

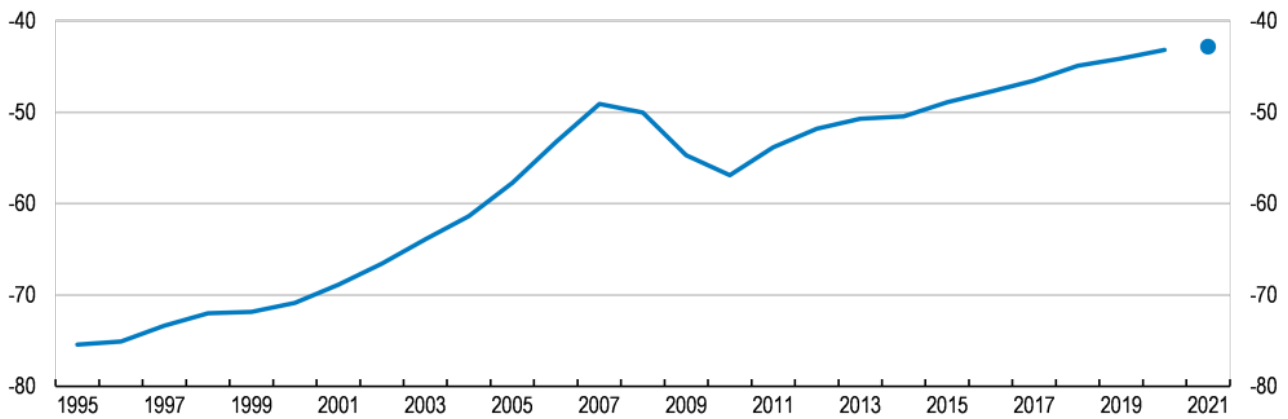
Unleashing Latvia's potential to accelerate economic convergence and improve well-being

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Latvia's economic growth over the past decades is impressive: its income per capita has reached almost 60% of the upper half of OECD countries vs. only 30% two decades ago (Figure 1). Prior to the COVID-19 crisis, the unemployment rate had fallen to its lowest rate in 10 years and the macroeconomic context appeared balanced, with inflation under control and prudent fiscal policies in place. In the aftermath of the first wave of the pandemic, unemployment peaked at about 8.7% and GDP dropped sharply. Nevertheless, as the new OECD Latvia Economic Survey shows the contraction was less severe than in other OECD countries, the recovery was robust, and Latvia's GDP per capita has continued to catch up. Fiscal policy has handled the health-system challenges while protecting jobs and firms, although more could be done to reduce inequality and poverty, especially among the elderly.

Figure 1. Latvia is catching up to its most affluent trading partners

Gap in GDP per capita against the upper half of OECD countries, %



Note: Percentage gap with respect to the population-weighted average of the highest 19 OECD countries in terms of GDP per capita (in constant 2015 PPPs).

Source: OECD calculations.

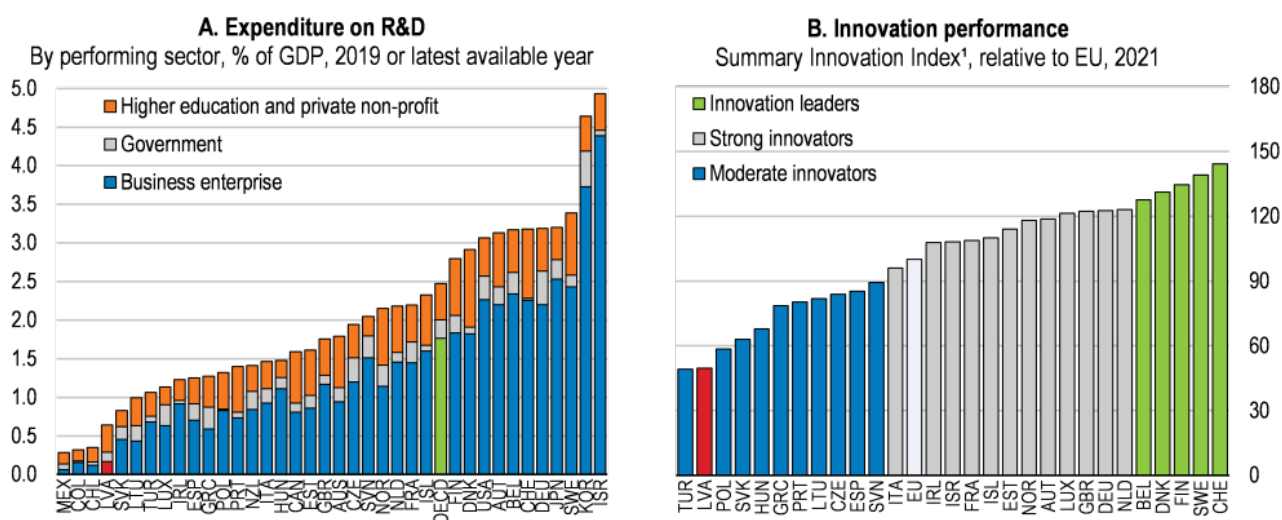
The pandemic has been superimposed on long-standing structural weaknesses and challenges. Latvia's population has been shrinking for three decades, driven by net migration, low fertility and relatively short (albeit rising) life expectancy. Looking forward, continued population shrinkage will lead to further losses in agglomeration benefits and accentuate fiscal challenges. It would also put the labour market under pressure from the decline and ageing of the labour force. This means Latvia must focus on getting the most labour out of those of working age.

Given the effects of the demographic outlook on labour supply and consumer demand, focusing on exports will be key for Latvia's growth strategy. However, Latvia's exports have underperformed in recent decades. This may be attributable to the country's industrial structure, which is still dominated by low- and medium-low tech firms, along with the persistent rise in real labour costs. The good news is that Latvia is in a good position to make necessary changes, as considerable EU funding will be available in the coming years. The OECD Economic Survey 2022 highlights five main priorities for making economic growth strong and socially and environmentally sustainable:

- **Improving the innovation system.** The 2018 corporate tax

reform left Latvia in an unusual position – treating R&D like any other investment; this should be re-examined in light of persistently low R&D spending in relation to GDP, especially by businesses (Figure 2). It should also allow academic researchers to share in returns on their inventions and increase the share of tertiary education funding that is performance-based.

Figure 2. Innovation is weak



Note: The colours show normalised performance in 2021 relative to that of the EU27 in 2021: green above 125%; grey: between 95% and 125%; and blue between 50% and 95%. Innovation performance is measured using a composite indicator, which summarises the performance of 27 different sub-indicators.
Source: OECD Main Science and Technology Indicators database; European Commission, *European Innovation Scoreboard 2020*.

- **Securing an adequate supply of skilled labour** by: i) boosting active labour market spending, notably on job training, to reduce long-term unemployment (the share of the jobless who have been out of work for more than a year was 28% in 2020, compared to under 20% in Estonia and in the average OECD country); ii) continuing to raise the retirement age by automatically linking it with life expectancy; iii) addressing gender stereotypes and enforcing anti-discrimination legislation to reduce the growing gender wage gap, which is among the EU's

highest; iv) giving schools more flexibility in setting teachers wages to improve the quality of instruction; v) providing tertiary students with greater financial support to reduce the high tertiary dropout rates; and vi) implementing training funds through tripartite social dialogue to increase presently scarce employer-provided training.

- **Spending more on health and long-term care, while lowering out-of-pocket spending** to improve access and treatment quality, which, according to available indicators (such as preventable mortality) and patient satisfaction (including unmet needs), are poor. Enhancing the efficiency of the hospital network by providing more resources for preventive measures, primary and home care, mental health treatment and long-term care (all of which are underfunded) should be prioritised. Making greater use of digitalisation and training more nurses to take over more functions would also help. Lifestyle-related risk factors (including air pollution) accounted for 43% of all Latvian deaths in 2019, well above the EU-average share. Raising applicable excise taxes and better informing citizens of the benefits of dietary change and more exercise are crucial steps towards healthier lifestyles.
- **Meeting the National Development Plan's housing objectives**, notably by raising the supply of affordable and social housing and improving home-heating systems to boost Latvia's labour mobility and attractiveness to potential foreign investors. Housing investment as a share of GDP has been the OECD's lowest for many years, and the disadvantaged suffer from especially poor housing conditions, notably overcrowding.
- **Dealing with environmental challenges.** Despite some progress, Latvia (like other OECD countries) should do more to achieve green and sustainable economic growth. Greenhouse gas emissions per capita are still rising, and air pollution from fine particles weighs heavily on

health outcomes. Lowering and ultimately removing the favourable treatment of natural gas and diesel for vehicle use (while protecting the poor) would help. Policies will also need to seek to raise the share of renewables and to integrate regional power and gas markets. In addition, remaining untreated wastewater could be tackled by consolidating regional water companies, and increasing the share of protected land should be considered.

Reference

OECD (2022), *OECD Economic Surveys: Latvia 2022*, OECD Publishing, Paris, <https://doi.org/10.1787/c0113448-en>.