

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.



From:
OECD Economic Surveys: Latvia 2015

Access the complete publication at:
<https://doi.org/10.1787/9789264228467-en>

Please cite this chapter as:

OECD (2015), "Executive summary", in *OECD Economic Surveys: Latvia 2015*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/eco_surveys-lva-2015-2-en

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