



FICIL  
RAISE THE BAR!



Position Paper No. 1

# Foreign Investors' Council in Latvia Position Paper on Macroeconomic Policy Issues

16 September 2021



# Introduction

## A sound, sustainable, and investment-friendly policy required

So far, the Latvian economy has overcome the impacts of the COVID-19 pandemic relatively well and clear signs of economic recovery can be noted after a fall in the first quarter. In June, the economic sentiment jumped to the highest level over the last four years, reaching 105.6 points. Due to the favourable external situation, export will be one of the drivers of economic growth and will strongly stimulate development of the manufacturing sector.

Consumption will also increase, hence a growth in trade will gather pace and a growth in services will return. The situation will also stabilise in the sectors which have suffered the most, namely catering and accommodation, as well as entertainment and recreation. However, full recovery of these sectors requires a longer period than previously anticipated and also a more predictable epidemiologic situation. After a reduction in construction activity at the start of the year, the construction sector is now expected to recover quickly. A slowdown will continue in the transport and storage sectors.

Despite the different situations in sectors, wages will rise at a faster pace and unemployment will drop, putting additional pressure on inflation and highlighting competitiveness issues. This means that, in spite of positive growth perspectives for the economy, the

situation in sectors and social groups will remain unequal, also echoing a different sentiment and assessment of the economic situation. The prevailing uncertainty puts additional responsibility on the implementation of a smart and forward-looking macroeconomic policy in order to avoid unwanted consequences on the financial and economic stability of the country in the long-term.

FICIL welcomes the activities of Krišjānis Kariņš' Government in respect of the fight against the COVID-19 pandemic, initiating and taking forward the vaccination process, as well as providing support to entrepreneurs and residents in tackling the crisis. FICIL emphasises the ability of the Government to implement important reforms in the education system, achieve the administrative territorial reform and also introduce the Economic Affairs Court. A further positive aspect is that the new long awaited Residential Tenancy Law has been adopted and also amendments to the Law on Residential Properties have been adopted. Initiatives designed to address social issues should also be supported. We believe that the COVID-19 crisis has not only precipitated certain trends in the existing aspects, but also created new elements in the future transnational competition. Therefore, FICIL would like to highlight several directions and topical issues to ensure a smooth transition to the sustainable economic growth of Latvia.



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## Strengthening the international competitiveness

Although the indicators such as the gross domestic product (GDP) show that Latvia has overcome the crisis more successfully than other euro-zone countries on average, and macroeconomic growth forecasts for the coming years suggest strong growth (from 3-4 % in 2021 and 5 % in 2022), concerns are raised by the development trends already lagging behind those of Lithuania and Estonia. In our opinion, a comprehensive assessment of the situation should be carried out and appropriate measures taken to prevent a further widening of the gap. Though improvements can be noted, the progress in the initiation, attracting of external investment projects and establishment of a supporting environment is still insufficient in comparison with neighbouring countries.

## Proactive behaviour to deal with the consequences of the pandemic

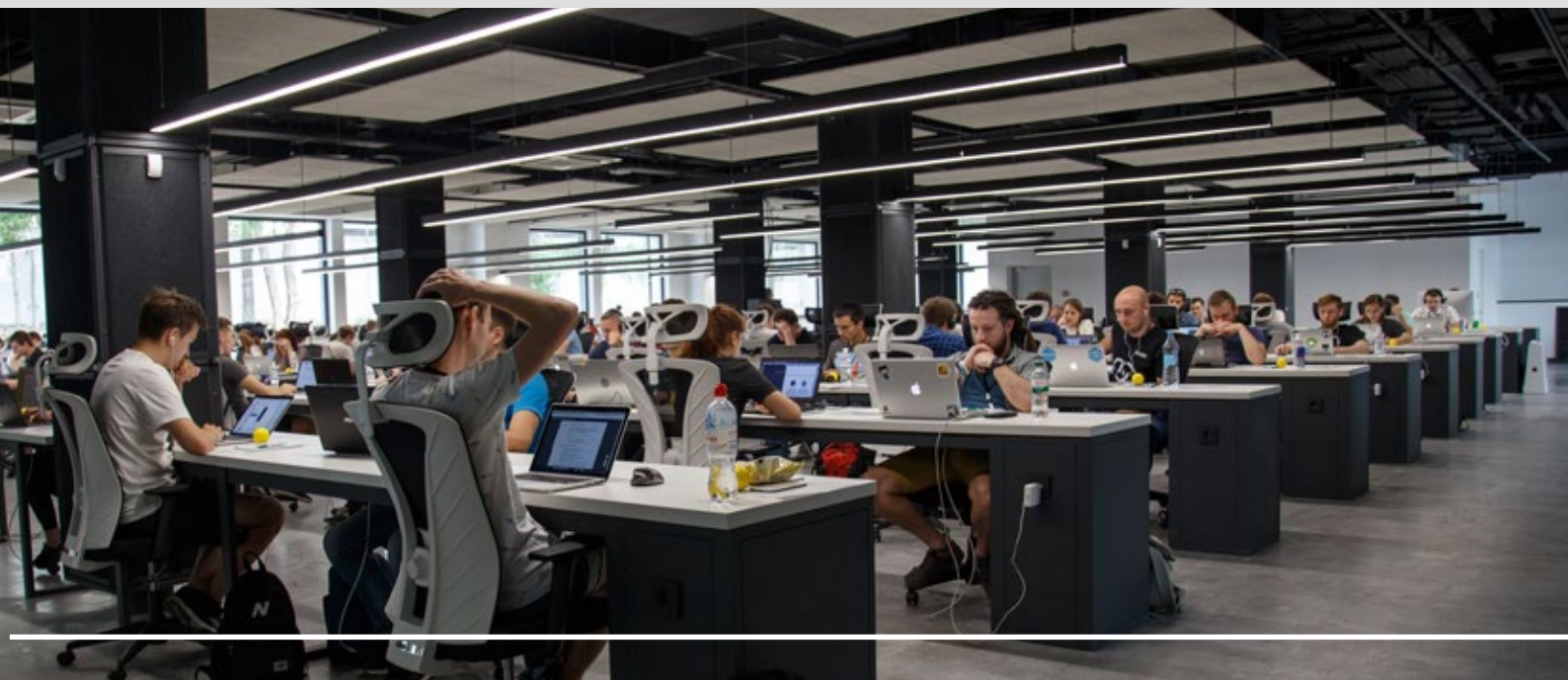
Variants of the COVID-19 virus will continue to spread in the world which means that the presence of the infection will remain as one of the major risks to the economy. Thus, considerable uncertainty remains and a policy supporting entrepreneurship will also be of vital importance in the future, in particular for exporting companies. A flexible approach should be maintained to the support, both in terms of time and conditions. Support should be provided in a more thoughtful and targeted manner, in particular supporting an increase in competitiveness and productivity.

In this context, it is necessary to devise a predictable action plan for support to entrepreneurs who will face difficulties in entrepreneurship for a longer period than the change in regime of restrictions. This will help avoid unwanted insolvency cases. Although the vaccination programme is moving at a good pace, this process is likely to slow down in the foreseeable future. This means that new approaches should be sought to address the more sceptical part of the population, since it is expected that the risks of the virus will re-escalate in autumn. Thus it may be predicted that the approach should differ depending on the level of vaccination in different regions by restricting economic activity as little as possible. Consequently, the future remains uncertain in many sectors. A reliable and predictable model of conditions and action is also missing for the introduction and removal of restrictions on which entrepreneurs could rely.

## Investing RRF funds in the long-term development

The large-scale European Union (EU) funding will help investments and growth to recover in general. The challenge now is for Latvia to invest the Recovery and Resilience Facility (RRF) funds efficiently, focusing on increasing its long-term growth potential for the economy to adapt successfully to the most important challenges, such as digitalisation and combating climate change. This will determine Latvia's competitiveness after 3-5 years and show whether the gap between the neighbouring countries will narrow or, on the contrary, widen. It is obvious that the available EU funding will not be sufficient to achieve the goals, hence work should begin in a timely manner to develop support mechanisms for the attraction of funding. This applies in particular to the segment of small and medium-sized enterprises (SMEs) for which it might be most difficult to make the necessary investments in order to reach the goals outlined. It is also important to establish an appropriate monitoring mechanism which would follow progress towards the goals, as well as assess the long-term effectiveness of use of the funding. The RRF plan anticipates that 40 % or EUR 643.21 million from the EU will be diverted towards implementation of the private sector projects, yet approximately 60 % or EUR 1.15 billion will be directed towards implementation of the public sector projects. FICIL believes that the amount of the financing to be channelled to the private sector should be increased to the greatest extent possible.

One of the most essential tasks is to ensure that the influx of investments into construction is done as evenly as possible in order to protect the sector from the risks of overheating. In the next few years, a significant amount of investments will flow into the sector. According to the calculations of the Fiscal Discipline Council, 65 % of the total investments from the EUR 1.82 billion EU Recovery Fund will be diverted towards infrastructure projects. This poses a threat to the stability and prospects of the real estate sector, since a sharp increase in construction costs will be inevitable. A more even influx of investments will allow a reduction in fluctuations in the sector and also ensure implementation of the private sector investment plans.



## Digital transformation

The pandemic has accelerated changes in business models and people's behaviour. This includes more active shopping online, a decrease in the use of cash, wider use of technologies and working from home. This has the potential to reduce costs and increase productivity and profitability. Latvia's ranking in the Digital Economy and Society Index (DESI) has dropped to 18 in 2020. The weakest link is human capital where Latvia ranks only 24th among the EU countries. Latvia is significantly lagging in terms of integration of digital technologies which leads to a low use of online services despite the quality infrastructure. Although Latvia is better placed in respect of public services, digitalisation of public administration and synchronisation of services should move more quickly, improving availability and the user-friendliness of the existing processes and procedures.

A significant factor in the slow digital development of Latvia is the fragmented digitalisation policy. It causes unnecessary competition in the public sector in respect of resources, financing and support for development projects, as well as inhibiting the harmonious long-term development at national level. FICIL calls on the government to upgrade digitalisation issues giving them a higher priority and also to establish a single centralised authority responsible for the national digital development issues.

At the same time, attention should be paid to the lack of digital skills of the Latvian residents. The RRF plan of Latvia includes the target of increasing the proportion of people who have at least basic digital skills to 70 % in 2027. FICIL emphasises that the achievement of this target requires a detailed plan clearly allocating the responsibilities of the involved parties and specifying the activities to be carried out and mechanisms to monitor progress.

It should also be emphasised that Latvia's performance has declined in the EU Innovation Scoreboard 2021. Latvia ranks 25th among 27 countries thus placing it in the group of countries which are considered to be emerging innovators. A fall in innovation performance in comparison with 2020 is related to a sharp fall in the venture capital investments (from 0.215 % to 0.019 % of GDP) and development of environmental technologies (from 12.4 to 5.1). Progress of innovations has also been relatively slow from 2014 to 2021, which demonstrates the need for a rapid response to address the consequences.

## Review of the labour policy

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A shortage of a labour force should be dealt with by improving the requalification system. As the economy recovers, labour issues become increasingly important. In the new post-crisis context, new business models will emerge with a more intensive focus on the use of technologies, hence the re-profiling of business models and up-skilling of the labour force are greatly needed. In a time of rapid digitalisation and robotisation, lifelong learning and constant further training of the labour force are an integral part of economic activity benefiting both employees and employers.

Research based decisions are required on the existing capacity of the human capital and skills needed in the labour market in order to adjust the educational curricula and training. In developing labour requalification and re-profiling policies in cooperation with employers, more efficient labour participation will be promoted. Requalification of employees will play a significant role in reducing the burden on the social budget and reducing inequalities. More effective solutions are required to favour regional mobility (construction of official accommodation facilities and rental housing, non-taxation of travel and accommodation costs of employees).

Centralised responsibility is an essential precondition for successful changes also in this area. At the moment, governance over the requalification policy is very fragmented which leads to the setting of different uncoordinated priorities and a lack of responsibility for the results to be achieved. FICIL calls for the

establishment of a centralised centre of competence providing an extension of the functionalities of the State Employment Agency, as an example.

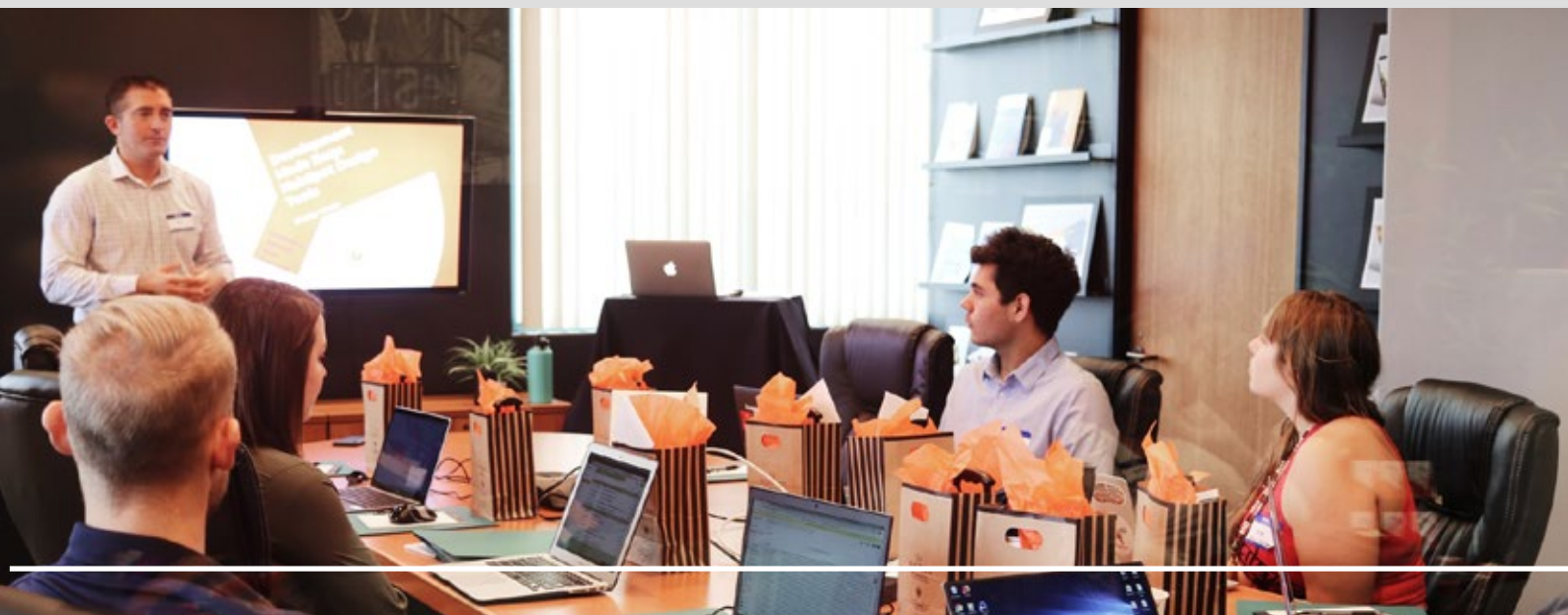
## Transparency of the tax system

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Changes in the tax system should be balanced and well-prepared. FICIL supports the principal aspects of the tax reform introduced this year. In our opinion, however, the reform carried out is incomplete and requires some improvement, including in the issues affecting part-time employees. In light of the lack of employees, favourable conditions should be created for their participation in the labour market.

There is also the potential to make the system more transparent and simpler which would also improve the overall assessment of the tax system and the country. Investors would like to see a longer term national tax strategy on which they could rely when weighing up their investment plans and which would be strictly followed when making any tax changes. Investors also expect broad public participation in the planning of tax changes and the timely informing of the public regarding the planned initiatives.

Further digitalisation of tax administration will promote efficiency of the system and effectiveness of payments. Availability of public services, support measures and procurement related to tax payment criteria still has untapped potential.





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FICIL is a non-governmental organisation that unites 38 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.

[www.ficil.lv](http://www.ficil.lv)