



24 September 2015

Position Paper on Sustainable Economic Development

1. Executive Summary

Latvia's economy continued to develop and grow in the first six months of 2015 despite problems in external markets, although this growth lagged behind the predictions on which the 2015 budget was based. It is expected that Latvia's GDP growth this year could be a little above 2%. Bearing in mind the importance of export and the continuing high uncertainty in external markets at the same time, the capacity of Latvia's exporting companies to re-orient themselves and to continue increasing export volumes is to be commended. At the same time it must be conceded that Latvia continues to remain in a situation where it needs an economic "breakthrough", to reach a level like that of the most developed EU nations. The pace of economic growth up till now, which is within the region of two to three percent, will not let it attain that level in the foreseeable future.

Currently, three significant factors have been identified by the members of the Foreign Investors' Council in Latvia (FICIL) to enable a more rapid increase in competitiveness, which could substantially promote a faster pace of economic development: (i) companies, increasing their competitiveness through developing and broadening their operations and markets for sales; (ii) the government, by implementing structural reforms and modernizing the business environment in which the companies' operate; (iii) innovations and the development of innovation ecosystems, which must become one of the long-term national economic goals.

The factors mentioned above have also been clearly identified in the "**Foreign Investors Council in Latvia's Sentiment Index**" which was undertaken for the first time in 2015. Current investors in Latvia responded to questions about the factors, which determine their decisions on whether to continue to invest in Latvia, as well as the conditions which directly influence the nation's competitiveness in attracting new investment. The survey will serve as a good instrument for improving the overall investment climate in Latvia facilitating the entry of new investors in the country.

2. Recommendations

The "**Foreign Investors Council in Latvia's Sentiment Index**" confirmed that, for Latvia to start moving towards sustainable, rapid and comprehensive growth, it must return to the reform programme it had commenced and must immediately focus on the following areas:

- (i) ***The productivity, availability and quality of the labour force***: the concentration of human and financial resources must be continued; the higher and professional education system must be optimized by reducing the number of its infrastructure units and improving quality and practical skills; a smart immigration policy must be developed and implemented to provide the high quality human resources required for economic development, and at the same time to reduce the pressure on the social security system in the long term. (Detailed

proposals have been collated in a separate FICIL Position Paper on Availability and Quality of Labour Force);

- (ii) **Quality of the education system:** a very important pre-condition for sustainable economic growth. FICIL's view is that reforms must be undertaken in the education system, so that it is competitive on an international scale, and becomes the driving force behind Latvia's economic development. The main focus in the reforms should be on changing the funding model for higher education and undertaking a consolidation of the higher education system. (Detailed proposals have been collated in a separate FICIL Position Paper on Education System Development.);
- (iii) **Effective and reliable law enforcement system:** one of the most important factors in adopting a decision to make an investment in a particular country is the existence of an effective and reliable law enforcement system guaranteeing secure business environment. A non-transparent, unpredictable business environment and instability in general, interfere with the attraction of investment. In this regard, further work should be continued not only towards promotion of security of business transactions and of flow of capital, and the enhancement of the efficiency of the court system, but also regarding promotion of the stability of legislation and facilitation of wider involvement of all stakeholders, industry professionals as well as the public in the law-making process. (Detailed proposals have been collated in a separate FICIL Position Paper on Investment Security and Court System Efficiency.);
- (iv) **Monitoring and quality of the insolvency process:** the continual improvement of the Insolvency Law does not ensure that a just and transparent insolvency process will ensue. The quality of the insolvency process system is also determined by application of legal norms, which lies in the hands of the courts, insolvency process administrators and the Insolvency Administration. The fundamental part of the insolvency process is the supervision function, as poor monitoring significantly influences both the debtor, and the interests of the creditors involved in the process. FICIL has carried out a research about the implementation of the insolvency process in the period from 2008 through 2014 and has prepared proposals, which will allow for the improvement of the rule of law in the insolvency process and will increase trust in the insolvency process regulation in Latvia. (Detailed proposals have been collated in a separate FICIL Position Paper on Insolvency Process.);
- (v) **Efficiency of the health care and social security system:** Reforms to the health care sector so far have not provided noticeable improvements in the health indicators of Latvian residents (current and future employees). The key to successful reforms would be strong political will combined with significant, evenly distributed and sustained investment. This could mean unpopular and difficult decisions that have to be taken. The quality of the labour force is among the most important pre-conditions, which the investors assess in weighing up future investment decisions. Education, skills and experience of the employees play an important role, however, concerns about a stable social security system and availability of health care services can have greater impact on the investment decisions.
It is widely acknowledged that health is an important factor contributing to overall productivity. Government has declared that health is among its priorities - coordinated cross-sectoral co-operation and action, appropriate investments and returning to the reform agenda in health system is the only way to demonstrate it in reality. Increasing investment in health system is inevitable; however it should be conditional to appropriate reforms. In 2014 FICIL in a detailed Position Paper already focused on the negative economic consequences of ill health, as well as clearly indicated scope of required reforms;
- (vi) **Support for innovations and development of an innovation eco-system:** the development of innovations must become one of the long-term goals of the national economy, which must have adequate political support. Single Government entity should take responsibility to

coordinate and lead innovation agenda;

- (vii) **Elimination of barriers for business financing:** the current situation is favourable to secure funding for business development and growth, given the low interest rates and high competition between credit institutions. But one of the barriers that currently reduces business demand for financing and willingness to invest in the development is delay in access to the EU funds under the new EU programming period. It is important to ensure access to the EU funds as soon as possible to enable business to modernise production, strengthen competitiveness of new products and services, invest in research and achieve other goals;
- (viii) **Implementation of predictable taxation policy:** predictability is one of the cornerstones for creating an environment that is attractive to investments. Currently the lack of a long-term economic vision is hindering further investment. As observed during the development of the state budget for 2016, competition for state funding to ensure state functions has significantly increased, but there is lack of transparency and determination in its distribution. Unexpected and late notification of the introduction of new taxes proves that there is no long-term policy. The state needs to review if the volume of tax collected for carrying out its functions is adequate and must look for appropriate and sustainable (not campaign-type) solutions in a timely manner and in close dialogue with the business. Political leadership must identify and define the growth potential of the country and must help the business to achieve it.
- (ix) **Reduction of the shadow economy:** this is the main way to increase taxation revenues and to improve fiscal flexibility needed for the implementation of structural reforms. The size of Latvia's shadow economy, relatively speaking, seems noticeably greater than in comparable countries. The shadow economy influences tax collection and the Latvian budget in a negative way. But, what is even more significant, by altering the distribution of resources, it distorts competition in various ways, reducing growth and its potential, including making the attraction of foreign direct investment more difficult. At the same time, it should be unacceptable to introduce legal norms that discriminate against certain groups of business and harms those market participants that operate legitimately.

3. Rationale for the Recommendations

The public administration must assess its current performance effectiveness and take all necessary measures to effectively manage sustainable development of Latvia. According to the European Union's sustainable development strategy definition, sustainable development must promote a dynamic economy, full employment, a high level of education, good medical care, social and territorial cohesion and environmental protection in a peaceful and secure world, respecting cultural diversity.

The concept of sustainable development is based on the need to optimize the economic development and social systems, as well as the impact on the environment and use of resources. This development model is meant to ensure sustainability of economic, environmental and social spheres.

In the environment of tight fiscal discipline, public administrations globally review their operation models and try to re-orient towards more dynamic models where it is possible to deliver more with less.

In 2009-2011 Latvia commenced a number of significant structural reforms but the pace of reforms has currently stopped. In addition, the list of work to be done is topped by politically and socially sensitive topics like, health care and education, which need strong political will, ability to reach consensus and ensure continuity. By ignoring these tasks furthermore, the overall business

environment will be significantly weakened, and competitiveness reduced. Reforms undertaken and implemented formally without a clear picture of their real effect, create new bureaucratic hurdles instead of making the business environment easier.

We believe that the productivity, availability and quality of the labour force are amongst the most significant issues that could facilitate further growth of the Latvian economy. Lack of attention to this issue could result in the labour force (i.e, the lack of it) becoming a barrier to growth. However, properly addressed, it could unlock valuable resources critical to further growth. The factors, which primarily determine a country's long-term economic development, are the availability and quality of the labour force. As indicated by existing investors, businesses already encounter shortage of labour and consider that the basic problem for economic development and further investment is not capital, but specifically the availability of labour. However, the introduction of qualified labour force with the required skills from other countries is often made difficult. In terms of the quality of the labour force, businesses are forced to make significant investments to compensate for the shortcomings in the quality of the education system. In the long term, the access to, and costs of, health care, as well as the sustainability of the social security system, is of concern.

Investment activity in Latvia continues to remain at a comparatively low level, which, in our opinion, threatens Latvia's long-term development. It should be noted that with a continuation of geopolitical tensions in neighbouring countries, a rapid increase in investor activity cannot be expected. Investors make decisions about investments based on such factors as labour force and resource availability, the size of the market and the accessibility of other markets and on work productivity. The support provided by the government is also significant. Unfortunately, due to various reasons, Latvia does not stand out as a self-evident investment destination. As a consequence, focussed work on attracting investments and improving the business environment is important for raising Latvia's overall competitiveness.

Closely related to investments is the issue of support for innovations, which is particularly important when considering the country's long-term development. A powerful innovation ecosystem will both strengthen the state economy and assist in attracting investment. In this regard, it is important to overcome Latvia's passivity in innovation (according to the Innovation Union Scoreboard carried out by the European Commission, Latvia continues to be placed in the "modest innovator" category) and to provide support for science and innovative businesses, to facilitate the commercialisation of innovations, as well as to ensure the protection of intellectual property.

Finally, we wish to emphasise once again the importance of the country's legal environment and the government's actions in ensuring a predictable business environment. Acknowledging some progress in a number of areas, for example, improving insolvency law, more work is required in combatting the shadow economy that allows tax avoidance and distorts competition. A long-term vision for the country's economic development is also needed.

Due to the reasons mentioned, this year FICIL during the High Council meeting wants to emphasise the need to return to reforms launched during the economic crises. Their implementations could give a qualitative boost for faster economic development, reaching the targeted 4 – 5% annual growth in GDP.

FICIL members are firmly convinced that for Latvia to be able to utilize its potential as a small and open economy at the crossroads of Europe's western and eastern trading routes, it will be particularly important to continue solving the abovementioned problems.