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FICIL Position Paper on Macroeconomic Policy Issues

First steps taken, but a long journey lies ahead

The economic growth rate in Latvia in 2015 was 2.7% dropping to just 2% in 2016. Such speed of development is not satisfactory and it does not meet the population's expectations of more noticeable improvement of the standard of living, which would catch up with the welfare level of Western European countries. The household consumption, which increased by 3.5% last year continues to remain the main driver of development. Although increase of state revenue has allowed a rise in government spending **the investment level remains critically low. Last year it dropped by 11.7% and accounts for 18.3% of the GDP, which is the lowest level within the last 18 years.**

More favourable global conjuncture and increasing inflow of the EU funding will ensure that **during the next two to three years the economic growth of Latvia will accelerate**. This will improve the investment activity and export and will facilitate consumption, thus creating relevant conditions for implementation of reforms. This **will strengthen the long-term growth potential and will allow the achievement of the 5% growth target set forth by the government. A predictable environment will provide opportunities for attracting new foreign investors, among others, for supporting the existing investors**. This is especially important in the circumstances of geo-political tension, due to which investors are cautious, while their presence is an important security factor. The FICIL appreciates the reforms commenced by the government last year and cooperation in solving current issues, at the same time calling the government to more decisive action in the critical matters:

Tax reform: The FICIL believes that the basis of the announced tax reform is correct and necessary, and it will eventually strengthen the competitiveness of national economy. The outcome of alterations should be a simpler, more transparent and effective tax system. The announced development deadline is very ambitious and the scope of changes is grand. In order to achieve the desired result, the development and implementation has to be well thought over, with consideration of complaints and suggestions of the stakeholders. **The FICIL recommends commencement of the tax reform in 2019. At the same time, work should be continued with reviewing of the scope and expenses of the current functions of public administration.**

Industry and export: The policy launched during the post-crisis period, aimed at the development of industry and export, has proved to be correct. Therefore the FICIL calls for continuation of the commenced sustainable energy policy initiatives, which would allow businesses to strengthen their competitiveness. Taking into account changes in global and regional conjuncture, **it is important to maintain and increase**

support for the development of Latvian export, especially with regard to entering new markets. This is especially important when introducing changes to the tax system, which would provide an incentive for the permanence of development.

Education: The FICIL appreciates the reforms commenced in the education sector. However, **taking into account the existing challenges, the pace of reforms is of crucial importance.** The quality of the education system is a cornerstone of the potential of the economy of each country and of the entire society. We therefore suggest more decisive and faster reorganisation of the education system, especially with regard to the Latvian vocational education and higher education.

Investment policy: The EU funds are an opportunity of stability but at the same time also of perfunctory economic policy. Their inflow may create a crooked view of economic trends, cause self-satisfaction and decrease determination to continue the commenced changes. Therefore, **considering the importance of the EU funds and uncleariness regarding their availability after 2020, it is necessary to timely develop action plans, which would provide for more successful adaption to the new situation.** Foresighted action would include support for more active development of capital market. Hence it is necessary to move towards development of stock market, risk capital and other financial instruments the successful operation of which would mitigate the effect of reduced EU funds. Action should be also taken to improve the attractiveness of Latvia as an investment destination. **One of the most important risks in the opinion of the FICIL is the marked stagnation in allocation of resources for research and development.** The funds allocated for research and development in 2015 were only 0.6% of the GDP, although the target set forth by the government was 1.5%. We call for increased consideration of the development of requirements and instruments.

Demographics: Decrease in the number of population and ageing are among the most serious and acute challenges for Latvia. In 2009 65.2% of the population was of working age, while senior citizens accounted for 20.7%. The proportion of the people of working age has decreased to 61.5% in 2016, while the number of senior citizens has increased to 23.2%. This trend will continue over the next years creating pressures for the labour market, the state budget and social insurance system. The FICIL approves the initiatives taken so far in birth rate promotion, reducing the risk of poverty for families with children, as well as reduction of emigration. However, to achieve a turning point in the trend, the support for families and other demographic improvement measures have to be increased. **These issues should continue to be among the most important government priorities.**

Labour market: The unemployment level continues to exceed the average indicator of the EU countries and is the highest in the Baltic countries. There were 91 000 jobseekers at the end of last year, out of which 39 500 were long-term unemployed. Furthermore, unemployment continues to bear clearly marked regional differences. **Special attention should be given to returning of the long-term unemployed to the labour market.** Taking into account demographic trends, it is necessary to facilitate holding in the labour market of senior employees, as well as engagement of other able-bodied but currently economically inactive residents in the labour market. Workforce restrictions may become a serious impediment of growth in the nearest future.

Administrative reform: Implementation of the administrative reform is very important for the development of regions. It must be ambitious, with a sight into the future and a clear aim to improve the economic conditions for the residents of the regions. Due to the limited resources, in the opinion of the FICIL a greater concentration of human resources, financial resources and administrative resources will improve the development opportunities for regions and will stop decrease of the number of the population. At the same time there should be mechanisms, which would help the population to adapt to the changes. By means of investment policy equal conditions, market and correction of the mistakes made by the government should be ensured; the education system must be optimised by reducing the number of infrastructure units, improving quality and implementing such funding mechanisms, which promote innovation.

Shadow economy: Regardless the positive trends and achievements in the reduction of shadow economy, its proportion is still the highest in the Baltic countries. It continues to maintain a situation of unequal competition, increases inequality in the society, hinders development of honest businesses and restrains investment flows. Therefore effective reduction of shadow economy, especially tax evasion, is a critical factor for further development of Latvia. Transparent and equal conditions provide favourable investment evaluation of a country. In this context an important instrument in both limiting shadow economy and facilitating efficiency of public authorities is a more active movement toward development and wider application of e-services.

Strengthening of economic preconditions will accelerate movement of Latvia closer to the EU standards of quality of life, which will in its turn improve the mood of the society, reduce the attractiveness of populism and emigration. Therefore the ability of the government to achieve results in implementation of reforms in the next years is very important for the future of Latvia. **Latvia has to become an environment attractive for business and the region's investment destination with a stable growth potential.**