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Executive summary

- The Latvian Economy has grown robustly but not enough for strong convergence in living standards
- Boosting growth requires better export performance
- Better access to housing, jobs and health care would boost inclusive growth
The Latvian Economy has grown robustly but not enough for strong convergence in living standards

Latvia’s economy has grown robustly in recent years on the back of a strong track record in implementing structural reforms, despite a challenging international environment. Rising wages have supported household consumption. After a severe setback in 2008-09, catch-up with higher income OECD countries may have resumed. Government finances are solid and financial market confidence in Latvia is strong. Private sector indebtedness is now lower than in many OECD economies. Unemployment has fallen but remains high, adding to poverty. Many young Latvians emigrate. Informal economic activity is still widespread. Improving access to housing, health care, education and training would improve economic opportunities for low-income households and requires additional government spending.

Boosting growth requires better export performance

Export performance, including diversification of products and destinations, is improving, but Latvia’s exports still rely heavily on low value-added, natural resource intensive products, reflecting in part skills shortages and weak innovation. Few Latvian firms participate in global value chains, although those which do have much higher productivity, employment and wages. Weak credit recovery from insolvent firms holds back access to credit for firms with growth potential. Skill mismatch and widespread informality prevent firms from moving up the global value chains.

Better access to housing, jobs and health care would boost inclusive growth

High long-term unemployment, weak social safety nets and high labour taxes for workers on low pay contribute to widespread poverty. Unemployment is particularly high in Eastern regions of Latvia. Many low-income households are inadequately housed. Few Latvians live in rented housing, which reduces their mobility, and social housing is scarce, especially in the Riga area, where unemployment is low and good jobs more abundant. High out-of-pocket payments for health services limit access of low-income households to health services.
## MAIN FINDINGS

### Using fiscal policy to support structural reform priorities

- **High taxes on low wage incomes contribute to informality, high unemployment, poverty and the emigration of the young.**
  - Reduce the labour tax wedge on low earnings. Raise more revenues from the taxation of real estate and energy. Broaden the base of business income taxation by removing tax exemptions.

- **The budgetary situation is strong and public debt is low.**
  - Continue to comply with the European Union’s fiscal rules and make full use of available fiscal space, including the flexibility mechanisms, to fund structural reforms.

- **Informal activity is widespread, holding back tax revenues, productivity and coverage of workers with social safety nets. Perceptions of weak governance and low trust in the government reduce willingness to pay tax.**
  - Strengthen the budgetary independence of the Corruption Prevention and Combating Bureau (KNAB).
  - Make better use of information and communication technology for tax law enforcement.
  - Remove political influence in the appointment of judges.

### Improving productivity and access to better economic opportunities for all

- **Underskilled workers and low-skill workers have high unemployment and poverty risks.**
  - Provide more generous grants for students attending vocational schools who are from low-income families.
  - Expand grants for university students and target them to students from low-income families.

- **Most university students receive no income support from the government and there is no support targeted to students from low-income households.**
  - Strengthen the specialisation of judges.

- **Weak loan recovery in insolvency procedures holds back bank credit.**
  - Increase government funding of programmes with strong evaluation results.

- **Innovation activity is weak. The productivity gap vis-à-vis high income countries is large. Integration in global value-added chains and inward foreign direct investment are low.**
  - Increase government funding of programmes with strong evaluation results.

- **Infrastructure investment spending is high but the quality of infrastructure still falls short of standards in high-income countries.**
  - Apply the same cost-benefit tests to large national projects as are applied to EU-funded projects.

### Improve access to health services, housing and jobs

- **Few households rent their homes. This reduces labour mobility and contributes to keeping unemployment high in some regions. 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. Housing conditions for low-income households are poor and low-cost housing falls short of demand, especially in the Riga metropolitan area.**
  - Improve legal certainty in rental regulation and encourage out-of-court procedures.
  - Simplify the administrative process for obtaining a building permit.
  - Provide more funding for low-cost rented housing in areas of expanding employment.
  - Expand the mobility programme, which provides temporary support for relocation and transport.

- **Health outcomes are poor and access to care is limited especially among low-income households. Budget restrictions result in rationing of care at the end of each year. Efficiency in health care provision is also held back by insufficient granularity in health service data.**
  - Reduce out-of-pocket payments especially for the low-income population.
  - Develop key service quality and performance indicators for health care providers at national, local and provider-level.
  - Create a platform to co-ordinate policies of all municipalities where most residents commute to Riga.

- **The metropolitan area of Riga is a key driver of growth and employment but lacks adequate governance.**
  - Lower operating costs in the compulsory private pension system, for example by introducing a low-cost fund as the default choice.
Assessment and recommendations

- Income convergence may have resumed but growth needs to become more inclusive
- Fiscal policy to support pressing structural and social policy priorities
- Improving living standards requires boosting productivity and stronger integration in global value chains
- Improving access to housing and health care is key for more inclusive growth
- Environmental outcomes are good
Income convergence may have resumed but growth needs to become more inclusive

Latvia’s economy has grown robustly in recent years (Figure 1), although it suffered in the global recession and faces a challenging environment as exports to Russia have fallen. Latvian exporters have gained market share. Rising wages have supported growth in household consumption. The fiscal position is solid, with a balanced government budget in 2016 and government debt near 40% of GDP. Private sector indebtedness has fallen to relatively low levels. Modest government and private debt and a solid financial sector underpin strong financial market confidence. The Riga metropolitan area is a key driver of economic growth, hosting the country’s nascent high-tech sectors, and contributes about 69% to national GDP.

Recent progress on structural reform priorities can lay the base for invigorating growth and well-being. Latvia stands out as the country which has taken most action on structural reform priorities identified in OECD’s Going for Growth (OECD, 2017a). The quality of education and training has improved and active labour market policies have been upgraded with EU funds. Administrative burdens to entrepreneurship have been reduced, the efficiency of the judiciary has been enhanced by consolidation of small district courts and efforts to boost tax revenue collection have born some fruit.

Despite these advances, the gap in income and productivity to high income OECD countries remains large. This gap also remains larger than in other Baltic countries or
Central European countries. Productivity growth has slowed since the crisis, in Latvia as elsewhere (OECD 2016g). Diversification of export products and destinations have improved, still participation in global value chains remains concentrated on low-value-added activities. Unemployment has fallen but remains above 8%, and the incidence of long-run unemployment is still high, despite the short duration of unemployment benefit entitlements, which contributes to high poverty. Informal economic activity is still widespread, weighing on productivity, poverty and on tax revenues. Large emigration, mostly of young Latvians, contributes to skill shortages. As data from the Latvian Statistical Office show, a third of Latvian emigrants were between 20 and 30 years old in 2015. Geographic disparities in growth, employment and wellbeing are large.

Latvians are less satisfied with their lives than the OECD average (Figure 2, Panel A) and in most of the dimensions of the OECD's Better Life Index, Latvia scores below the OECD average. An exception is educational attainment, as almost all Latvians are educated at least to upper secondary level. However, vocational education has not been sufficiently attractive and has therefore undergone substantial reforms recently. The areas of relative weakness highlighted by the Better Life Index point to little access to well-paid jobs, and problems in the health care system and the housing market. Poverty is among the highest in the OECD (Panel B). The availability of affordable quality housing is low, for instance, 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. Fifteen per cent of dwellings lack basic facilities. Life expectancy at birth in Latvia is 74 years, six years below the OECD average. The gap in health status between rich and poor households is large (Panel C). Income inequality is also high (Figure 3).

A high incidence of poverty and unequal access to quality housing, jobs, education, health and transport services pose risks for social cohesion. Indeed trust in public institutions is generally low, which also damps willingness to pay tax. Weaknesses in effective law enforcement are also likely to have contributed. The government has introduced a broad range of reform initiatives to strengthen the judicial system. Social conflict in the form of strike has remained rare and the government has made efforts to consult social partners with important reform projects such as recent education reforms and the recent tax reform (see below).

Against this background, the main policy messages from the Survey are:

- Latvia has recovered strongly from the global crisis. Greater integration in higher value added activities within global value-chains is key to build on this success and to continue improving living standards.
- Policies which encourage capital and labour to move to firms with high growth potential, for example, through better allocation of credit and mobility of workers, would support this process.
- Inclusive growth would benefit from improving access to jobs, better upskilling opportunities, improved healthcare and better transport, especially in rural areas.

**Economic growth has been consumption-based while exports are still largely low value-added**

Economic growth slowed in 2016 (Table 1), notwithstanding continued robust household consumption supported by strong real wage growth (Figure 4). Investment fell due to the delay in the disbursement of EU structural funds (Figure 5, Panel A), which also affected
residential investment, but has recovered recently. Residential investment also fell because
restrictions on residence permits for non-EU citizens were introduced in 2014. Exports to
Russia were subdued reflecting the economic crisis there. As in other Baltic economies,
exporters gained market shares (Figure 6). The unemployment rate has fallen but remains
high (Figure 5, Panel B). Consumer price inflation remains low.

Latvian exports have diversified, contributing to gains in market shares. Latvia has
increased exports to new markets to compensate for the drop in exports due to Russia’s
economic downturn and its ban on EU food product imports. The share of exports going to
Russia remains the third largest after Lithuania and Estonia (Figure 7). Machinery as well as
information and communication technology (ICT) and travel service exports have gained
ground (Figure 8). Nonetheless, Latvia’s goods exports still largely consists of raw materials and natural-resource-intensive products. Demand of these tends to grow little with rising incomes. In the medium-term the transit of exports from Russia is expected to continue declining but still contributes substantially to service export revenues.

Reflecting strong wage growth, Latvia’s relative unit labour costs have increased since 2010, more so than in the other Baltic countries (Figure 9), which have gained more export market share. However, wage growth may have been overstated as underreporting of wages to tax authorities diminished. Also, Latvian export market shares have improved markedly since 2014. The depreciation of the Euro and the appreciation of the Ruble reversed the trend in late 2016 but may only have a temporary impact. Since Latvia’s exports are concentrated on industries and activities with relatively small room for quality

Figure 3. **Income inequality is high**
Gini coefficient and gap of household disposable income between rich and poor, 2015 or latest year

A. Gini coefficient¹

B. P90/P10 disposable income decile ratio²

1. It ranges from 0 (when everybody has identical incomes) to 1 (when all income goes to only one person).
2. The ratio of 10% of people with highest income to 10% of people with lowest income.
3. Unweighted average of the data shown.

StatLink [link](http://dx.doi.org/10.1787/888933582341)
upgrading and product differentiation, further loss of cost competitiveness can undermine Latvia’s export performance.

Wage growth is largely driven by skills shortages, in part on account of emigration, which remains high (Figure 10). Moreover, unemployment in the dynamic capital region is already very low, while mobility and skill barriers prevent the unemployed from other regions to take up jobs there. The minimum wage has risen.

GDP growth is projected to strengthen in 2017 (Table 1). Disbursement of EU funds picks up, boosting investment strongly. Household consumption is projected to remain robust on the back of sustained real wage growth. Exports will strengthen thanks to the gradual recovery in the main trading partners. The current account balance will diminish as strong consumption and investment increase imports, and is projected to move into a small deficit. Unemployment is projected to fall only slowly due to high structural unemployment. Inflation will remain low, although the impact of low energy prices fades.

<table>
<thead>
<tr>
<th>Table 1. Macroeconomic indicators and projections</th>
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<td>Annual percentage change, volume (2010 prices)</td>
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<td>Gross domestic product (GDP)</td>
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<td>2.1</td>
<td>2.7</td>
<td>2.0</td>
<td>4.3</td>
<td>3.7</td>
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<td>Private consumption</td>
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<td>1.3</td>
<td>3.5</td>
<td>3.4</td>
<td>4.2</td>
<td>3.6</td>
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<td>Government consumption</td>
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<td>3.1</td>
<td>2.7</td>
<td>3.7</td>
<td>2.5</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
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<td>-1.8</td>
<td>-11.7</td>
<td>17.4</td>
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<td>Housing</td>
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<td>-19.5</td>
<td>-11.1</td>
<td>10.0</td>
<td>4.3</td>
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<td>Final domestic demand</td>
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<td>2.2</td>
<td>0.1</td>
<td>6.6</td>
<td>4.5</td>
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<td>Stockbuilding</td>
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<td>-1.0</td>
<td>0.2</td>
<td>3.0</td>
<td>-0.2</td>
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<tr>
<td>Total domestic demand</td>
<td>23.5</td>
<td>0.1</td>
<td>2.4</td>
<td>3.0</td>
<td>6.1</td>
<td>4.4</td>
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<tr>
<td>Exports of goods and services</td>
<td>13.7</td>
<td>3.9</td>
<td>2.6</td>
<td>2.8</td>
<td>5.5</td>
<td>4.5</td>
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<tr>
<td>Imports of goods and services</td>
<td>14.5</td>
<td>0.5</td>
<td>2.1</td>
<td>4.6</td>
<td>8.5</td>
<td>5.7</td>
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<td>Net exports</td>
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<td>0.3</td>
<td>-1.1</td>
<td>-1.7</td>
<td>-0.8</td>
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Other indicators (growth rates, unless specified)

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<table>
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<td>Potential GDP</td>
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<td>Output gap</td>
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<tr>
<td>Employment</td>
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<td>Unemployment rate</td>
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<tr>
<td>GDP deflator</td>
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<tr>
<td>Consumer price index</td>
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<tr>
<td>Core consumer prices</td>
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<tr>
<td>Household saving ratio</td>
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<tr>
<td>Current account balance</td>
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<tr>
<td>General government fiscal balance</td>
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<tr>
<td>Underlying general government fiscal balance</td>
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<tr>
<td>Underlying government primary fiscal balance</td>
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<tr>
<td>General government gross debt (Maastricht)</td>
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<tr>
<td>General government net debt</td>
<td>16.1</td>
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<tr>
<td>Three-month money market rate, average</td>
<td>0.2</td>
</tr>
<tr>
<td>Ten-year government bond yield, average</td>
<td>2.5</td>
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</tbody>
</table>

1. Contribution to changes in real GDP.
2. As a percentage of potential GDP.
3. As a percentage of household disposable income.
4. As a percentage of GDP.

As a small open economy, Latvia is exposed to developments in its main trading partners, the European Union and Russia. While exports to the United Kingdom grew in 2016, the decision of the UK to leave the European Union may affect export prospects in the medium term, as the UK is an important trading partner. It may also lower Latvian emigrants’ remittances, which amount to 0.8% of GDP. A further risk to the outlook is that financial market turbulence could reemerge in the euro area, which may also increase macroeconomic risks for Latvia. Such turbulence could tighten lending conditions throughout the euro area and reduce demand in Latvian export markets. Increased
economic uncertainty may raise precautionary household saving, damping consumption, as limited social protection provides little insurance against income risks. Indeed, the Latvian economy has a track record of volatility in response to shocks, as documented in the 2015 Economic Survey of Latvia (OECD, 2015a). On the other hand, if Latvia implements structural reforms that boost inclusive growth at a faster pace, exports would grow more strongly and resilience could improve. Stronger economic recovery in Russia could also boost exports beyond the projected level. Steps to deepen European integration, including steps to complete the banking union within the European Monetary Union, could boost confidence. The decision of the United Kingdom to leave the European Union could boost economic performance in the short run. The figures show that exports from Latvia, Estonia, and Lithuania are improving, with Latvia showing the most consistent growth.

**Figure 6. Export performance is improving**

Four-quarter moving average, index 2010 = 100

Note: Export performance is measured as the ratio of actual export volume to the country’s export market.

**Figure 7. The shares of most of the largest export destinations have declined**

% of total merchandise exports

Source: Central Statistical Bureau of Latvia.
ASSESSMENT AND RECOMMENDATIONS

Figure 8. **Exports are still concentrated in resource-intensive goods and transport services**

A. Composition of good exports

B. Composition of service exports

1. Includes mechanical appliances; electrical equipment; transport vehicles; optical instruments and apparatus (inc. medical); clocks and watches; musical instruments.
2. Includes products of the chemical and allied industries; plastics and articles thereof; rubber and articles thereof; base metals and articles of base metals; and mineral products.


Figure 9. **Relative unit labour costs have risen**

OECD competitiveness indicator¹, four-quarter moving average, index 2010 =100

1. The competitiveness indicator is the ratio of own unit labour costs relative to those of trading partners. An increase corresponds to lower competitiveness.


return migration to Latvia. Possible low-probability shocks which would completely alter the economic outlook if they materialise include the intensification of geopolitical risks related to Russia (Table 2).

**High structural unemployment raises the risk of poverty**

Big local differences in unemployment and vacancies contribute to high structural unemployment and poverty. Unemployment and poverty are much higher in the East of
Latvia, particularly in the Latgale region, than in the Riga area (Pierriga and Riga, Figure 11). Seventy-two per cent of vacancies notified to the public employment service are in Riga. Forty-five per cent of the unemployed were unemployed for a year or longer in 2015, mostly in the Eastern rural areas. Unemployment benefits are reduced by a half after six months and expire after nine months. The large number of workers whose salaries are only partly declared to the tax authorities also reduces unemployment benefit entitlements in case of job loss. Income inequality is reflected in large local differences in personal income tax revenues (Figure 12).

Credit growth is subdued despite very supportive monetary policy

As elsewhere in the euro area, expansionary monetary policy has resulted in extremely low interest rates. Financial sector confidence is strong, as spreads vis-à-vis interest rates on German government debt have remained close to zero. Private sector indebtedness has fallen below levels in many OECD countries (Figure 14). Non-financial
Figure 11. 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.

Figure 12. Income tax revenues per inhabitant vary strongly

Figure 13. **Low-skilled and older workers face the highest risks of unemployment and poverty**

Unemployment and poverty rate by educational attainment and by age group

**A. Unemployment rate**

- % of active population aged 25-64
- % of corresponding active population

**B. Poverty rate**

- % of population aged 18-64
- % of corresponding population

1. Includes post-secondary non-tertiary education.
2. Share of population with disposable income below 60% of median household income.


StatLink  http://dx.doi.org/10.1787/888933582512

Figure 14. **Private debt is falling**

Debt as % of GDP

**A. Latvia**

- Households
- Non-financial corporations

**B. International comparison**

Households and non-financial corporations, 2015

1. Includes non-profit institutions serving households.


StatLink  http://dx.doi.org/10.1787/888933582531
businesses deleveraged sharply in the aftermath of the crisis, as banks wrote off loans to non-viable firms and demand for loans was low. Nonetheless, lending to non-financial corporations has recovered only slowly while the decline of credit to households has levelled off (Figure 15). Bank lending surveys suggest that loan demand has increased, but banks have not eased their lending standards (Bank of Latvia, 2016a). Banks report that low equity, weak credit records of firms, a weak judiciary and informal economic activity prevent them from easing lending standards.

Figure 15. **Lending to the non-financial private sector is weak**

Year-on-year percentage change of credit stock

![Lending to the non-financial private sector is weak](image)

Note: Lending data are corrected to exclude one-off effects due to the withdrawal of credit institution’s licences.

Source: Bank of Latvia.

Although firms depend mainly on bank lending, alternative financing platforms are growing. Internet-based loan issuance has increased strongly, and is among the most developed in Europe, although the share in overall lending is still very small (KPMG, 2016). Including internet lending in prudential regulation, as planned, could strengthen financial intermediation and contain risks. Another welcome step is the creation of the Baltic Market through the merger of the stock exchanges of the three Baltic countries, which may help improve the capacity for Latvian firms to raise equity.

Latvia’s banking sector is overall healthy and supervision is sound. Capital and liquidity ratios are comfortably above required levels (Table 3). The ratio of non-performing loans has fallen below the EU average and coverage of loan loss risk with provisioning is high. Profitability is strong. The three largest banks, of which two are owned by Scandinavian banks, are directly supervised by the ECB. Latvia benefits from the Single Resolution Mechanism (SRM), which provides an EU-wide framework for orderly resolution of large banks. The smaller Latvian banks are supervised by Latvia’s Financial and Capital Market Commission (FCMC). Macro-prudential policies are implemented by the FCMC, which consults with the Bank of Latvia, and the Ministry of Finance. They form the Macroprudential Council, an advisory body. It can issue non-binding recommendations on the principle of “comply or explain”.

House prices in Latvia have been rising in recent years, but broadly in line with incomes (Figure 16). Housing demand has been bolstered by lower down-payments.
Lending to households is nonetheless moderate, suggesting low financial sector risks on this front. Low incomes of many Latvian households and tighter lending standards since the crisis have barred low-income households from purchasing new housing, while the private rented housing market is underdeveloped. Therefore, despite lower house prices, for low-and middle-income households quality housing is still difficult to afford (see below). A government programme providing loan guarantees for housing mortgages for families with children helps to some extent, but by increasing housing demand may also result in higher prices.

Table 3. The Latvian banking sector is robust
Selected prudential and performance indicators. Per cent, 2016 (latest available quarter)

<table>
<thead>
<tr>
<th></th>
<th>Latvia</th>
<th>EU average</th>
<th>Minimum requirements</th>
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<tbody>
<tr>
<td>Total capital adequacy ratio</td>
<td>21</td>
<td>18</td>
<td>11</td>
</tr>
<tr>
<td>Common equity Tier 1 ratio</td>
<td>18</td>
<td>14</td>
<td>8</td>
</tr>
<tr>
<td>Leverage ratio(b)</td>
<td>9</td>
<td>14</td>
<td>8</td>
</tr>
<tr>
<td>Liquidity ratio(c)</td>
<td>61</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>NPL(d) ratio</td>
<td>4</td>
<td>5</td>
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<tr>
<td>NPL coverage ratio(e)</td>
<td>89</td>
<td>44</td>
<td></td>
</tr>
<tr>
<td>Loan to deposit ratio</td>
<td>71</td>
<td>122</td>
<td></td>
</tr>
<tr>
<td>Return on equity(f)</td>
<td>14</td>
<td>6</td>
<td></td>
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</tbody>
</table>

1. Proposed.
a) Sample average, end-June 2016, of major banks covering about 85% of the EU banking sector; see EBA (2016c).
b) Tier 1 capital/Total risk unweighted assets (%).
c) Liquid assets/current liabilities (with maturity up to 30 days), where Liquid assets = vault cash + claims on central banks and other credit institutions + debt securities of central governments and other liquid debt securities; and current liabilities = claim liabilities and liabilities with residual maturity not exceeding 30 days.
d) Past due (> 90 days) loans to total loans.
e) Non performing loans coverage ratio (provisions for principal amount of loans/past due > 90 days loans).
f) Annualised profit/loss for the reporting period to average equity (branches of foreign banks not included in the calculation).

Source: Financial and Capital Market Commission, Latvia; European Banking Authority.

Figure 16. House price increases have been aligned with income growth

1. The nominal house price is divided by the nominal disposable income per head.
Foreign deposits at Latvian banks, mostly related to business links with Russia, amount to around 43% of total deposits end-2016. They have decreased since 2015 following the introduction of stricter anti-money laundering and counter-terrorism financing rules (Figure 17). These rules will be tightened further in 2017. Increasing uncertainty over geopolitical risks and weakening of CIS economies could trigger further withdrawals of foreign deposits. They could also weaken banks’ profitability, as banks offering foreign deposits have claims in CIS countries, and eventually some of them might need to downscale their business. However, these banks are subject to more demanding capital and liquidity requirements, and stress tests by the Bank of Latvia suggest that they can withstand large withdrawals.

**Figure 17. The share of foreign deposits is large**


Fiscal policy to support pressing structural and social policy priorities

Latvia has a rigorous budgetary framework, underpinned by an independent fiscal council and transparent national fiscal rules defined in the Fiscal Discipline Law. The fiscal council performs regular monitoring of compliance with the requirements of the Fiscal Discipline Law and prepares an annual report which is submitted to the parliament together with the Medium-Term Budgetary Framework Draft Law. This institutional set-up should be an effective means of keeping public expenditure growth consistent with fiscal sustainability (Economic Survey of Latvia 2015, OECD, 2015a).

Latvia’s budget planning is subject to structural budget balance rules to comply with the European Union’s Stability and Growth Pact (SGP). The medium-term objective for the structural deficit consistent with the SGP is 1% of GDP. The government is making full use of allowed deviations on account of recent pension and healthcare reform, based on the SGP’s flexibility mechanism, until 2019. In addition, national rules limit the structural deficit to 0.5% of GDP. These are currently not binding because the national authorities have currently estimated a lower structural deficit. Rigorous commitment to fiscal rules has kept Latvia’s public debt near 40% of GDP, considerably lower than the limits set by the Fiscal Discipline Law (60%). Substantial reforms are ongoing to improve public sector efficiency (Table 4).
The long-term outlook is robust, as expected increases of ageing-related spending are modest, reflecting past reforms which reduced the generosity of government-paid pensions. However, poverty among pensioners is high and may rise as pension benefit replacement rates are projected to fall.

The fiscal stance is expected to be moderately expansionary in the near term. The 2017 budget foresees additional spending of 0.3% of GDP to improve access to health care. The government has also improved access to social assistance for families with children and has raised benefits for the third and subsequent children. Government investment is also expected to expand with the disbursement of new EU funds. These are welcome measures.

There is a case for making full use of available fiscal space under SGP rules, including the flexibility mechanisms to fund structural reforms, also beyond 2019. This could support policies which boost economic growth in an inclusive way. Assuming low nominal GDP growth of 3.5% per year, a deficit of 1.5% of GDP would keep the debt-to-GDP ratio broadly unchanged until 2030. Assuming higher nominal GDP growth of 4.5% per year, a
sustained government deficit of 1.5% would allow government debt to fall below 40% (Figure 18). The current low-interest environment offers a near-term window of opportunity to invest in economic and social infrastructure which boosts inclusive growth without raising the debt-to-GDP ratio (OECD, 2016h). Current macroeconomic conditions are consistent with higher government spending, as inflation and lending growth remain low. Moreover, a chapter on public sector efficiency in the 2015 Economic Survey of Latvia (OECD, 2015a) has not identified scope for substantial spending cuts, as government expenditure in Latvia is low. While social spending is not targeted to the poorest, it is low and largely consists of pension and unemployment benefits, which are universal entitlements.

The government plans to raise currently very-low level of means-tested social assistance benefits by 90%, to 20% of median income (94 euros per month for the first adult). On current plans municipalities would remain responsible for paying social assistance. The central government will support low income pensioners by increasing the minimum old-age pension commensurately. It will also raise pensions for pensioners with long insurance periods. Social assistance transfer spending is higher in poor municipalities while their tax revenues are lower. Therefore, higher social assistance payments may limit their capacity to fund other key social services for which they are responsible, such as childcare. Further progress in reducing informality is important to strengthen the effectiveness of the means-test, so as to ensure means-tested social assistance benefits are well-targeted to the poor.

A wide range of structural reform priorities is essential for boosting inclusive growth and these require more government funding. In particular out-of-pocket payments for health-care services should be reduced especially for the low-income population. Access to vocational education and training and to higher education as well as the funding of active labour market policies need to improve. Investment is also needed in road infrastructure.
Policies are needed to make more low-cost rented housing available in areas which provide good access to jobs. This is discussed in more detail below.

**Tax reform could make growth more inclusive and raise more revenues**

Parliament has approved a reform of personal and corporate income tax in the framework of a broad tax reform. It reduces the basic personal income tax rate from 23% to 20% for incomes up to 20,000 euros per year starting in 2018. It also raises the corporate tax rate from 15% to 20%. However, non-distributed corporate tax income will be fully tax-exempt, effectively turning the tax into a tax on distributed profits, as in neighbouring Estonia. Lower personal income taxes reduce the taxation of labour, which is welcome. However, in view of high poverty, targeting these tax reductions to low-wage workers may be preferable.

The corporate tax reform could encourage investment by boosting retained earnings, which is the main source of finance for business investment. However the current corporate tax rate is already low and accelerated depreciation allowances are generous. The reform could also reduce administrative costs to some extent (Staehr, 2014). In Estonia firms have responded to the tax system largely by accumulating cash rather than investing in fixed assets (Hazak 2009). There may perhaps have been some positive investment and productivity effects on individual firms (Masso et al., 2013), but no benefits to macroeconomic performance can be shown (Staehr, 2014).

The government estimates the tax reform package to have a cost of 0.6% of GDP in the budget when it is fully implemented by 2020, which would make it harder to address key spending priorities to improve access to health care and education. However revenue risks from the corporate income tax reform could be substantially bigger.

Steps to eliminate exemptions from business taxation could strengthen revenues and avoid unwanted disincentives for firms to grow. The micro enterprise tax system exempts small eligible firms from income tax and social security contributions. They pay a low turnover tax instead. The scheme encourages firms to remain small or to keep part of their activity in the informal sector to benefit from low taxation and harms inclusiveness. Young start-up firms financed with venture capital pay a low lump sum tax per worker, which is regressive. The employees in these start-up firms are not covered by unemployment or pension insurance. These tax breaks should be abolished. Any tax support for start-ups should be limited in time, to reduce disincentives to grow, and ensure full coverage with social security. There are also generous tax credits and exemptions for special economic zones, mostly in the port areas. However, these are subject to competition from similar arrangements in other countries of the region.

The government has taken steps to lower labour taxes on low-income earners and raised excise and environmental taxes, as recommended in the 2014 Economic Survey of Latvia (OECD, 2014a, Table 5). This is welcome. Indeed, the labour tax wedge is high, although Figure 19 does not include most recent reductions. Reducing the high labour tax wedge on low income earners (Figure 19) further could have particularly large benefits for Latvia: it could reduce unemployment and undeclared employment and could damp emigration of young workers, whose wages tend to be low. Recent legislation has increased the basic income tax allowance for low-income households. This tax allowance now diminishes as income rises. The solidarity tax levied on high salaries also introduces some
progressivity in the personal income tax system, which is welcome in view of high income inequality. But workers have to claim the basic allowance, and low-income workers may fail to do so. Besides, personal income tax reductions are less effective in reducing taxation of workers on the lowest salaries, as they typically pay no or little income tax. By contrast, social security contributions must be paid from the first euro. Therefore, reducing social security contributions for low wage workers would be particularly effective in promoting formal employment of these workers, and would increase the inclusiveness of the tax system. In Colombia, reducing payroll contributions also resulted in a substantial increase of formal jobs in the short-run (Bernal, Eslava and Meléndez, 2015; Medina and Morales, 2016). In Latvia’s notional defined contribution public pension system, pension payments are linked to contributions. Lower social security contributions should however not result in lower pension benefit entitlements, as pension income replacement rates are low. An

Table 5. Implementation of recommendations on the tax system

<table>
<thead>
<tr>
<th>Earlier OECD recommendations</th>
<th>Actions taken</th>
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<tbody>
<tr>
<td>Decrease labour tax for low-income earners.</td>
<td>From 2016 a differential non-taxable minimum income allowance has been introduced with a higher tax-exempt level for low income (EUR 160 per month for lowest wages). The monthly allowance for dependents amount has been raised from EUR 165 to EUR 175.</td>
</tr>
<tr>
<td>Raise additional revenues by increasing property and environmentally related taxes. Increase energy tax rates, making them depend on their relative carbon content. Phase out environmentally harmful fuel subsidies.</td>
<td>In 2015 and 2016 the excise tax rates for alcohol, tobacco and several oil products were raised and the tax base was broadened. Excise tax rates will be raised gradually until 2018. Car and motorcycle taxes have been abolished in 2017 and replaced by the vehicle exploitation tax where rates are based on CO2 emissions. The tax exemption for electricity expenditure has been abolished. Tax rates for extraction of natural resources in several categories of minerals and soil were increased by 25-29%. Taxes for the disposal of municipal waste have been increased for hazardous waste and production waste. Tax rates on activities emitting CO2 and on goods harmful to the environment were increased.</td>
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</table>

Figure 19. Taxes on low labour incomes are high

% of total labour compensation, single person at 67% of average earnings without children, 2016

Note: Labour taxes include personal income tax and employee plus employer social security contributions and any payroll tax less cash transfers.
alternative option would be the introduction of an earned income tax credit for low-income households.

The tax reform foresees setting tax rates on capital income received by households (such as interest income) at 20%, at the same rate as other household income. This is welcome as capital income received by households (such as interest income) is currently taxed at lower rates than other household income. Low taxes on such income tend to favour high-income households, making the tax system less inclusive. Yet an inclusive tax system is important in view of high income inequality. There is scope to raise taxation of energy and real estate, including through approximating cadastral valuation to current market values. However given the high home ownership, even among low-income households, this could be accompanied by the introduction of a tax-exemption up to a suitable value ceiling. There is also scope to continue raising taxes on alcohol and tobacco further.

**Encouraging firms and workers to fully declare their economic activity**

Informal activities remain widespread. While it is difficult to capture the exact size of the informal sector, in 2015 it was estimated to amount to more than 20% of GDP in Figure 20. The government has made considerable effort to improve tax collection by intensifying tax audits on individuals and firms operating in sectors where informal activity is widespread; introducing criminal sanctions against employers paying undeclared wages; strengthening controls, resources and co-ordination among relevant authorities (tax authorities, labour inspectors and customs); and raising fines and increasing personal liability of company board members. These steps helped increase tax revenues, which are estimated to have reached 31% of GDP in 2016, up from 29% in 2015 (Figure 21).

To provide essential social services and lower the tax burden on low income earners the government is aiming to raise tax revenue further. It is planning to make better use of ICT for tax law enforcement which is welcome. It plans to require electronic record keeping cash registers. The government also plans to combat tax evasion in electronic commerce and to enable electronic exchange of information between credit institutions and the tax authorities.

But more fundamental measures that strengthen the incentive for tax compliance by firms and workers are needed. Perceptions of weak governance undermine the willingness to pay tax. Surveys of company owners and managers shows that acceptance of informal activity is strongly related to their dissatisfaction with business legislation (Putnins and Sauka, 2016). In comparison with Estonia and Lithuania more Latvian businesses display lower trust in the government (Putnins and Sauka, 2016). Trust in public governance is also weak in the population at large (Figure 22). Greater trust in government helps improve tax morale (Daude et al., 2012). Torgler and Schneider (2007) show that better governance and more direct political participation possibilities for the population improve willingness to pay tax. Williams and Horodnic (2015) link the informal economy to low motivation to pay taxes and conclude that policies to reduce informality should focus on improving trust in government. This can be done by developing greater procedural justice, strengthening perceptions of impartial treatment of all citizens as well as broad and fair access to public services.

Reforms to improve public sector efficiency have included more steps to fight corruption of the Latvian Corruption Prevention and Combating Bureau (KNAB; Table 4 above). The KNAB’s core budget increased in 2016 and 2017. This shows the commitment of Latvia to
fighting corruption and avoid political interference with the work of the KNAB. However, scope for further improvement remains, for example, by raising the budgetary independence. The budget of the KNAB continues to be proposed by the Council of Ministers and is approved by parliament annually, weakening independence. Full independence is important so KNAB is perceived to be able to investigate corruption within these institutions. As is the case for competition authorities, budgetary independence should be reinforced by mechanisms reducing government discretion, such as fixed

Figure 20. **The size of the informal economy is large**

Estimated size of the informal economy and underreported corporate profits and wages, 2016

Note: The aggregate size of the informal economy is estimated from the firm-level information. Underreported corporate profits and wage payments by registered firms in the three Baltic countries are based on survey data.


Figure 21. **Tax revenues are low**

2015

multiannual budget allocations, the allocation of fixed revenue sources, for example fees or taxes, or a combination of these (OECD, 2016i).

Many judges are appointed by parliament, which may expose them to political influence. Stronger independence from political influence in the procedures to appoint judges could also improve perceptions of governance. It is welcome that legislation to strengthen the independence of judges is being considered by parliament. There is also scope to strengthen rules on the engagement of lobbyists in the legislative process (Council of Europe, 2016). Broadening access to key social services, notably health services, may also strengthen perceived fairness and thereby willingness to work in the formal economy (see below).

**High operating costs reduce the pensions workers accrue in the second pillar pension system**

Since 2001, all young workers taking up employment in Latvia are enrolled in the compulsory, second pillar (private) pension scheme, which complements the first pillar (public) pension scheme. Six per cent of workers’ salaries flow into a privately managed plan chosen by each worker. But high operating costs imposed by private investment managers, particularly costs from excessive marketing activities, considerably reduce risk-adjusted returns. Operating costs of private pension funds amounted to close to 2% in 2015 (Figure 23), although they were somewhat lower (1.6%) for funds in the compulsory second pillar system. The high costs significantly reduce the capital workers accumulate in the fund over their working lifetime. With current contributions and risk-adjusted returns today’s workers will have to lower their living standards considerably when retiring.

Empirical evidence suggests that marketing activities of fund managers with the purpose of attracting contributors to their funds has no benefit for workers (Hastings et al., 2013). Such activities raise costs as well as suppliers’ market power because they attach
workers to pension funds for reasons unrelated to performance, especially low-wage contributors. Berstein and Micco (2003) show that, in oligopolistic market structures, pension funds have incentives to engage in marketing that reduces social welfare but generates costs, to raise profit margins. Proposals currently under discussion in Latvia are to lower the cap on the general fee from currently 1% and stricter requirements for performance-related higher charges. These steps would be welcome. To reduce costs and boost net returns in second pillar pension systems, Australia and Sweden, for example, have introduced a low-cost default-choice fund (OECD, 2013a; Tapia and Yermo, 2008), in which contributors invest unless they take a deliberate decision to invest elsewhere. Costs in these funds are kept low with passive investment strategies and by avoiding marketing expenses. In Sweden, such funds have proven to offer higher returns than managed funds.

**Improving living standards requires boosting productivity and stronger integration in global value chains**

Latvia enjoyed strong productivity growth until the early 2000s. However, as in many OECD countries, productivity growth has slowed significantly in the past decade (Figure 24). Reinvigorating the productivity of Latvian firms is key for Latvia to continue to improve living standards.

As a small open economy, Latvia needs to be integrated into the global economy to boost productivity. International trade and foreign direct investment (FDI) channel knowledge from advanced economies (Coe et al., 2009; Alfaro, 2016). Imports of intermediate goods boost productivity by enabling firms to diversify production and upgrade quality (Amiti and Koning, 2007). Integration in global value chains (GVCs) intensifies such knowledge transfer and use of imported inputs and enables Latvia to further diversify its exports and to tap into world demand through GVCs. Indeed, entry to export market boosts significantly the productivity, employment and wages of Latvian firms (Figure 25; Benkovskis et al., 2017). For example, starting to export boosts labour productivity.
productivity by more than 23% in the year of export entry. Employment and wages also increase by 21% and 8% respectively in the third year. These effects are particularly strong for firms that are likely to be participating in high value added activities within GVCs, such as exports of intermediate goods and knowledge intensive services (see Chapter 1).
Only few Latvian firms export (6%, or 28% of firms with more than 10 employees, in 2014) and an even lower share of firms participate in GVCs. Participation in GVCs requires upfront investment such as developing capabilities to comply with quality standards (OECD, 2013b; Henson and Humphrey, 2010). This acts as entry barrier for small and low productive firms. Policies that remove barriers to the reallocation of resources would help firms with high growth potential to attract the capital and labour they need to expand. They thus allow more firms to participate in GVCs and boost productivity. Indeed, productivity in Latvia could be up to 25% higher if capital, labour and other inputs were reallocated to more productive firms (Benkovskis, 2015). This could set off a virtuous cycle of improving export and productivity performance, as higher productivity also boosts firms’ export performance.

The large scale of informal activities also holds back productivity, as informal firms limit their size and use backward production technologies to avoid detection (Dabla Norris et al., 2007). Informality hampers efficient resource allocation by giving informal firms a cost advantage (Perry et al., 2007). Informal activities tend to be concentrated in low-skill jobs with low wages and with no integration in global value chains such as construction. Informal sector jobs are estimated to be on average 30% less productive than formal jobs in Latvia (Putnins and Sauka, 2016).

**Foreign trade and FDI are weak**

Latvia’s exposure to trade is lower than its peers’ (Figure 26, Panel A). Latvia also makes little use of imported intermediate inputs (Figure 26, Panel B). FDI in Latvia is also lower than in Estonia (Panel C). Participation in GVCs lags behind other Baltic and Central European countries (Figure 27). In 2014, less than 40% of domestic value added was generated from GVC participation, less than in Estonia, Lithuania and Central European countries.

Figure 26. **Latvia has room to boost productivity through trade and FDI**

1. OECD estimates based on the 2011 Inter-Country Input-Output (ICIO) table and the OECD Bilateral Trade Database by Industry and End-Use (BTDIxE).


StatLink  ➤  [http://dx.doi.org/10.1787/888933582987](http://dx.doi.org/10.1787/888933582987)
Almost one-third of Latvia’s employment is sustained by GVC participation (OECD, 2016b). However, the value-added per worker from GVC participation is low compared to advanced OECD economies (Figure 28). This is partly explained by knowledge intensity, as Latvia’s share of knowledge intensive services included in its exports is lower than that of Estonia or advanced OECD economies (Figure 29). In order to boost productivity and create more high-skilled jobs, Latvia needs to expand the scope of its participation in GVCs to more high value added activities such as new product development, manufacturing of technologically advanced components, as well as marketing, branding and after-sale services (OECD, 2013b). Facilitating broader access to such jobs to workers in low-income households will also make growth more socially inclusive.

**Improving the supply of labour market relevant skills**

The shortage of relevant skills holds back Latvian firms’ adoption of advanced technologies or management practices. The misallocation of skills, often represented by a large presence of workers over or under-skilled for their jobs, constrains productivity growth by making it difficult for productive firms to hire more skilled workers (Adalet McGowan and Andrews, 2015). Around 11% of Latvian workers report being underskilled and 20% are overskilled. The share of workers in Latvia reporting that their skills were below the level required for their job is among the highest in European OECD countries (Figure 30, Panel A). By contrast over-skilling is low in international comparison (Panel B).

Important reforms have improved the quality of vocational education and training (VET) (Table 6). The educational contents of VET have been upgraded. Education programmes which can be completed in separate modules have improved flexibility (OECD, 2015a, 2016c). Many VET students are likely to originate from low and middle-income families. In periods in which they are on workplace-placed training, they may receive a stipend from their employers. The stipend benefits from a tax-exemption (up to a ceiling).
However, most students only receive 40-70 euros per month of means-tested income support, which is not sufficient as the sole income source for students (Baranovska et al., 2015). This makes it difficult for students from low income households to pursue VET. Also, students receiving support are no longer eligible for family allowances (Baranovska et al., 2015). Income support for VET students from low-income families should be scaled up to the level that allows students to focus on pursuing VET degrees and made compatible with...
Figure 30. Under-skilling is frequent while over-skilling is rare in international comparison

2014

A. The share of employees reporting lower skill level than required for their current jobs

B. The share of employees reporting higher skill level than required for their current jobs


Table 6. Implementation of recommendations on vocational education and training

<table>
<thead>
<tr>
<th>Earlier OECD recommendations</th>
<th>Actions taken</th>
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<tbody>
<tr>
<td>Proceed with the reform of vocational education and training, including the planned extension of work-based learning.</td>
<td>The network of vocational education and training (VET) schools was consolidated in 2015 and 18 schools were upgraded to VET Competence Centres (VECC). The regulation of Sectoral Expert Councils was adopted in 2016 to increase involvement of entrepreneurs in VET, particularly in workplace based learning. A project funded by the EU to expand the provision of workplace-based learning was launched in December 2016. Since 2017, VET students’ pay in workplace-based learning is exempt from personal income tax up to EUR 280. The second phase of curricula reform supported by EU structural funds started in December 2016. Starting from the 2017/2018 academic year, VECC and other VET schools will begin implementing the modular VET programmes developed in the first phase of the curricula reform.</td>
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the family allowance, which amounts to between 11 and 50 euros per month. The government envisages additional support for students at risk of early school leaving, funded by EU structural funds, which is welcome.

Substantial progress has been made to increase the effectiveness of active labour market policies (ALMPs) such as by profiling job seekers to determine programs according to their characteristics and by evaluation. Training programmes are designed by a committee involving social partners to respond to skill demands in the labour market. But participation in active labour market programmes (ALMPs) is low by international standards. Latvia spends only 0.2% of GDP on employment services and related ALMPs (Figure 31). Plans to improve access of the unemployed to the reformed modularised vocational education system are welcome.

Recent reforms of universities have strengthened internal and external quality assurance and have linked funding to the result of quality assessments (OECD, 2016c). The quality assessments will incorporate indicators of labour market performance of graduates. However, few students receive income support through grants. They are mainly based on merit. Household income only plays a role when merit is the same. Some universities also offer their own grants for students from low-income families. This hampers access of students from disadvantaged socio-economic backgrounds despite the availability of free study places (OECD, 2016c; World Bank, 2014). The purely merit-based system should be modified to include means-tested income support to improve access to higher education for students from disadvantaged socio-economic backgrounds who are able enough to get a free study place.

Immigration of skilled individuals from abroad can ease skill shortages, help attract foreign direct investment and facilitate knowledge transfer. Latvia’s immigration policy lacks strategic focus on foreign skilled workers (OECD, 2016a). Foreign workers from outside the EU...
are not covered by public health insurance and must buy private health insurance, which tends to be more expensive. Latvian language proficiency requirements for many occupations which require communication with the public or government authorities also create barriers. Students from outside the EU who finish their studies in Latvia are subject to a labour market test and do not benefit from any fast track visa and residence permit procedures. Further wage tax reductions could also help retain young Latvians in the country.

Policies to remove barriers for women to access good job careers can also improve the supply of skills. The gender wage gap is particularly large for well-paid positions, pointing to poor utilisation of highly skilled female employment, and can for the most part not be explained by job or personal characteristics (Gaveika and Skrūzkalne, 2012). Shortages in the supply of formal early child care hold back the reconciliation of employment and family life (European Parliament, 2015). Steps to encourage women to study science, technology, engineering or mathematics (STEM), where free study places are abundant and labour market demand is strong, would reduce skill shortages and the gender gap in earnings (OECD, 2016c). Barriers to female entrepreneurship could also be identified and addressed. Another option, suggested by Turk et al. (2010), is to require firms to identify and address pay inequalities between men and women. Germany has recently taken steps in this direction.

**Boosting co-operation in innovation, especially with foreign institutions**

Innovation is the key driver of productivity growth and essential in capturing higher value added from GVC participation. In 2015, Latvia invested only 0.6% of GDP in research and development, among the lowest in the OECD countries (Figure 32). Business-driven research and development is particularly weak. Less than one-fifth of product and process innovations are completely new to the market (OECD, 2015b). However, several indicators of innovation performance such as the number of non-EU doctoral students in Latvia have improved most recently, allowing Latvia to exit the group of least performing EU countries (European Commission, 2016).

![Figure 32. Research and development expenditure is among the lowest in the OECD](http://dx.doi.org/10.1787/888933582835)
One factor limiting the innovation performance of Latvian firms is the low co-operation between businesses and higher education and research institutions (CSB, 2016). Enhancing such collaboration would improve the ability of Latvian firms to identify and absorb best practices and latest technologies produced outside Latvia (Jesilevska, 2016), but would require additional funding. Reform of higher education funding introduced in 2015 also provides incentives for universities to co-operate with businesses, which is welcome. Co-operation with foreign firms and research institutions is particularly important but is rare. Stronger co-operation with foreign research institutions would facilitate the transfer of advanced technologies from advanced OECD economies and contributes to Latvia’s competitiveness in high value added activities within GVCs.

Latvia has taken several policy initiatives in order to boost innovation and co-operation, especially in areas defined in the Smart Specialisation Strategy. It includes the EU-funded Competence Centre support programme which aims to raise the competitiveness of Latvian firms by fostering co-operation between research institutions in developing new products, as well as the EU-funded Applied Research Grants programme, the Post-doctoral Research Grants programme and the support programme for the Modernisation of Higher Education and Research Infrastructure. Other measures such as the Cluster programmes and the Innovation Voucher scheme help firms, including SMEs, to access knowledge in research institutions and encourage local and international knowledge transfer. Steps have also been taken to stimulate mobility of workers between the business sector and the public sector. Many of these policies have been implemented only recently or are in the process of implementation. They are open to Latvian research institutions as well as foreign institutions. The government should evaluate these programmes and identify which ones are effective in promoting co-operation between businesses and research institutions, particularly international co-operation with foreign firms and research institutions.

**Strengthening judicial and insolvency regimes to enhance resource allocation**

Effective judicial processes that ensure contract enforcement and intellectual property rights support GVC participation by allowing firms to outsource complex, highly tailored tasks (Levchenko, 2007; Essaji and Fujiwara, 2012). A transparent and efficient insolvency regime facilitates lending to finance investment needed for GVC participation and higher value added activities (Manova and Yu, 2016). Effective insolvency also encourages firm creation and eases the exit of unproductive firms, thereby enhancing re-allocation of scarce resources such as skilled workers (Andrews and Adalet McGowan, 2016).

In terms of the time and costs of enforcing a contract, Latvia is almost as efficient as an average OECD country, but the debt recovery rate in Latvia is low (Figure 33). The government has been engaging in reforms of the judicial system, including the gradual consolidation of district courts, which will be completed in 2018. A large scale training program was launched in 2016 to improve the competency of personnel. These measures are likely to improve the judicial system and contract enforcement. The quality of judgement can be improved by specialisation of courts or judges, especially in insolvency cases. While Latvia does not have many unviable firms remaining in business, as banks wrote off loans to non-viable firms quickly following the economic and financial crisis, there are concerns about transparency and abuse in insolvency cases (FCIL, 2016), which likely reduce debt recovery. Specialised insolvency judges may be better equipped to reduce abuse. Steps were taken to strengthen the expertise and accountability of insolvency administrators. Legislation to strengthen the qualifications and tighten the supervision on administrators came into force in early 2017, which is welcome.
Transport and energy infrastructure policies can improve openness and inclusive green growth

Survey evidence suggests that the quality of infrastructure still falls short of standards in other countries of the region, notably high-income countries (Figure 34), in particular in road transport (World Economic Forum, 2015; International Bank for Reconstruction and Development/World Bank, 2014). This is the case even though Latvia plays an important role as a transport hub for the Baltic region and has absorbed most of the structural funds it has received from the European Union.

Evaluation of transport infrastructure projects is uneven. When funding is provided by the EU, evaluation of large investment projects follows a standardised methodology which includes social cost-benefit analysis. When no EU funding is provided, the evaluation approach depends on the project and the state-owned company carrying it out. There are risks that state-owned enterprises subordinate policy priorities to operational priorities. State-owned enterprises may prioritise the survival of their business model, rather than the best investment projects. The same cost-benefit tests should therefore be applied to national projects as are applied to EU-funded projects. Planning should be based on lifetime costs. The development of a national transport model would allow having the best possible forecasts of future developments in transport.

Transport policies also need to address regional economic disparities within Latvia. Rural regions are experiencing a rapid decline in population and low population density makes it difficult to sustain adequate public transport services. The Latvian government already supports public transport, including bus services between towns, with subsidies of 0.3% of GDP per year. New mobility concepts may offer opportunities to provide services at a low cost and better suited to individual needs. ITF (2015) found that car-sharing and ride-sharing services can be suited to rural markets. Demand-responsive bus services have
shown promising results, adjusting mobility services to the needs of the customer. In a number of countries local governments have brokered agreements to combine school bus services, postal delivery services, ambulance services. Evidence from Norway suggests that these can improve access to medical services and raise wellbeing among the young (Dotterud Leren and Skollerud, 2015). To enable this, policy makers must ensure that there are no barriers that would hamper the creation of these services. It is promising that the government is already working on developing these innovative public transport services.

With 9.5 road deaths per 100,000 population per year, Latvia still has one of the highest road mortality rates in the EU or the OECD, although impressive progress has been made in reducing mortality since Latvian independence in 1991 (Figure 35). More priority needs to be given to investment in safer road infrastructure. For example, investments in motorway sections and to develop pedestrian friendly infrastructure in urban areas would boost road safety.

Latvia benefits from good wind resources, with large suitable offshore and onshore areas for wind energy development (EEA, 2009). While Latvia uses renewable energy sources extensively, thanks to hydropower and biomass, Latvia’s installed capacity of wind generation accounts for a small share of electricity generation. A feed-in tariff to promote renewable energy generation has been put on hold until 2020 due to concerns over cost (Dreblow, 2014). Several countries use competitive tenders or procurement auctions. Such tenders have resulted in record-low bids. The most recent example in Europe is Germany’s new Renewable Energy Act. Another interesting model is the “Contract for Difference” (CFD) for renewable energy recently introduced in the United Kingdom.

**Making the most of the economic potential of Riga**

The Riga metropolitan area is a key driver of economic growth and is a major regional transport hub. The city and its surrounding municipalities are home to more than half of the Latvian population and contribute 69% to national GDP. It boasts growth in knowledge-intensive services, low unemployment, and attractive natural assets (Chapter 2). More than
80% of Latvian enterprises in the ICT sector are located in Riga and high-tech sectors are growing strongly, albeit from a small base (Riga City Council, 2016). The network effects of metropolitan areas are key drivers of innovation (OECD, 2015c). Since 2010, Latvia’s population declined by 6%, whereas the population decline was only 3.6% in the metropolitan area. Riga has a high share of working population aged 30-45. The metropolitan area has an important role to play for retaining young adults and families in Latvia. Effective housing policies, as described below, can go a long way in making the most of this potential.

But Riga’s international competitiveness is lagging behind equivalent cities in the Baltic region. For example, GDP per capita is on average about 70% of that in other capital cities around the Baltic Sea (VASAB, 2016). Since 2010, the metropolitan Area of Riga performed less well than its peer cities in Estonia and Lithuania (Eurostat, 2016a, 2016b).

OECD experience shows that good metropolitan governance plays a critical role in improving economic growth, well-being and environmental outcomes (Ahrend et al., 2014; OECD, 2015c). Metropolitan governance arrangements result in higher labour productivity, and thus durably higher wages, less urban sprawl and pollution as well as more residents’ satisfaction with public transport. Governance mechanisms that match daily mobility patterns of the residents are essential.

The benefits of co-ordination across local governments within the metropolitan area of Riga are receiving increasing attention by Latvian municipalities. But no formal governance arrangements exist covering the entire metropolitan area. The “Riga Planning Region” provides a discussion platform for most municipalities in the area. However, it does not include all municipalities where most residents commute to Riga. Moreover, experience across OECD countries shows that better metropolitan governance can be built by extending participation beyond the local governments, to include the central government and major education and research institutions. The central government can provide financial incentives to identify and carry out metropolitan projects beyond the confines of individual municipalities and create reliable sources of metropolitan financing, for example, to better co-ordinate public transport. A long-term process for metropolitan monitoring and evaluation is also needed (OECD, 2015c). OECD evidence...
shows that such policies lower infrastructure costs. Denser cities also have substantially lower CO₂ emissions, helping to achieve emission reduction targets (Ahrend et al., 2014; OECD, 2015c).

**Improving access to housing and health care is key for more inclusive growth**

Affordable housing in neighbourhoods which are well connected to employment opportunities is an important driver for inclusive development and labour mobility. This is especially true in Riga, where housing is relatively expensive, while unemployment is low and high-productivity sectors are expanding, offering good employment opportunities. Housing market policies shape residential mobility, which is positively correlated with worker reallocation (Caldera Sánchez and Andrews, 2011) and the efficiency of job matching (OECD, 2015d). Therefore, they help reduce unemployment in high-unemployment regions. Affordable housing is also important for supporting other wellbeing dimensions, such as health and educational outcomes. Despite substantial improvement over the past decade, life expectancy at birth remains the lowest among OECD countries. The gap in life expectancy by education background is substantially larger than in other OECD countries. The poor, less educated and unemployed are more likely to be in worse health or die prematurely than those in more favourable socioeconomic circumstances (OECD, 2016e).

**Housing policy needs to improve access to economic opportunities**

Overcrowded housing is widespread among low and middle-income households in Latvia (Figure 36). While population has declined markedly since independence, low income among many home owners has contributed to the high incidence of low-quality housing. Moreover, population trends are unequal within the country, resulting in markedly stronger demand for housing in economically dynamic areas with good employment opportunities. About 81% of the Latvian population live in the homes they own. Even among low-income households, few rent (Figure 37).

![Figure 36. Many households live in overcrowded housing](http://dx.doi.org/10.1787/888933582892)
There appears to be no commercial housing development aimed at the rental market. A stronger private rented housing sector would support the provision of affordable housing for households that do not have the financial means to purchase a home. It also encourages labour mobility. Higher home-ownership rates are associated with higher skill mismatch, and housing policies which impede residential mobility might amplify skill mismatch. Housing policies appear to be particularly relevant for young people since they have a naturally higher propensity to move (Caldera Sánchez and Andrews, 2011). In the Latvian context, good housing policies could also encourage young people to seek opportunities in Latvia rather than emigrate. Different housing demand and house price trends across regions in Latvia are likely to have reduced labour mobility, as home owners from high-unemployment areas are likely to find it difficult to afford buying housing in areas with good employment opportunities.

The government has introduced a mobility allowance for unemployed workers who take up a job at a distant location to help cover their commuting and moving costs. However, the allowance is available for a short period of time and is not available in Riga, where most jobs are located. Providing workers with subsidies to cover the costs of relocating can be a cost-effective way to enhance labour mobility. For instance, in Germany workers participating in a relocation subsidy programme are matched with higher paying and more stable jobs than non-participants (OECD, 2017c).

Low legal certainty appears to hold back the rental market. It appears to be difficult to conclude rental contracts such that the landlord and the tenant are confident that the contract complies with law (Kolomijceva, 2016; Hussar, 2016). Most court cases take more than 6 months (Kolomijceva, 2016). This may deter some owners to offer housing for rent, as they

Figure 37. 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 rental market prices include tenants renting at reduced prices for Australia, Canada, Chile, Denmark, Mexico, the Netherlands and the United States. For Sweden, data on tenants renting at reduced prices are not capturing the full extent of coverage due to data limitations.

Source: OECD (2016), OECD Affordable Housing Database, Table HM1.3.3, December [www.oecd.org/social/affordable-housing-database.htm].
may not receive any rent payment for some time. Indeed, court decisions are always required, for example, to evict a tenant who does not pay rent. Indeed, weak protection of landlords’ property rights affects worker mobility and productivity negatively because of its negative impact on the rented housing market (OECD, 2015c). The government is therefore considering developing out-of-court procedures. By law, decisions to evict low-income tenants can be implemented only if social housing is available for them. This rule prevents social hardship, in view of widespread poverty and low social assistance entitlements. However, the supply of social housing is low, and waiting lists are long. Therefore, steps to increasing the supply of social housing could also help encourage private home owners to offer more housing for rent. Reducing tax evasion and fostering long-term lease contracts could also increase reliability of contracts and make rented housing more attractive for tenants (Hussar, 2016).

Government spending on social housing and on cash housing benefits for low-income households are among the lowest in the OECD (Figure 38). Support for low-income households to improve access to quality housing only cover a small share of the low and middle income population. Waiting lists for housing at subsidised rates are often long, especially in high demand areas as the Riga metropolitan area. Cash-benefits to help low-income households pay rent in the private market would not be effective for as long as the private rented housing market is not well-developed. In the near term, social housing should therefore be the preferred option to improve access to housing for low-income households. Housing policies are mostly designed at the national level and implemented at the local level. An eligible person can only apply for assistance in the municipality where she resides, limiting labour and residential mobility.

**Figure 38. Government spending on housing support is low**

Government spending as % of GDP, 2015

Investment in energy efficiency of residential buildings can, over time, reduce housing costs, make economic growth more environmentally sustainable and help meet long term greenhouse gas emissions targets. Indeed energy efficiency makes up the bulk of investment...
needs to limit global warming in line with the Paris agreement (IEA, 2016). Latvia has made much progress in reducing energy consumption for housing, using EU funds, but it remains high. Low wealth and lack of access to bank loans hold back investment. In some OECD countries, local governments have successfully stimulated renewable energy and energy efficiency retrofits by offering up to 100% upfront financing for these projects. Property owners then repay the loan over the long-term in form of an extra addition on their property tax (Wesoff, 2015). This however requires upfront government financing. Utility companies can also provide loans for energy-efficient appliances, and allow repayment to be made as part of the monthly electricity bill (Terry, 2016).

A nation-wide register that allowed eligible persons to apply for social housing where they expect better job opportunities could help support residential mobility. To ensure that places in social housing are allocated to the targeted population, incomes should be verified not only at the time of application, but also in regular time intervals following the rental agreement. 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). The responsiveness of housing supply to demand is lower in countries where it takes longer to acquire a building permit (Andrews et al., 2011), and this increases skill mismatch and damps productivity (OECD, 2015d). It is therefore welcome that the Latvian government is planning to accelerate building permit procedures.

**Low-income and rural households forego medical treatment**

The National Health Service (NHS) is the single purchaser of publically funded personal health services. It provides universal coverage to the entire population and is financed through general taxation. However, public expenditure on health is very low, 3.3% of GDP in 2014. 41 per cent of total health care expenditure in 2014 was out-of-pocket spending, a share that is among the highest in OECD countries (Figure 39, Panel A). Patients must make substantial co-payments towards the cost of general practitioner visits, specialist visits, hospital stays and pharmaceuticals. For low-income households health care needs can result in a significant drop in the disposable income they can use for other expenditure (WHO, 2016; Ke, 2005). Fifteen per cent of the low income population in Latvia reported forgoing needed medical examination in 2014 for financial reasons, (Figure 39, Panel B). Recent OECD research shows that out-of-pocket payments are harmful to the cost-effectiveness of public health care spending in the long run, as they may reduce demand for early health care interventions which can prevent more expensive interventions later (de la Maisonneuve et al., 2016).

Exemptions from co-payment requirements only apply to the poorest households, with less than EUR 128 per person monthly income. Financial barriers to care for low-income households are also exacerbated toward the end of the year, when annual budgets for healthcare are exhausted and any demand for health services for the rest of the year may need to be paid out-of-pocket (OECD, 2016e). To improve access to care, Latvia recently reduced co-payments for daily inpatient charges in hospital from EUR 13.52 to EUR 10 per day and co-payments for inpatient surgical intervention from EUR 42 to EUR 31. These steps are welcome. Expanding exemptions from co-payments for a broader range of low-income households and eliminating end-of-year rationing for key services should be a policy priority.

Access to care is particularly limited in rural areas. Challenges in rural areas relate to shortage of some health care professionals. Latvia could consider innovative solutions to reduce geographical barriers to accessing health care, for example making better use of
existing health resources for rural populations. These can play a larger role in preventive care. Pharmacists, could take a greater role in managing chronic conditions and the role of nurses’ and physicians’ assistant could also be expanded (OECD, 2016e).

**Improving efficiency of health care provision**

The number of hospital beds declined from 8.8 to 5.7 per 1 000 population between 2000 and 2014. This is still higher than the OECD average and indicators of quality of care in hospitals give cause for concern. The recent introduction of diagnosis-related groups is a step in the right direction to promote a more efficient use of hospital resources (OECD, 2016f). However, hospitals do not have incentives to promote quality. The NHS could undertake more strategic contracting to incentivise quality and efficiency. It could for instance strengthen monitoring and evaluation of hospital activities, to selectively contract with better-performing hospitals to drive quality improvement. It is important to identify low-volume hospitals, which generally are not able to promote high quality care, and

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1. Includes non-profit institutions serving households.
2. Unweighted average of the data shown.
Source: OECD (2017), OECD Health Statistics (database) and Eurostat.

StatLink: [http://dx.doi.org/10.1787/888933582949](http://dx.doi.org/10.1787/888933582949)
underperforming hospitals. Such a mapping of services has already started, which is welcome.

Despite the high quality of the Latvian health information infrastructure (OECD, 2016e), there are still important gaps in information on health care quality in primary and secondary care. In primary care, indicators do not reflect patients’ clinical outcomes. Worsening risk factors, including obesity and alcohol consumption, and low preventive screening rates signal a failure in preventive efforts at primary care level. In the area of hospital care, Latvia does not report several OECD health care quality indicators (OECD, 2017b). Provider-level data can generate several opportunities for improving both quality and efficiency. By gaining a better understanding of these variations in treatment outcomes, resources can be reallocated to best use. A core set of reliable quality and performance indicators should be made available at national, local and individual provider level to guide health policy, monitor progress, and benchmark performance of providers.

Environmental outcomes are good

Latvia’s energy intensity declined significantly during the 1990s (Figure 40). Per capita greenhouse gas (GHG) emissions are well below average, partly because of the contribution of renewable energy, which supplied around 40% of total primary energy supply in 2014, the absence of heavy industry, and relatively low incomes. As in many OECD countries, Latvia’s imports embody more GHG emissions than domestic production, as the CO₂ intensity of demand is higher than the CO₂ intensity of production (Panel A) so its contribution to climate change through demand is greater than through domestic production. Both GHG intensity and energy intensity were declining through to about 2010, but the decline may have slowed since then.

The share of renewables in total energy supply increased enormously at the end of the last century as the use of wood for fuel, especially in households, grew. Air quality is very good with hotspots for particle pollution limited to occasional occurrences in the capital, Riga. Average exposure to particle pollution across the country has been stable for many years.

Municipal waste generation per capita has always been well below the average for the European Union (Eurostat, 2017a; Latvian data comparable to OECD data is not yet available); it was 40% below the EU average in 2010. But since then it has risen by over one fifth while the EU average continued to decline, even though a landfill tax was introduced in Latvia in 2002 and has been steadily increased. A further increase is planned by 2020. There are no facilities for waste incineration in Latvia. 27% were recycled or composted in 2015. The rest goes to landfill.

Eurostat data show relatively high environmental tax revenue, about 2.5% of GDP and nearly 10% of total government revenue. As in all countries, the bulk of this is energy tax revenue and transport-related taxes. The share of environmental inventions in total patents has risen substantially since the early 1990s, as in many countries, but the absolute level of environmental patenting is extremely low, in line with Latvia’s low overall level of R&D.
Figure 40. **Green growth indicators: Latvia**

**A. CO₂ intensity**
- CO₂ per GDP - production based (kg/USD, 2010 PPP prices)
- Latvia
- OECD

**B. Energy intensity**
- CO₂ tonnes per capita, demand and production based
- Demand
- Production
- Latvia
- OECD

**C. Population exposure to air pollution**
- Mean annual concentration of PM2.5 (μg/m³)¹
- Latvia
- OECD

**D. Municipal waste generation and recycling**
- Municipal waste 2014 (% of treated)
- Latvia
- OECD

**E. Environment-related taxes**
- Environment-related tax revenue 2014 (% of GDP)
- Latvia
- OECD (median)

**F. Environment-related technologies**
- Inventions per capita 2011-13 (patents/million persons)
- Latvia
- OECD

1. Data in 2014 are the average of 2013 and 2015.

StatLink: http://dx.doi.org/10.1787/888933582968
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ANNEX

Progress in structural reform

This annex reviews action taken on recommendations from previous Surveys. They cover macroeconomic and structural policy priorities. Each recommendation is followed by a note of actions taken since the January 2015 Survey. Recommendations that are new in this Survey are listed in the relevant chapter.
### Fiscal policy

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<th>Recommendations in the previous Survey</th>
<th>Actions taken</th>
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<tr>
<td>Reinforce countercyclical liquidity buffers.</td>
<td>Countercyclical liquidity buffers have not yet been built up because economic activity is still below potential. A fiscal buffer for 2017, 2018 and 2019 amounting to 0.1% of GDP each year has been incorporated in the planning of the 2017 annual budget.</td>
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### Enhance public sector efficiency

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<tr>
<th>Recommendations in the previous Survey</th>
<th>Actions taken</th>
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<tbody>
<tr>
<td>Carry out co-ordinated and regular assessment of productivity challenges as an input for regulatory reform.</td>
<td>The government is envisaging setting up the National Productivity Board in 2018 to improve co-ordinated and regular assessment of productivity challenges. The European Commission, the OECD, as well as representatives from Latvian public administration, parliament, academia and social partners have been consulted to set up the board in the most effective manner.</td>
</tr>
<tr>
<td>Restore the funding of the State Audit Office to at least pre-crisis levels.</td>
<td>The grant to the State Audit Office has been increased in the 2017 Budget to EUR 5.9 million, still 11% lower than the 2008 level.</td>
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<tr>
<td>Reinforce regulatory impact assessments by reducing fast-tracking for the assessment of new regulation and establishing methods to select proposed regulations that require in-depth assessments.</td>
<td>Amendments to improve the ex ante regulatory impact assessment framework were developed in 2016. Approval by the Cabinet of Ministers is expected in 2017. A conceptual report proposing an ex post evaluation framework was approved in 2016. Two pilot projects are launched in 2017 to develop the evaluation methodology.</td>
</tr>
<tr>
<td>Introduce regular reporting on long-term spending trends and the adequacy of social programmes, such as pensions and healthcare.</td>
<td>Long term social insurance budget projections are produced regularly and are used for political decision making, analysis, monitoring, ensuring the long term stability. The Ministry of Health has made estimates of the health care funding for 2017-23. The European Commission's Ageing Report to be published in 2018 will include such projections.</td>
</tr>
<tr>
<td>Ensure that local governments are sufficiently resourced and autonomous by increasing their tax revenues, reducing the share of earmarked revenues, and improving the equalisation system.</td>
<td>A new financial equalisation law strengthening the autonomy of local governments was introduced in 2016.</td>
</tr>
<tr>
<td>Modernise human resource management by further developing results-oriented pay.</td>
<td>Legislation in 2016 aims at reducing pay gaps between the public and the private sector. A pilot project to develop a new remuneration system will be evaluated by September 2017. Additional pay for key experts was introduced. Law amendments will be developed in 2017 in order to introduce additional measures to link remuneration with performance indicators and to reduce the pay gap. A comprehensive public administration senior manager development program was introduced in 2016. In 2017 the topic of the senior managers’ development program is performance management.</td>
</tr>
<tr>
<td>Strengthen the transparency of public procurement by ensuring the independence of institutions in charge of combating corruption and by providing practical guidance on conflicts of interest.</td>
<td>An evaluation of the implementation of the Conflict of Interest Prevention Law is to be conducted in 2017. A working group has been set up by Parliament. The Corruption Prevention and Combating Bureau (KNAB) provided training to government officials on prevention of conflict of interest, ethics and internal control in 2016. The independence of the Corruption Prevention and Combating Bureau (KNAB) was strengthened in 2016 by limiting the Prime Minister’s rights to control KNAB’s decisions.</td>
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### Strengthen social protection

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<th>Recommendations in the previous Survey</th>
<th>Actions taken</th>
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<tr>
<td>Evaluate the current benefit system and make universal social benefits more targeted at low-income households. Withdraw benefits targeted at low-income earners more gradually when they take up a job.</td>
<td>A mechanism to set minimum guaranteed income levels (social assistance) was proposed in June 2015. An action plan on improving the income situation of the most vulnerable groups for 2017-20 was produced in the first quarter of 2017. Amendments to the Law on Social Services and Social Assistance entered into force on February 2017, allowing workers to keep social assistance benefits during the first 3 months after starting employment and phasing them out afterwards. More families with children are entitled to social assistance.</td>
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### Recommendations in the previous Survey

**Make tax system more growth friendly**

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<th>Recommendation</th>
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<tr>
<td>Strengthen efforts to tackle tax fraud and improve tax collection. Continue to reduce the complexity of tax compliance.</td>
<td>In 2016 legislation introducing criminal liability for employers paying envelope wages on a large scale was adopted. Other measures to combat shadow economy were also adopted including: an obligation for the general contractor to pay minimal social contributions for all employees at construction sites regardless of whether they are employed by the general contractor or the subcontractor; expansion of the range of personnel who are liable to provide information to the State Revenue Service on suspicious transactions; prohibition of natural persons to perform cash transactions exceeding EUR 7 200; IT system to exchange information between the State Revenue Service and financial institutions for more efficient tax debt recovery; new regulations for e-commerce to prevent tax evasion. Several measures to increase revenue from the taxation of specific goods and services were introduced, such as VAT reverse charge for precious metals.</td>
</tr>
<tr>
<td>Decrease labour tax for low-income earners.</td>
<td>From 2016 a differential non-taxable minimum income allowance was introduced with a higher tax-exempt level for low income (EUR 160 per month for the lowest wages). The monthly allowance for dependents was raised from EUR 165 to EUR 175.</td>
</tr>
<tr>
<td>Raise additional revenues by increasing property and environmentally related taxes. Increase energy tax rates, making them depend on their relative carbon content. Phase out environmentally harmful fuel subsidies.</td>
<td>In 2015 and 2016 the excise tax rates for alcohol, tobacco and several oil products were raised and the tax base was broadened. Excise tax rates will be raised gradually until 2018. Car and motorcycle taxes have been abolished in 2017 and replaced by the vehicle exploitation tax where rates are based on CO₂ emissions. The tax exemption for electricity expenditure was abolished. Tax rates on the extraction of natural resources in several categories of minerals and soil were increased by the order of 25-29%. Taxes on the disposal of municipal waste were increased for hazardous waste and production waste. Tax rates on activities emitting CO₂ and on goods harmful to the environment were increased.</td>
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### Improve the business environment

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<th>Recommendation</th>
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<tr>
<td>Simplify the licenses and permits system, remove compulsory chamber memberships in professional services and reduce the complexity of regulatory procedures.</td>
<td>An action plan for the improvement of the business environment was approved by the government in 2017. Measures include on-line registration of a company starting from 2018, registration of property without a notary with a safe electronic signature, creation of a monitoring system of insolvency proceedings, public administration e-services, a single account for all tax payments, English communication with the State Revenue Service and specialisation of judges in the courts.</td>
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<tr>
<td>Bring the governance of state-owned enterprises further in line with the OECD Guidelines on Corporate Governance of State-Owned Enterprises. In particular, introduce boards of directors in all economically-oriented state-owned enterprises, together with regular assessments of the rationale and need for state ownership. Allocate adequate staff and resources to the Cross-Sectoral Co-ordination Centre. Extend corporate management best practices to port authorities and municipal corporations.</td>
<td>An annual report on state-owned enterprises is published, starting in November 2016. Boards of directors for the 12 largest state-owned enterprises were established by the end of December 2016. Assessments of the rationale and need for state ownership are progressing. Additional resources are allocated in 2017 and the following years to the Cross-Sectoral Co-ordination Centre.</td>
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<tr>
<td>Strengthen the independence of the Competition Council and enforcement of competition policy by giving it more financial and administrative autonomy.</td>
<td>Amendments to the Competition Law in 2016 increased the financial resources of the Competition Council approximately by 4% by allocating the revenue from the newly-introduced fee for merger notifications to the Competition Council. From 2016, public persons (central government and municipal authorities) are obliged to consult and receive an opinion from the Competition Council prior to entering relevant markets.</td>
</tr>
<tr>
<td>Continue improving the connectivity of energy networks with the rest of the European Union.</td>
<td>The desynchronisation of Baltic states from the Integrated Power System and the unified power system (UPS), which links the power grid in the Baltic states to Russia and other CIS countries, is ongoing and is planned to be implemented by 2025 as the key project in the European Energy Security Strategy and Baltic Energy Market Interconnection Plan (BEMIP). The key electricity infrastructure projects such as the 3rd electricity interconnection with Estonia are ongoing.</td>
</tr>
<tr>
<td>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.</td>
<td>Amendments to the legislation that will enable OECD member countries’ citizens to buy agricultural land are being prepared.</td>
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<td>Recommendations in the previous Survey</td>
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<tr>
<td>Continue with efforts to improve the court and out-of-court disputes settlement system.</td>
<td>District courts have been consolidated. The reorganisation of the judicial map is to be concluded by the end of 2018. The pay of judges and court employees was increased. A plan to develop the competence of judicial and law enforcement personnel was approved in 2015 and will be implemented by 2022. A comprehensive assessment of the judicial system will be conducted by December 2018. Amendments to the Arbitration Law that improve government control of the arbitration courts came into force in 2016. Since December 2015, sworn notaries and bailiffs may practice as certified mediators. Free consultations by mediators are provided in several courts.</td>
</tr>
<tr>
<td>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.</td>
<td>No action taken.</td>
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<tr>
<td><strong>Address skill shortages</strong></td>
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<tr>
<td>Proceed with the reform of vocational education and training, including the planned extension of work-based learning.</td>
<td>The network of vocational education and training (VET) schools was consolidated in 2015 and 18 schools were upgraded to VET Competence Centres (VECC). The regulation of Sectoral Expert Councils was adopted in 2016 to increase involvement of entrepreneurs in VET, particularly in workplace based learning. A project funded by the EU to expand the provision of workplace-based learning was launched in December 2016. Since 2017, VET students’ pay in workplace-based learning is exempt from personal income tax up to EUR 280. The second phase of curricula reform supported by EU structural funds started in December 2016. Starting from the 2017/2018 academic year, VECC and other VET schools will begin implementing the modular VET programmes developed in the first phase of the curricula reform.</td>
</tr>
<tr>
<td>Encourage lifelong learning and training by improving information about training opportunities and adult learning, while ensuring the portability of skills.</td>
<td>The Plan of Adult Education Governance Model 2016-2020 is being implemented with the support of EU funds. The Adult Education Governance Board, including representatives of ministries and social partners and providers of adult education, held its first meeting in 2017. A project funded by the EU to support the upskilling of employed adults with a special focus on older and low-skilled workers was launched end-2016. The upgrading of the national database providing information on adult education opportunities is envisaged using EU funds.</td>
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<tr>
<td>Continue helping minorities to acquire skills needed on the labour market.</td>
<td>Material for teaching Latvian as a second or foreign language is provided for free to support teachers of minority schools. Latvian language training is provided at the Public Employment Service as part of active labour market policy.</td>
</tr>
<tr>
<td>Continue offering programmes enhancing basic literacy and numeracy skills.</td>
<td>In the 2016/2017 academic year, competence approach-based general education content will be launched in 80 general education institutions. A project aimed at reducing early school drop-out by implementing preventive and intervention measures is also to be launched. New ICT study programs implementing a new curriculum standard are being tested in 157 schools from September 2015.</td>
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<tr>
<td><strong>Strengthen the innovation system</strong></td>
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<tr>
<td>Evaluate the newly reformed tax incentives for R&amp;D, also in view to reaching young firms.</td>
<td>The evaluation of the R&amp;D tax incentive is planned in 2017.</td>
</tr>
<tr>
<td>Consolidate the existing research infrastructure.</td>
<td>Research institutes have been consolidated through the allocation of funds following an external assessment of research quality. The number of research institutions receiving public finance is 21 as of early-2017, as opposed to 29 in 2015.</td>
</tr>
<tr>
<td>Develop incentives for international co-operation in local research and innovation as well as a regular external evaluation exercise.</td>
<td>The Baltic Bonus program provides support to research co-operation with other Baltic countries in applying for EU framework programs. The evaluation by international experts is incorporated in funding of research institutes and research and development activities.</td>
</tr>
<tr>
<td>Support the development of knowledge markets by providing firms with well-defined and high quality intellectual property rights.</td>
<td>The new Technology Transfer Program that supports the commercialisation of public research was launched in 2016. The program includes the Innovation Voucher that promotes knowledge transfer from research institutes to SMEs and protection of the intellectual property rights held by SMEs. The Competence Centres programme was launched to support innovation co-operation between scientists and businesses. The Law on Industrial Property Institutions and Procedures came into force in 2016, establishing an independent industrial property-related dispute settlement body. A pilot project to reduce the costs of processing patent applications and to improve their quality has been launched by the Patent Office in October 2016.</td>
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Green growth

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<th>Recommendations in the previous Survey</th>
<th>Actions taken</th>
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<tr>
<td>Ensure that feed-in tariffs for renewable energy production are cost-effective.</td>
<td>Regarding the current legislation from 1 January 2016 new producers cannot receive feed-in tariffs. Government subsidies are limited so the internal rate of return on capital investment does not exceed 9%. The total compulsory “feed-in” component of electricity rates is limited to EUR 26.79/MWh. The government intends to compensate those businesses most at risk of energy price increases due to support for renewables. At the same time Latvia has launched a process to develop a new and sustainable renewable energy support mechanism. Energy-intensive firms will have the opportunity to pay lower contributions to finance feed-in tariffs pending the European Commission’s approval.</td>
</tr>
<tr>
<td>Offer financial support to foster energy efficiency gains in the housing sector, in particular to credit-constrained households.</td>
<td>A program to foster energy efficiency in the housing sector was approved in 2016. A public fund of EUR 166.47 million will be disbursed to construction, reconstruction or implementation of building engineering systems and use of the renewable energy sources.</td>
</tr>
<tr>
<td>Provide stronger incentives to improve efficiency in district heating.</td>
<td>A program to increase energy efficiency and usage of renewable energy sources in district heating systems through grants was put in place the 1st quarter of 2017.</td>
</tr>
</tbody>
</table>