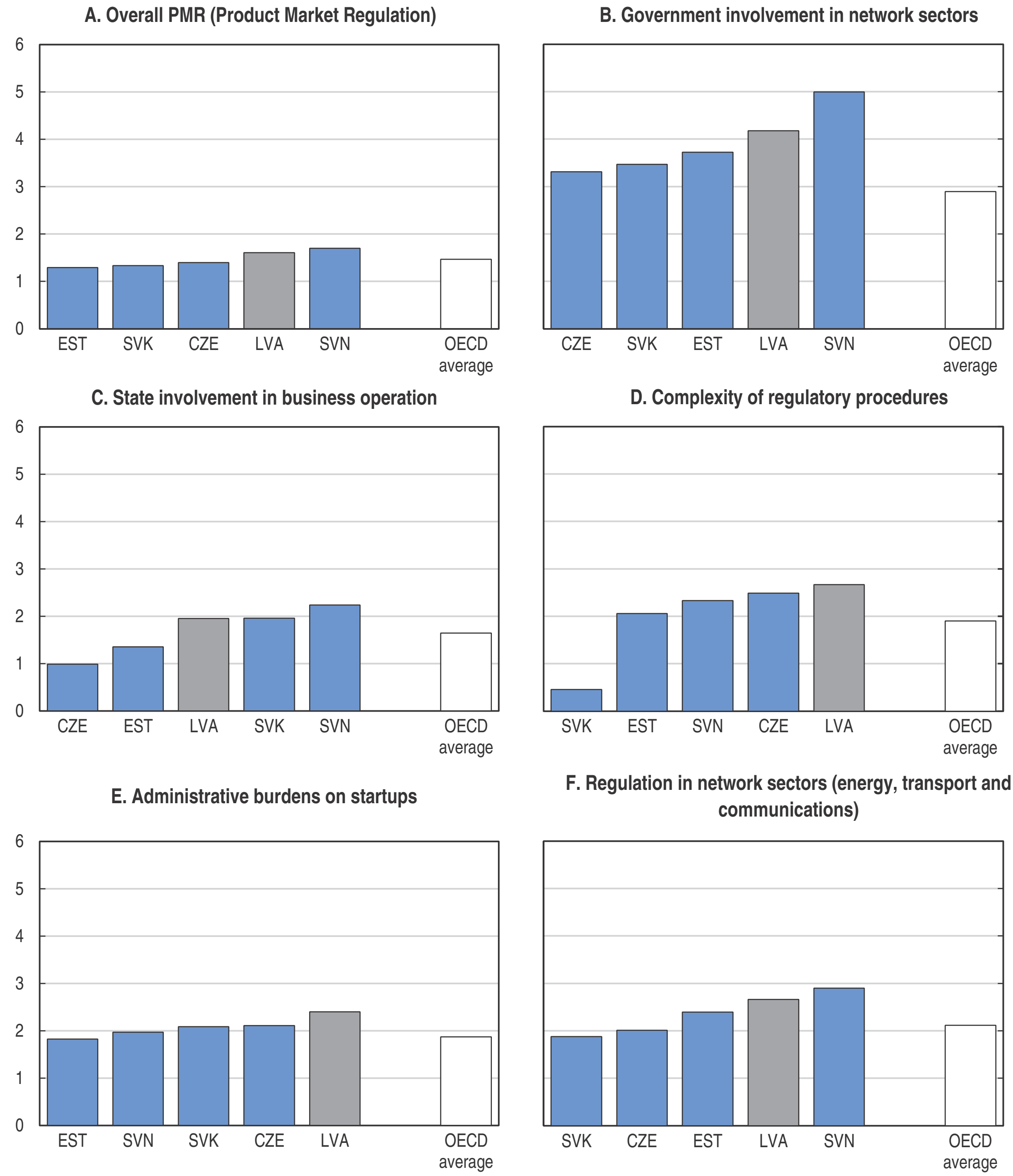
Latvia's score in the OECD's Product Market Regulation indicator (PMR), which measures *de jure* restrictiveness of regulation in terms of pro-competitive stance, stands above the OECD average – an uncomfortable position for a small open economy (Koske et al, 2015, *forthcoming*). Sub-indicators of the PMR highlight burdensome barriers to entrepreneurship, trade and investment as well as price controls (Figure 2.5). According to OECD estimates a gradual alignment of product market regulations to best practices in a broad range on non-manufacturing sectors could boost aggregate labour productivity levels – and thereby potential GDP –by several per cent over a decade (Bouis and Duval, 2011).

Since the indicator was established, it has shown that many OECD countries strive to lower their regulatory burdens in an effort to promote favourable and competitive business environments. In Latvia, an annual exercise to identify burdensome legislation exists, where the public can signal such regulations and based on this an action plan for the following year is prepared and reported on regularly in the government but this does not necessarily have competition concerns at heart. The PMR scores indicate further scope for improving the existing regulation in line with best practices by streamlining licenses and permits, removing compulsory chamber memberships in professional services, and reducing the complexity of regulatory procedures (Figure 2.6).

Other indicators assessing business environment point further to specific areas where red tape can pose obstacles to entrepreneurship. In the overall global perspective of business environment, Latvia ranks 23th in the World Bank's ease of "Doing Business 2015"

Figure 2.6. **There is scope to make regulation more pro-competitive**

2013, index scale of 0-6 from least to most restrictive



Source: OECD, Product Market Regulation Database.

StatLink http://dx.doi.org/10.1787/888933183933

behind Estonia (17th) and just above Lithuania (24th), with whom it ultimately competes for investment. Out of eleven areas covered in the ranking, Latvia stands out in terms of getting electricity and dealing with construction permits, both of which seem particularly cumbersome. The construction law has been reformed recently and now includes new time limits for issuance of construction permits.

Competition policy enforcement needs strengthening

Latvian competition framework is modelled on the EU competition rules (Box 2.2). This is also reflected in the OECD Competition Policy and Law Indicator, which measures *de facto* and *de jure* principles, and shows that the Latvian regime is in line with those of other EU members. This measure, however, does not attempt to describe all individual aspects of competition regimes (Alemani et al., 2013).

Box 2.2. **Latvian anti-trust framework**

The legislative framework has basic provisions on abuse of dominant position, restrictive agreements and mergers. A former Anti-monopoly office was turned into a Competition Council in 1998 and thereby gained expanded powers of enforcement and independence. Administratively, the Council falls under the Ministry of Economy and all its members and employees are public officials. It is headed by a chairman and two counsellors, who are confirmed by the government based on a recommendation by the ministry. Their mandate is five years and may be renewed.

Mergers – There is an obligation to notify the authority when the combined turnover is at least EUR 35 million or the combined share of all market participants concerned exceeds 40%; when there are three of more merging parties and/or in case of two merging parties the turnover of each exceeds EUR 2.134 million. A prohibition of the merger is conditional on a positive finding in either i) creation or strengthening of a dominant position or ii) substantial lessening of competition. The use of market share based thresholds is inconsistent with principles promoted by OECD Recommendations on merger review and a pending amendment would eliminate this, bringing Latvia in-line with international best practices.

Anti-competitive agreements – These include direct or indirect price or tariff fixing, restrictions on volumes of production or sales, markets, development, allocation of markets, territory etc., participation or non-participation in tenders or auctions (except for publically announced joint tenders) application of discriminatory conditions to equivalent transactions to third parties. Cartel as such is not defined in the law but it refers to horizontal cartel agreements.

The existing leniency programme has been introduced in 2004 and recently strengthened by introducing so-called 'leniency plus' by reducing the fine for a cartel participant who submits evidence on yet undisclosed cartel. The level of immunity differs according to the speed at which participants approach the Council, with the first applicant receiving a full immunity, the second a fine reduction of 30% to 50% and all other subsequent participants in the range of 20-30%. The burden of information provision is also differentiated accordingly.

Abuse of dominant position – Abusive conduct includes refusal to enter into transactions with other market participants, restriction of the amount of production or sale of goods, direct or indirect imposition or application of unfair purchase or selling prices or other unfair trading provisions. Fines can go up to 5% of the net turnover of a market participant, if the subject fails to comply, the fine can be increased up to 10%. The Council has a possibility of structural remedies, but these have been used only rarely.

Criminalisation of offenses – In general, infringement is not a criminal offense, but quasi-criminal sanctions may be imposed on an executive of a company for failing to comply with a decision of the Competition Council requests (imprisonment up to two months, community service, fine) so far have not been applied. In 2008, in addition to the general provisions on abuse of market dominance a concept of dominance in retail trade has been introduced that includes an exhaustive list of what is considered as an abuse.

The Competition Council has some 40 employees, half of them deal directly with the caseload. It is relatively active with around 40 investigations initiated in 2013, half of which related to mergers cases and other half to cartels and anti-competitive agreements. Cartels in procurement (bid rigging) have received a significant attention in recent years. To enhance the authority's effectiveness a cartel unit and an IT and economic data analysis unit were created in 2014. This should allow a concentration of expertise and production of large scale data analysis for market and sector studies to identify regulatory failures and competition abuses. The Council carries out regular market studies, in particular into the sectors with traditional monopolies, such as post, gas, electricity and rail. In 2013, only two of these actually resulted in uncovering anti-competitive practices.

Nevertheless, high activity is not reflected in the size of the sanctions. Generally, fines have been below the law's upper limit (10% of turnover in cartel cases and 5% in case of restrictive agreements). To strengthen the deterrent effect there is scope for the Council to seek higher fines (OECD, 2015a *forthcoming*). Compliance with the fines has been an issue in the past, as appeals delay the obligation to pay, but a proposed amendment of the competition law will introduce a possibility to secure the payment and reach legal successors of the firms (in cases where legal form of the firms has changed). The lack of strongly deterrent sanctions is not compensated by private enforcement. The law contains few provisions for private enforcement and a right to bring action in private litigation does not depend on the priori finding of a violation by the Council. Like in many other European countries, private litigation cases have been rare. Currently, one such case is pending before the Supreme Court (OECD, 2015a *forthcoming*).

Though the Council is independent in its decision, the government can in fact interfere indirectly in the everyday business as well as in the nominations for the top management. This is possible because the council and its staff are governed by rules and regulations of civil servants, one of which stipulates that any civil servant can be transferred at any time from one post to another within the administration. Indeed, this has already happened, when the government by-passed the open selection process for the members of the top management placing a civil servant instead.

An amendment to the competition law in the Parliament will, when approved, give the Council more leeway to prioritize cases, focus resources on investigating infringements and seize assets of those unlikely to pay imposed fines. The amendment will also move away from so-called market share notification threshold to focus on the turnover – it proposes compulsory merger notification when i) a combined turnover of all concerned exceeds EUR 30 million ii) turnover of at least two merging parties exceeds EUR 1.5 million or iii) in the health-care sector, turnover of two parties exceeds EUR 300 000.

Eliminating the market share-based threshold will bring Latvian competition law in-line with international best practices, though the new thresholds might be higher than in comparable EU jurisdictions. Improving fine collection will strengthen the enforcement, while prioritisation should lead to more efficient use of the Council resources. An earlier proposal for amending the competition legislation aimed at an administrative separation of the council from the Ministry of Economics, giving the Council also a greater financial independence. The proposal restricted the right to remove council members and increased transparency of nomination of the council members involving the Parliament in the selection process. Nevertheless, these changes have been dropped. To strengthen the oversight and enforcement of the competition policy and secure full independence, the Competition Council should be given more functional and financial independence.

A level playing field is not in place everywhere

State-owned enterprises as well those owned by the municipalities have been involved in competition abuse. There is a substantial presence of public entities in potentially competitive markets. This often reflects issues related to strategic considerations (i.e. geographical security concerns). However, when competition is impaired by public involvement in market activities, there is a high risk of resource allocation becoming inefficient. Additional negative effects include a higher-than-otherwise tax burden to finance often enterprises with only a soft budget constraint (further reducing allocative efficiency) as well as reduced innovation incentives (reducing dynamic efficiency) (OECD, 2004).

Public involvement is considerable in network sectors, most notably in the electricity sector, postal services, the national air-carrier *AirBaltic,* fixed and mobile phone operators and railway transport (Table 2.1). Over 6% of total dependent employment is in SOEs – one of the highest shares in the OECD. In principle, public involvement reduces new entry incentives and is particularly problematic where there are dominating incumbents.

Table 2.1. **Large Latvian state owned enterprises**

	Annual turnover (2012, million USD)	Number of employees (2012)
Latvenergo (energy)	1 414	4 457
Latvijas dzelzcels (railways)	629	12 289
Airbaltic (airline)	336	1 302
Latvijas Valsts Meži (forestry)	335	1 234
Lattelecom (telecoms)	277	2 113

Source: Government of Latvia, DAF/CA/SOPP (2014)2/REV1.

To avoid these negative effects, measures to secure a level playing field for all market participants and potential entrants have to be in place. This requires that state-owned enterprises (SOEs) be subject to standard business corporate governance practices and transparency, for which the international standard is set by the *OECD Guidelines on Corporate Governance of State-Owned Enterprises*. In Latvia, the SOE framework has many shortcomings (OECD, 2015b, *forthcoming*). The state ownership and other functions of the SOEs are blurred, which limits shareholders' ability to properly manage the companies and hold them accountable. Until 2012, there was no unified reporting obligations. Currently, the line ministries are obliged to prepare two reports on the SOEs under their management: one on past year's performance, another forward-looking on expected profitability and other financial indicators. Management nomination criteria and procedures were unified also only recently. Since 2009, boards of directors were abolished in most of SOEs and there is no independent body to nominate directors to the boards where they exist. The authorities themselves admit to a significant political influence over SOE governance and operational management (OECD, 2015b, *forthcoming*).

In many respects, Latvia had some of the best, but also some of the worst, corporate governance practices in SOEs in the region (Baltic Institute of Corporate Governance, 2012). Moreover, public perception was that the SOEs do not operate effectively and efficiently and equally well as private sector counterparts. The best ranked SOEs in the region (*Citadele Bank* and *Lattelecom)* scored well because of the presence of private shareholders that ensure adherence of the corporate governance standards including boards of directors.

A reform that came into force in January addresses a number of these shortcomings. A new coordination unit will be created, charged with financial and corporate governance oversight. Financial reporting of SOEs is to be enhanced and unified, including annual aggregate reporting. A nomination committee is to identify suitable candidates for supervisory boards and an open, fair and professional selection of the members of the boards is planned. An interactive website will assemble corporate governance practices and key performance indicators of the SOEs. This is welcome and implementation will now be key.

In some aspects, the authorities could go further. Reintroduction of boards of directors is planned only for the biggest SOEs and only in 2016. Earlier proposals included a regular re-assessment of the rationale and need for state ownership every five years and the nomination committee was originally planned as independent. Also, it will be important to observe an arm's length principle in related-party transactions of SOEs and adherence to strong financial reporting and auditing standards as most of the SOEs currently do not apply international financial reporting standards (OECD, 2015b, *forthcoming*). An ad hoc aggregate report on the SOEs in 2009 benchmarked the financial performance of the Latvian companies to its regional peers – both SOE and private – across various sectors and this should be continued. Municipalities are becoming increasingly involved in competitive markets, for instance waste management and public transport. Moreover, port authorities, public institutions of its own specific status, are not covered by the reform at all despite having been singled out for non-transparent management practices as well. It is therefore important that also other public entities observe similar standards as the SOEs.

Network sectors are dominated by public sector incumbents

While it is generally up to the competition authority to ensure enforcement of the competition law, the state – given its presence in a number of sectors of the economy – also has an *ex ante* role to play in avoiding distortions to competition, especially where it dominates. This is the case in many network sectors in Latvia. Much of the network liberalisation has been driven by EU-wide initiatives and legislation. In some sectors, such as electricity and telecommunication, market opening is more advanced than in others. Nevertheless, networks remain fairly concentrated, vertically integrated and within public ownership (Karnitis and Virtmanis, 2011). Such an environment underlines the importance of efficient regulation and oversight.

Regulation of the network sectors is concentrated in one integrated regulator, the Public Utilities Commission (PUC), which was established in 2001. The Commission approves tariffs in a number of the state-dominated sectors and sets compensations for universal service obligations: telecommunications, energy, post and rail. It is also tasked with the promotion of competition in the sectors under its regulatory powers. There have been a few cases of conflicting views between the Commission and the Competition Council, whereby the Commission approved tariffs that the Council later found breaching the competition law. A recent Supreme Court ruling on the judgement on the relationship of these two institutions seems to support the Council (OECD, 2015a, *forthcoming*).

Similarly to the Council, the Commission falls formally under the Ministry of Economy. Staffed with just over 100 employees, it is run by 5 commissioners nominated by the Parliament. Its functional independence is established by the law and funding comes from a state levy set on all network providers, approved by the Parliament. The Commission's employees fall under the general civil servants regulations and pay-scale, limiting human resources management and possibilities to attract expert staff (PUC, 2011).

Energy. The electricity sector has been liberalised and legally unbundled, but remains vertically concentrated and dominated by the incumbent, state owned *Latvenergo*. Most of the distribution is carried out by a subsidiary and 10 independent distribution system operators. The transmission grid operator was separated from the incumbent in 2012 and is managed by the Ministry of Finance. More than 200 licences for electricity generation have been granted, but *Latvenergo* continues to dominate the market share over 80%. There are active 11 electricity traders (although over 60 have registered). The Estonian electricity incumbent, Eesti Energia, is Latvenego's biggest competitor in the wholesale segment.

Since 2013 the country has been linked to the Nord Pool Spot, a trading platform of power exchange owned by the Nordic and Baltic transmission system operators. Business customers and households that chose to become voluntarily market participants have been able to choose an electricity supplier since 2007 and full liberalisation of the household market has happened this year. This is reflected in the prices households paid in the first half of 2014, which both pre- and post-tax were one of the lowest in the OECD. Some estimates show that the retail prices are actually below those of the wholesale energy costs, resulting in negative mark-up prices, potentially detrimental to competition (ACER/CEER, 2014). Meanwhile, the Latvian businesses pay more than its neighbours connected to the Nord Pool Spot trading platform (Figure 2.7, Panel A). This can be mainly explained by insufficient transmission capacity and limited connectivity.

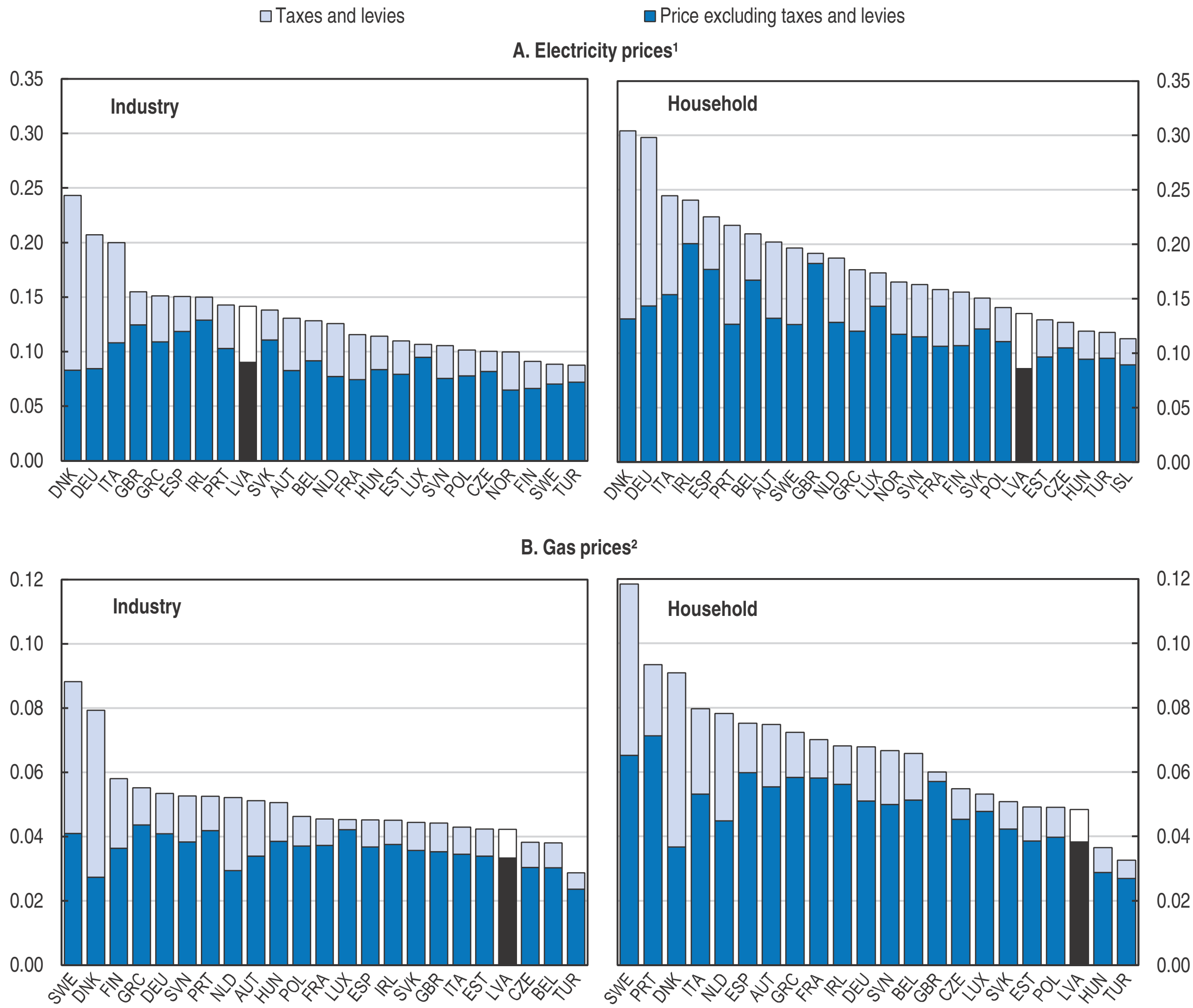
The natural gas market is a vertically integrated monopoly. Prospects of market liberalisation are complicated by the fact the pipelines are currently connected directly and indirectly (via neighbouring countries) to Russia only. The privatisation of the state incumbent (*Latvijas Gaze*) in the late 1990's included exclusive rights to transmission, distribution and to the only existing storage facility (*Inculakns)* until 2017. While gas consumption has been falling steadily over recent years, it still represents about 28% of energy consumption, and is used mainly in district heating and electricity production. The Latvian consumers pay one of the lowest prices in the OECD (Figure 2.7, Panel B).

EU-driven liberalisation of the gas market is in progress. Third party access to the distribution, transmission systems and a storage facility has been legally possible as of 2014. However, unbundling of the transmission system operator will only be completed in 2017, raising the issue of securing non-discriminatory access to essential facilities with natural monopoly characteristics. A current law allows for earlier liberalisation if a connection with an EU member state other than Estonia, Lithuania or Finland (all of which are also heavily dependent on natural gas supply from Russia) is established; or if the share of the main supplier decreases below 75%. This would be possible by diversifying gas supply to another storage facility (such as a floating terminal installed recently by Lithuania) or supplier. In absence of such options, customers will have a right to choose a supplier only in 2017.

Such environment is conducive to abuse of dominant positions and prone to allocation of excessive rents to the incumbent. In the absence of ownership unbundling, tariffs for access to the infrastructure (both in the electricity and gas sectors) could become an issue. Also, it can pose issues in terms of ensuring that appropriate level of investment is maintained into the infrastructure. The Competition Council fined *Latvijas Gaze* in 2013 for abusing dominant market position. In more than 500 instances the company refused to sign new gas supply contracts unless the outstanding debts of previous tenants were paid. Securing non-discriminatory access to essential facilities is crucial to ensure better

Figure 2.7. **More competition is needed in energy markets**

Electricity and gas prices, Euros per KWh, first half 2014



1. Annual consumption: for industry, 500 MWh < consumption < 2 000 MWh; for households, 2 500 kWh < consumption < 5 000 kWh.
2. Annual consumption: for industry, 10 000 GJ < consumption < 100 000 GJ; for households, 20 GJ < consumption < 200 GJ.
Source: Eurostat database.

StatLink http://dx.doi.org/10.1787/888933183948

functioning markets. In addition, structural measures such as establishing adequate infrastructure connections with the neighbours are need to promote competition in both electricity and gas markets. Should on-going breaches of competition rules be linked to a vertically integrated market structure, and regulation alone proves inefficient, ownership unbundling should be considered.

Telecommunications. A modern competitive telecommunication market is an important service industry for a small open export-oriented economy. The Latvian market was liberalised only in 2003 and the most notable success has been in the mobile phone segment, where there are now four main operators, one of which is still partly owned by the state (*Latvian Mobile Telephone*). The mobile subscription penetration rate is the highest in the EU, with more than two subscriptions per capita. Opening up the fixed-line market has been slower. Fixed-line voice services are still provided mainly by the majority state-owned incumbent *Lattelecom* (with around 80% share of the market) which is also responsible for universal service coverage. The level of termination rates has been a concern, both in fixed and mobile networks and the rates setting methodology has been criticised by the European Commission. A recent revision of the methodology should lead to lower rates in the future (OECD, 2015a, *forthcoming*).

In the internet provision services, *Lattelecom* is the largest player, but with only about 20% of the market. A plethora of smaller internet providers offer various means of new technologies such optical networks, co-location and cable TV. A relatively high share of households (40%) is covered by high speed broadband connection (i.e. above 30Mb/s) and others have access via much slower mobile services. This reflects the digital divide, in terms of coverage and access to telecommunication services, between the capital Riga and rural areas.

Standard fixed-line broadband coverage of rural areas is among the lowest in the EU, with only 44% of the rural population being covered. Moreover, the infrastructure outside the capital is not suitable for broadband services, partly reflecting that such provision is not economically viable and there is thus a lack of private investment. This has led the authorities to launch a publically-funded development plan for the next-generation network in rural areas. Currently, the public TV and radio provider is establishing a new network through which almost 200 local broadband connection points (so-called middle mile) across regions will allow for third party access by summer 2015. Additional 300 access points are to be built by 2020.

The postal market has been opened to competition since 2013 and by the end of that year 7 new entrants processed some 11% of postal items. Almost 50 operators are active and focus on relatively more profitable packages (PUC, 2013). Despite a steady decrease in market concentration, the former incumbent, *Latvijas Pasts*, remains dominant in the letters market but has only 4% of the parcel market. There are no plans to privatise the company and it has been allotted as a provider of the universal service for the next five years. The rationale for state ownership because of remote rural area is weak as private providers can be mandated to cover these areas by universal service obligation subsidised by the budget.

Retail sector. In inherently competitive sectors, such as retail, reforms have been successful in securing competitive markets. The regulatory burden in retail is generally low. A pre-crisis analysis of the grocery market showed that despite two leading retailers having more than 50% of the market the sector can be considered competitive (Paalzow and Vanags, 2007). Most retail trade is dominated by large and medium-sized shops and the downturn has led to further consolidation in the sector. The Competition Council has investigated the retail segment a number of times but no significant abuse of dominant positions or other breach of competition has been identified.

Nevertheless, some barriers to entry, such as licenses and permits, remain. In particular, the pharmacy sector is subject to a sector-specific regulation. Currently, there are quota for the number of pharmacies and subsidiaries based on a number of inhabitants. This regulation also restricts the geographical distance. In urban areas the distance between the pharmacies cannot be less than 500m; in rural areas this is limited to 5km. This regulation hinders new market entry and should be repealed.

The judiciary is receiving deserved attention

A large body of empirical evidence emphasises the importance of well-functioning judiciary for competition, firm growth, investment and specialisation (Palumbo et al., 2013). The World Economic Forum's Global Competitiveness Report puts Latvia's efficiency of legal framework in settling disputes at 117th out of 148 countries. The Latvian judiciary system has been identified as weak by various other institutions and studies too (EC, 2014; IMF, 2014). In particular, litigation of civil and commercial cases took a long time (in 2010, on average 330 days) though there have been improvements more recently. Meanwhile, there is evidence of diverse, inconsistent and unpredictable application of law, lack of specialised courts and judges in business disputes, abuse of insolvency proceedings (Deloitte, 2012).

A number of changes are under way. The resources allocated to the judiciary increased during 2008-12 (CEPEJ, 2014). All court decisions are now publically available on the internet. Judicial districts are undergoing reorganisation and court presidents have been given a bigger role in managing the processing time of cases. An evaluation of judges is due to be completed in 2016, based on criteria for competence, moral qualities, professionalism and efficiency. Such evaluations will then be carried out every five years and linked to the participation of judges in training. An e-justice programme, in cooperation with Switzerland, has been launched. The programme is introducing videoconferencing and audio recordings of hearings, an internet portal giving public access to judgements and decisions and electronic submissions to the courts (European Commission for the Efficiency of Justice, 2013).

These steps are starting to bear fruit as the length of proceedings and clearance rates have been improving since 2008. In 2012 and 2013 the number of considered cases was above that of received. Yet, more recently, the clearance rates for civil and commercial cases seem to be stalling (OECD, 2015c, *forthcoming*). The authorities are considering further changes: for instance, creating five court centres, where various specialisations would be concentrated under one roof, which could bode well for building up expertise in particular fields.

Out-of-court settlements of business disputes, an alternative to overburdened court system, had been rare. A reform of arbitration courts entered into force in January tightening the qualification requirements that had been singled out as problematic in the past. Also, a new law on mediation came into force in June 2014. It will remain as an optional tool, but in certain fields, such as family law, it will be promoted. These measures aim at relieving some of the burden on the courts and are welcome. Notwithstanding these and the on-going implementation of reform of the judiciary, efforts to improve the court and out-of-court system need to continue.

The insolvency regime has been substantially streamlined

Debt restructuring and insolvency proceedings matter a great deal for efficient allocation of resources. In the Latvian context, this means dealing with a substantial debt overhang, both among corporates and households, a legacy of the easy financial conditions of the boom period. A number of studies find bankruptcy indicators are connected with economic efficiency. For instance, countries with more debtor-friendly bankruptcy codes have higher total factor productivity growth and better allocative efficiency (Bravo-Biosca et al., 2013), and technological adoption from abroad is slower in countries with more punishing bankruptcy regimes (Westmore, 2013).

Moreover, bankruptcy regimes that overly penalise failed entrepreneurs are likely to reduce their willingness to take risk, reducing business dynamism (Bravo-Biosca et al., 2013) while a lower costs of winding down a business makes it less likely that inefficient firms with low growth potential continue to operate. Two objectives need to be carefully balanced: creating the right entrepreneurial environment of a "second chance", and securing strong creditor rights. Both have an impact on the cost of and access to credit in an economy. According to World Bank's Doing Business indicators it takes about a year and a half to resolve a corporate insolvency in Latvia, slightly less than the OECD average. However, the recovery rate is low and the outcome is likely to be a piecemeal sale of the asset rather than maintaining the business (going concern).

The Latvian insolvency framework has undergone a substantial overhaul. Two major reforms were passed in 2008 and 2010 that simplified proceedings, improved accessibility, changed funding system of the insolvency proceedings and ensured that the tax legislation does not discourage effective debt-restructuring (Erbenova et al., 2011). Three main avenues for dealing with corporate insolvency exist. The first one allows for restructuring of business under so-called legal protection proceedings; the second is liquidation of the remaining assets. A third option is also possible: out-of-court legal protection proceedings. In fact, most debt restructuring now happens out-of-court and indeed outside these legal protection tools. In this vein, the authorities issued principles and guidelines for such cases. While these are well regarded by the financial sector, the debtors are less aware of their existence (World Bank, 2012).

Personal insolvency has also been reformed substantially. It can be initiated at a request of the debtor and consists of two steps: first, the non-exempt assets of the debtor are sold and proceeds distributed to the creditor; and second, a repayment plan is prepared and approved by the court. Debt discharge is based on income and the ability to pay the remaining obligations (Erbenova et al., 2011). The debt discharge period was shortened from three years to one and last year a walk-away clause for mortgages was introduced, allowing those unable to pay a collateralised mortgage to transfer ownership of the property to the bank in exchange for debt cancellation.

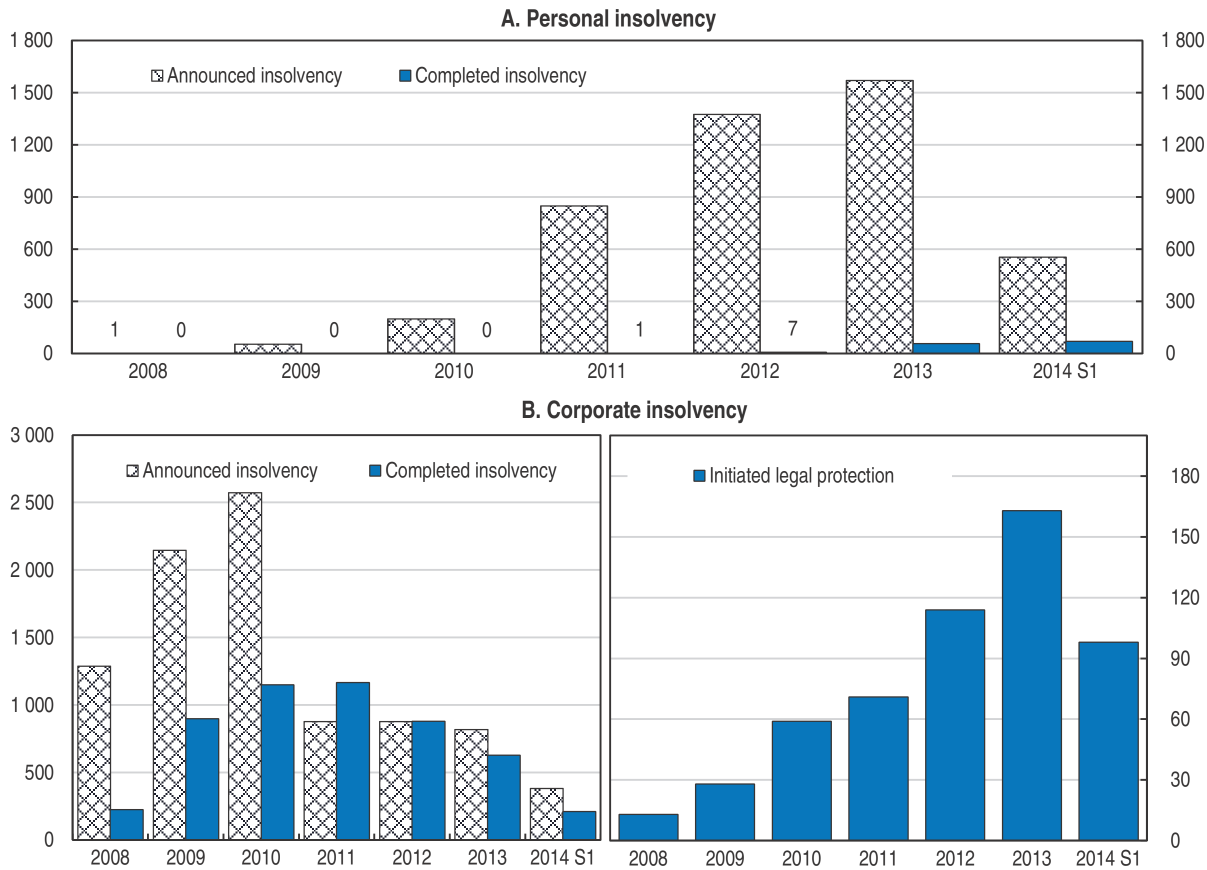
Both personal and corporate insolvency cases have risen, signalling improved functioning of the insolvency framework (Figure 2.8). A significant drop in the number of initiated cases is apparent on the corporate side, which could signal either improvement in the general economic environment and/or lower accessibility of due to the changes in the regulatory framework. In 2010, an insolvency deposit was introduced (double the minimum wage) when filing for insolvency of an enterprise. Restructuring has not proved very successful so far, with only a handful of completed legal protection proceedings ending in "full recovery" (Ministry of Justice, 2014).

The innovation framework has yet to deliver

Only about a third of local enterprises were innovative prior to the crisis, one of the lowest shares in the EU (Eurostat, 2013). Also, as noted above, the share of high-technology products in Latvian exports is small. Latvian businesses and researchers lag behind the regional peers in terms of patenting and commercialisation of research and the country lags behind also on other conditions for science, technology and innovation (Cunska et al., 2013). In particular, overall spending on research and development both in terms of public and private expenditure is low and the authorities have an ambitious goal

Figure 2.8. **Insolvency proceedings have become more accessible**

Numbers of proceedings



Source: Latvian authorities.

StatLink http://dx.doi.org/10.1787/888933183959

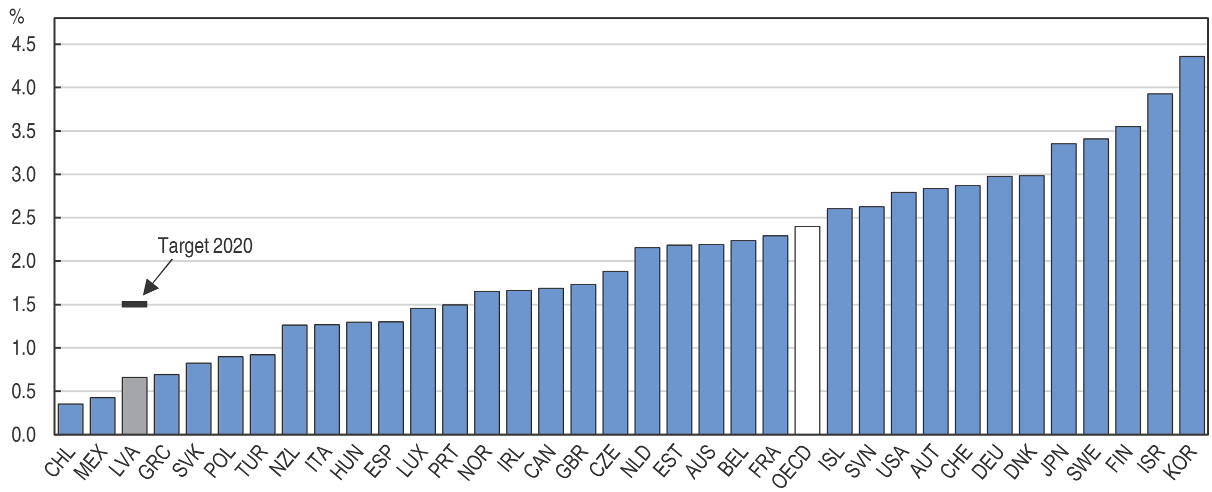
of more than doubling the spending, from current 0.6% of GDP to 1.5% of GDP by 2020 (Figure 2.9).

The current policy mix consists of both direct and indirect support measures. Two tax incentives are in place. Under the first one, taxable income can be reduced by one and a half times the cost of purchased new production technology equipment (capital cost). This tax incentive has been available since 2006 and is popular. It is used mainly by manufacturing and energy sectors, and had an estimated fiscal impact of EUR 30 million per year during 2008-12. Under the second tax incentive, 150% of the purchase costs of intangible assets could be deducted from the taxable income. So far, this instrument has been used only by few companies. In response, the authorities have recently made the second tax incentive significantly more flexible and generous (scaling it up to 300% of the cost of intangible assets with no cap).

Estimates of the private 'R&D price elasticity' to policy measures imply a significant impact of such measures, but only in the long-term (Bloom et al., 2002) as the supply of scientists and engineers is not sufficiently elastic in the short-term. The Latvian incentive scheme allows for the purchase of R&D services anywhere in the EU or the EEA, which could partly address the issue of shortage of skilled employees in the domestic market.

Figure 2.9. **R&D expenditure is among the lowest compared with OECD countries**

Gross domestic expenditure on R&D, % of GDP, 2012 or latest year available



Note: 2011 for Iceland, New Zealand and Mexico. 2010 for Australia. 2008 for Switzerland.
Source: OECD Main Science and Technology Indicators database and Eurostat database.

StatLink http://dx.doi.org/10.1787/888933183711

While R&D fiscal incentives boost R&D expenditure, it is more difficult to establish a clear cut positive effect on productivity growth (Westmore, 2013). This could be attributed to a number of “distorting” impacts , such as increase in the price of R&D via higher wages of scientists as opposed to increase in volumes; re-labelling of existing non-R&D activities, etc. A way to hold these in check is to use incremental support such as tax incentives that apply to expenditures only above certain thresholds and to impose a cap on the eligible amount (Andrews and Criscuolo, 2013).

One of the unintended consequences of R&D tax incentives can be favouring of incumbents over young innovative firms. More generous R&D tax credits are associated with a less dynamic distribution of firm growth in R&D intensive sectors, thus disproportionately benefitting the slowest growing incumbent firms (Bravo-Biosca et al., 2012). Tax incentives that lack immediate cash refunds or carry-over provisions are less favourable to young firms (i.e. new market entrants), which do not typically make much profit in the early years of an R&D project and are therefore not able to benefit from the incentive at all. This can be addressed by a cash refund and carry-forward conditions, as is the case in Ireland, Netherlands and Spain. The current tax incentive in place contains a carry-forward option, which is welcome. The newly reformed tax incentives should be evaluated, also in view to reaching young firms.

A plethora of direct R&D support programmes is available, subsidized largely by EU structural funds, many of which focus on providing help to young start-ups. Six so-called Competence Centres have been established in the following sectors: pharmaceuticals and chemicals, wood, environment, bioenergy and biotechnologies, electrical and optical equipment, ICT, transport, and engineering. There are ten business incubators, eight technology transfer contact points, innovation vouchers for small and medium sized enterprises (SMEs), innovation and entrepreneur motivation trainings. Most of these have funding allocated up to 2017. These measures are welcome as recent OECD evidence finds that direct government support for private sector R&D is positively associated with business R&D spending (Westmore, 2013).

In principle, direct funding schemes allow governments to select activities with the highest marginal social returns. In reality, this is very difficult due to information asymmetries and rent-seeking behaviour. Therefore, it is important that allocation of such support is based on competitive, objective and transparent selection; for instance by involving independent international experts (Andrews and Criscuolo, 2013). By nature of the EU funding, evaluation is carried out based on general provisions (ex-ante, mid-term and ex-post). To ensure good value for money in the longer run, collection and ex-post full access to data should be available for academic researchers and independent evaluation agencies.

The sub-par patenting system may have contributed to the low research and innovation spending, particularly in the public sector. Only 32 patents were registered with the US Patents Office originating in Latvia over the period of 1995-2010, which is only a half of what has been registered from even smaller Estonia. Some attribute this to a sub-par legal framework for intellectual property rights (Cunska et al., 2013). Until 2010 intellectual property (IP) rights were assigned to the institution where an innovation was made, and when that institution was funded by the state, the rights was transferred to the state.

Such system may have given only little incentives for commercialisation of innovation and discouraged domestic research. In neighbouring Sweden and Finland, university employees can privately hold patent rights even if the research was publically funded (Cunska et al., 2013). The Latvian legislation has been amended in 2013 and the patent rights now stay with the research institution. The institution has now also the discretion to pass the rights on to the inventors. Various kinds of university intellectual property holding and management arrangements require extremely professional approach with top specialists and a long-term view (OECD, 2013b).

Industry-science links are vital for innovation and tend to be driven mainly by matching of university orientation to business needs (Box, 2009). More collaboration between private and public research entities is associated with stronger productivity growth for firms in R&D intensive sectors (Andrews and Criscuolo, 2013). Bar a few exceptions, the existing Latvian research activities are not very well connected to business needs. They are spread out over 150 research institutions and units with outdated infrastructure and an ageing workforce. An international independent evaluation of the scientific institutions revealed that only a fraction of them produces high-level research (Technopolis Group, 2014). Latvian research lags behind in terms of internationalisation, in particular when measured by the small number of scientific co-publications. Separation of teaching and research, originating from the Soviet set-up of the higher education system, is linked to unsatisfactory outcomes. Therefore, the authorities are moving away from this model. Brain drain and ageing of the scientific workforce highlight the need to improve overall human resources, skills and capacity building (OECD, 2014b). Other areas of policy focus include encouraging innovation in firms and entrepreneurship, reforming the public research system and strengthening the R&D capacity and infrastructure as well as improving the returns to and the impact of science.

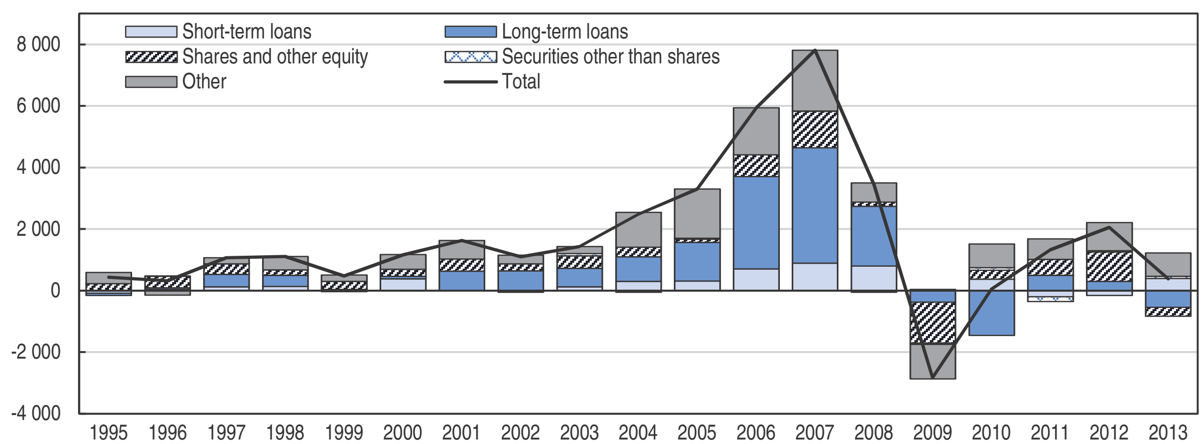
The authorities recently established a Research and Innovation Strategic Council under the direct supervision of the Prime Minister and are launching a structural reform (EC, 2014). This includes bringing research into the tertiary education sector and consolidating the existing research infrastructure, which is welcome and should go ahead. It is important that the reform also includes incentives for international cooperation as well as regular external evaluation. In this vein, Latvia should capitalize on its participation in the Baltic inter-ministerial expert group on research infrastructure and the Baltic-Nordic cooperation platform.

Access to finance could be improved

Despite underdeveloped financial markets, Latvia scores well in terms of access to finance for the business sector (EC, 2013; World Bank, 2013). Bank lending has been the predominant financing source and was amplified by relatively easy access to financing prior to 2009 (Figure 2.10). The enterprise sector has become highly leveraged. The recovery so far has been credit-less, which has been attributed to both demand and supply factors, with businesses still dealing with accumulated debt and banks significantly tightening lending standards (IMF, 2014). Risk aversion of the banks has increased, requiring more collateral and granting shorter maturity.

Figure 2.10. **Business financing relies on banks**

Structure of non-financial corporations' liabilities (net incurrence of liabilities, euro million)



Source: Eurostat database, Central Bank of Latvia.

StatLink http://dx.doi.org/10.1787/888933183967

Small and medium-sized enterprises are at the forefront of the banks' lending activities, while micro-enterprises have difficulty accessing credit. Loans are of short maturity, typically a maximum of six years. In addition to fixed-asset collateral, personal guarantees are often required, which banks have justified by lack of reliable and available information about creditors. A public credit information registry is run by the Bank of Latvia, with relatively high coverage rates in terms of population, but since it was created primarily for supervisory purposes, it does not function in the same way as credit bureaus in other countries, such as credit scoring or information from utilities and commercial non-licensed lenders (World Bank, 2012). A new law adopted last year allows for creation of standard credit bureaus that should improve information availability on creditors and thereby also access to finance.

Micro-finance institutions that could provide better for the numerous microenterprises are not active in the Latvian market and this segment is not seen as strategic by many commercial banks. Other forms of business financing, such as leasing, have shrunk significantly following the crisis; credit unions play a very small role in the financial sector and are restricted to credit provision to individuals. Potentially, the credit unions could be better suited for financing the micro-enterprises, which would however require changes in regulatory requirements and supervision (World Bank, 2012) and risks of such a move would have to be carefully considered.

The capital market in Riga is small, with few trades and listings. Currently some 30 companies are listed and capitalisation at just under 4% of GDP in 2012, down from 16% in 2005. The Riga stock exchange is part of the Baltic Nasdaq index, together with the stock markets of Estonia and Lithuania, offering harmonized and cost-effective packages of listings. Lack of liquidity has been attributed to both supply and demand factors: the absence of large private companies operating on the market and limited investor interest to investing in smaller companies (World Bank, 2012). On the demand side, a number of reasons for low demand for equity financing have been suggested, including wide-spread tax evasion, deliberate misreporting and bribery (Cunska et al., 2013). Nevertheless, the potential for further capital market development exists. Institutional investors include 27 state pension funds that as a result of on-going pension reform have increasing assets under management. The current pension funds regulation puts too much emphasis on short-term returns effectively restricting their investment horizon (World Bank, 2012).

Venture capital, one of the main alternative sources of financing, especially for high-growth firms wanting to diversify their funding, is available. Pre-crisis estimates of the venture capital market of around 0.3% of GDP (Laizans and Lace, 2009) placed Latvia above the regional average of 0.2% of GDP. The EU structural funds provided additional resources for this activity. Since 2005, several waves of funds were allocated to both domestic as well as international investors, conditioned on matching private capital, with varying degrees of success. A regional initiative led to the creation of the Baltic Investment Fund in 2012 with a planned capital of EUR 200 million to be invested over next 10 years. In addition, some EUR 2 million is available to early stage funding for high-tech companies. An effective use of these funds requires training and general information awareness both on the side of entrepreneurs and potential private investors in order to avoid sectoral capture (Avots et al., 2012).

Addressing barriers to trade and investment

Latvia has an open FDI regime, as reflected in the OECD *FDI Regulatory Restrictiveness* Index that is below the OECD average (OECD, 2016, *forthcoming*). There are no horizontal restrictions on FDI investment, with the exception of ownership of land in border areas, in protected areas, and of land containing mining deposits of state significance. In the field of inward direct investment, there are restrictions on agriculture and forestry, mining, air transport, gambling and lotteries, and security services.

OECD Trade Facilitation Indicators show that Latvia does better than the average on a number of them. Nevertheless, internal and external cooperation with the border agency seems problematic. This could be remedied by introducing a “single window” for customs related matters, enhancing cooperation and coordination of documents and physical border controls between various border agencies, speeding up clearance procedures for perishable goods and streamlining fees and charges (OECD, 2016, *forthcoming*).

The authorities, well aware of the importance of the shipping industry, have established in late 1990s two free ports and one special economic zone in the main port cities. Forty percent of Russian trade still passes through the Eastern Baltic Sea ports. Of the Latvian ports, Riga is the biggest. It deals primarily with dry bulk such as coal, rather than containers. Other important ports include Ventspils and Liepaja. Overall, Latvia ranks third in terms of goods handled per capita, right after Norway and Estonia, and it is estimated that up to 80% of this is transit goods. Companies located in the free ports and special economic zone can benefit from significant (80%) rebates on corporate income tax, withholding tax for dividends, management fees and payments for the use of intellectual property rights for non-residents. There is also zero value added tax on most goods and services purchased or exported, including the construction works. These favourable business conditions were recently extended up to 2035. Similar arrangements exist in ports of the other two Baltic countries.

Recent studies on the competitive position of Baltic ports highlight a number of shortcomings. While the Baltic ports overall are perceived as more flexible and have lower handling charges vis-à-vis Nordic ports, low transparency of decisions, lack of independence of port boards and weak collective accountability have been flagged (KPMG, 2013, World Bank, 2013). The three biggest ports are governed by three public authorities and supervised directly by the cabinet. State representatives at the boards of the ports are political appointees and have recently changed with the change of the ministers in the government. This echoes the lack of transparency in the governance of the SOEs, as highlighted earlier, and needs to be addressed.

Incentivising human capital accumulation

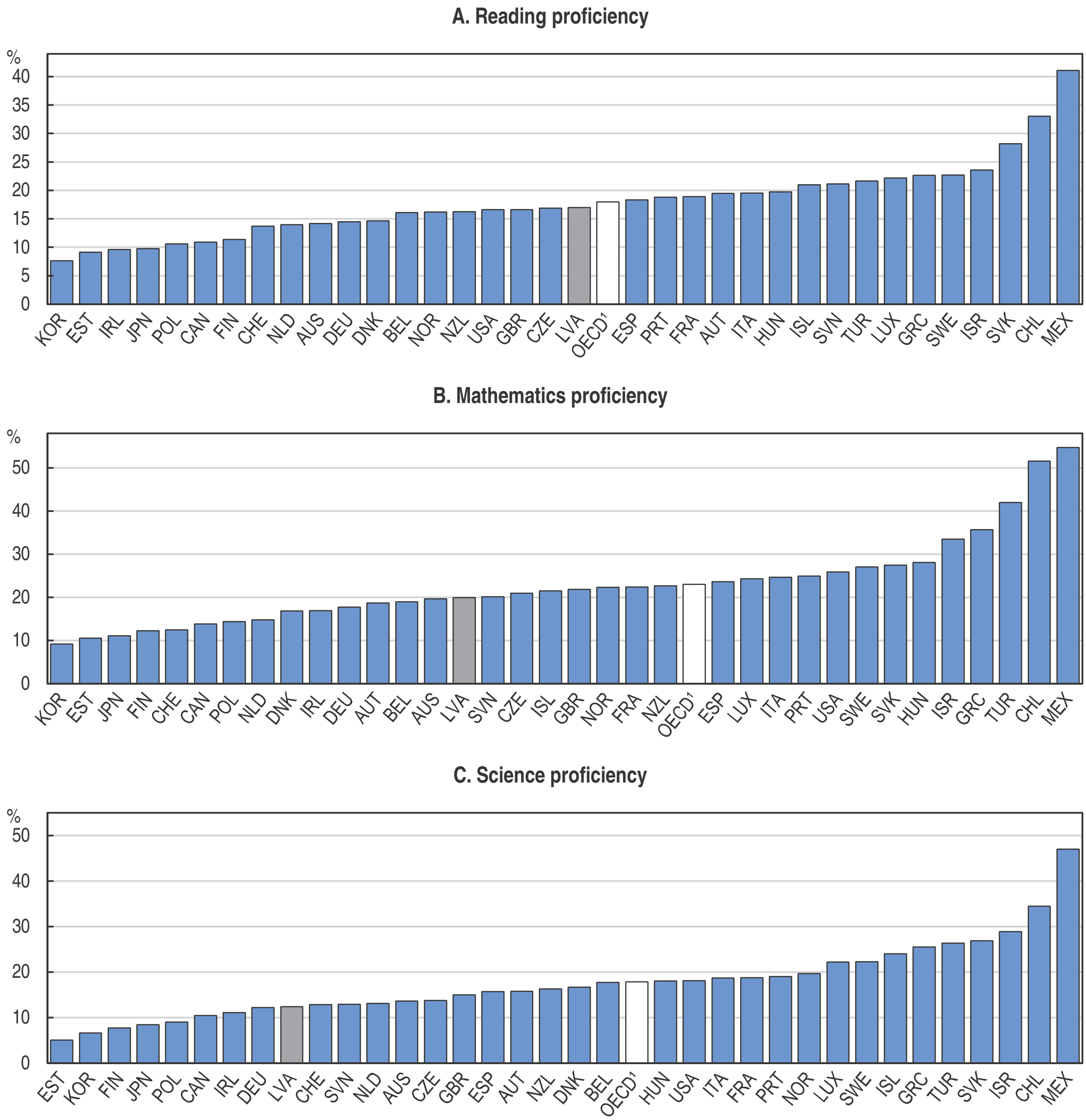
The Latvian workforce is well educated. About a third of the economically active population has tertiary education, a significant increase from about 20% ten years ago. The secondary education attainment is also high, 80% of the working age cohort has at least upper secondary education. The education system has undergone significant reforms during the transition and students perform relatively well. PISA outcomes are at or just below the OECD average and the share of students lacking basic skills (i.e. performing below proficiency level 2) is below the OECD average (Figure 2.11). Nevertheless, around 15% of the total population has only basic education and early school leavers, in particular boys, are a long-term policy issue.

Employment rates of those with tertiary education are high in comparison with top OECD performers. Yet, there is a considerable gap in employment rates of those with secondary and basic education (Figure 2.12). The gap is smaller for the younger cohorts, which can signal difficulties in maintaining appropriate skills once out of the education system but also that the younger cohorts have better labour market skills (given that the older cohorts acquired education under the centrally planned economy). The educational profile of the unemployed shows that vocational education and training (VET), professional and general secondary education graduates represent over 60% of the unemployed, those with basic education another 20%. Among the inactive those with only basic education dominate.

Notwithstanding the recent improvements in economic situation, the unemployment rate remains high (11%). A large part of it is structural. Various estimates of NAIRU remain elevated (10-13%) pointing to skills mismatch (IMF, 2014), though the degree of uncertainty of estimates of NAIRU in any catching up economy is high. For instance, a manufacturing specific survey found that 76% of employees face some kind of skills mismatch in their

Figure 2.11. **Share of students lacking basic skills**

Percentage of students at below level 2 of proficiency



1. OECD average.

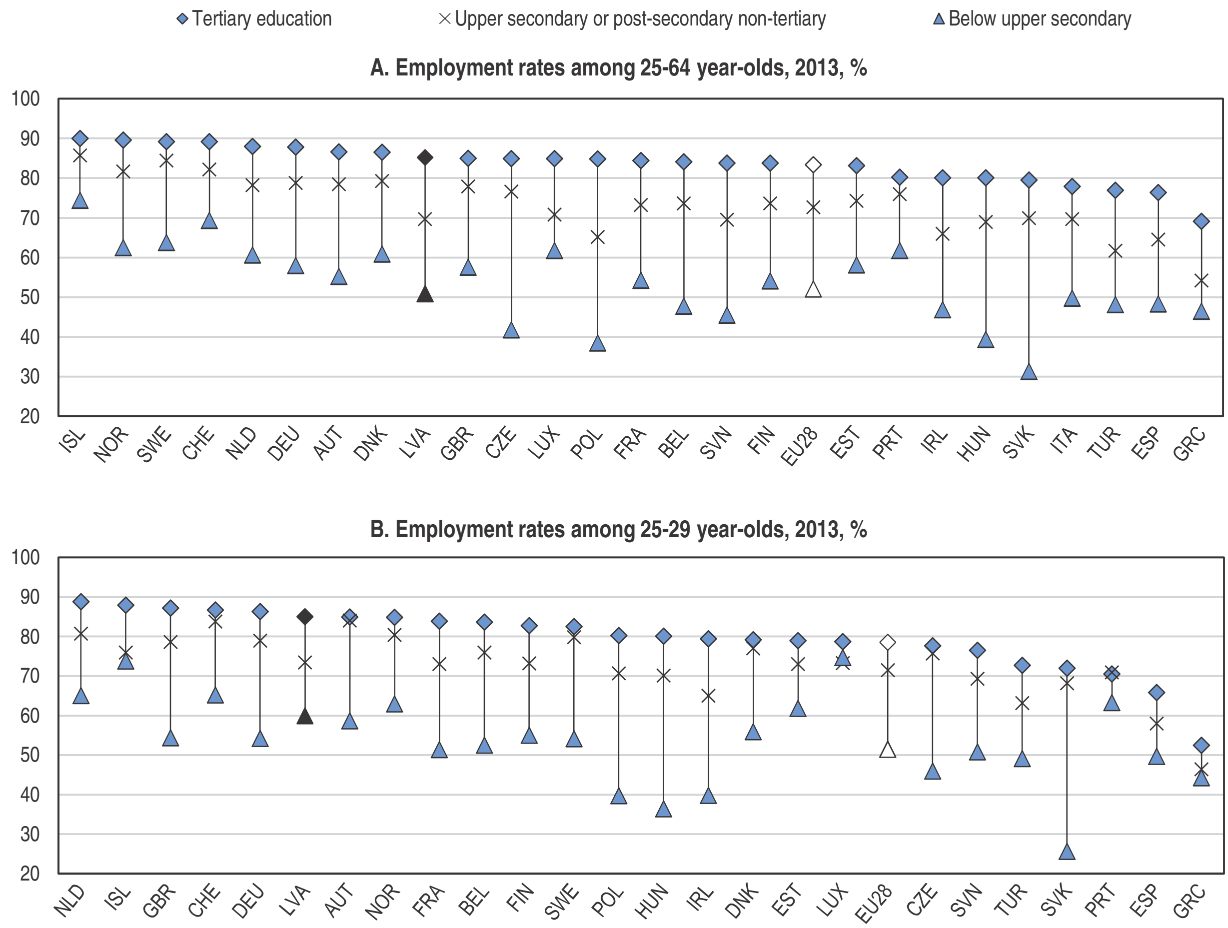
Source: OECD (2014), PISA 2012 Results: What Students Know and Can Do (Volume I, Revised edition, February 2014), Table I.4.1a, Table I.2.1b and Table I.5.1b.

StatLink http://dx.doi.org/10.1787/888933183974

current job and half of those lack skills (Purtins and Zumente, 2011). A large share of the Latvian labour force acquired its education under the Soviet regime. Given the low participation in lifelong learning, and persisting informality, many of the working-age population are missing the skills to become more productive.

Despite the elevated level of unemployment, tensions are emerging. The Latvian labour market is affected by significant emigration. Since the turn of the century, Latvia lost some 14% of the working age population in several waves of emigration (Hazans, 2012).

Figure 2.12. **The employment rates of those with lower education attainment lag behind top OECD performers**



Source: Eurostat database.

StatLink http://dx.doi.org/10.1787/888933183983

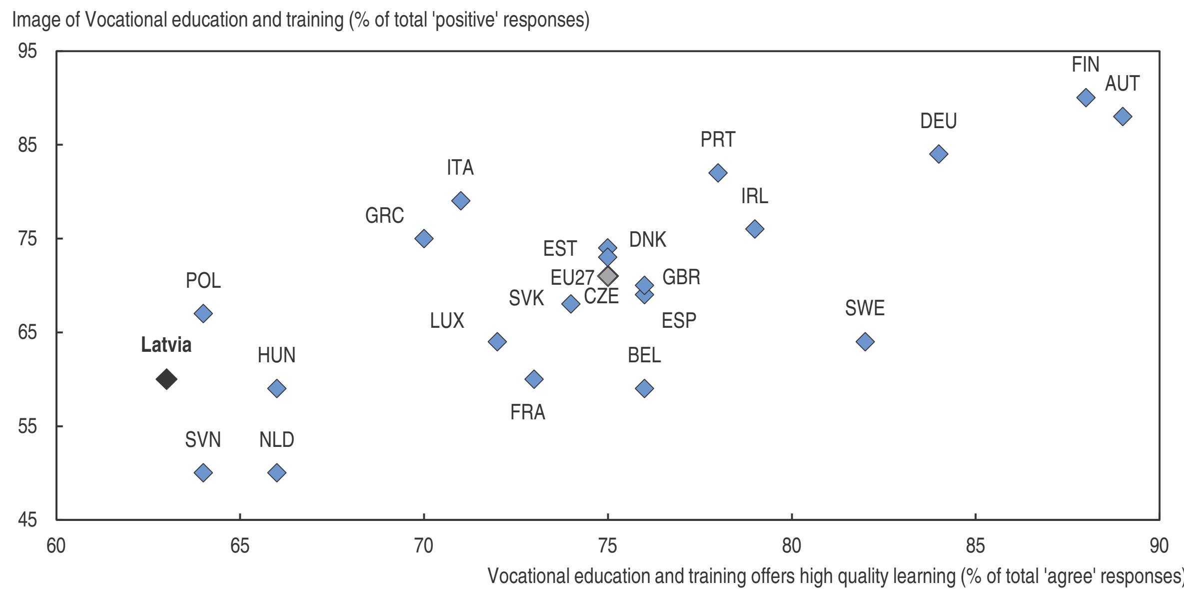
Over a half of the migrants were younger than 34 years at the time of departure. In terms of the educational structure, 60% of them had completed secondary and 24% tertiary education. During the 2008-13 the country has lost to migration some 8% of the total population and the emigrants have been disproportionately young and relatively well educated (OECD, 2013). While returning migrants have often higher productivity, only a few do return. Secondly, wage pressures are emerging: the quarterly average wage growth jumped by 7% at the beginning of last year, an acceleration from previous post-crisis years, when the wage growth was more moderate, at around 4%. This has been linked to an increase in the statutory minimum wage but also to emerging skills-mismatches in certain sectors as noted above.

Upgrading of vocational education and training is timely

Effective investment in youth skills will determine the capacity of countries to face various shocks and to get the most out of globalisation, technological changes and innovations. A well-performing school system is important for an effective transition from school to work and many countries have recently renewed their interest in VET as well as apprenticeship programmes (OECD, 2012). Across OECD countries for which data are available, 76% of individuals with vocational upper secondary or post-secondary non-tertiary qualification are employed. This is 5 percentage points higher than the rate for individuals with a general upper secondary education as their highest qualification.

The Latvian authorities aim for equal shares of students enrolled in vocational and general secondary education by 2020. This will be a challenging task as the current shares of VET to general secondary students stood at 39 to 61 in the school year 2012/2013. High enrolment rates in VET can be found in countries such as Austria, Belgium and the Czech Republic. To date, VET education has not had a particularly good image in Latvia. According to the 2011 Eurobarometer Survey, the share of those who thought that the VET offers high-quality learning was well below the EU average (Figure 2.13).

Figure 2.13. **Perceived vocational education and training image and quality**



Source: European Commission, Special Eurobarometer 369, "Attitudes towards vocational education and training", Report, September 2011.

StatLink http://dx.doi.org/10.1787/888933183998

A comprehensive reform of vocational education and training is under way. It involves all the stakeholders via 12 so-called Sector Expert Councils that comprise representatives of the government, employers and employees:

- Streamlining of the existing network of VET is under way, reducing the number of schools by a half and upgrading their equipment. Among these, 14 have received so-called competence centre status, as they met criteria such as a certain number of implemented programmes, the ability to provide adult education, career guidance etc. Based on cooperation between regional and sectoral stakeholders, the centres will offer re-training for both employed and unemployed, as well as career guidance and validation of non-formal and informal learning.
- Short and medium-term projections of labour market needs are being developed to feed into the national debate on composition of the education system.
- A pilot programme of work-based learning, following the German and Austrian models of VET, is currently under way in 6 VET schools with enrolment of over a hundred students. In the next school year this will be extended to 300-500 students, in order to

assess the feasibility of such system in the Latvian context. One of the potential hurdles can be a large share of micro-enterprises, with only limited resources or very specific skills needs but the pilot programme currently under way has already raised strong interest among employers. Pooling of apprenticeships could be considered such as done in Norway, where firms can share apprenticeship places.

- Last but not least, a voucher programme has been launched to encourage lifelong learning. Currently it is available for unemployed and those at risk of unemployment, i.e. over 45 years old and at risk of social exclusion. Over 8 000 have participated in the programme in 2014.

The reform covers many of the important features of a well-balanced skills strategy. In some areas, it could go even further. VET institutions are managed by four different ministries and local governments, although most of the schools fall under the responsibility of the Ministry of Education and Science. Appropriate coordination and national standards should be enforced. Modular programmes are being developed, which is welcome. It is important to offer a chance to enhance basic literacy and numeracy skills as well. To allow for up-grading skills of the employed, schedules of the programmes need to accommodate adults with work and home commitments.

Professional career guidance is not used very often (Eurobarometer, 2011). Career guidance has weaknesses in many OECD countries and its provision in the curricular varies widely (OECD, 2010). Often, those offering it are not adequately acquainted with labour market issues; at times it plays a subsidiary role to psychological counselling and is fragmented, being offered by various organisations with their own interest and priorities. In Latvia, career guidance is a shared responsibility of the State Employment Agency and the State Education Development Agency. A wider, advisory forum, the Cooperation Council for the Career System is also in place and the newly created competence centres are to play also a role of career-guidance. Partnership with employers and an independent base for supporting objective career guidance is important (OECD, 2010).

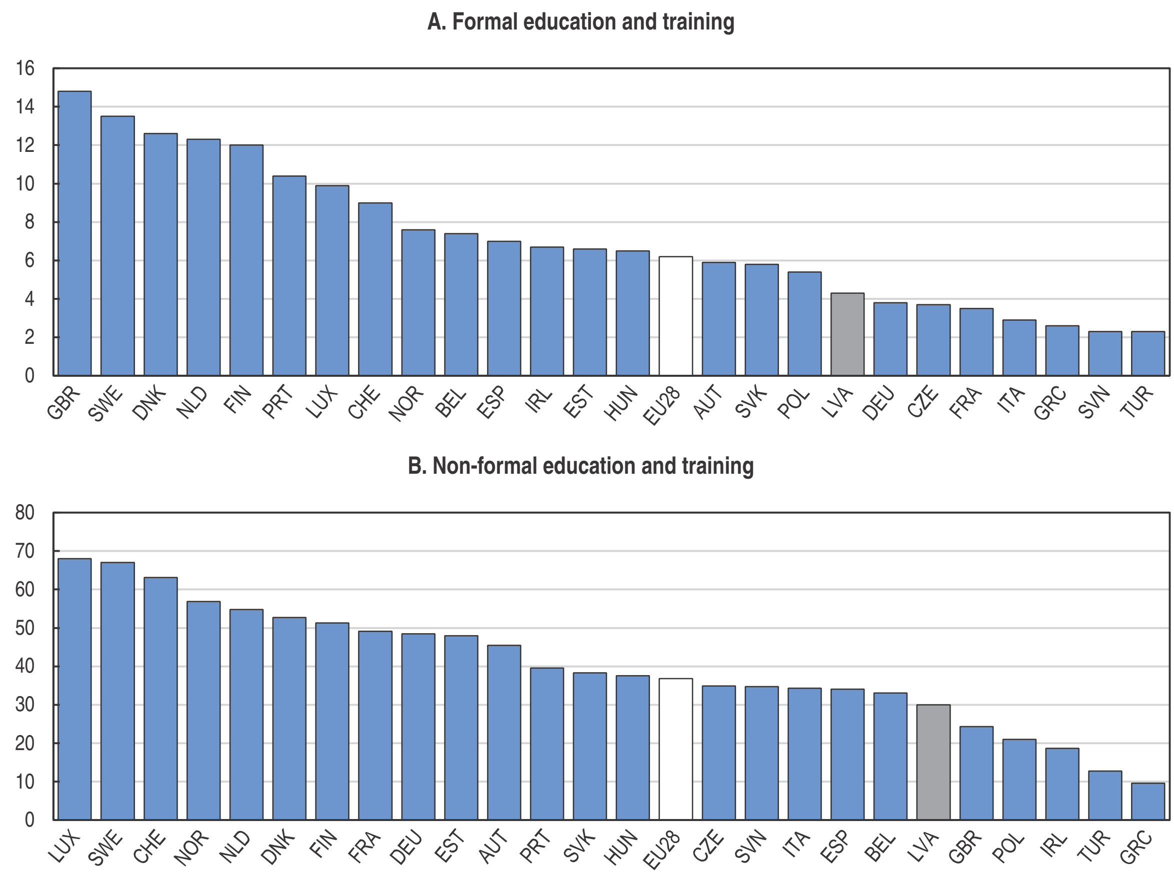
OECD (2010) recommendations stress the importance of career guidance as a separate and independent profession from psychological counselling as well as provision of adequate resources for pro-active delivery. Prior to the crisis extra funding from EU funds was available for development of teachers training and for guidance, but during the downturn this funding was stopped. Currently, schools can fund career guidance from the general government transfers for education, but it is not clear how much resources are actually spent. Mandating short internships towards the end of compulsory education could help increase focus on the issue.

Employee training and lifelong learning deserve attention

Lifelong learning is underdeveloped and the participation rates in both formal and non-formal forms of education and training of the working age population are low (Figure 2.14). Across the OECD some 40% of adults participate in formal and non-formal education and training and the proportion ranges widely from 60% in New Zealand and Sweden to 15% in Greece and Hungary. According to the results of the PIAAC survey, in most OECD countries, adults with already-high levels of literacy and numeracy are much likely to participate in further adult education and training. In combination with generally lower employment rates, this means that involving the low-skilled should be a priority (OECD, 2013c).

Figure 2.14. **Participation in lifelong learning is low**

Participation rate in formal or non-formal education and training, 25-64 years-olds, 2011, %



Note: Based on the adult education survey (AES). The reference period for AES is the 12 months before the interview. 2007 data for Turkey.
Source: Eurostat database.

StatLink http://dx.doi.org/10.1787/888933183705

Minorities were hit disproportionally by the downturn in terms of employment, suggesting that these groups should also be in the policy focus. This could be partly related to the uneven distribution of the unemployment rate across the country, being higher in the eastern part of the country with a larger proportion of minorities, nevertheless factors behind these outcomes have not yet been fully identified. A relatively lower educational level and the lack of Latvian language skills certainly play a role. Insufficient public supply of general and professionally oriented Latvian language courses for the adult population was identified as one of the barriers to better integration of the ethnic minorities (Hazans, 2011). Language training offered by the public employment service for the unemployed has been developed since 2012, as well as for those employed but at a risk of job-loss. Efforts to help minorities to acquire skills needed on the labour market should continue, combined with professionally-oriented Latvian language courses.

A tax deduction for training is available under the personal income tax and employers can include training costs as business expenditure. Given the light corporate taxation, tax incentives on the employers' side might not be desirable, not to mention the potential deadweight loss of such incentives. Evidence suggest that underinvestment in adult learning is often a result of barriers on the demand side (OECD, 2013b). While many are simply unaware of the need and benefits of continued learning, others face difficulties in terms of time due to work and family obligations. Affordability and return on investment into lifelong learning can also be an issue.

Labour unions as well as employers are currently involved in discussions of the occupational standard setting under the so-called Sector Expert Councils, part of the on-going VET reform. This is welcome as experience of countries like France, Finland and Germany shows that involvement of social partners is useful for designing the content of training and supervision of the provision (Bassanini et al., 2005).

Improving access to good quality education and preventing poor educational outcomes in the first place should support training and adult learning demand in the long run. Meanwhile, firms need to overcome various obstacles to investing in employee training such as time, workload pressures, resources and costs, and SMEs are much more likely to use informal rather than formal skills development (OECD, 2012). In the Latvian context of SMEs and micro-enterprises, policies should focus on incentives to formal training and recognition of informal skills development. The authorities have an important role to play in improving information about training opportunities, adult learning and ensuring the portability of skills. Similarly to the VET, policy responsibility for lifelong learning is fragmented: ten different institutions are in charge of implementing lifelong learning programmes. It is unclear whether in a small country such fragmentation is desirable and does not contribute to slow progress on implementing lifelong learning strategy. Responsibilities for the implementation of lifelong learning should be streamlined.

Recommendations to raise productivity and ensure robust convergence

- Carry out coordinated and regular assessment of productivity challenges as an input for regulatory reform.

Improving business environment

- Make regulation more competition-friendly by reducing entry barriers, for instance by repealing regulations hindering new market entry for pharmacies.
- Continue reducing red tape. Simplify the licenses and permits system, remove compulsory chamber memberships in professional services and reduce the complexity of regulatory procedures.
- Bring the governance of state-owned enterprises further in line with the OECD Guidelines on Corporate Governance of State-Owned Enterprises. Improve their management and transparency by implementing the recent reform, notably strong financial reporting and auditing standards.
- Strengthen the independence of the Competition Council and enforcement of competition policy, by giving it more financial and administrative autonomy. Ensure a level playing field, in sectors where state-owned enterprises continue to dominate.
- Continue improving the connectivity of energy networks with the rest of the European Union.
- Introduce boards of directors in all economically- oriented state-owned enterprises, together with a regular assessments of the rationale and need for state ownership.
- Extend corporate management best practices to port authorities and municipal corporations.
- Remove barriers to trade and investment such as restrictions on the ownership of agriculture and forestry land. Introduce a single window for customs related matters, speeding up cross–border paperwork.
- Continue with efforts to improve the court and out-of-court disputes settlement system.
- Explore the potential to improve the financing of micro-enterprises such as developing this function in the credit unions sector, which would require changes in regulatory requirements and supervision.

Recommendations to raise productivity and ensure robust convergence *(cont.)*

Fostering human capital accumulation

- Proceed with the reform of vocational education and training, including the planned extension of work-based learning. Pooling of apprenticeships, whereby firms can share apprenticeship places, could be considered.
- Encourage lifelong learning and training by improving information about training opportunities and adult learning, while ensuring the portability of skills.
- Continue helping minorities to acquire the skills needed on the labour market.
- Continue offering programmes enhancing basic literacy and numeracy skills in vocational education and training and lifelong learning.
- To facilitate the up-grading of skills among the employed, programme schedules need to accommodate adults with work and home commitments.
- Reduce the number of authorities managing the VET schools and streamline the responsibilities for the implementation of lifelong learning.

Fostering innovation

- Support the development of knowledge markets by providing firms with well-defined and high quality intellectual property rights.
- Consolidate the existing research infrastructure. Develop incentives to international cooperation in local research and innovation as well as a regular external evaluation exercise.
- Evaluate the newly reformed tax incentives for R&D, also in view to reaching young firms.

Bibliography

Agency for the Cooperation of Energy Regulators and Council of European Energy Regulators (ACER/CEER) (2014), Annual Report on the Results of Monitoring the Internal Electricity and natural Gas Markets in 2013, October 2014, Brussels.

Aghion P., N. Bloom, R. Blundell, R. Griffith, P. Howit (2001), “Competition and Innovation: An inverted-U relationship”, *Quarterly Journal of Economics*, Stanford University.

Alemani, E., et al. (2013), “New Indicators of Competition Law and Policy in 2013 for OECD and non-OECD Countries”, *OECD Economics Department Working Papers*, No. 1104, OECD Publishing.

Andrews, D. and C. Criscuolo (2013), “Knowledge-Based Capital, Innovation and Resource Allocation”, *OECD Economics Department Working Papers*, No. 1046, OECD Publishing.

Avots, K., R. Strenga, A. Paalzow (2012), Public venture capital in Latvia, Baltic Journal of Economics 13 (1), Stockholm School of Economics, Riga.

Bassanini A., A. Booth, G. Brunello, M. De Paola, E. Leuven (2005), “Workplace training in Europe”, *IZA Discussion Paper* No. 1640, June 2005.

Baltic Institute of Corporate Governance (BICG) (2012), *Governance of State-Owned Enterprises in the Baltic States*, *www.corporategovernance.lt/en/news/41*.

Benkovskis, K., (2012), Competitiveness of Latvia’s Exporters, *Working Papers 2012/03*, Latvijas Banka.

Bouis, R. and R. Duval (2011), “Raising Potential Growth After the Crisis: A Quantitative Assessment of the Potential Gains from Various Structural Reforms in the OECD Area and Beyond”, *OECD Economics Department Working Papers*, No. 835, OECD Publishing.

Box, S. (2009), OECD Work on innovation – a stocktaking of existing work, OECD Publishing.

Bravo-Biosca, A., C. Criscuolo and C. Menon (2012), “What Drives the Dynamics of Business Growth?”, OECD *Science, Technology and Industry Policy Papers*, No. 1, OECD Publishing.

Blanchard, O., M. Griffiths, B. Gruss (2013), Boom, Bust, Recovery Forensics of the Latvia Crisis, Final conference draft, 2013 brooking Panel on Economic Activity, Economic studies , Brookings Institution, Washington.

Bloom, M., and J. Van Reenen (2002), "Patents, Real Options and Firm Performance", The Economic Journal, 112 (March), C97-C116.

Competition Council (2012), Annual Report, Competition Council, Riga.

Competition Council (2013), Annual Report, Competition Council, Riga.

Cunska, Z., C. Ketels, A. Paalzow and A. Vanags, (2013), *Latvia Competiveness Report*, Stockholm School of Economics in Riga and Baltic International Centre for Economic Policy Studies.

Eichengreen B., D. Park, K. Shin (2013), "Growth slowdowns redux: New evidence on the middle-Income Trap", *NBER Working paper,* No. 18673.

Erbenova, M.,Y. Liu, M. Saxegaard, (2011), "Corporate and household debt distress in Latvia: Strengthening the incentives for market-based approach to debt restructuring", *IMF Working paper*.

Eurobarometer (2011), Attitudes towards vocational education and training, Special Eurobarometer 369, European Commission, Brussels.

European Commission for the Efficiency of Justice (2014), "Report on European judicial systems – Edition 2014 (2012 data): efficiency and quality of justice", Council of Europe, *www.coe.int/t/dghl/cooperation/cepej/evaluation/2014/Rapport_2014_en.pdf*.

Foreign Investors' Council in Latvia (FICIL) (2012), "Position Paper on Proposals for the Improvement of the Insolvency Process", Riga.

Government of Latvia (2012), *National Industrial Policy*, Riga.

Gordon, R. J. (2012): "Is the US economic growth over? Faltering Innovation confronts the six headwinds, Center for Economic Policy Research", September 2012, Insight No. 63.

Hazans, M. (2011), "Labour market integration of ethnic minorities in Latvia", in Kahanec, M. and Zimmermann K., F. (eds.), Ethnic Diversity in European Labour Markets: Challenges and solutions, Edward Elgar, London.

Hazans, M. (2012), "The Changing face of Latvian Emigration and the Changing face of Latvia", March 2012 presentation to the American Chamber of Commerce, Riga.

IMF, (2013), "Republic of Latvia: Selected Issues", *Country Report*, No 13/28. IMF, Washington.

IMF, (2014), Baltic Cluster Report: Selected Issues, IMF, Washington.

Johansson, Å., et al. (2013), "Long-Term Growth Scenarios", *OECD Economics Department Working Papers*, No. 1000, OECD Publishing.

Karnitis E., A. Virtmanis (2011), "Multi-sectoral Regulation of Services of General Economic Interest – Ten year Experience of Latvia", Public Utilities Commission, Riga 2011.

Koske, I., I.Wanner, R. Bitetti and O. Barbiero (2015), "The 2013 update of the OECD product market regulation indicators: policy insights for OECD and non-OECD countries", *OECD Economics Department Working Papers*, *forthcoming*.

KPMG, (2013), Competitive Position of the Baltic States Ports, KMPG Baltics.

Laizans, T. and N. Lace (2009), "Factors Affecting Venture Capital Development: Comparing Latvia and European Markets, RTU FEEM Scientific conference on economics and entrepreneurship", Conference proceedings, Riga.

Nicoletti, G., S. Scarpetta and O. Boylaud (2000), "Summary Indicators of Product Market Regulation with an Extension to Employment Protection Legislation", *OECD Economics Department Working Papers*, No. 226, OECD Publishing, *http://dx.doi.org/10.1787/215182844604*.

OECD (2010), *Off to a Good Start? Jobs for Youth*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264096127-en*.

OECD (2012a), *Lifelong Learning and Adults*, in OECD, Education Today 2013: The OECD Perspective, OECD Publishing.

OECD (2012b), *Better skills, Better Jobs, Better Lives: A strategic approach to skills policies*, OECD Publishing.

OECD (2013a), *International Migration Outlook 2013*, OECD Publishing.

OECD (2013b), *Education at a Glance 2013*, OECD Publishing, Paris.

OECD (2014), *OECD Science, Technology and Industry Outlook*, OECD Publishing.

OECD (2015a), *Accession Review: Competition Law and Policy in Latvia*, OECD Publishing, *forthcoming*.

OECD (2015b), *Review of Latvia's position relative to the OECD guidelines on corporate governance of state-owned enterprises*, OECD Publishing, *forthcoming*.

OECD (2015c), *Accession briefing note Latvia: an overview of public governance arrangements*, OECD Publishing, *forthcoming*.

OECD (2016), *Accession Examination of Latvia under the OECD Investment Instruments*, OECD Publishing, *forthcoming*.

Palumbo, G., et al. (2013), "The Economics of Civil Justice: New Cross-country Data and Empirics", *OECD Economics Department Working Papers*, No. 1060, OECD Publishing.

Paalzow A., A. Vanags (2007), Competition in the Latvian and Baltic Grocery Retail Markets, SEE Riga, BICEPS Occasional Paper No. 3, Riga.

Public Utilities Commission (2011), Annual Report, Riga.

Public Utilities Commission (2013), Annual Report, Riga.

Putrins, K., I. Zumente (2011), "Skills mismatch in Latvian manufacturing sector", *SEE Riga Student Research Papers*, 2011:7, (136).

Shekhar A., R. Duval, D. Puy, Y. Wu, L. Zhang (2013), "Growth slowdowns and the middle-income trap", *Working paper* No. 13/71, IMF, Washington.

Soms K.(2013), Industrial Policy: pros and cons. A literature review. *www.evf.lu.lv/fileadmin/user_upload/lu_portal/projekti/evf/konferences/konference_2013/report/4Session/Soms.pdf*.

Technopolis Group, (2014), Latvia – Innovation System Review and Research Assessment Exercise: Final Report, Riga. *http://izm.izm.gov.lv/upload_file/2014/Latvia-systems-review_2014.pdf*.

Westmore, B. (2013), "R&D, Patenting and Growth: The Role of Public Policy", *OECD Economics Department Working Papers*, No. 1047, OECD Publishing, *http://dx.doi.org/10.1787/5k46h2rfb4f3-en*.

World Bank (2014), *Doing Business Economy Profile: Latvia* (2014), Washington.

World Bank (2014), Review of the ports sector of Latvia: Competitiveness and Governance, Washington.

World Bank (2012) Financial Sector Assessment – Republic of Latvia, June 2012, Washington.

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a unique forum where governments work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The European Commission takes part in the work of the OECD.

OECD Publishing disseminates widely the results of the Organisation's statistics gathering and research on economic, social and environmental issues, as well as the conventions, guidelines and standards agreed by its members.

OECD PUBLISHING, 2, rue André-Pascal, 75775 PARIS CEDEX 16
(10 2015 04 1 P) ISBN 978-92-64-22845-0 – 2015

OECD Economic Surveys

LATVIA

SPECIAL FEATURES: IMPROVING PUBLIC SECTOR EFFICIENCY; RAISING PRODUCTIVITY

Most recent editions

Australia, December 2014
Austria, July 2013
Belgium, February 2015
Brazil, October 2013
Canada, June 2014
Chile, October 2013
China, March 2013
Colombia, January 2015
Czech Republic, March 2014
Denmark, January 2014
Estonia, January 2015
Euro area, April 2014
European Union, April 2014
Finland, February 2014
France, March 2013
Germany, May 2014
Greece, November 2013
Hungary, January 2014
Iceland, June 2013
India, November 2014
Indonesia, September 2012
Ireland, September 2013
Israel, December 2013
Italy, May 2013
Japan, April 2013
Korea, June 2014
Latvia, February 2015
Luxembourg, December 2012
Mexico, January 2015
Netherlands, April 2014
New Zealand, June 2013
Norway, March 2014
Poland, March 2014
Portugal, October 2014
Russian Federation, January 2014
Slovak Republic, November 2014
Slovenia, April 2013
South Africa, March 2013
Spain, September 2014
Sweden, December 2012
Switzerland, November 2013
Turkey, July 2014
United Kingdom, February 2015
United States, June 2014

Consult this publication on line at ***http://dx.doi.org/10.1787/9789264228467-en.***

This work is published on the OECD iLibrary, which gathers all OECD books, periodicals and statistical databases.
Visit ***www.oecd-ilibrary.org*** for more information.

Volume 2015/5
February 2015

OECD*publishing*
www.oecd.org/publishing

ISSN 0376-6438
2015 SUBSCRIPTION
(18 ISSUES)

ISBN 978-92-64-22845-0
10 2015 04 1 P

9 789264 228450