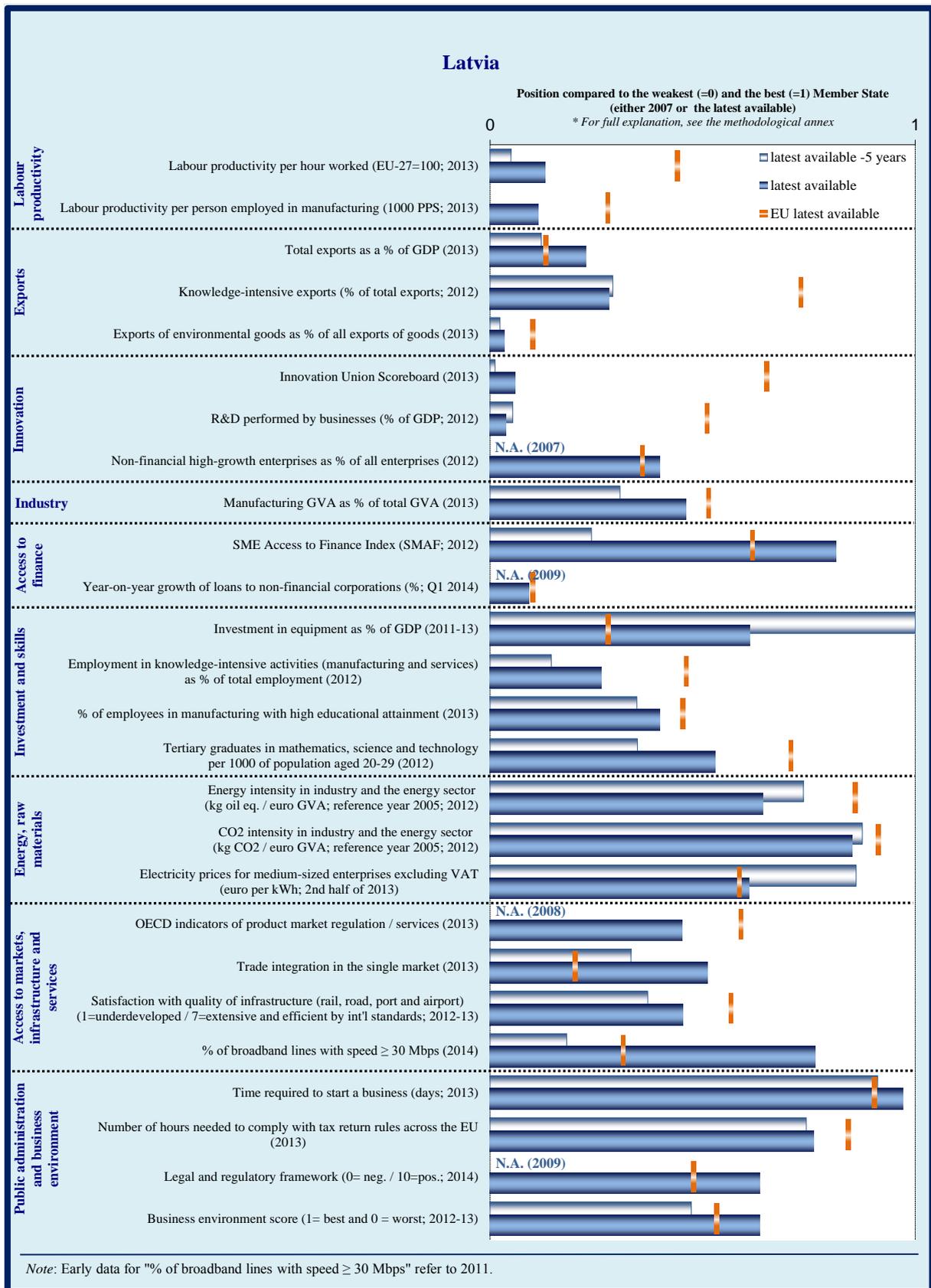
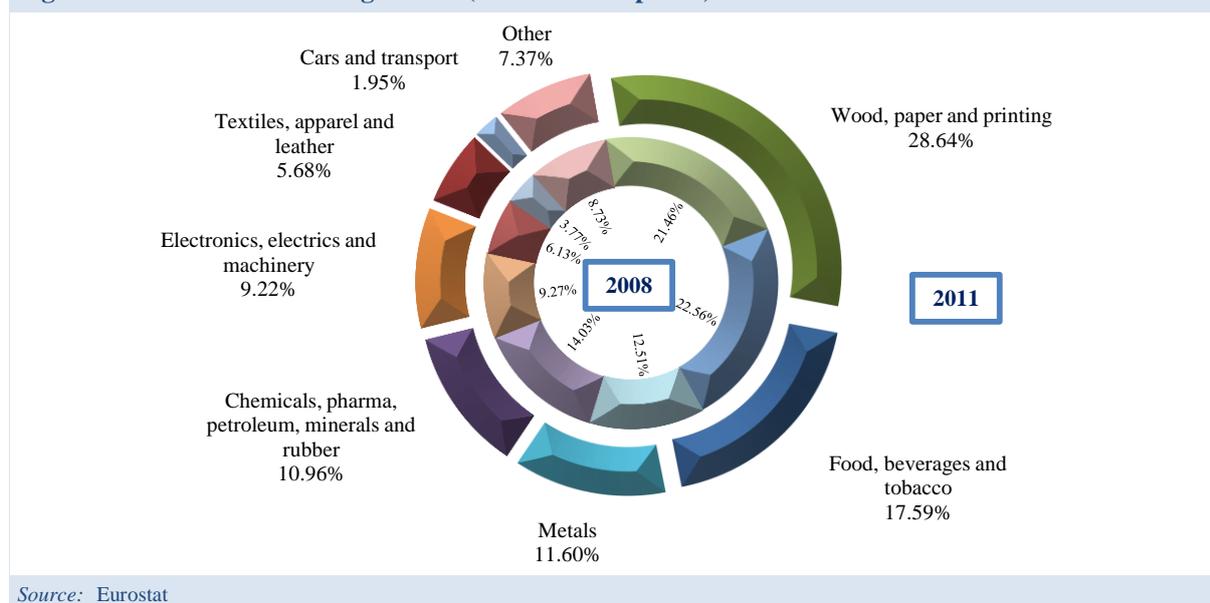


### 3.14 Latvia



**Figure 3.14.1: Manufacturing sectors (GVA at basic prices) - Latvia**

### 3.14.1 Introduction and performance

In 2013 Latvia's GDP growth was 4.1 % and the economic situation remains strong despite a slight slowdown compared to 2012. The unemployment rate dropped to 11.9 % in 2013 from 15 % in 2012 and youth unemployment went down from 28.5 % to 23.2 % in the same period. Manufacturing's contribution to the Latvian economy increased to 14 % in 2013 from 10.8 % in 2008 and is adding considerably to growth and employment. Processed products based on natural resources such as wood and food, as well as metals, chemicals and machinery, are the main contributors to exports and to Latvia's attractiveness to investors. Foreign direct investment stock in manufacturing sectors reached EUR 1.4 billion in 2013, from EUR 1.2 billion in 2012. Productivity remains relatively low, mainly due to the prevalence of low-tech and medium-low-tech industries. Nevertheless, the growth rate of the past five years has been sustained and labour productivity increased from 54 % of the EU average in 2007 to 66.3 % in 2012.

### 3.14.2 Access to finance

Most indicators of access to finance are considerably better than the EU average. They include access to public financial support, the perceived willingness of banks to give a loan, the strength of legal rights and the interest rate difference between loans above or

below EUR 1 million. The World Bank ranks Latvia among the top performers for ease of getting credit and the legal rights for borrowers and lenders. The traditional financial instruments in place are: loans aimed at increasing competitiveness and growth, credit and export guarantees, venture capital, seed capital and start-up capital funds, 'mezzanine' loans, start-up loans and grants.

The Mortgage and Land Bank (MLB) completed the sell-out of its commercial portfolio and is now fully focused on development financing. In December 2013, the government also completed the first phase of setting up a single development institution (SDI) merging the Latvian guarantee agency, the rural development fund and Altum (the former MLB).

#### *Bank lending*

Obtaining credit is not among the major issues for companies; however, small and medium-sized enterprises (SMEs) and in particular start-ups continue to face challenges in getting access to finance. As deleveraging in commercial banks continues, the government has taken some measures to improve the effectiveness of public support for financing.

According to a market gap analysis, which pointed to the need to focus finance programmes more on micro and small companies, the 'Financial engineering instruments' have been reorganised, a new micro financing programme for loans up to EUR 25 000

added and a new call for financial intermediaries specialised in micro lending launched to improve the offer for start-ups. In addition, the ‘mezzanine’ programme has been refitted, interest rates for the start-up lending programme cut and the limits on government intervention in lending operations reduced.

#### *Venture capital and other finance*

To improve the availability of equity financing, the government has supported the creation of the Baltic innovation fund, which has operated at macro-regional level since 2012. In 2013 three financial intermediaries became operational and three new risk capital funds were launched to provide growth capital for micro, small and medium-size enterprises and promote the development of Latvia’s venture capital market. Finally, a new pilot project for a business accelerator has been publicly funded.

### 3.14.3 Investment, innovation and skills

#### *R&D investment developments*

In 2012, total expenditure on research and development activities accounted for 0.66 % of GDP, down from 0.7 % in 2011. While these results are still far below Latvia’s 2020 target of 1.5 %, in the last five years R&D expenditures grew at an average annual rate of 3.1 %. Corporate R&D funding accounted for 23.8 % of the gross domestic expenditure on R&D, corresponding to 0.15 % of GDP, compared with 0.19 % in 2011.

#### *Innovation*

The Innovation Union scoreboard identifies Latvia as a modest innovator, with an aggregate score below the EU average. Latvia’s main challenges include continuing the transition to higher value-added products, boosting convergence between R&D and innovation and reducing the skills mismatch through a structural reform of higher education.

To address these issues the government has established incentives to increase investment in innovation activities, including corporate income tax rebates on large-scale projects, new beneficial depreciation ratios for specific R&D expenses such as technological equipment, a carry forward of losses and several labour-related incentives at different

stages of the hiring process. Additional financial incentives include state and EU supported loans, credit guarantees and venture capital.

The effectiveness of public funding was until recently undermined by a lack of independent, external evaluation of scientific institutions. The results of the first independent assessment undertaken by the Nordic Council became available at the end of 2013 and showed that only 10% of the research units evaluated can be considered high level international research centres.

#### *Skills*

Shortage of qualified staff, poor and fragmented infrastructure and the lack of cooperation between research institutions and businesses are hampering Latvia’s capacity to innovate, resulting in inadequate commercialisation of research results.

To address these issues the government has adopted the Science Technology and Innovation Development guidelines and the Education Guidelines, which include a number of policy measures for integrating research more closely with industry and higher education. A new financing model for higher education and research institutions is currently being devised in cooperation with the World Bank. This aims to ensure that higher education is better targeted at providing skills that are needed for in the labour market. However, this measure is unlikely to enter into force before 2016.

In addition, several measures have been taken to make vocational education and training more relevant to the labour market and to increase the provision of quality work-based learning. These measures include modernising infrastructure and redesigning curricula with the close involvement of social partners. If properly implemented, these measures may represent a first step in promoting effective work-based learning in Latvia.

### 3.14.4 Energy, raw materials and sustainability

#### *Energy use and price*

Several projects set out in the Baltic energy market interconnection plan are scheduled for the coming years. Major projects concern the development of

infrastructure and the liberalisation of the energy market. In the electricity sector, the interconnector Estlink 2 was inaugurated in March 2014, the third Estonian-Latvian interconnection has reached the implementation phase and the first stage of the 'Kurzeme Ring' has been completed. This is part of a major project to improve the stability of supply and network interconnections between Latvia and Lithuania.

### *Resource efficiency*

The share of renewables in final energy consumption reached 35.8 % in 2012. Renewable energy's share of the heating sector has slightly increased due to investments in the renovation of district heating networks and the substitution of fossil fuels in regional co-generation plants. The transport sector accounted for 27 % of total greenhouse gas emissions in 2011 and around 30 % of total energy consumption. The major concerns in this sector are the inadequate public transport network, poor vehicle fuel efficiency, a relatively low level of excise duties and an ageing car fleet.

Some investments in transport sustainability have been made, such as extending and developing tram lines in larger cities, while a comprehensive overhaul of the public transport planning system is also being prepared. Latvia has also implemented a number of measures to reduce CO<sub>2</sub> emissions in the transport sector, such as increased taxes on fuels, exemptions for biofuels and the introduction of a registration tax for passenger cars based on emission levels. More recently, the government has taken action to promote electric vehicles by adopting, in February 2014, a short-term electro-mobility strategy that focuses on developing recharging infrastructure and the electric vehicle market. Finally, the Latvian railway network electrification project is planned for the programming period 2014-2020, with the support of cohesion funds and the Connecting Europe Facility.

### *Other sustainability issues*

Reducing the infrastructure gap and improving the regulatory framework for the collection and recycling of waste are still considerable challenges for Latvia. In 2012, the rate of landfilled municipal waste was 84 %, against an EU average of 33 %, while only 12 % was recycled and 4 % composted (EU averages: 27 % and 14 %). Meeting the 2020 landfill diversion target of 75 % and the re-use and recycling target of

50 % is unlikely under the current framework. Moreover, the 'National Waste Management Plan 2013-2020' does not seem to provide a convincing national strategy for achieving these targets. Further action seems to be needed to encourage private investment in waste management, ensure competitive neutrality and sustain resource efficiency and waste diversion from landfill.

## 3.14.5 Access to markets, infrastructure and services

### *Internal market*

While the government has proposed some measures to reduce the administrative burden in certain markets, customs and public procurement procedures, discriminatory technical regulations and relatively low protection of industrial property still hamper the competitiveness of Latvian businesses. The government's strategy to address these issues is composed of an industrial policy plan, a set of guidelines for promoting exports and attracting foreign investment and an annual action plan for improving the business environment. Measures included in these documents, such as fostering the digitalisation of customs documents or implementing the 'International freight logistics and port information system', are likely to increase the country's openness to trade if properly implemented.

The bottleneck in regulation of the construction sector has been addressed by the government with the adoption of a new construction law. This amends and clarifies rules on construction plans, design, responsibility and supervision, as well as procedures for certifying specialists, classifying merchants and defining the involvement of institutions in the sector. In addition, the law reduces from 152 to 68 days the time needed to obtain a construction permit and establishes a 'State building control office', clarifying the responsibilities in overseeing construction processes and compliance with legislation. These amendments should enter into force in October 2014 and constitute a substantial step forward for the competitiveness of Latvia's construction sector.

### *Internationalisation*

Among the measures to improve access to export markets, the government has set up a scheme of guarantees coupled with an advisory service. At the

same time, the integration of businesses into international supply chains is being promoted by a network of foreign economic representative offices, which encourage and support the participation of firms in international exhibitions and trade missions. This network was expanded to 21 offices in 2013.

#### *Business service, network industries and infrastructure*

Latvia is increasing the accessibility to the country and the Baltic Sea region by continuing to develop Riga's international airport. In addition, the Rail Baltic railway infrastructure is a priority for Latvia and is to be submitted for funding from the Connecting Europe Facility. However, as a result of the three Baltic States' different priorities, there have been significant delays in the overall process. Latvian authorities are showing their commitment to the project by actively participating in the negotiations, with the aim of reducing scope for further delays.

The poor quality of road infrastructure is a major concern as it makes logistics more difficult for business and contributes to a high rate of road accidents. While structural and cohesion funds are helping to improve the situation gradually, there is still a need to increase national funding and develop a viable long-term funding mechanism for road maintenance. The plan for improving national roads seems to rely excessively on EU funding and appears insufficient to remedy infrastructural weaknesses and achieve the government's ambitious objective of having between 90 and 100 % of state main roads and 75 % of regional roads in good condition by 2020.

#### **3.14.6 Public administration and business environment**

To improve Latvia's business environment the government needs to continue strengthening the efficiency of the legal system and modernising the public administration. The former is particularly crucial as lengthy civil and commercial case proceedings in the first instance and low clearance rates have caused a significant backlog of court cases in recent years and there are still shortcomings in insolvency proceedings, including lack of transparency and accountability of insolvency administrators. In addition, corruption remains a risk, particularly in public procurement.

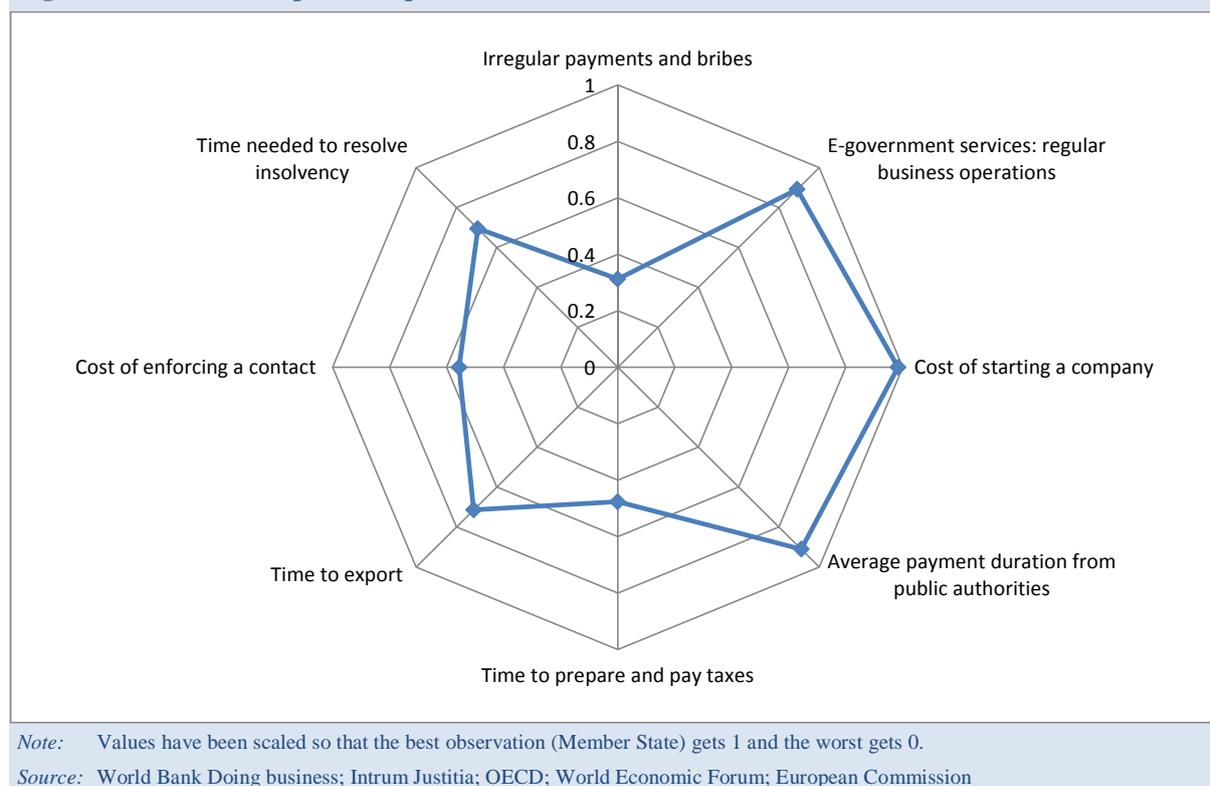
The European Commission's released an EU anti-corruption report on Latvia in February 2014. The Commission welcomed the searchable online database of political donations and the track record of investigations by the bureau for preventing and combating corruption. The report also suggested strengthening the bureau's independence to protect it from potential political interference, especially regarding supervisory and budgetary procedures, and further stepping up efforts to detect corruption in public procurement

#### *Administrative modernisation*

The government is acting to strengthen the regulatory framework and enhance the capacity of the Latvian justice system of the judiciary. The code of civil procedure has been amended to streamline the judicial process. The law on mediation has been adopted, while parliament is continuing its work on the insolvency law and the arbitration law. The length of proceedings has been reduced and the capacity of courts to handle their workload has been increased through the allocation of additional judges and administrative staff to the Riga court. Furthermore, professional evaluation of judges started in January 2013 and the use of information and communication technologies has improved the registration and management of cases as well as accelerating the information flow between courts and parties in judicial proceedings. A number of amendments to the code of administrative violations are now in force, establishing administrative sanctions for violations of procedures in public procurement, public-private partnerships and the award of concessions.

Requirements for local governments to use centralised procurement and publish small procurement contracts online have also been established, while penalties for suppliers who fail to deliver according to procurement contracts have been increased. The Competition Council has prepared amendments to the Competition Law as regards greater institutional and financial independence. One of the key proposals refers to independent budgeting of the institution, which would ensure greater financial independence similar to other regulators (e.g., financial, utilities regulators).

There is considerable additional scope for reforming the public administration, in particular to increase its efficiency, reduce corruption and increase the motivation of civil servants. Present reform efforts

**Figure 3.14.2: Overall profile of public administration - Latvia**

are limited to a strategic framework for human resource development in public administration approved in February 2013. This applies only to the central public administration and has been insufficient to lead to credible reforms to recruitment and career development. In the 2014 budget additional financing has been granted to the lowest pay grades as well as for further equalisation of salary levels for similar work across different ministries/institutions.

burdensome regulation in many sectors, the inefficiency of the judicial system and corruption; however, additional measures are required, in particular to modernise the public administration and the education system, foster innovation, increase the quality of infrastructure and facilitate the transition to a more sustainable and efficient use of resources.

### 3.14.7 Conclusions

Latvia is among the fastest growing economies in the EU, with the Commission's latest forecast pointing to 3.8 % growth in 2014. The transition to manufacturing with higher added value and technology intensity is the main challenge for Latvian industry as productivity and labour costs are moving towards the EU average. While SMEs benefit from favourable financing conditions, the increasing skills gap, coupled with insufficient investment in innovation and fragmented infrastructure, are hampering Latvian industry's competitiveness.

The government is increasing its efforts to improve the business environment, addressing issues such as