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FICIL Position Paper No. 1

Foreign Investors' Council in Latvia on Macroeconomic Policy Issues

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Introduction



Significant short-term challenges, but long-term vision must be maintained

The unexpected appearance of COVID-19 has shaken not only the economic environment of Latvia, but also the global economy, which is why the world is expecting one of the worst crises since the Second World War. In the first quarter, Latvia's GDP shrank by 1.5%, followed by an even steeper drop in the second quarter. The economic decline will be markedly smaller than in the previous crisis, the virus continues to spread worldwide. Thus, the recovery could take more time and resources than expected. For this reason, the level of uncertainty remains unprecedentedly high, making state aid for businesses vital. Foreign Investors Council in Latvia (FICIL) highly appreciates the management of the crisis by the Cabinet of Ministers headed by Mr. Arturs Krisjanis Karins, avoiding a wide spread of the epidemic in Latvia, which allowed for a reduced economic decline and limited the increase in unemployment. FICIL praises the Government's ability to implement significant educational reforms and the administrative-territorial reform. At the same time, it should be stressed that the pace of the reforms must be maintained. The difficult circumstances increase the responsibility to implement a balanced and forward-looking macroeconomic policy in order to avoid lasting consequences for society as well as to seize the opportunities for the post-crisis phase. COVID-19 will accelerate certain trends that create new opportunities and challenges in the competitiveness of countries. Latvia seems to have managed the crisis very successfully so far, but more challenges are yet to come.

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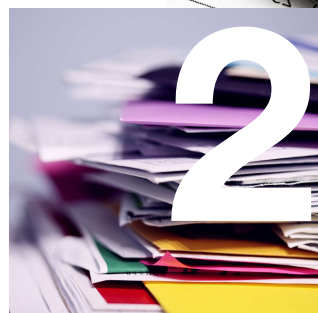
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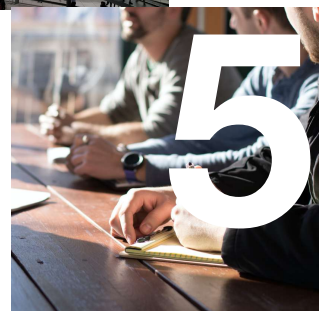
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Recommendations

The main priority is to speed up the digitalisation processes

The virus will be a part of our daily life for a long time; therefore, it is necessary to assess the changes that it brings about in society and business. Behavioural changes are already visible and will only accelerate in the future. Namely, more active online shopping, a reduction in the use of cash, greater use of technology, working from home. This has the potential to reduce costs, increase productivity and profitability. Thus, the main priority should be improving the digital skills of the society and creating such conditions that allow entrepreneurs to adapt in a timely manner. In the 2020 DESI (*Digital Economy and Society Index*) Latvia has dropped to 18th place from last year's 15th. The weakest link is human capital, which ranks Latvia 24th among EU countries. Latvia is also lagging significantly behind in the integration of digital technologies. The consequence is low use of internet services. Although Latvia is in a better position in regards to public services, the digitalisation of public administration and service synchronisation needs to move forward effectively, improving the availability and convenience of existing processes and procedures.

The priority status of Research and Development (R&D) must be proven with an increase in funding

Despite the high priority in political rhetoric, there is a marked stagnation in the allocation of funding for R&D areas. According to NDP2020, this year the funding for research and development was already expected to reach 1.5% of GDP. In 2016, funding for R&D dropped to the level of 2009, but in 2018 it increased only up to 0.64% of GDP. Without the consistent allocation of funding in this area, the objective of significantly increasing the share of knowledge, technology-intensive and exportable products as well as services will remain unachieved.



Recommendations



The effectiveness of the supervision of the financial system needs to improve.

Latvia has demonstrated that it is able to mobilise to achieve important goals, in this case avoiding being on the “grey list” of MONEYVAL. The measures put in place have forced the financial sector to organise itself and improve transparency, which includes business as well. However, many of the conditions established for entrepreneurship have become a new burden, often disproportionate. Therefore, we call for further improvement in the efficiency of the supervision of the financial system, which would not impair the competitiveness of business. The supervisory framework must be further developed so that its activities do not make it difficult to attract foreign investment.

New incentives must be found in the fight against the shadow economy

The high share of the shadow economy continues to remind us that being in the grey economy can still be seen as beneficial. In times of crisis, as they are now, its growth will be natural. It will not be possible to rapidly reduce the shadow economy without unpleasant side effects. Thus, the most important thing now is to continue to maintain comprehensive initiatives that would gradually reduce interest, primarily opportunities to be in the grey economy. The quality and effectiveness of the investigation of economic crimes needs to be further improved. It can be observed that judicial understanding and the penal system are adapting and becoming more severe. The work must continue to rule out cases where the offender finds ways to avoid punishment. The obligation to pay taxes should become the subject of a wide-ranging debate, including the continuation of the discussion on solidarity and the conditions for aid.



Recommendations

FICIL welcomes the timely implementation of government support measures

At the same time, caution should be taken regarding the risks of deficit and debt growth, which may impose a serious burden on the economy and the budget in the future. It is also important to continue the work regarding control mechanisms to assess the effectiveness of various State support measures, while focusing on changing economic circumstances.

Support measures for businesses must be maintained for as long as necessary

The progress of economic recovery can be inconsistent, requiring support mechanisms for entrepreneurs, especially exporting ones, to remain flexible, as regards both time and conditions. The aid must become even more thought-out and targeted, in particular facilitating increased competitiveness and productivity.

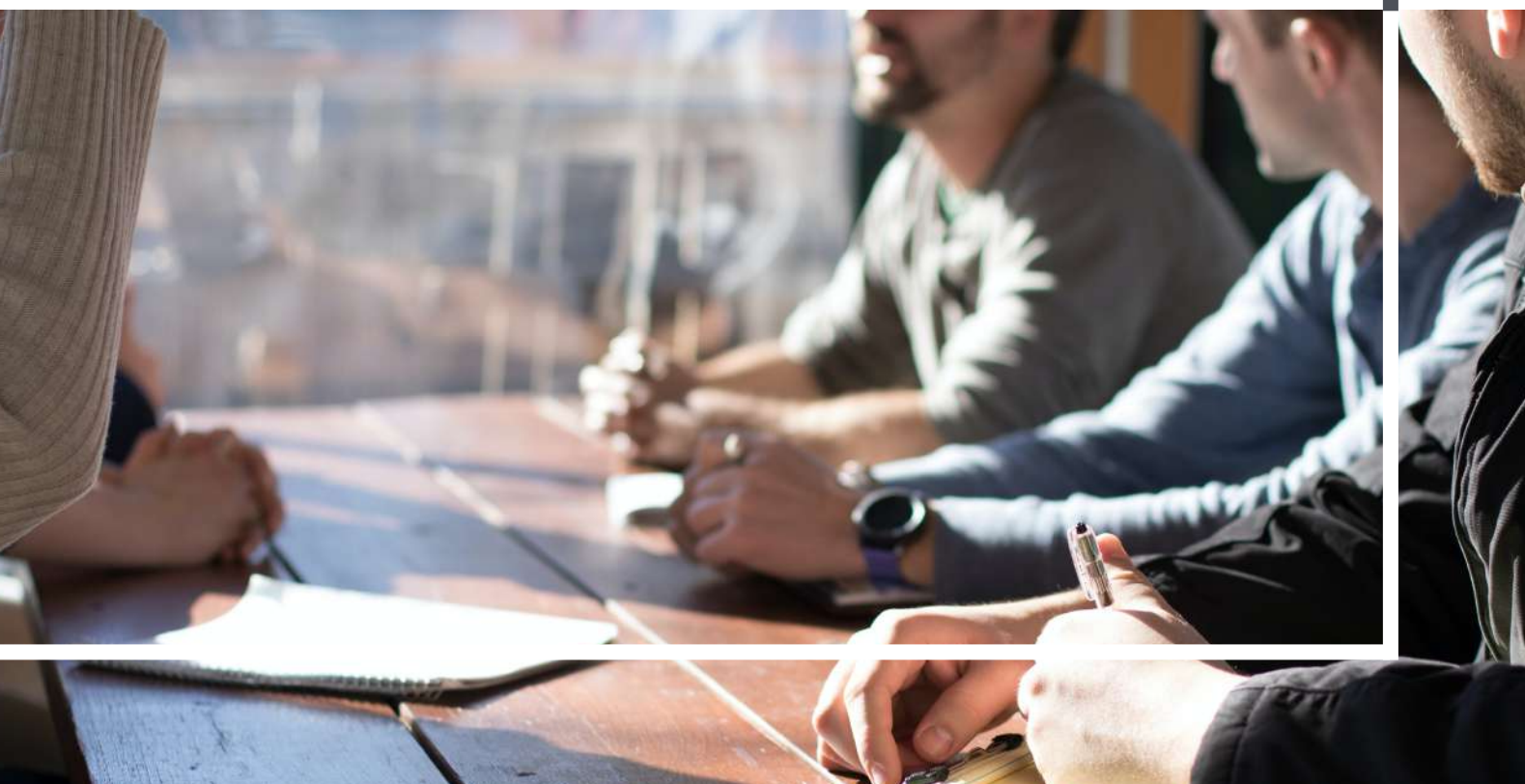
Recommendations

The demographic issue should remain a high priority

Despite a gradual improvement of the welfare of the countries inhabitants, the population continues to decline. It is therefore necessary to seek tools to stabilise the population numbers and to further increase it. FICIL welcomes the progress in stimulating birth rates and reducing the risk of poverty in families with children. However, it should be stressed that progress in reducing inequality has been insufficient.

The labour market will soon recover, and the issue of labour shortage will regain its urgency

It is difficult to predict the duration of the effects of the virus, but, as the economy recovers, labour issues will quickly become urgent again. New business models will be developed in the new post-crisis environment with an intensified focus on the use of technology, thus transforming business models and improving the skills of the workforce is an essential necessity. In the fast-paced age of digitalisation and robotisation, lifelong learning and continuous upgrading of the qualifications of the labour force are an integral part of economic activity, benefiting both employees and employers. Research-based decisions on existing human resource capacity and skills needed in the labour market are needed to adjust education programmes and training in due time. Greater emphasis should be placed not on academic knowledge, but on the upskilling and reprofiling of the labour force in cooperation with employers. This will contribute to a more effective way of involving people in the labour market. Effective retraining of workers will play an important role in reducing the burden on the social budget. More effective solutions are needed to promote regional mobility (construction of dormitories and rental housing, non-taxation of workers' travel and housing costs).



Recommendations

Changes to the tax system must be carefully considered

Maris Kucinskis' government carried out a fundamental reform of the tax system. FICIL believes that this provided a few benefits. At the same time, many shortcomings have emerged, requiring further solutions, particularly in the context of the labour tax burden that is still high. We therefore call for a timely opening of discussions on changes to the tax system in order to avoid haste and adopt carefully considered solutions, taking into account the views of the social partners. The tax system must be more transparent and straightforward. Further digitalisation of tax accounting and payment will contribute to the transparency of the system and efficiency of payment. It is worth considering a greater emphasis on the availability of public services and support measures, linking it to the criteria for paying taxes.

Solutions needed for improving housing affordability

The negative impact of the lack of modern housing is not examined in full yet and requires active government involvement to improve the situation. This is confirmed by the continuing stagnation of the development of the housing stock in Latvia and also includes the potential of solving many other issues such as employment, social conditions, life satisfaction, etc. According to the OECD, investment in the renovation of the housing stock in Latvia is only 2% of the GDP, while in OECD countries the average is 5%. The issue of the rental market has long been unresolved. It is therefore essential to adopt the new rental law that would give a new impetus to the development of the real estate market. FICIL is in agreement with the OECD recommendations on the development of a comprehensive long-term housing policy strategy with adequate funding provision.





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FICIL is a non-governmental organisation that unites 37 largest foreign capital companies from various industries, 10 foreign chambers of commerce in Latvia, French Foreign Trade Advisers and Stockholm School of Economics in Riga. The goal of FICIL is to improve Latvia's business environment and overall competitiveness in attracting foreign investment, using the experience and knowledge of its members to provide recommendations to Government and state institutions.