Latvia: Raising investment to support growth and increase living standards

Category: Latvia
written by oecdecoscope | April 25, 2024



By Enes Sunel and Robert Grundke

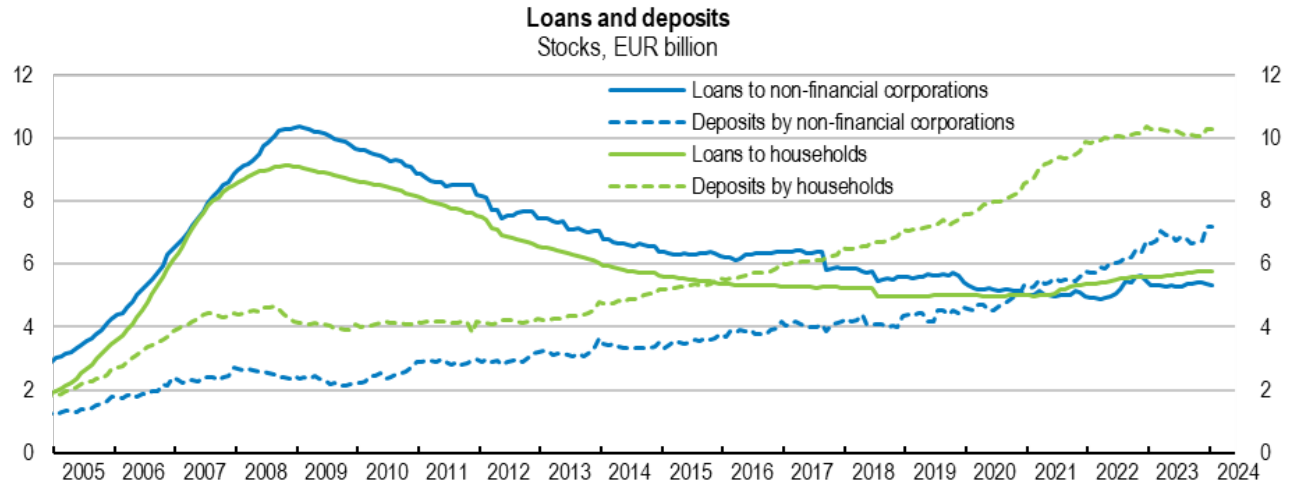
Investment in Latvia has slowed since the global financial crisis, in contrast to its Baltic neighbours, Estonia and Lithuania. This has weighed on potential growth and slowed the convergence of living standards towards the OECD average. High risk aversion of banks, weak competition in the financial sector, and shallow capital markets have limited access to finance for firms. At the same time, investment demand has been low as high informality, weak competition and skilled labour shortages have weighed on business dynamism, innovation and productivity.

How can Latvia raise investment to support growth and increase living standards? The 2024 Economic Survey of Latvia identifies five priorities:

1. **Improve bank credit provision.** Banks have been reluctant to lend, despite strong deposit growth (Figure 1). A history of low asset recovery and money laundering cases made banks more risk averse. Recent reforms, including the establishment of a specialised Economic Court, have significantly improved insolvency procedures and strengthened the fight against money laundering and corruption. However, the cost of credit,

lending standards and collateral requirements still remain high compared to other Euro Area countries. Increasing competition in the banking sector by reducing barriers to customer mobility and strengthening the legal and investigative powers of the Competition Council to monitor anti-competitive behaviour in financial markets could help to lower borrowing costs. Improving banks' management of anti-money laundering risks could also help raise access to credit. Providing continuous training to compliance officers in the financial sector could help to lower the administrative burden for clients and avoid unwarranted de-risking.

Figure 1. Bank lending has decreased despite rising deposits



Source: Bank of Latvia

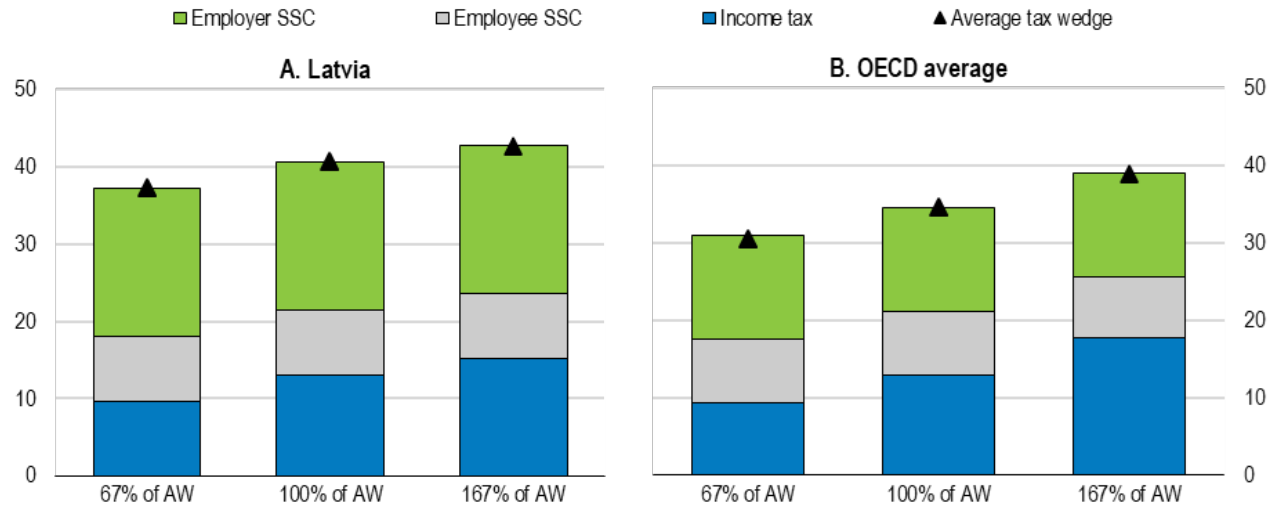
2. **Deepen capital markets to foster alternative sources of credit.** Latvia's stock market is the second smallest in the euro area, while none of the large state-owned enterprises (SOEs) are listed. Listing minority stakes in SOEs could help attract foreign investors, deepen capital markets and improve the corporate governance of SOEs. Corporate bond issuance is another source of non-bank finance and also needs to improve. Further reducing the administrative costs of bond issuance, improving the financial literacy of smaller firms, and facilitating greater investment of domestic institutional investors, such as second-pillar pension funds, in domestic securities would help deepen capital markets and improve

access to non-bank finance.

3. **Reduce informality to foster business dynamism and innovation.** The shadow economy accounts for more than a quarter of economic activity and has not decreased since 2012. Widespread informality hampers access to finance for firms, restricts training opportunities for workers and distorts the level playing field, reducing business dynamism and innovation. Strengthening tax enforcement by improving data infrastructure and analysis as well as the human resources of the State Revenue Service, raising the quality of public services and continuing the fight against corruption to raise trust in institutions and the tax morale would help lower informality. Moreover, social security contributions for low-wage earners are much higher in Latvia than in other OECD countries, reducing incentives to formalise work (Figure 2). Lowering social security contributions for lower incomes, while maintaining social security benefit levels, would help to reduce informality and could be financed from general tax revenue, for example by raising revenue from property and corporate income taxes or increasing the progressivity of personal income taxes for higher incomes.

Figure 2. Reducing high labour taxes for low-wage earners would raise incentives to formalise work

Average tax wedge decomposition, % labour costs, 2022

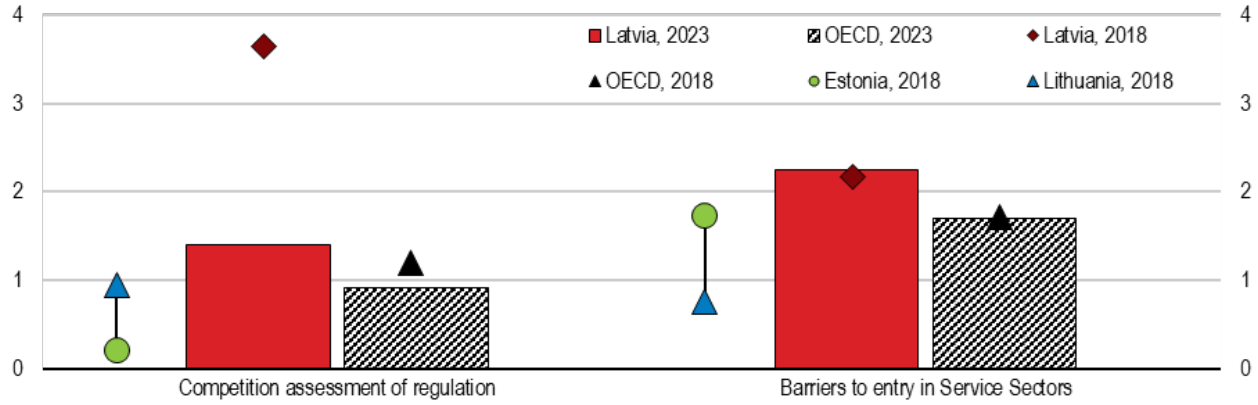


Note: The tax wedge is the sum of personal income tax, employee plus employer social security contributions, minus social benefits as a percentage of labour costs. The tax wedge is shown for a single individual without children. Panel B and C show the tax wedge by income level measured in percent of the income of the average worker (AW).
Source: OECD Taxing Wages database.

4. **Improve competition enforcement.** Low competitive pressures for incumbents reduce their incentives to innovate and become more productive. Barriers to market entry and competition are high, particularly in many services sectors where the presence of state-owned enterprises is high (Figure 3). Although there has been some improvement since 2018, Latvia still ranks below the OECD average in the competition assessment of regulation. To strengthen competition enforcement, the Competition Council should receive the power to start investigations and challenge administrative decisions and regulations that restrict competition, as is the case in Italy or Spain. Moreover, the strong presence of state-owned enterprises (SOEs) in many markets may introduce entry and growth barriers for private firms. To enforce competitive neutrality of SOEs, it is key to increase the power of the Competition Council to conduct market investigations and initiate evaluations of state ownership rationales of SOEs.

Figure 3. Reducing high entry barriers in services sectors and improving competition assessment of regulation would help fostering business dynamism and innovation

OECD Indicators of Product Market Regulation (PMR), index scale of 0-6 from least to most restrictive (higher values indicate worse performance)

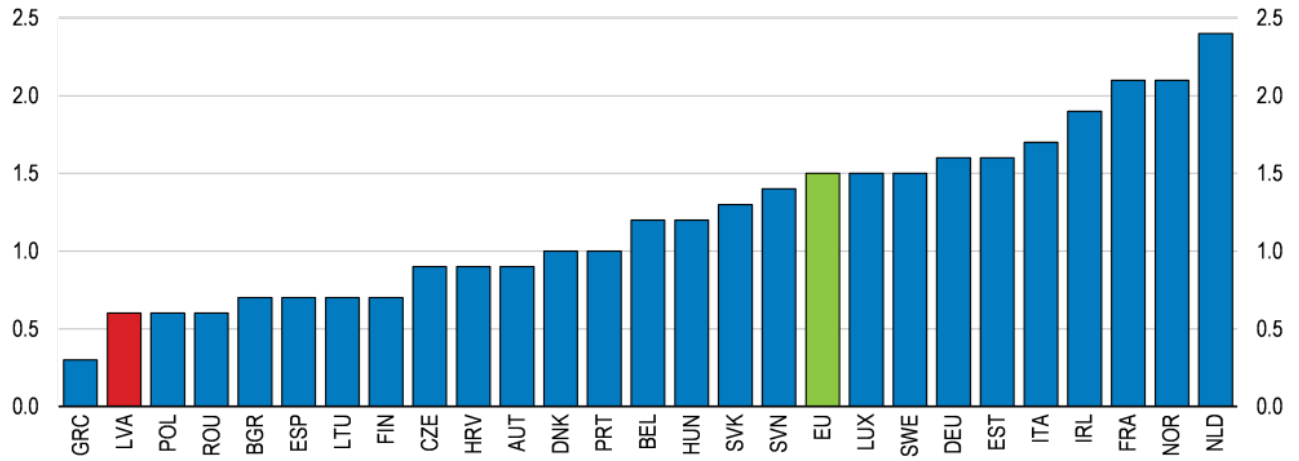


Note: OECD average for 2023 includes all OECD countries, apart from Belgium, Hungary, Mexico, the Netherlands, and the United States for which data collection is still ongoing. PMR values for Estonia and Lithuania for 2023 will only be released in Summer 2024.
Source: OECD (2023), Product Market Regulation Database (forthcoming).

5. **Addressing skilled labour shortages by stepping up training.** The low level of digital and management skills hinders the adoption of digital technologies by Latvian firms and reduces their productivity and competitiveness. Nevertheless, Latvian firms invest little in training (Figure 4). This is related to the large number of small firms, which lack resources to provide training. Moreover, severe skilled labour shortages and weak coordination among firms, as only about half of firms are members of an employer organisation, exacerbate the problem of poaching of skilled employees by other firms, further reducing incentives to invest in training of employees. To strengthen training provision in small firms and reduce concerns about employee poaching, sectoral training funds could be established to improve cooperation between firms and training providers in training design and delivery.

Figure 4. Firms need to step up training

Spending for continuing vocational training (CVT) courses, % of total labour cost of all enterprises, 2020



Source: Eurostat, Continuing vocational training survey (CVTS) 2020.

Reference:
OECD (2024), *OECD Economic Surveys: Latvia 2024*, OECD Publishing, Paris, https://doi.org/10.1787/dfeae75b-en

---

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

Category: Latvia
written by oecdecoscope | April 25, 2024

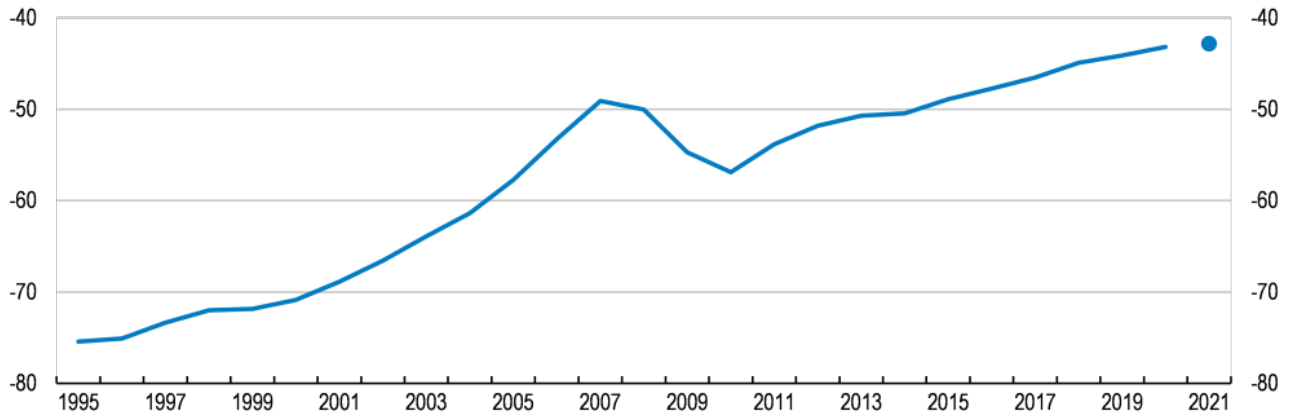


By Peter Jarrett and Zeev Krill, OECD Economics Department

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.

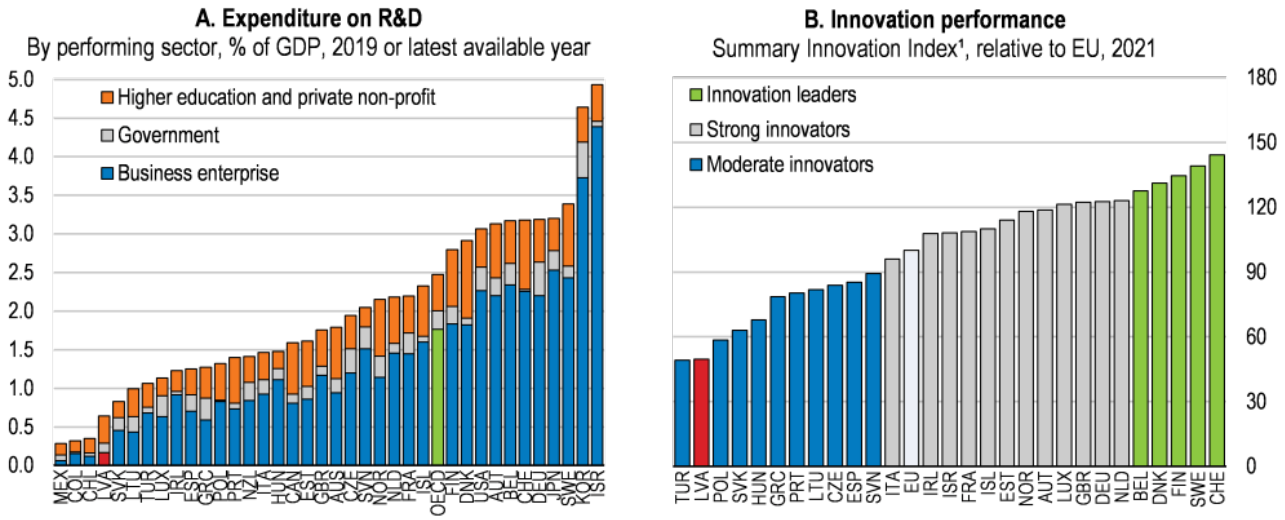
The pandemic has been superimposed on long-standing structural weaknesses and challenges. Latvia’s population has been shrinking for three decades, driven by net migration, low fertility and relatively short (albeit rising) life

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

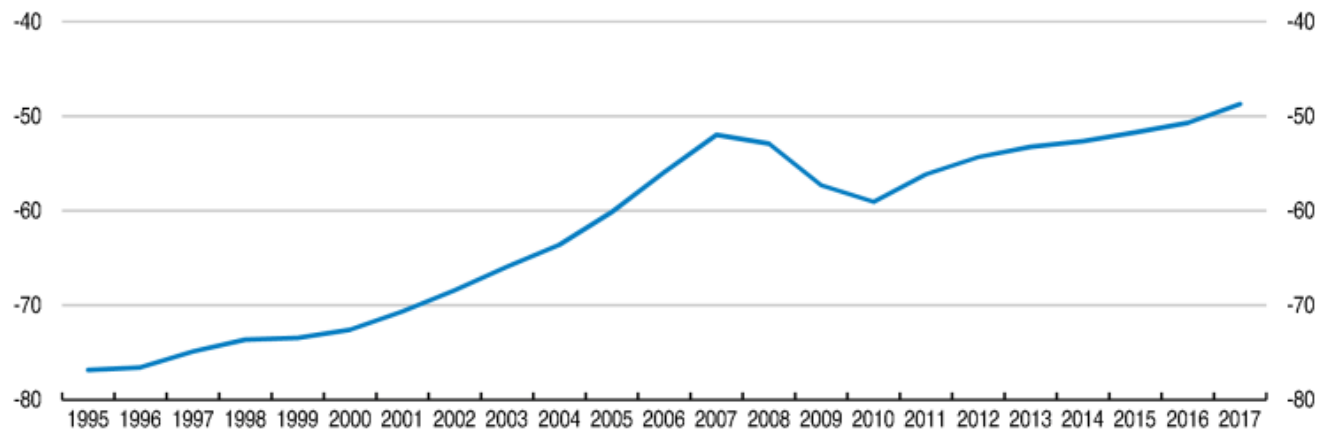
OECD (2022), *OECD Economic Surveys: Latvia 2022*, OECD Publishing, Paris, https://doi.org/10.1787/c0113448-en.

Latvia: Working towards stronger and more inclusive growth

Category: Latvia,Uncategorized
written by oecdecoscope | April 25, 2024
by Naomitsu Yashiro, Latvia Desk, OECD Economics Department

Latvia is a dynamic economy that joined the OECD in 2016. It has enjoyed strong economic performance in recent years and its macroeconomic policy is sound. Nevertheless, Latvia's per capita GDP is still only about a half of the average level of high income OECD countries (Figure 1). Latvia also faces one of the fastest declines in the working-age population in the OECD due to ageing and outmigration. Hence, strong productivity growth is crucial for Latvia to ensure continued catch up of living standards with higher income OECD countries.

Figure 1. Gap in GDP per capita against the upper half of OECD countries, %

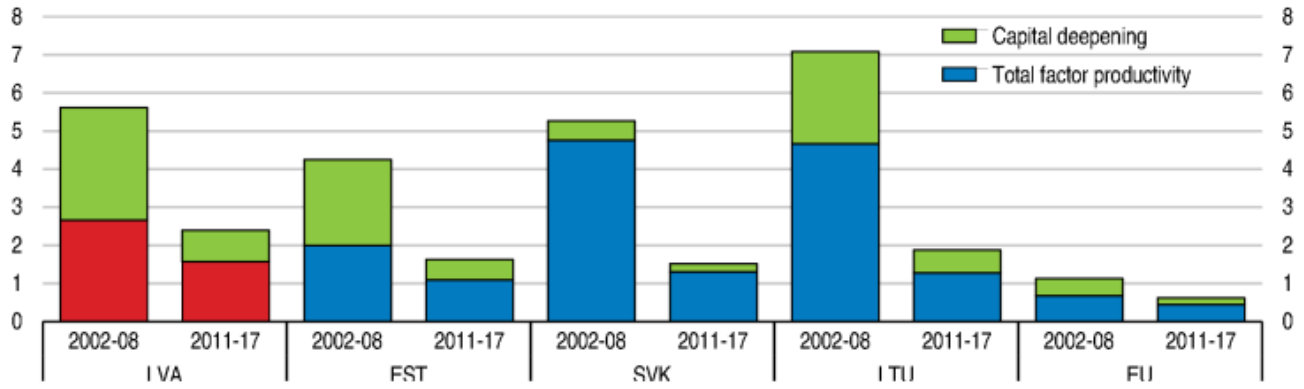


Note: Percentage gap with respect to the weighted average using population weights of the highest 17 OECD countries in terms of GDP per capita (in constant 2010 PPPs).

Source: OECD (2019), Economic Policy Reforms 2019: Going for Growth (forthcoming).

Although Latvia's labour productivity growth is among the highest in the OECD, it decelerated considerably after the crisis mostly due to a smaller contribution of investment (Figure 2). Business-based innovation is weak and the use of digital technologies lags considerably behind other OECD countries despite fast Internet connection speed. A slow take-up of new technologies is due to shortages of qualified workers and weak knowledge transfer from research institutions to firms. Furthermore, subdued bank lending, owing partly to low debt recovery in insolvency procedures and widespread informality, prevents productive firms from investing and growing larger.

Figure 2. Decomposition of average annual growth in labour productivity, %



Source: OECD (2019), Economic Policy Reforms 2019: Going for Growth (forthcoming).

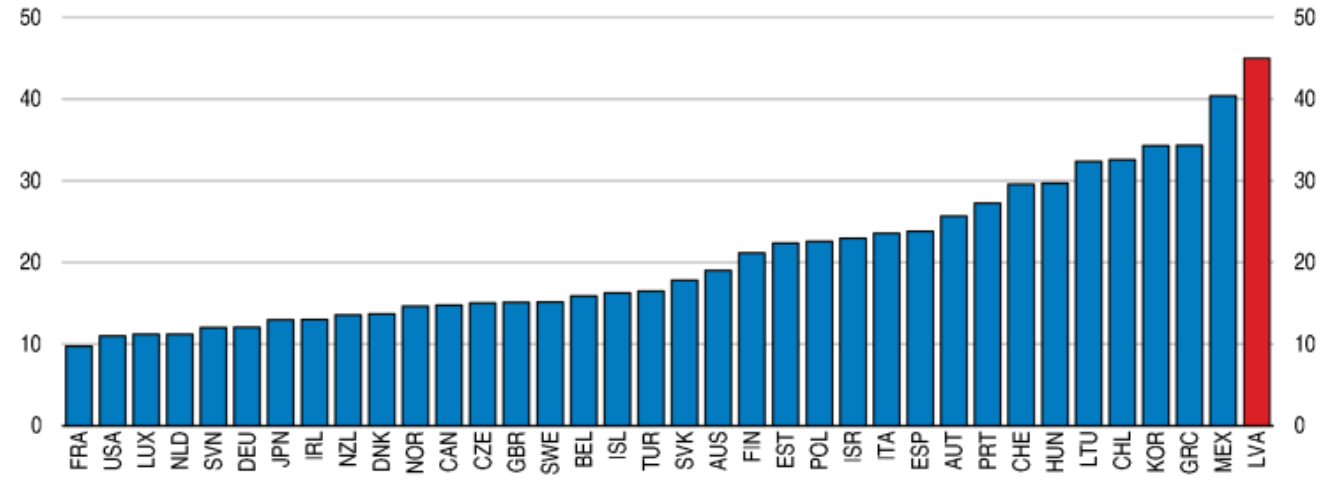
The government has implemented reforms to align education and training with labour market needs and promote science-

industry linkages
with support from EU funds. It is also working hard to strengthen the capacity
of the judiciary and law enforcement agencies to fight economic crimes like tax
evasion and money laundering. This
should help strengthen investor confidence and the ability of firms to better
document their income to obtain credit. The *2019 Economic Survey of Latvia* calls for more investment in skills, innovation
and continued efforts to strengthen competition, in particular in sectors with
a strong presence of municipal or state-owned enterprises.

More needs to be done to strengthen wellbeing and social inclusion. Building on a recent reform that lowers taxes on lower-income workers the tax-and-benefit can be used more to reduce high income inequality. Access to healthcare is highly unequal owing partly to exceptionally high out-of-pocket expenditure (Figure 3). The government's efforts to boost healthcare spending need to continue. Its recent decision to suspend a reform that would have threatened universal healthcare is also welcome.

Figure 3. Share of households' out-of-pocket expenditure in health care

% of total current expenditure on health care, 2017 or latest available year



Source: OECD Health Statistics Database.

The regional gap in public service quality and economic opportunities is also large. The planned territorial reform will be an excellent opportunity to merge municipalities, and improve the efficiency of municipal service provision. A shortage of affordable housing hinders labour mobility and better job matches. More public funding for affordable rental and social housing would help this.

Further reading:

- OECD (2019), OECD Economic Survey: Latvia 2019, OECD Publishing, Paris.

Making the most of Riga metropolitan area can boost wellbeing and economic growth in Latvia

Category: Latvia,Uncategorized
written by oecdecoscope | April 25, 2024

By Daniela Glocker and Andrés Fuentes Hutfilter, OECD Economics Department

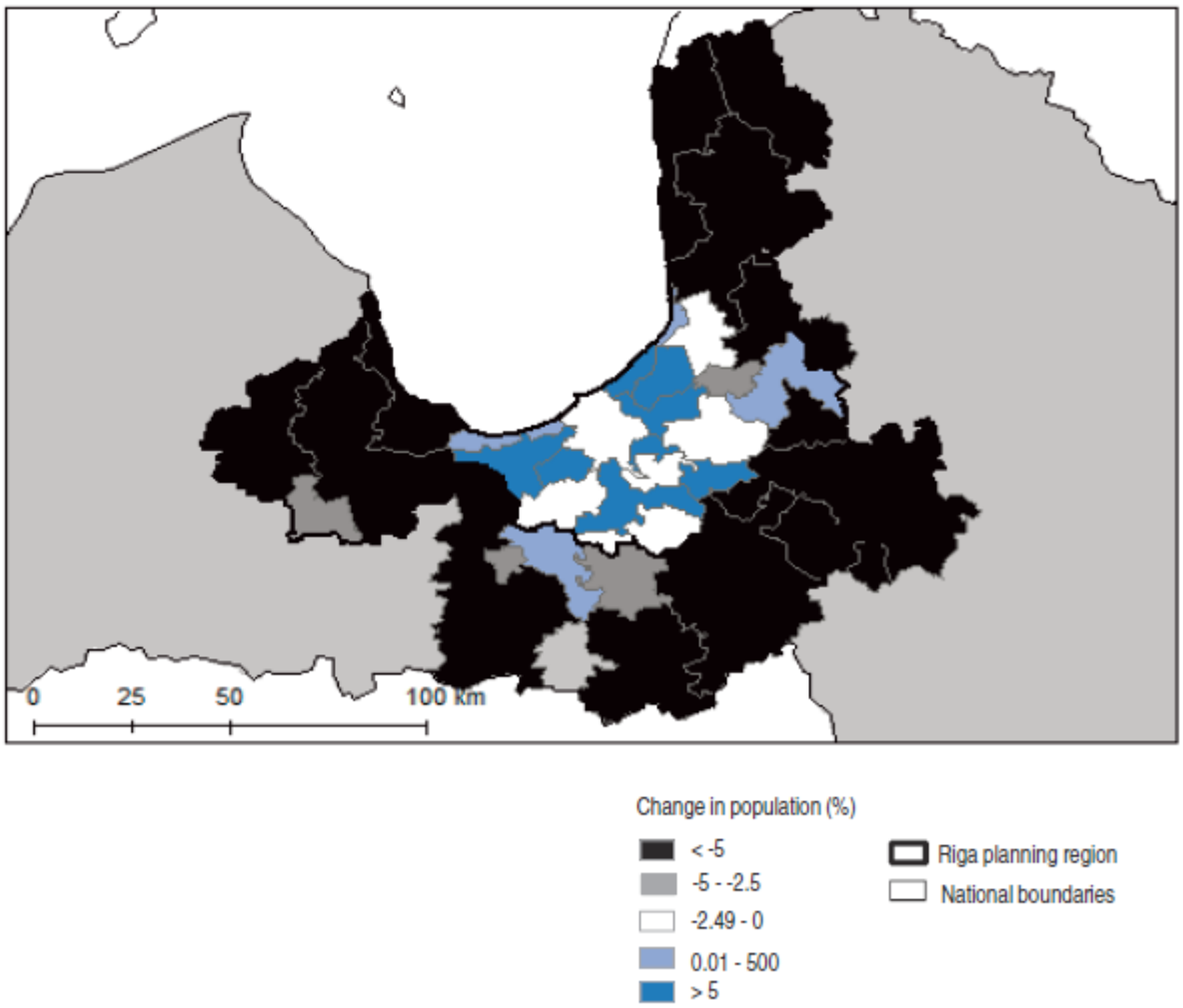
Located at the centre of the Baltic States, Latvia's capital city Riga and its surrounding municipalities are a strategically important logistic centre with access to markets in Europe and Russia. It is the largest city in the Baltic States and the third largest in the Region of the Baltic

Sea.The city and its surrounding municipalities are not only home to more than half of the Latvian population but also contribute about 69% to national GDP. Better urban policies improve the quality of life for a large share of the population, boost economic performance by making the area more attractive, and can help retain young people who have emigrated from Latvia in large numbers, as argued in the *2017 Economic Survey of Latvia* (OECD, 2017).

The city of Riga has lost inhabitants mostly to surrounding suburban municipalities in commuting distance, resulting in urban sprawl. Urban sprawl is driven by low density developments. It can give rise to socio-economic, transport, infrastructure and environmental concerns, with negative effects on economic performance and quality of life. Urban sprawl therefore increasingly contributes to congested roads and environmental pollution. For instance, between 2000 and 2010 the number of private vehicles in Riga increased by 60%, whereas the flow of incoming vehicles from surrounding areas of Riga doubled.

Figure 2.8. **Population has declined in many municipalities but has grown in municipalities surrounding Riga**

Population growth, 2010-15



Note: Only municipalities that are part of the Riga planning region or the Riga agglomeration are depicted.
Source: OECD calculations based on RDIM (2016), Regional development indicators (*www.raim.gov.lv*).

Urban sprawl is driven by middle to high income households, contributing to a concentration of households with similar socio-economic status in neigbourhoods. Residential segregation can result in unequal access to quality education. Residential segregation in Riga is still lower than in other European capital cities but has been increasing. Latvia's fiscal framework incentivises municipalities to follow a strategy that maximises their revenues by individually adjusting their spatial planning. This is because high income households generate more local tax revenues. Municipalities may lack incentives to provide amenities that might attract lower income households, such as social housing. While there is redistribution of tax revenue across municipalities, it

only offsets a small part of the revenue differences.

To reap the benefits that come with urban agglomeration, Riga city and the surrounding municipalities need better co-ordination and joint strategic planning. The appropriate scale of such metropolitan governance needs to match daily mobility patterns of residents and ensure good co-ordination not only across local but also regional and national governments as well as across policy sectors (OECD, 2015a). Across the OECD, good metropolitan governance has shown to be linked to higher productivity, durably higher wages and better quality of life (Ahrend et al., 2014; OECD, 2015b). For example, residents' satisfaction with public transport in metropolitan areas with a dedicated transport authority is higher and air pollution is lower. Metropolitan areas without tailor-made governance arrangements have experienced an increase in urban sprawl, whereas those with a metropolitan authority densified.

References

Ahrend, R., C. Gamper and A. Schumann (2014), "The OECD Metropolitan Governance Survey: A quantitative description of governance structures in large urban agglomerations", *OECD Regional Development Working Papers*, Paris, http://dx.doi.org/http://dx.doi.org/10.1787/5jz43zldh08p-en.

OECD (2017), *Economic Survey of Latvia,* OECD Publishing, Paris.

OECD (2015a), Governing the City, OECD Publishing, Paris, https://doi.org/10.1787/9789264226500-en.

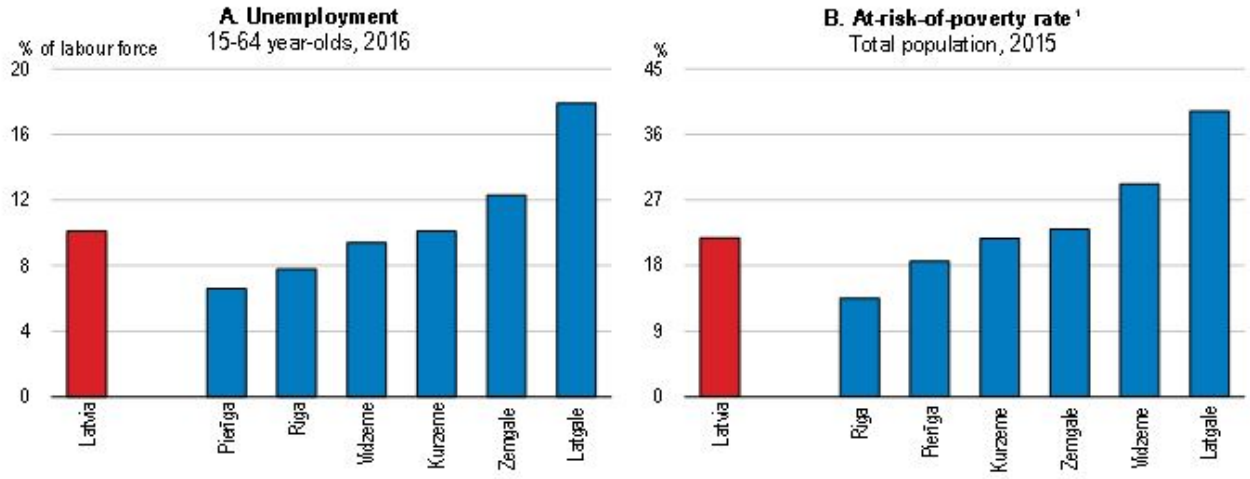
OECD (2015b), *The Metropolitan Century: Understanding Urbanisation and Its Consequences*, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264228733-en.

Boosting economic opportunities and wellbeing in Latvia: why housing matters

Category: Latvia,Uncategorized
written by oecdecoscope | April 25, 2024
by Andrés Fuentes Hutfilter, Germany-Latvia Desk, OECD Economics Department

Unemployment is still above 8% in Latvia and contributes to poverty, in part because many unemployed have been without a job for an extended period of time. High unemployment and poverty are concentrated in some regions (Figure 1).

Figure 1: Poverty is high in regions with high unemployment rates



1. Share of population with disposable income below 60% of median household income.

Source: Central Statistical Bureau of Latvia.

Housing policies shape residential mobility and can encourage workers' movement to jobs (Andrews et al, 2011). The 2017 *Economic Survey of Latvia* therefore argues that good housing

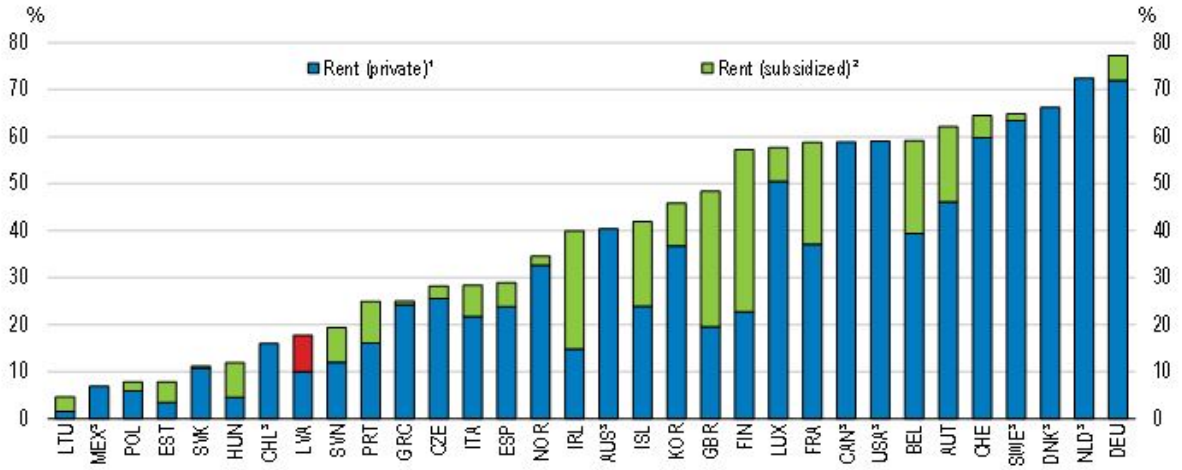
policies help reduce unemployment in high-unemployment areas. By helping workers find better jobs, they can also boost productivity and wages. Housing policies are particularly relevant for young people since they have a naturally higher propensity to move. Good housing policies could also encourage young people to seek opportunities in Latvia rather than emigrate.

Affordable quality housing is also important for wellbeing. Overcrowded housing is widespread among low- and middle-income households in Latvia. The share of households' housing spending in total expenditure (26%) is high, and higher than in other countries with similar income level, such as Estonia. Policies are therefore needed to make quality, affordable housing available in neighbourhoods which are well connected to employment opportunities.

Few households rent their homes, even among low-income households (Figure 2). Home owners from high-unemployment areas are likely to find it difficult to afford buying housing in areas with good employment opportunities, where house prices are likely to be higher. There is little development of new housing for rent. Legal uncertainty and long legal procedures hold back the development of the private rented housing market. Reducing tax evasion and fostering long-term lease contracts could also make contracts more reliable and make rented housing more attractive for tenants. Several OECD countries have also successfully expanded affordable housing by requiring private developers to allocate a proportion of the dwellings as affordable units (Salvi del Pero et al., 2016).

Figure 2: Few low-income households rent their homes

Share of rental housing, low-income households, 2014 or latest year



Note: Low-income households with income in the bottom quintile of the net income distribution. For Chile, Mexico, Korea and the United States, gross income is used due to data limitations.

1. Share of households renting their dwelling at market prices on the private rental market.
2. Share of households renting their dwelling at reduced market prices.
3. Data on tenants renting at private include tenants renting at subsidized for Australia, Canada, Chile, Denmark, Mexico, the Netherlands and the United States. For Sweden, data on tenants renting at subsidized are not capturing the full extent of coverage due to data limitations.

Source: OECD (2016), *OECD Affordable Housing Database*, Table HM1.3.3, December *(http://www.oecd.org/social/affordable-housing-database.htm)*.

Social housing is scarce and waiting lists are long, especially in the Riga area, where unemployment is low and good jobs more abundant. Government spending on social housing and on cash housing benefits for low-income households is low. Support only covers a small share of the low and middle income population. More funding for low-cost rented housing in areas of expanding employment would boost employment and lower poverty. An eligible person can only apply for assistance in the municipality where she resides, limiting labour and residential mobility. A nation-wide register that allowed eligible persons to apply for social housing where they expect better job opportunities could support residential mobility.

References:

OECD (2017) *Economic Survey of Latvia.*

Salvi del Pero, A., Willem, A., Ferraro, V., Frey, V. (2016), “Policies to promote access to good-quality affordable housing

in OECD countries," *OECD Social, Employment and Migration Working Papers,* OECD Publishing, Paris.

Andrews, D., A. Caldera Sánchez and Å. Johansson (2011), "Housing Markets and Structural Policies in OECD Countries", *OECD Economics Department Working Papers*, No. 836, OECD Publishing, Paris.

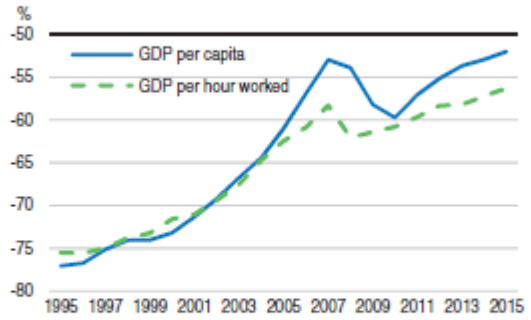
Latvia: time to reboot inclusive productivity growth

Category: Latvia,Uncategorized
written by oecdecoscope | April 25, 2024
by Andrés Fuentes Hutfilter and Naomitsu Yashiro, Latvia Desk, OECD Economics Department

Latvia's economy is growing strongly. Driven by the recovery of exports and investment as well as strong private consumption, real GDP growth is expected to strengthen from 2% in 2016 to around 4% this year and next. Exporters have gained market shares. More disbursement of EU structural funds is boosting investment. Real wage growth is supporting private consumption. Growth is also underpinned by the government's strong track-record in pursuing pro-growth reforms. Administrative burdens to entrepreneurship have been reduced and the efficiency of the judiciary has been enhanced. The quality of education and training has improved and active labour market policies have been upgraded. Government finances are solid: The government budget was in balance in 2016 and government debt is 40% of GDP, lower than in most OECD countries.

The gap in GDP per capita remains large

Gap vis-à-vis the upper half of OECD countries[1]



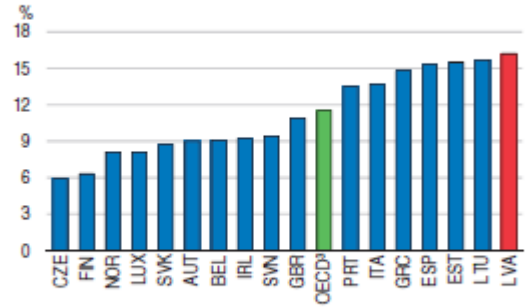
1. Percentage gap with respect to the weighted average using population weights of the highest 17 OECD countries in terms of GDP per capita and GDP per hour worked (in constant 2010 PPPs).

Source: OECD (2017), OECD National Accounts Statistics and Productivity Statistics (database).

Important challenges remain. Productivity is lower than in other Baltic or central European economies and the gap with leading OECD economies remains large (chart A). Yet, productivity growth has slowed after the financial crisis, as elsewhere. To converge to the living standards of high income countries, Latvia has to reinvigorate productivity. As the 2017 Economic Survey of Latvia argues, better integration in global value chains, especially in sectors characterised with rapid technology changes, is key. Latvia has made progress in diversifying its exports. For example, exports of ICT services have increased. But most exports still rely on low-value added activities, such as wood processing or transit transport services.

Poverty is high

Share of population with disposable income below the poverty line,[1] 2015 or latest year



1. The poverty line is half of median household income. Household income is adjusted to take into account household size.
2. Unweighted average.

Source: OECD (2017), OECD Social and Welfare Statistics (database).

Poverty is among the highest in OECD countries (chart B) and is concentrated in some regions in part reflecting high unemployment. Lack of access to good and affordable housing makes it more difficult for low-income workers to move to well-paying jobs. Access to health services and higher education are also uneven and limit access to economic opportunities for low income households. Many young Latvians emigrate. These issues and policies to address them are analysed in the 2017 Economic Survey of Latvia.

Further reading

OECD (2017), *OECD Economic Surveys: Latvia 2017*, OECD Publishing, Paris.