Assessment and recommendations

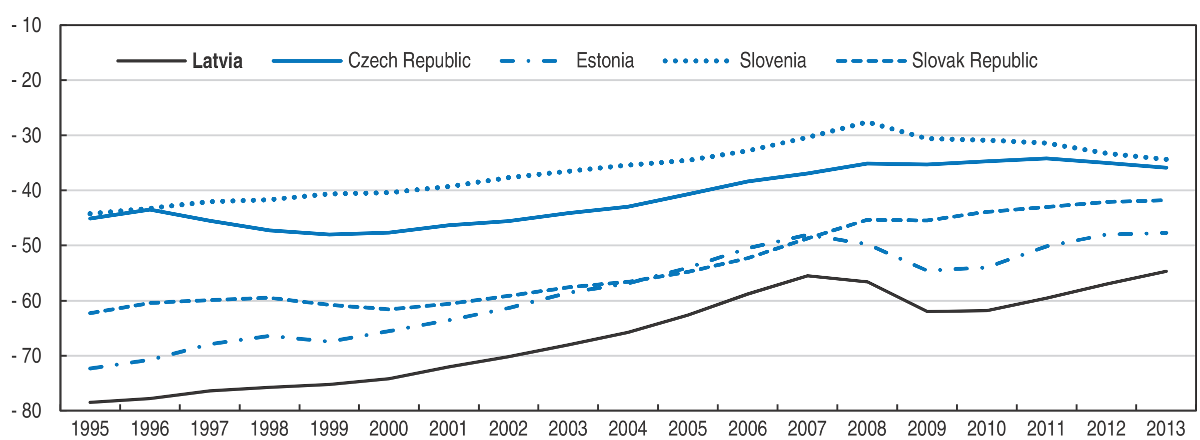
- *A volatile economy*
- *Strong recovery clouded by weakening regional prospects*
- *Limiting the risk of repeated boom and bust cycles*
- *Improving public sector efficiency for more inclusive growth*
- *Raising productivity and ensuring robust convergence*

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.

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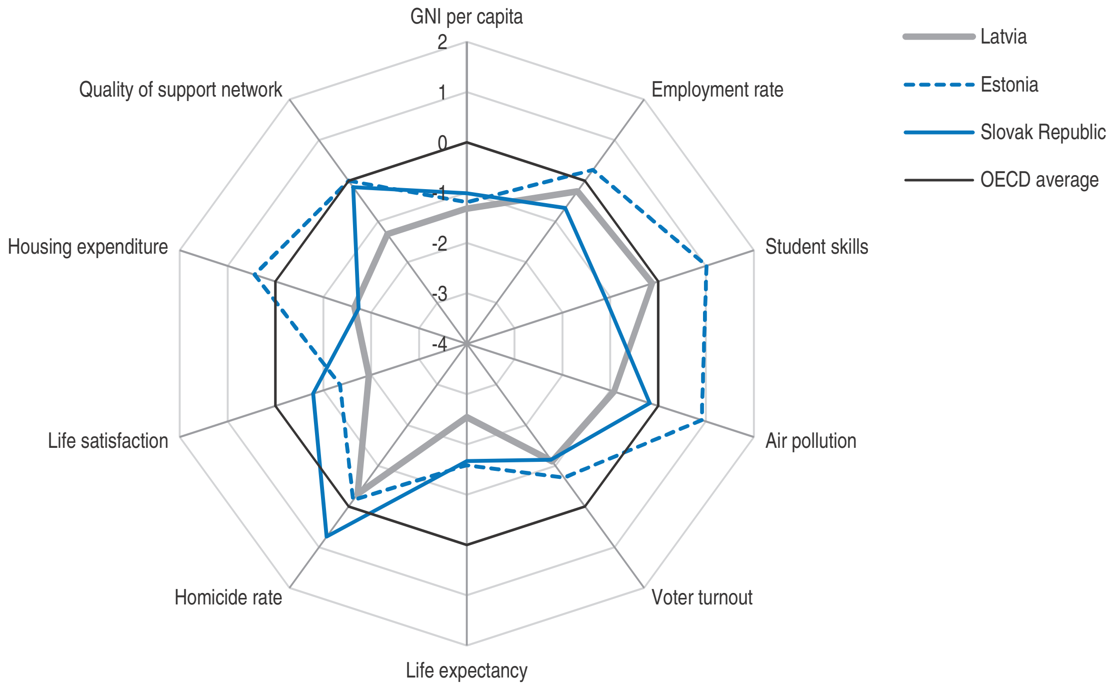
Figure 2. **Well-being indicators suggest a large scope for catching up**



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.

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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

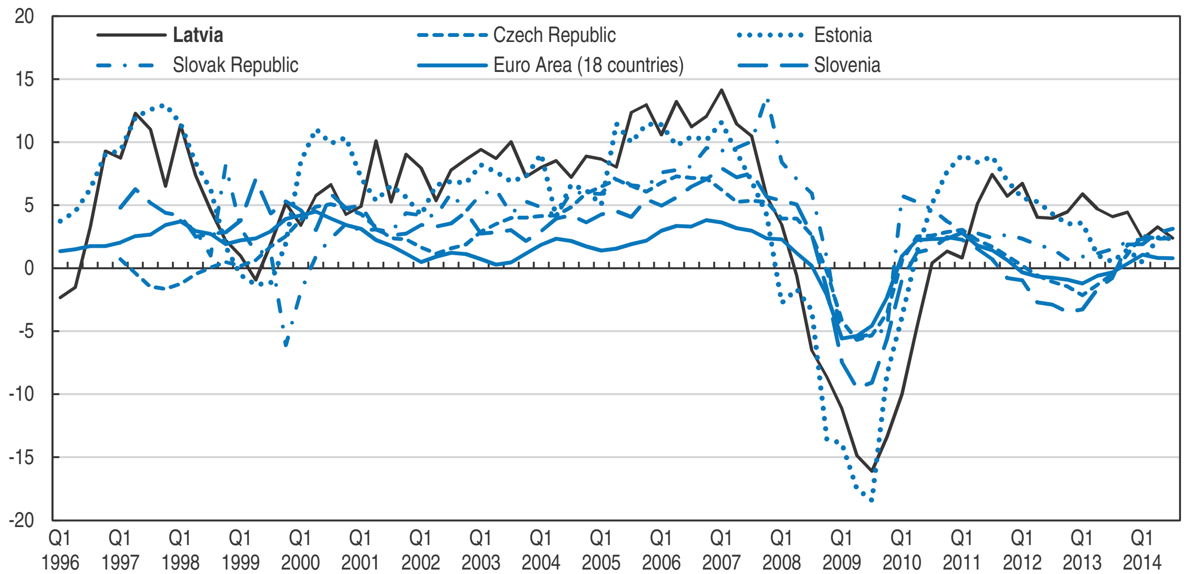
The economy is marked by high volatility (Figure 3). In recent years, Latvia passed through four major economic downturns: the collapse of the central planning system in 1991; the local banking crisis in 1995; spill-overs of the Russian financial crisis in 1998, and the most recent boom-bust episode 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.

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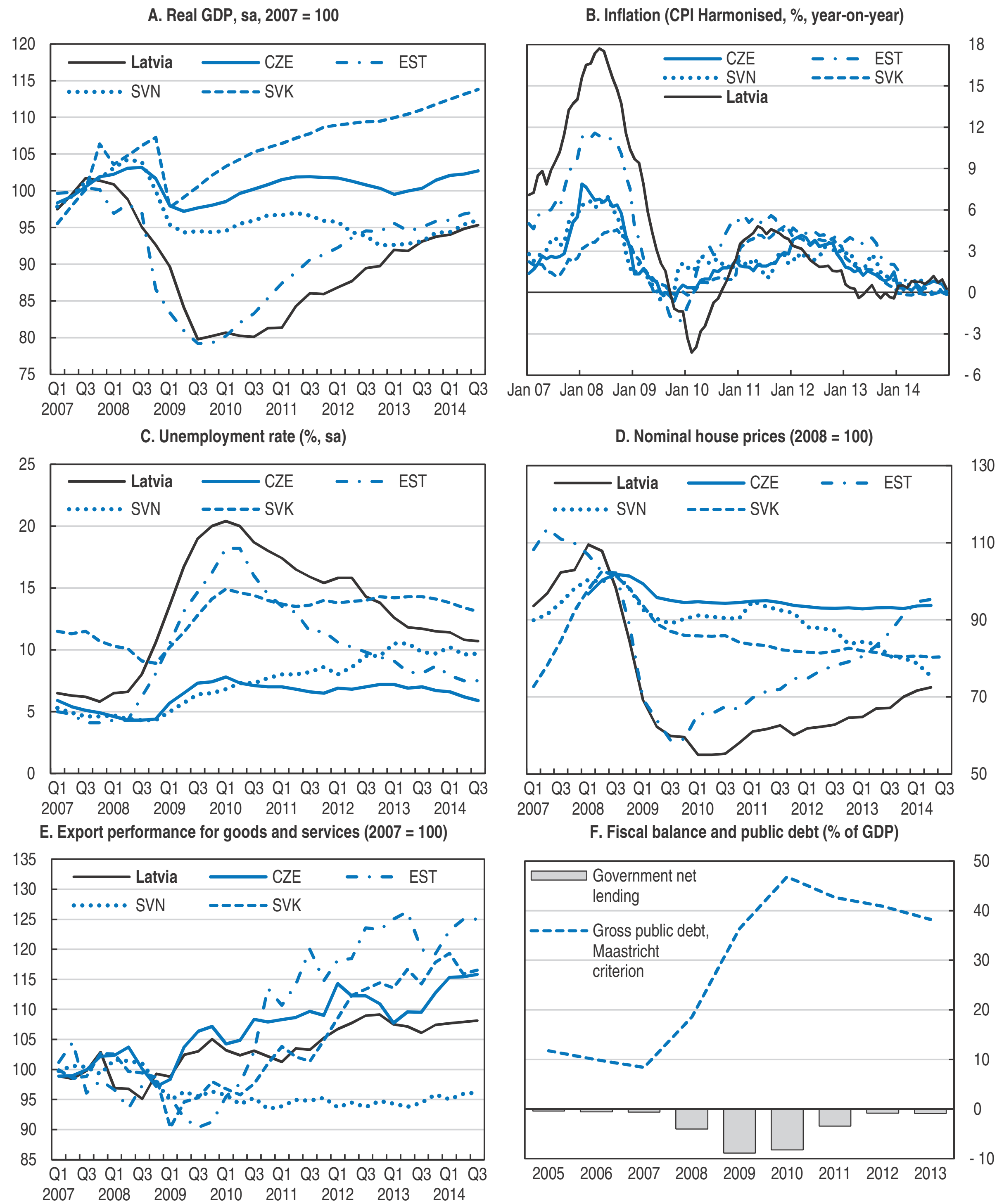
The adjustment has been rapid and impressive, but has come at a cost. Empirical studies suggest that high volatility reduces trend growth and welfare, notably by restraining investment in physical and human capital and raising economic insecurity (OECD, 2012). A significant part of the adjustment in 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.

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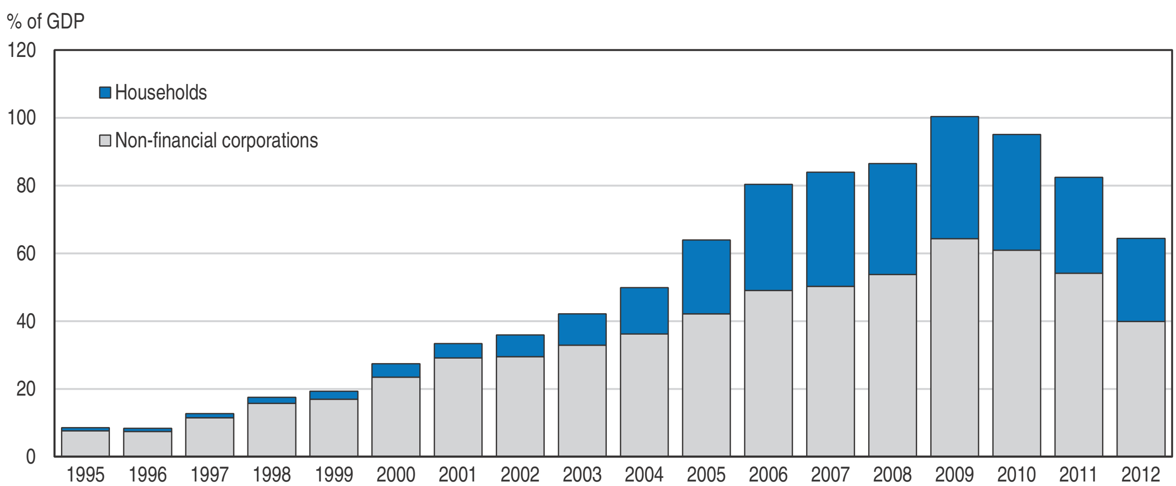
Increases in net wages, from low levels, amounting to around 5% on average over the past two years, supported household purchasing power. As the government deficit declined to below 1% of GDP and the Medium-Term Objective was reached, fiscal consolidation softened, decreasing the tax burden of households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

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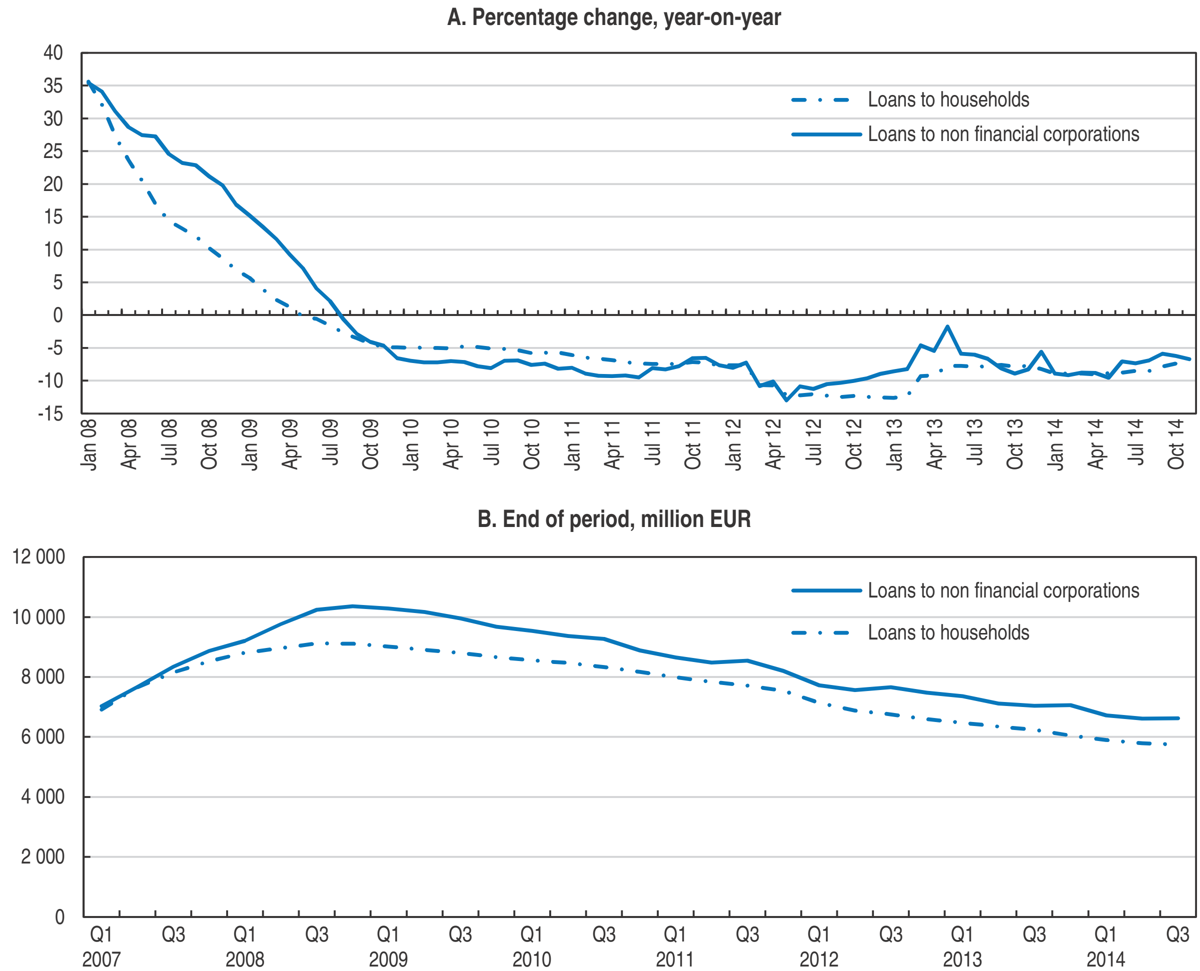
In 2014, economic growth slowed and is estimated to have fallen below 3% (Table 1). The deterioration of the global environment, in particular growing regional geopolitical tensions and their indirect impact on the outlook of the EU and Russia (which account respectively for around 70% and 10% of total 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.

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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.

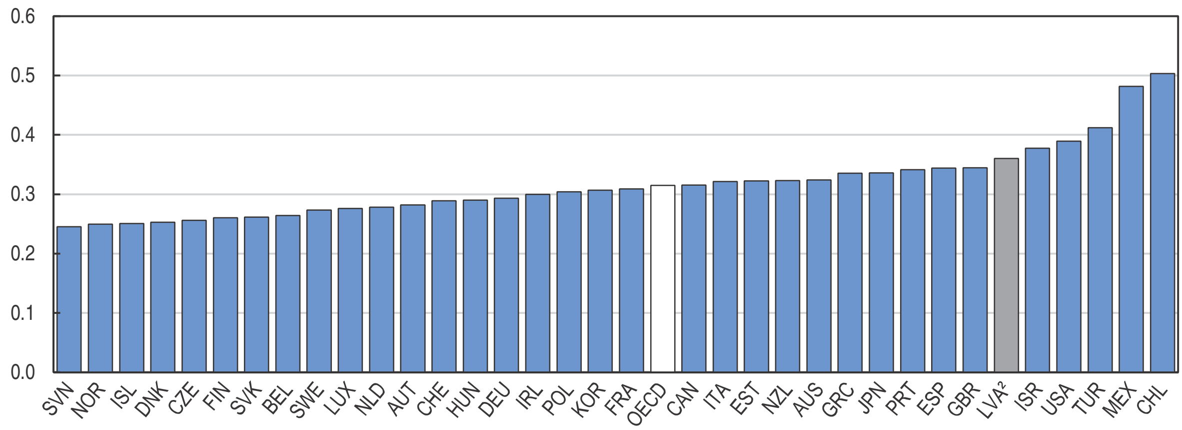
Improving public sector efficiency for more inclusive growth

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.

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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.

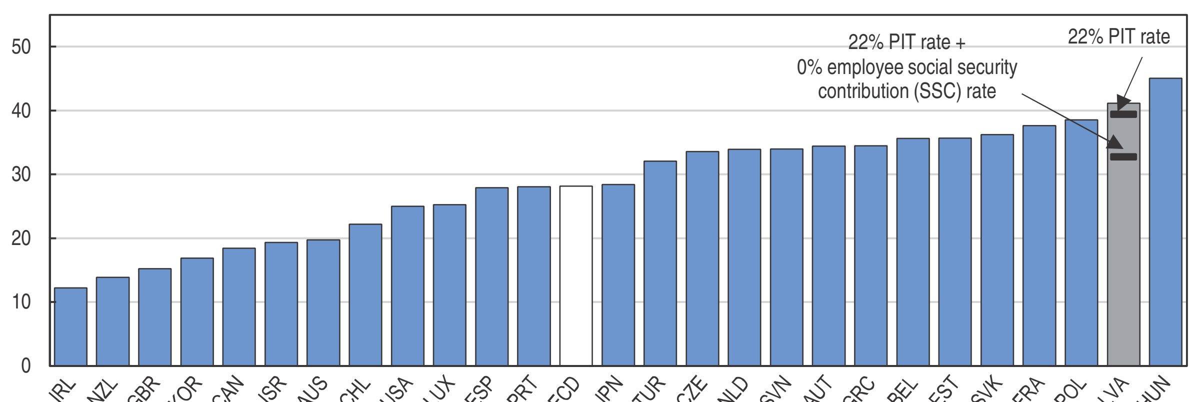
- Vocational and tertiary education needs to continuously improve in order to ensure it meets the requirements of a catching-up economy. Any efficiency-enhancing reforms will be difficult without far-reaching interventions, like implementing a new financing model that rewards quality and strengthens 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).

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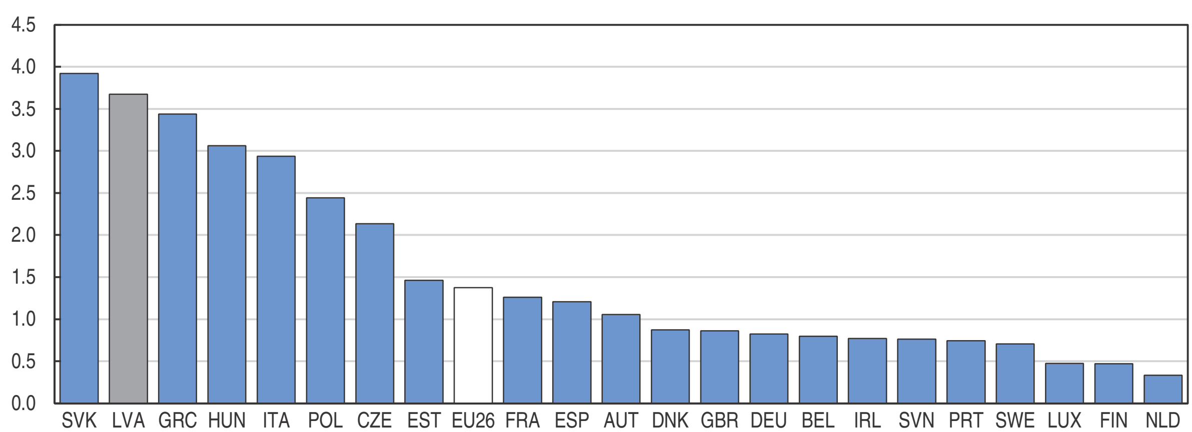
The tax wedge is one of the main factors behind the elevated structural unemployment rate in Latvia (IMF, 2014). The policy issue now is how to reduce the labour tax wedge further, in particular for low-income earners. In this vein, one possibility would be to decrease social security contributions on 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.

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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.

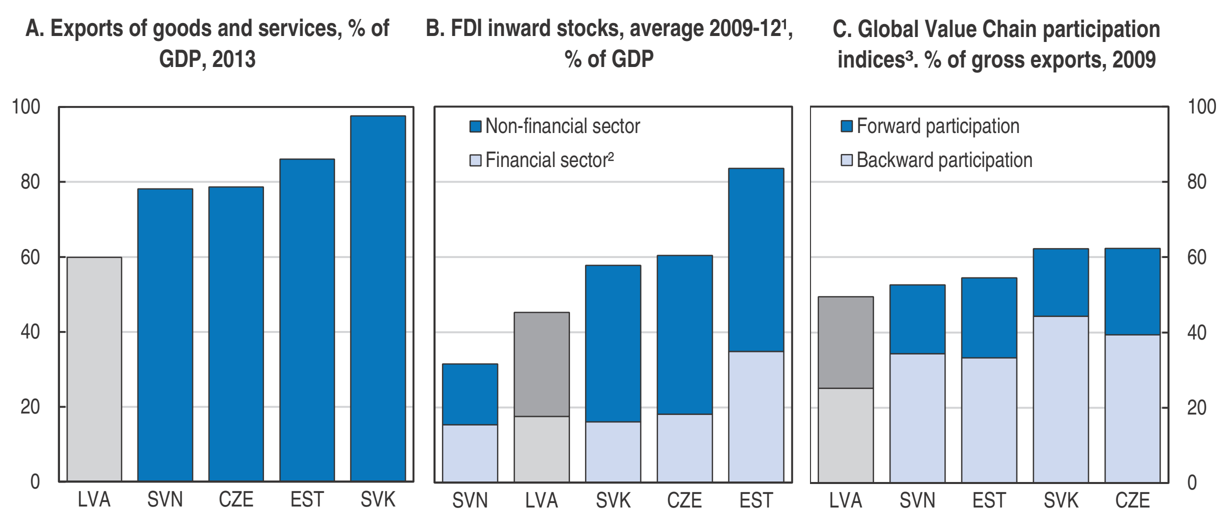
Other recommendations

- 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 world-wide 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.

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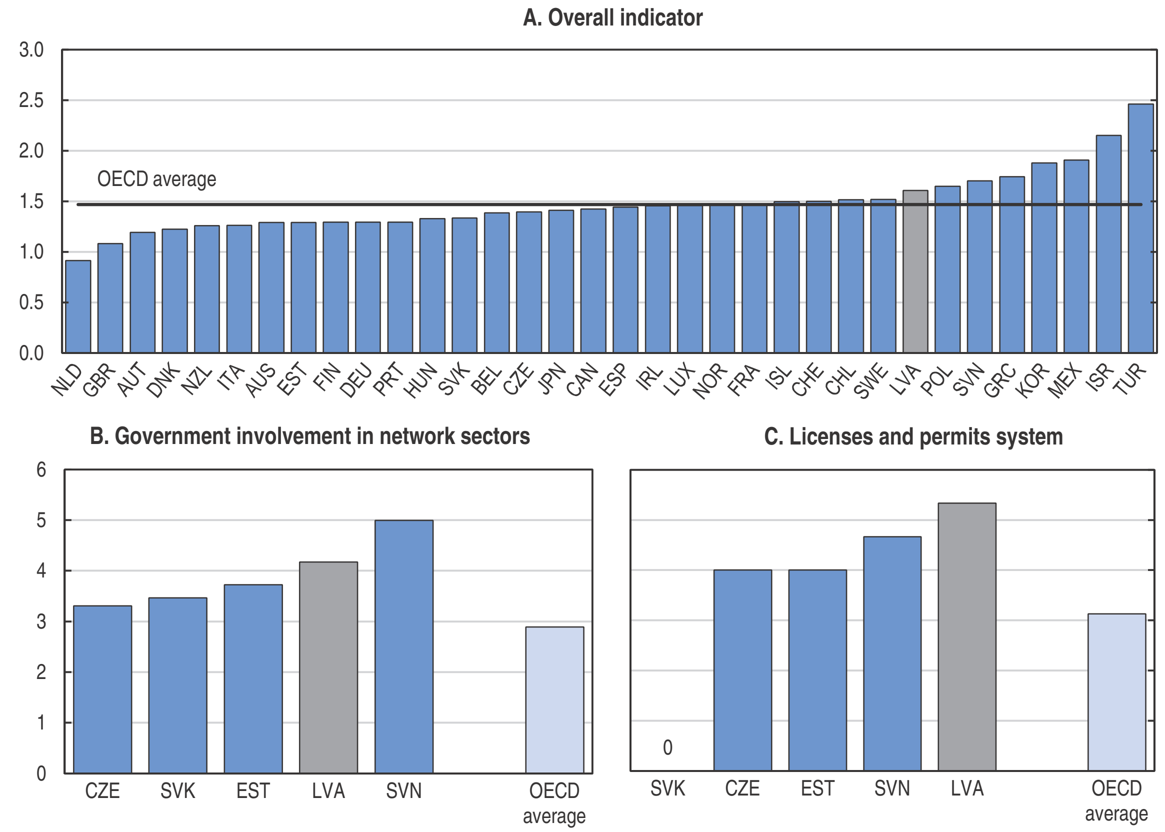
The following section looks at the main aspects of the business environment: the regulatory burden, competition, the judiciary and access to finance. It concludes by exploring the potential for innovation and the deepening of skills.

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.

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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

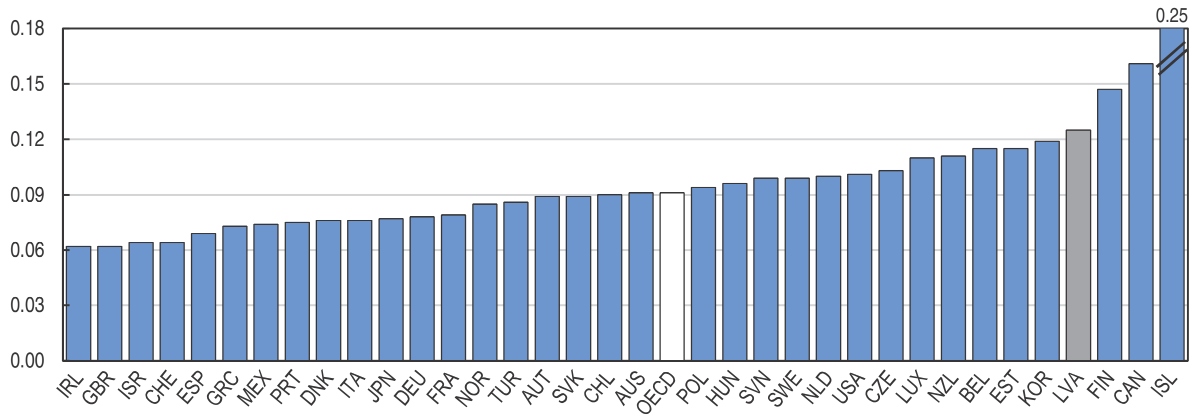
Latvia is an energy intensive economy when compared with other OECD countries (Figure 12). This is worrisome, as the economy is vulnerable to supply disruptions: gas accounts for a large share of energy supply and is provided by one supplier. Also, the relatively high level of energy consumption per 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.

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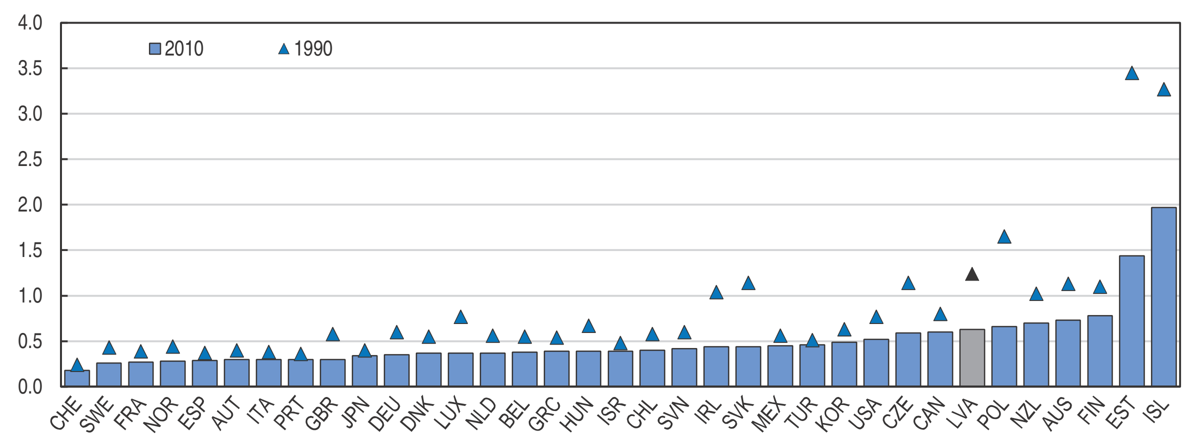
Figure 13. **Greenhouse gas emissions intensity is above the OECD average**

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.

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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.

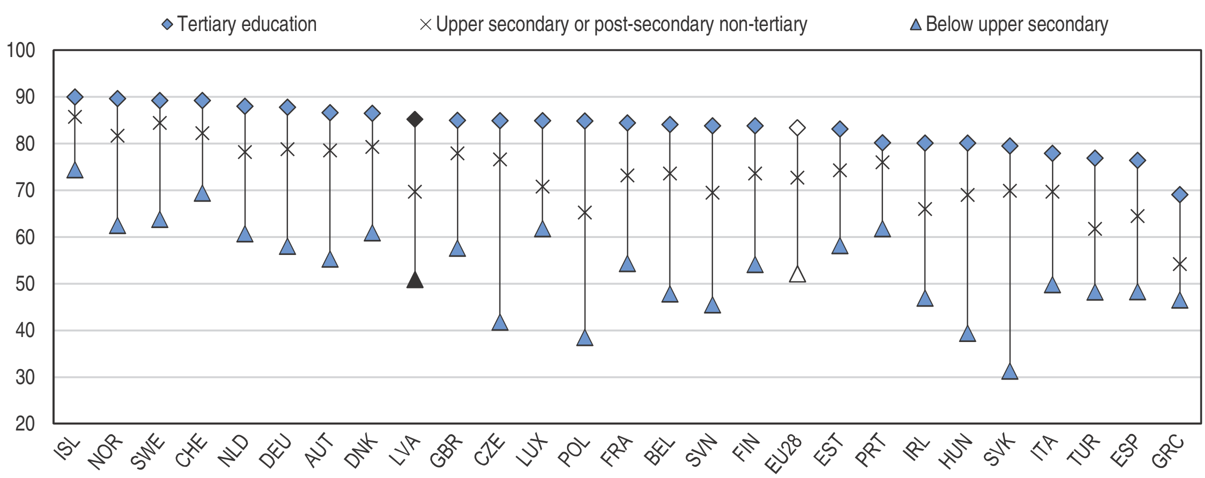
With good natural conditions for hydropower and biomass, renewable energy sources accounted for 36.3% of total primary energy supply in 2012, one of the highest shares in the EU (Central Statistical Bureau of Latvia). Renewables reduce dependency on foreign energy suppliers and mitigate GHG emissions. 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

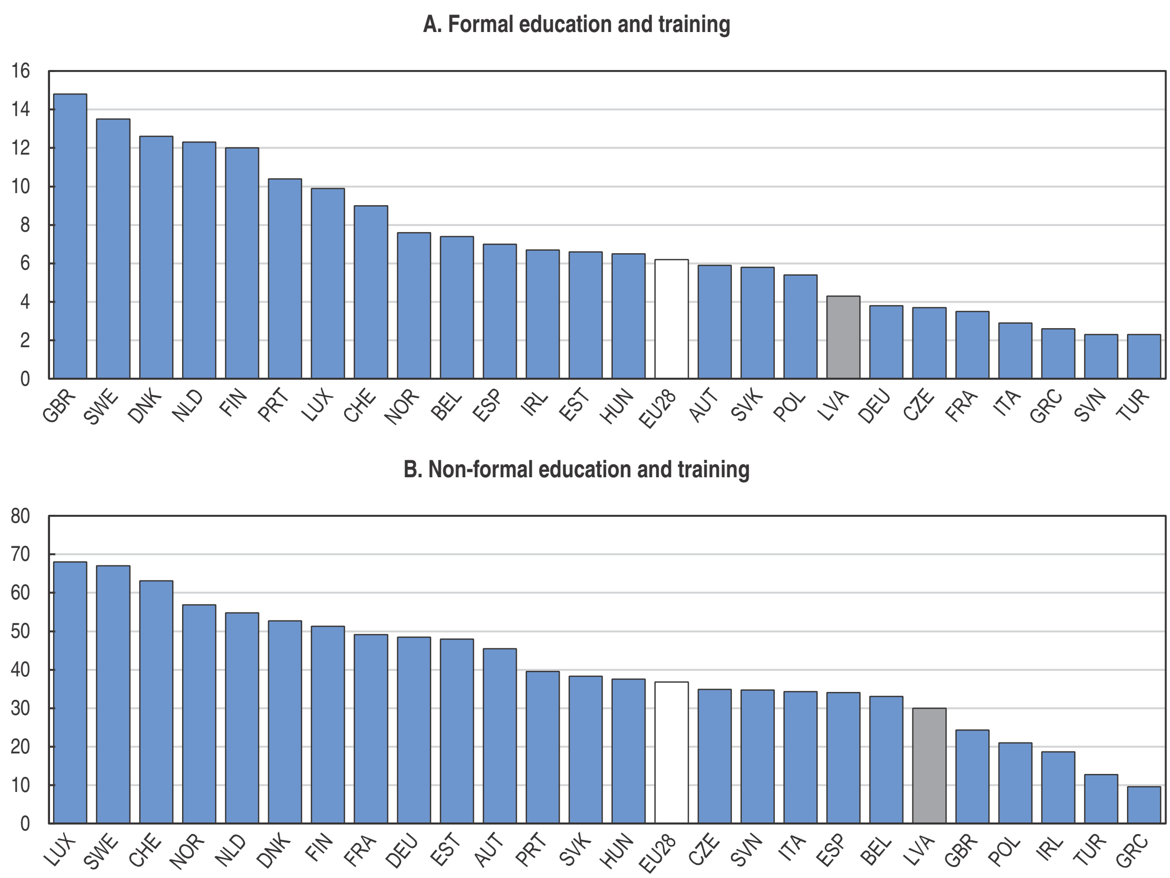
Vocational education and training (VET) is to play an increasing role. The authorities aim is for half of students to attain VET and half a general education by 2020; the current share being 40 to 60. To date, the VET has not had a particularly good image; the share of those who consider that VET provides 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

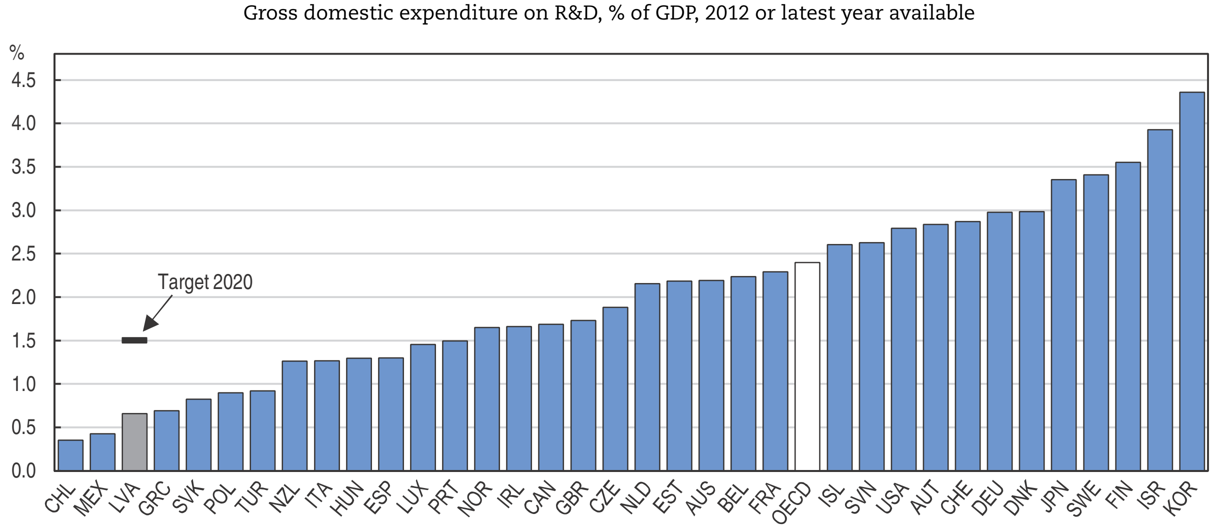
Insufficient public supply of general and professionally oriented Latvian language courses for the adult population was identified as one of the barriers to better integration of the ethnic minorities (Hazans, 2011). Language training is now offered by the public employment service, as well as for employed 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.

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