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## The FICIL's Position Paper on Macroeconomic Policy Issues

### Through reform to reputation renewal

Last year, Latvia's economy pulled itself out of a phase of sluggish growth and reached its highest growth rate of the previous six years - +4.5%. This impressive growth was reflected by the investment level (+16%). However, the rapid increase should be assessed as a conditional achievement, as in 2016, measured against the GDP, this was the lowest level in the last 18 years. Favourable external conditions facilitated a growth in the volume of goods and services' exports (4.4%). Household consumption increased by 5.1%. Regardless of the favourable trends, the mood among the society and entrepreneurs differs. Moreover, Latvia has recently been drawn into a whirlwind of events, which has cast a serious shadow over the state's reputation. **FICIL highly rates the government's initiated reform process and cooperation in resolving important issues. At the same time, the Council recommends more decisive action in resolving critical matters – especially in strengthening the state's reputation. Implementation of an effective reform is potentially the most favourable method of achieving this goal, as it would create a stable foundation for the development of a sustainable economy.**

**The rate of reform must be maintained.** The economic cycle currently suggests that growth will continue. It is based on favourable conditions both domestically and externally and provides opportunities for the government and entrepreneurs to invest and fulfil other ambitions. However, the risk remains that the current upward trend will promote self-satisfaction in political circles and the rate of reform will slow down. Leading indicators warn that the leading economies are at the peak of the cycle, therefore the favourable climate may gradually weaken. By not using existing opportunities, reforms will need to be implemented in the downturn phase, which will considerably hinder the process. The current situation should be regarded as an advance for subsequent years, when the external environment will change. The inflow of EU funds will shrink and budget priorities will need to be significantly reassessed.

**Timely preparations need to be made for the next EU fund financing period.** Considering the lack of clarity about the availability and conditions of EU funds post-2020, an action plan should be developed well in advance, to allow successful adaptation to the new conditions. As experience has shown, the success of a farsighted policy is to reduce the impact of economic cycle. It is very important, therefore, that the direction continues, not only towards a balanced budget, but to also finally start developing a surplus, to allow amortisation in case of a downturn.

**Development of the tax system must be continued.** The government has fundamentally rebuilt the tax system. FICIL considers that this will strengthen economic competitiveness in the long-term. However, the results will depend on how quickly and successfully any shortcomings are addressed. Although a step has been taken in the right direction, the tax burden on the workforce still requires further solutions. Moreover, the changes have added to the bureaucratic load. The

tax system must be transparent and straightforward. Continuing a successful tax reform will also multiply support for further reform in public administration.

**Public administration reforms must be continued.** The Council highly rates the work that has commenced on the public administration functions, expenditure and number of personnel. FICIL supports the quick and effective implementation of the 2020 public administration reform plan.

**The amount of funding for research and development must be increased.** Although the funding available in many fields has grown, there is obvious and considerable political stagnation in the field of research and development, as a result of which the situation continues to worsen. The funds allocated for research and development in 2015 were 0.63% of the GDP, but in 2016 this had dropped to 0.44% of the GDP. It must be noted that the government's set target amount is 1.5%. FICIL calls for this target to be set as one of the priorities and to aim towards achieving the set amount.

**Emphasis on exports must be maintained.** The favourable economic climate has allowed a growth in export amounts, and its role in the development of the economy continues to grow. Initiatives for supporting exports, which have reaped returns, should therefore be maintained. Where possible, this support should be increased. A lack of ambition and information continues to pose a great challenge among small- and medium-sized businesses, who continue to refrain from exporting, due to a lack of knowledge and determination.

**There are considerable achievements in the struggle with the shadow economy.** Although it is shrinking proportionately, the shadow economy in Latvia is still the highest in the Baltics. This is a significant challenge both for the successful development of the economy, and for budget revenue. Considerable improvements can be seen in the daily work and attitude of the SRS. The initiated proactive policy should be continued, creating a favourable environment for entrepreneurship and investor opinions about the state. More active progress towards the development and wider use of an e-environment and services is a significant instrument for curbing the shadow economy, as well as raising the effectiveness of state institutions. We emphasise the need to ensure a transparent and open selection procedure for the next head of the SRS.

**The issue of mandatory procurement components (MPC) has shifted.** Following prolonged hesitation, progress in the review of the MPC system can be felt. This has allowed a reduction of MPC payments for many and especially for large manufacturing companies, and increased their competitiveness. However, the critical matters of the system have still not been resolved. Subsequent improvements are especially essential, in order to ensure a balance between the sustainability of the system and competitiveness of companies.

**The demographic situation must also furthermore be among one of the main government priorities.** The quality of life of residents is gradually improving however, a decrease in the population continues. FICIL appreciates efforts made to promote the birth rate and reduce the risk of poverty for families with children. The commenced work must continue and the incentives for these aims boosted, as well as being developed more purposefully.

**FICIL emphasises the importance of implementing the administrative territorial reform.** The current territorial division does not comply with the aim of Latvia's economic sustainability. Such conditions prevent the creation of a sufficient basis for regional development, and halt the improvement of welfare for regional residents. A greater concentration of administrative, financial and human resources will improve opportunities for entrepreneurship and a more

attractive environment for investments will develop. Improvement of economic conditions in the regions will allow a break in migration trends. With the help of an investment policy, an optimal infrastructure should be ensured, including a prime network of educational establishments for regional development, which often means reducing the number of infrastructure units and introducing such funding mechanisms which promote innovation. Special emphasis must be placed on the creation and development of digital services.

**The situation with the labour market is becoming the greatest challenge.** The number of residents of working age continues to drop. This reduces the number of available able-bodied persons and slows inflation. The situation is becoming more acute, and pressure is mounting on payments and inflation. The unemployment rate is dropping, however it is the highest in the Baltics and exceeds the average indicator of European Union Member States. At the end of 2017, 85,400 residents were seeking employment. This should be tackled in the first instance. Huge financial resources are invested in training unemployed people, and the effectiveness of the existing programme should be reassessed, making changes where necessary. Special attention should be paid to motivating the long-term unemployed to acquire the qualifications required by the market. Conditions for the older generations should be developed, especially to hold and return senior employees to the labour market. The high unemployment level in the regions demonstrates structural shortcomings. A lack of workplaces in the regions is a catalyst for the emigration of residents and the permanence of regional inequalities. Mobility of residents should be endorsed, as well as the improvement of knowledge and skills of unemployed residents. Attention should also be paid to incentives that would stir interest in taking up employment, also among economically inactive residents. In the 4<sup>th</sup> quarter of 2017, there were 434,000 such residents. This is a resource whose potential should be seriously assessed. One of the solutions for the lack of a workforce is immigration. A weighted immigration policy is needed, to allow fulfilment of the main aim– to create services and goods with a high added value. Reforms in the education system need to be consistently driven forward, especially in higher education. A favourable and predictable entrepreneurial environment will promote investments and allow production to rise more rapidly, as well as alleviate the challenges of a shortage of workforce.

**Through reform to a flawless reputation.** Growth in the coming years will bring the residents of Latvia closer to the quality of life standards of the EU. However, long-term improvements will be changeable. To speed up the positive changes, the government must be able to improve the state's reputation through purposeful reforms. The aim to create a Latvia, with an environment appealing to investors with a stable growth potential, remains unchanged.