Chapter 2

Raising productivity and ensuring robust convergence

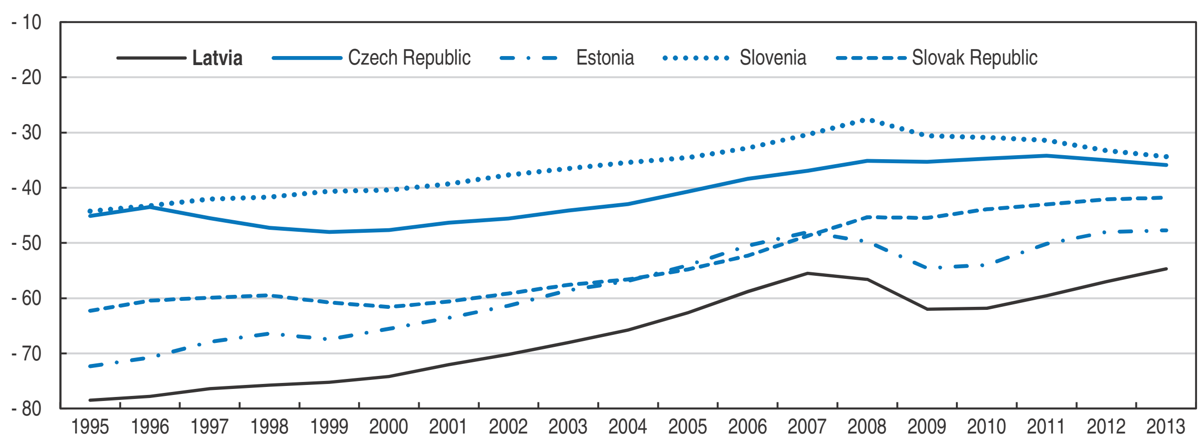
Much of the convergence of the Latvian economy needs to come from productivity increases. To achieve this, policy makers can do more to facilitate the integration of the economy into global trade and promote the competitive business environment, both of which should help in increasing productivity. This 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.

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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:

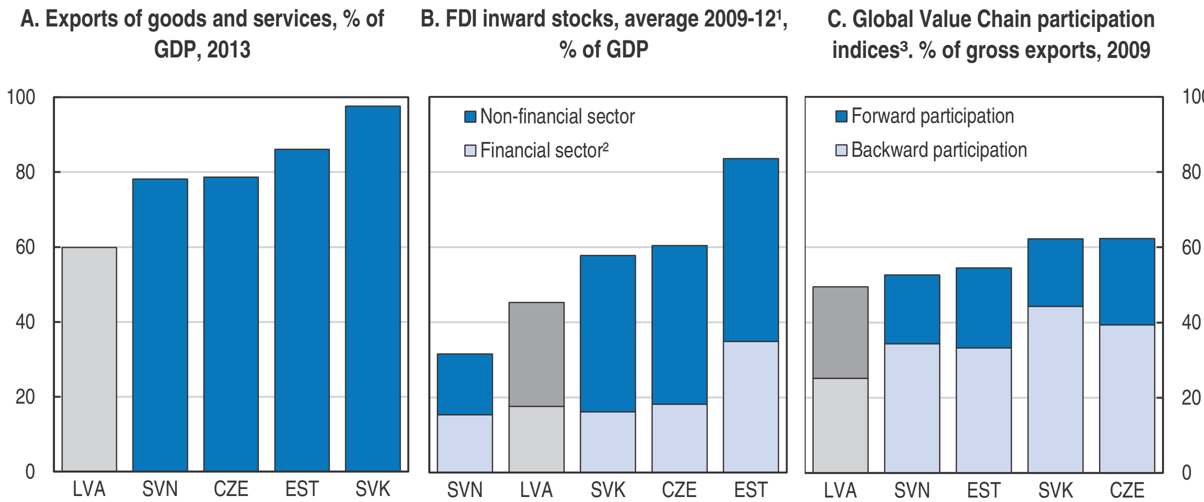
- Policy makers can do more to facilitate integration of the economy to global trade and promote the competitive business environment, both of which should help in increasing productivity. This can be done by decreasing regulatory burden even further, by removing trade and investment barriers, by strengthening 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.

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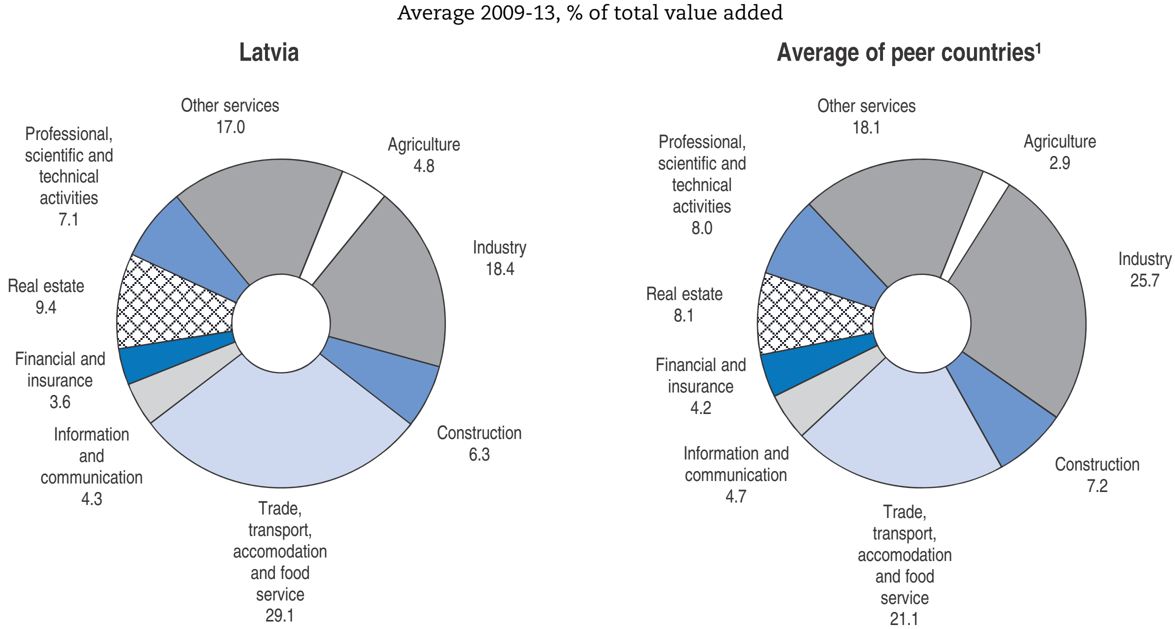
Figure 2.3. **Services play an important role in the economy**

Average 2009-13, % of total value added



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

Source: Eurostat database.

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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.

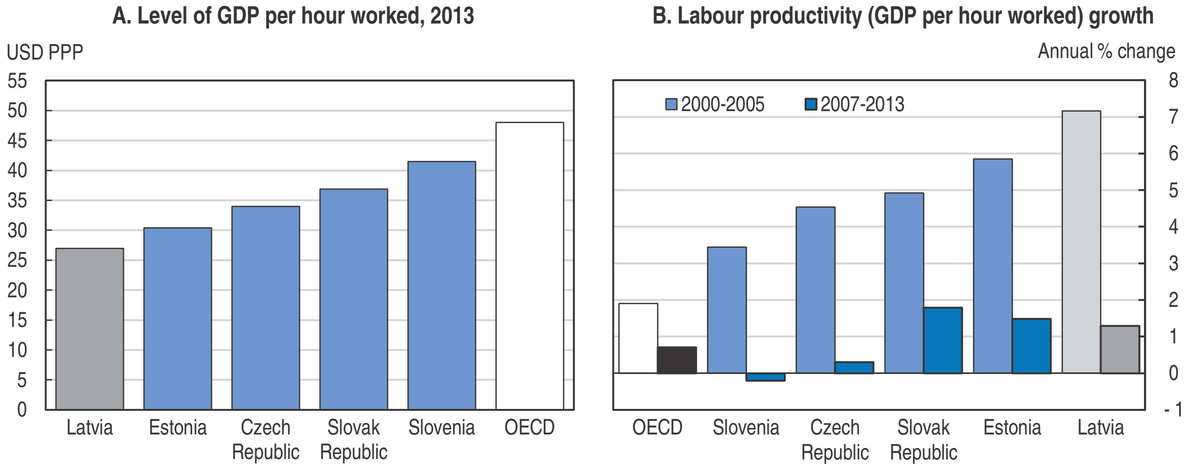
Covering the same period, the National Industrial Policy (NIP) and its Guidelines have been developed with a goal to diversify sources of growth away from real estate and financial sector that was at the heart of the boom-bust experience. This should be done by boosting role of the manufacturing sector 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.

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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.

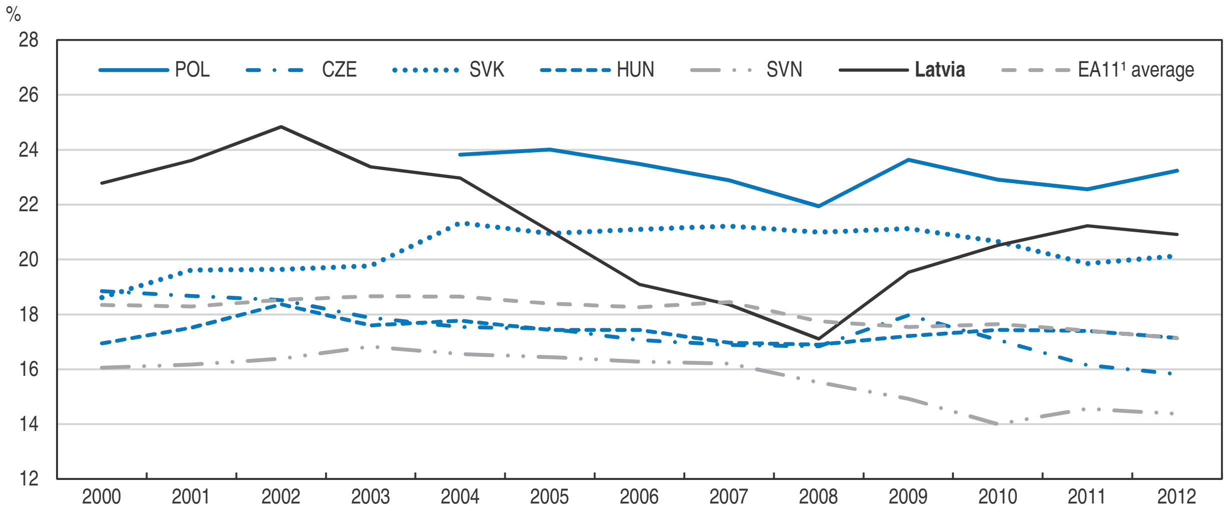
A number of authorities in OECD countries consult independent advisory bodies on microeconomic policy reforms and their impact on productivity. While in Denmark a temporary commission had been set up recently, in Netherlands and Australia these bodies have a permanent status and have a well-established 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.

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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).

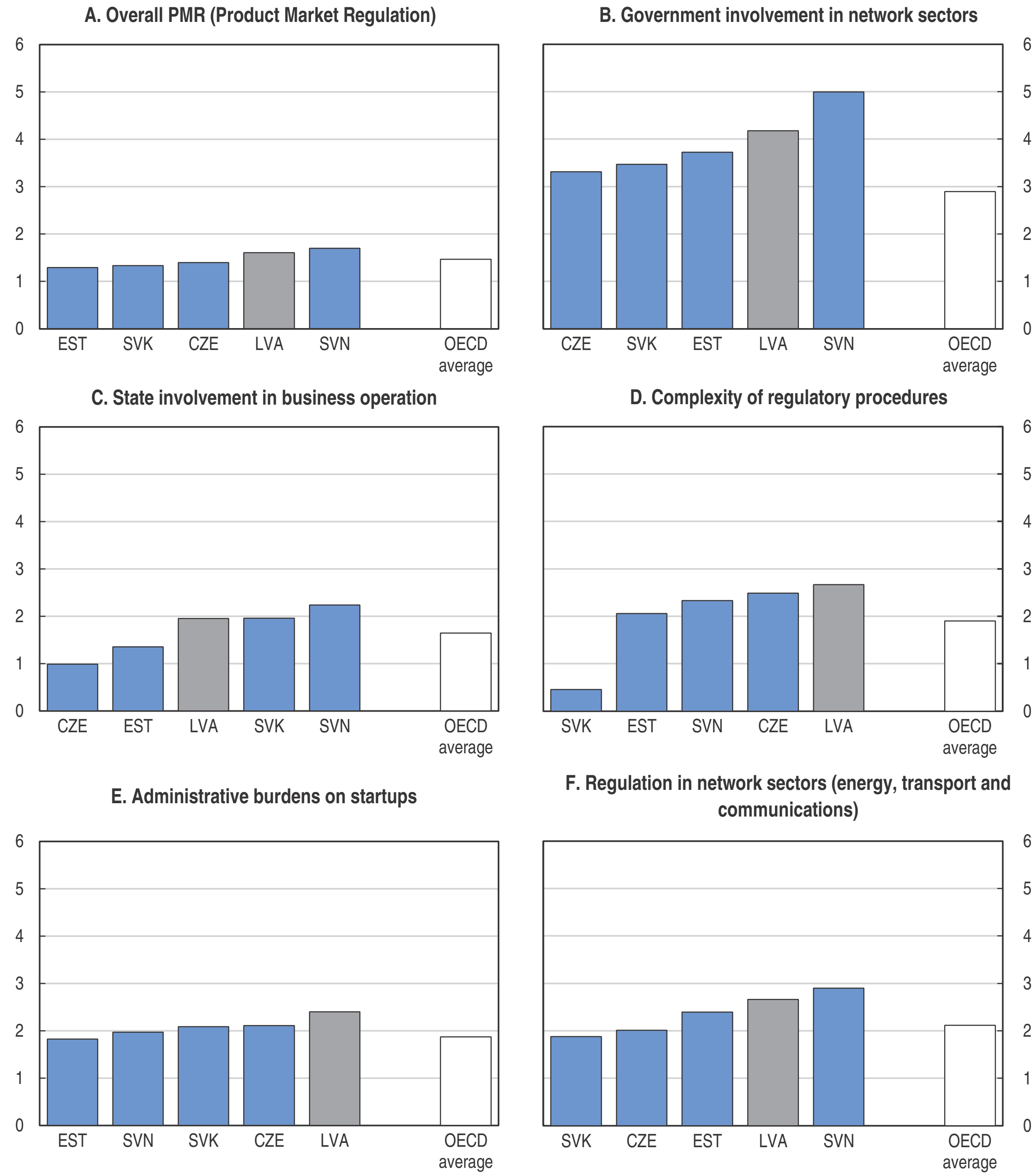
Latvia's score in the OECD's Product Market Regulation indicator (PMR), which measures *de jure* restrictiveness of regulation in terms of pro-competitive stance, stands above the OECD average – an uncomfortable position for a small open economy (Koske et al, 2015, *forthcoming*). Sub-indicators of the 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.

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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.

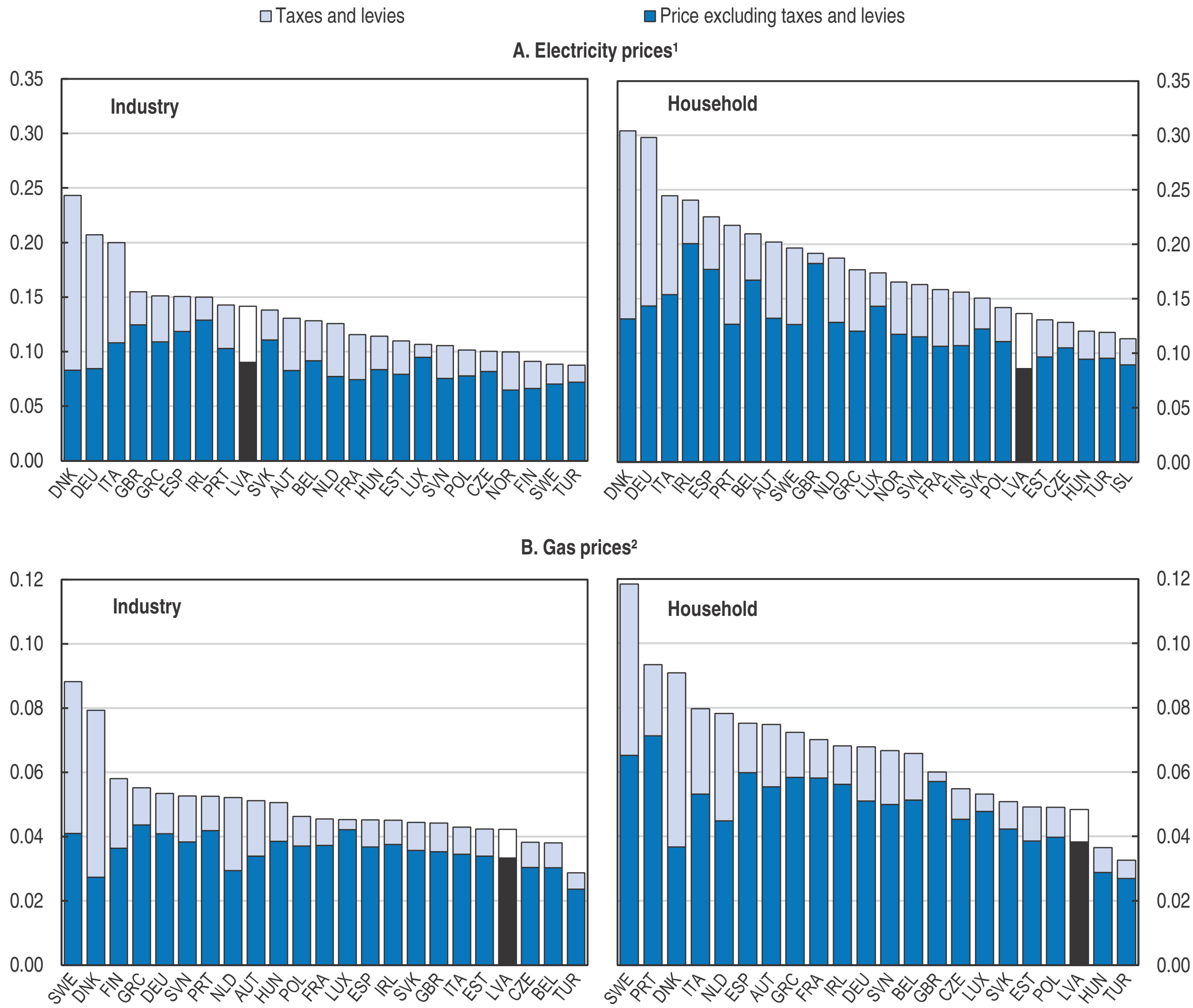
The natural gas market is a vertically integrated monopoly. Prospects of market liberalisation are complicated by the fact the pipelines are currently connected directly and indirectly (via neighbouring countries) to Russia only. The privatisation of the state incumbent (*Latvijas Gaze*) in the late 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.

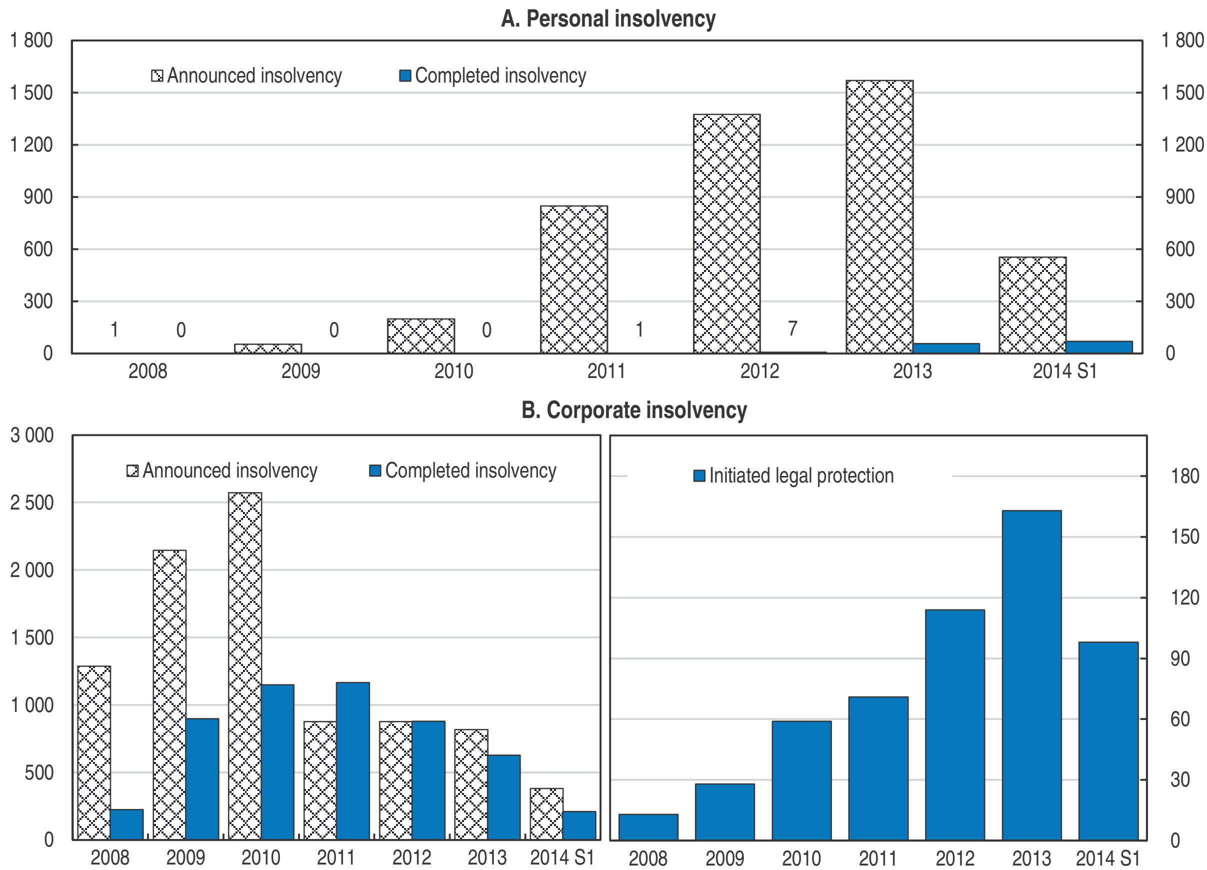
Both personal and corporate insolvency cases have risen, signalling improved functioning of the insolvency framework (Figure 2.8). A significant drop in the number of initiated cases is apparent on the corporate side, which could signal either improvement in the general economic environment and/or lower 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

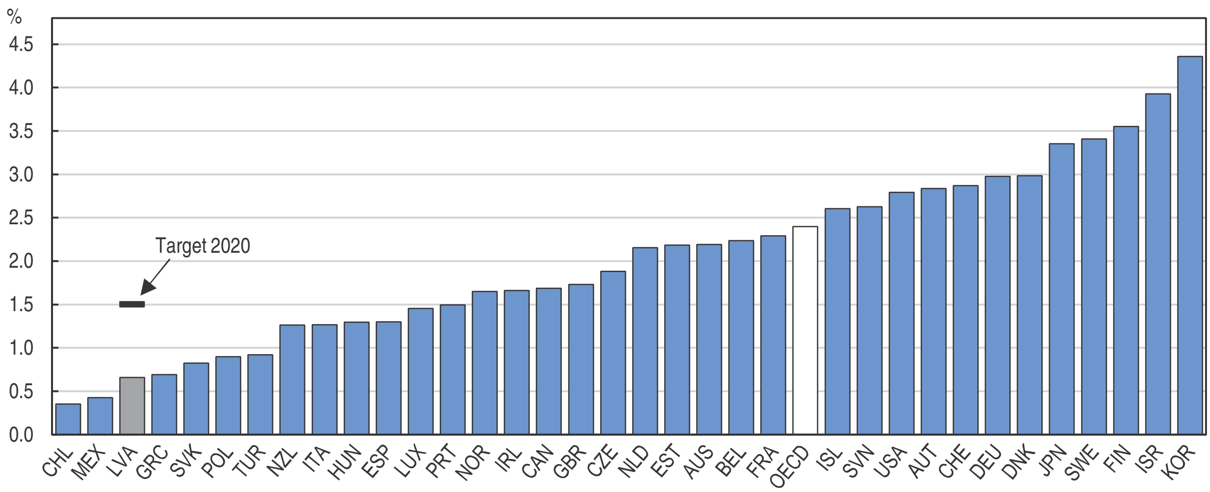
of more than doubling the spending, from current 0.6% of GDP to 1.5% of GDP by 2020 (Figure 2.9).

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.

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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.

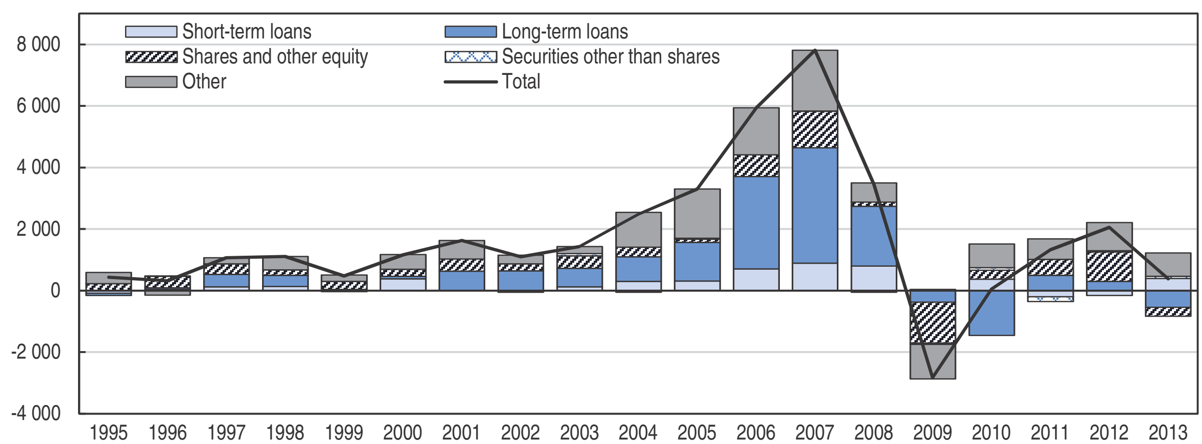
The authorities recently established a Research and Innovation Strategic Council under the direct supervision of the Prime Minister and are launching a structural reform (EC, 2014). This includes bringing research into the tertiary education sector and consolidating the existing research infrastructure, 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.

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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

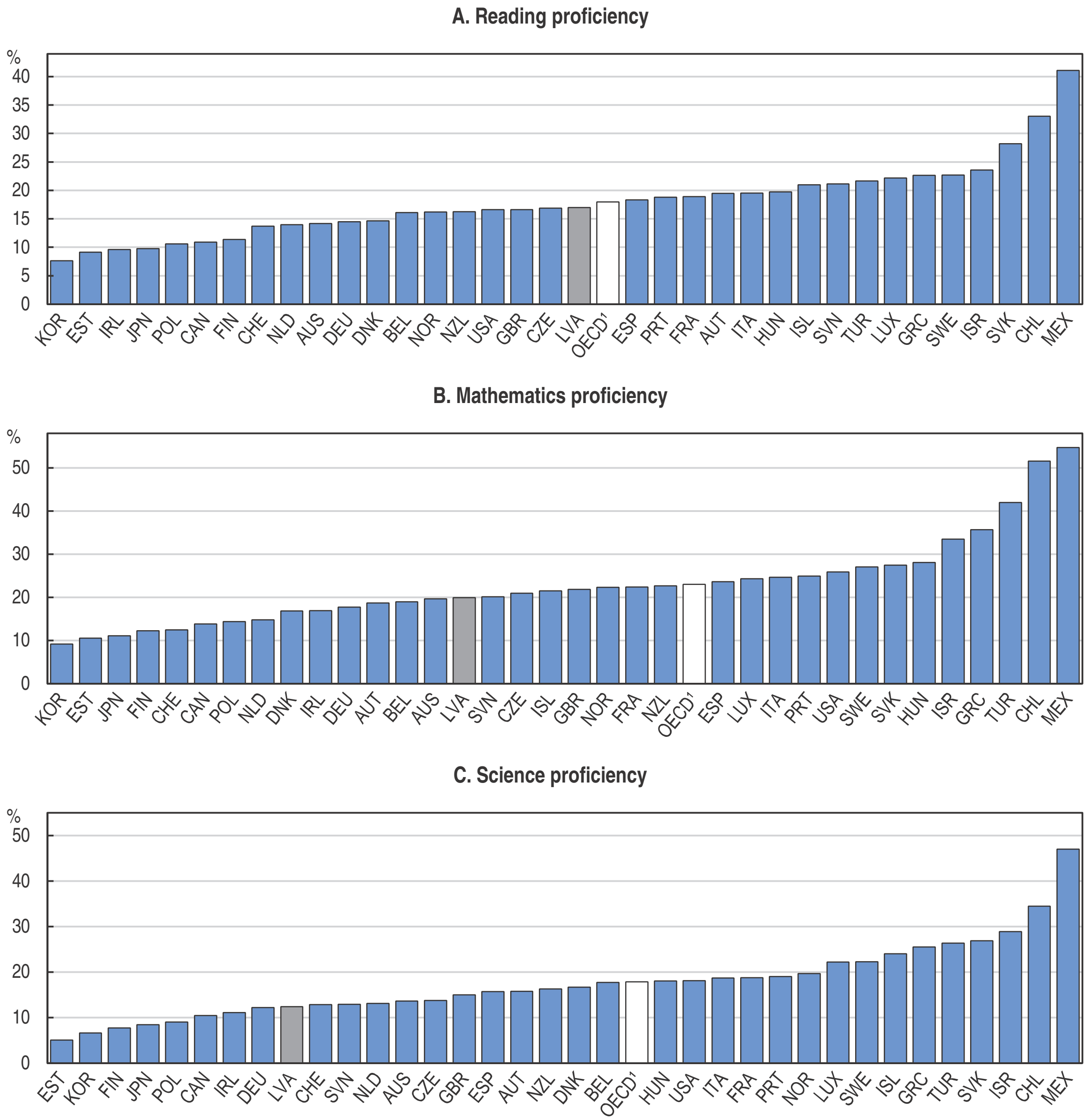
The Latvian workforce is well educated. About a third of the economically active population has tertiary education, a significant increase from about 20% ten years ago. The secondary education attainment is also high, 80% of the working age cohort has at least upper secondary education. The education 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.

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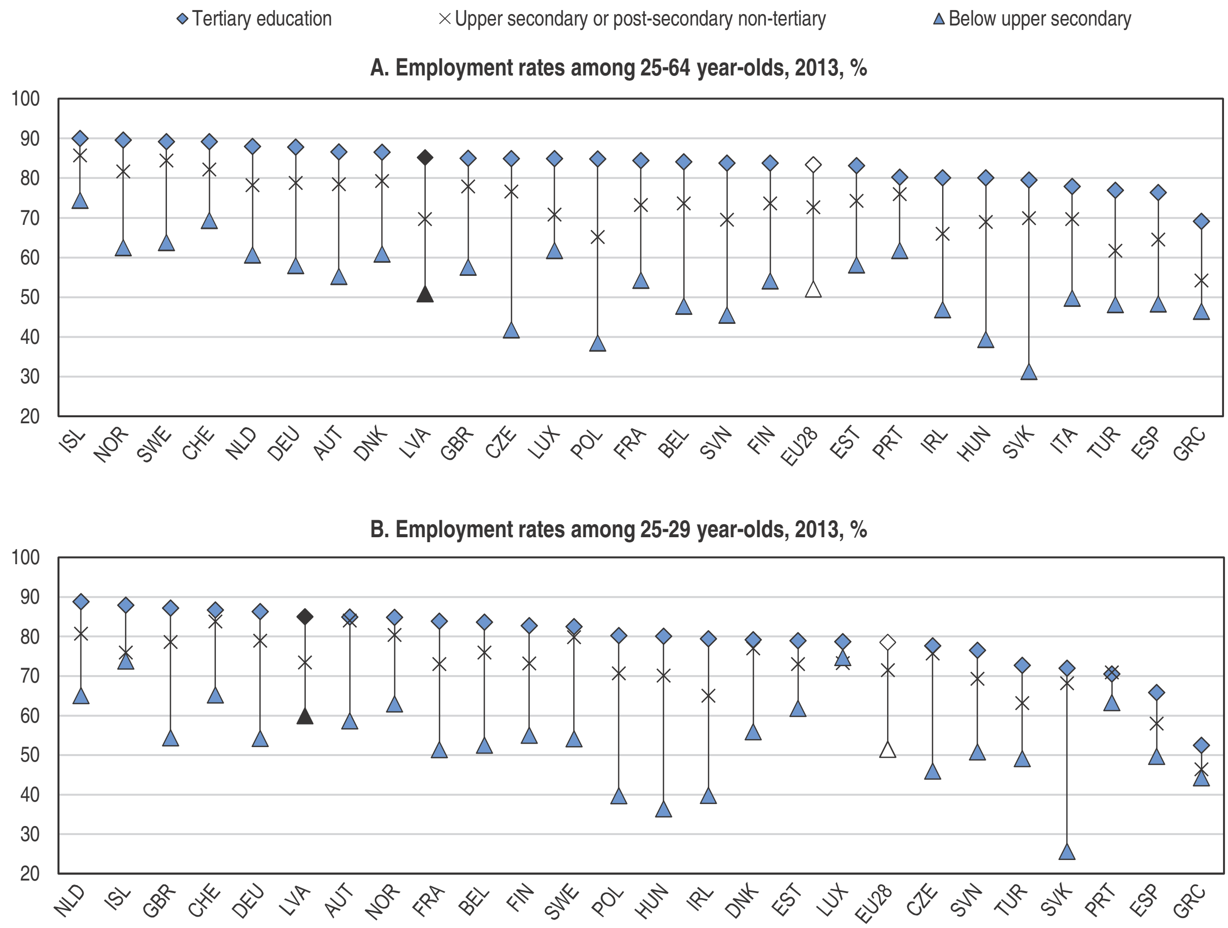
current job and half of those lack skills (Purtins and Zumente, 2011). A large share of the Latvian labour force acquired its education under the Soviet regime. Given the low participation in lifelong learning, and persisting informality, many of the working-age population are missing the skills to become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

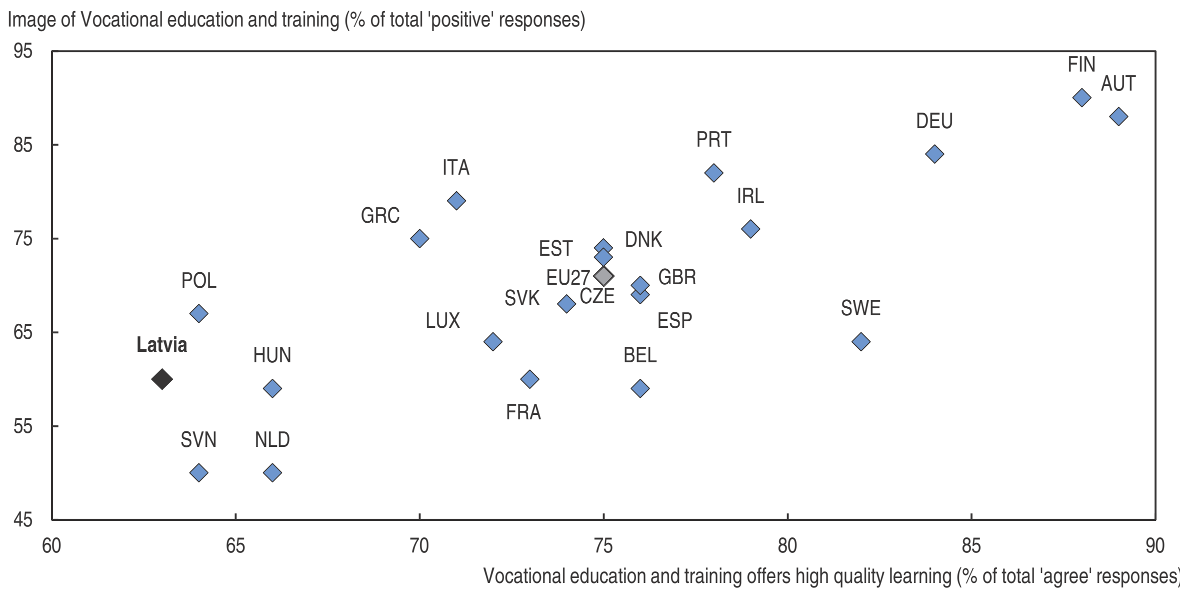
Over a half of the migrants were younger than 34 years at the time of departure. In terms of the educational structure, 60% of them had completed secondary and 24% tertiary education. During the 2008-13 the country has lost to migration some 8% of the total population and the emigrants have been disproportionately 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).

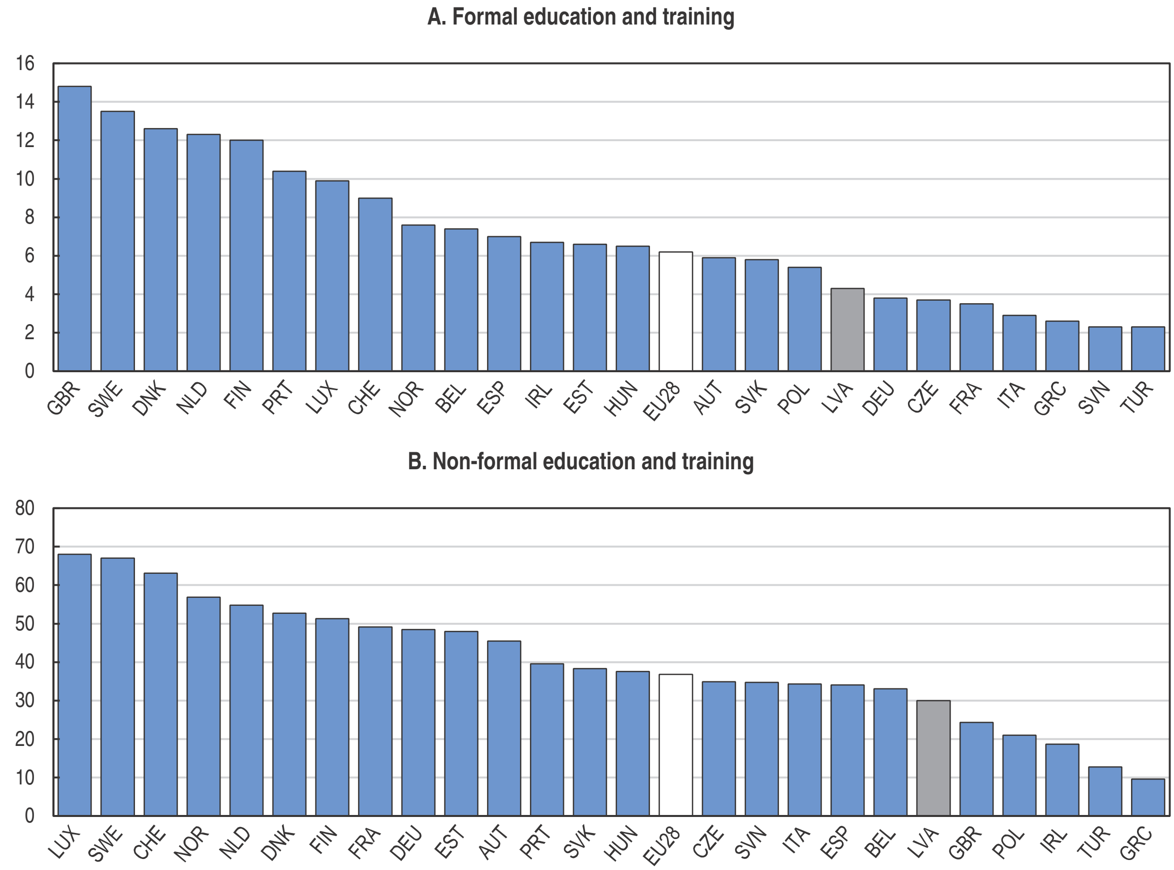
OECD (2010) recommendations stress the importance of career guidance as a separate and independent profession from psychological counselling as well as provision of adequate resources for pro-active delivery. Prior to the crisis extra funding from EU funds was available for development of teachers training 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.

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