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Foreword

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Latvia were reviewed by the Committee on 28 February 2024. The draft report was then revised in light of the discussions and given final approval as the agreed report of the whole Committee on 3 April 2024.

The Secretariat's draft report was prepared for the Committee by Robert Grundke and Enes Sunel under the supervision of Mame Fatou Diagne. Research and drafting inputs from Keita Dicmane and Zeev Krill as well as research inputs from Konstantīns Beņkovskis and Kārlis Vilerts from the Bank of Latvia, Francesco Manaresi and his colleagues from the DynEmp and MultiProd teams of the OECD Directorate for Science, Technology and Innovation, Carlo Menon and Jeyul Yang from the Scale-up project team in the OECD's Centre for Entrepreneurship, SMEs, Regions and Cities, and Cristiana Vitale and Eszter Danitz from the OECD Economics Department are gratefully acknowledged.

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The previous Survey of Latvia was issued in March 2022.

Information about the latest as well as previous Surveys and more details about how Surveys are prepared is available at www.oecd.org/eco/surveys

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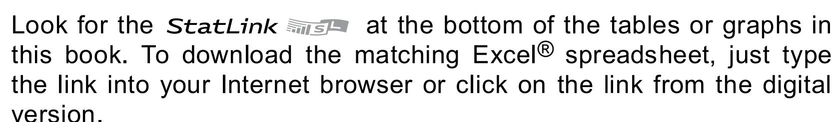

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BASIC STATISTICS OF LATVIA, 2023[1]

(Numbers in parentheses refer to the OECD average)[2]

LAND, PEOPLE AND ELECTORAL CYCLE					
Population (million,2022)	1.9		Population density per km² (2022)	30.3	(39.0)
Under 15 (%, 2022)	15.6	(17.2)	Life expectancy at birth (years, 2021)	73.3	(78.7)
Over 65 (%, 2022)	21.9	(18.0)	Men (2021)	68.6	(75.9)
International migrant stock (% of population, 2019)	12.4	(13.2)	Women (2021)	78.2	(81.7)
Latest 5-year average growth (%)	-0.6	(0.4)	Latest general election	October-2022	
ECONOMY					
Gross domestic product (GDP)			Value added shares (%, 2022)		
In current prices (billion USD)	43.6		Agriculture, forestry and fishing	5.8	(2.8)
In current prices (billion EUR)	40.3		Industry including construction	23.7	(28.3)
Latest 5-year average real growth (%)	1.2	(1.6)	Services	70.5	(68.8)
Per capita (thousand USD PPP, 2022)	41.0	(60.2)			
GENERAL GOVERNMENT Per cent of GDP					
Expenditure (2022)	40.9	(42.9)	Gross financial debt (2022)	50.5	(113.4)
Revenue (2022)	36.3	(39.6)	Net financial debt (2022)	16.6	(67.6)
EXTERNAL ACCOUNTS					
Exchange rate (EUR per USD)	0.92		Main exports (% of total merchandise exports, 2021)		
PPP exchange rate (USA = 1)	0.50		Machinery and transport equipment	20.5	
In per cent of GDP			Manufactured goods	19.1	
Exports of goods and services	64.1	(31.3)	Crude materials, inedible, except fuels	16.2	
Imports of goods and services	68.0	(31.6)	Main imports (% of total merchandise imports, 2021)		
Current account balance (OECD: 2022)	-4.0	(-1.0)	Machinery and transport equipment	29.5	
Net international investment position (2022)	-27.2		Manufactured goods	14.7	
			Chemicals and related products, n.e.s.	12.9	
LABOUR MARKET, SKILLS AND INNOVATION					
Employment rate (aged 15 and over, %, 2022)	57.0	(57.5)	Unemployment rate, Labour Force Survey (aged 15 and over, %, 2022)	6.8	(5.0)
Men (2022)	62.4	(65.4)	Youth (aged 15-24, %, 2022)	15.2	(10.9)
Women (2022)	52.6	(50.1)	Long-term unemployed (1 year and over, %, 2022)	2.0	(1.2)
Participation rate (aged 15 and over, %, 2022)	61.1	(60.9)	Tertiary educational attainment (aged 25-64, %, 2022)	39.5	(40.7)
Average hours worked per year (2022)	1,553	(1,752)	Gross domestic expenditure on R&D (% of GDP, 2020)	0.7	(2.9)
ENVIRONMENT					
Total primary energy supply per capita (toe, 2022)	2.3	(3.8)	CO_2 emissions from fuel combustion per capita (tonnes, 2022)	3.1	(7.8)
Renewables (%, 2022)	45.5	(12.0)	Water abstractions per capita (1 000 m³, 2021)	0.1	
Exposure to air pollution (more than 10 μg/m³ of PM 2.5, % of population, 2019)	69.5	(61.7)	Municipal waste per capita (tonnes, 2021, OECD: 2020)	0.5	(0.5)
SOCIETY					
Income inequality (Gini coefficient, 2021, OECD: latest available)	0.343	(0.316)	Education outcomes (PISA score)		
Relative poverty rate (%, 2021, OECD: 2020)	16.0	(11.8)	Reading	475	(476)
Median disposable household income (thousand USD PPP, 2021, OECD: 2020)	19.9	(26.6)	Mathematics	483	(472)
Public and private spending (% of GDP)			Science	494	(485)
Health care (2022)	8.8	(9.2)	Share of women in parliament (%, 2022)	30.0	(32.5)
Pensions (2019)	7.2	(9.5)	Net official development assistance (% of GNI, 2017)	0.1	(0.4)
Education (% of GNI, 2021)	3.8	(4.4)			

1. The year is indicated in parenthesis if it deviates from the year in the main title of this table.

2. Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 80% of member countries.

Source: Calculations based on data extracted from databases of the following organisations: OECD, International Energy Agency, International Labour Organisation, International Monetary Fund, United Nations, World Bank.

Executive Summary

Slowing economic convergence and the effects of the war in Ukraine call for accelerating structural reforms

Russia's war of aggression against Ukraine has led to higher energy prices and disruptions in trade and supply chains, weighing on economic growth. Even before the pandemic and the war, economic convergence had slowed down (Figure 1).

Ample fiscal space has enabled strong support of households and firms during the pandemic and the energy crisis. However, weak targeting of support measures during the pandemic and the energy crisis increased fiscal costs and inflationary pressures in the context of intensifying supply-chain bottlenecks.

Table 1. Domestic demand will lead the recovery

	2022	2023	2024	2025
Real GDP growth	3.0	-0.3	1.8	2.9
Unemployment rate (%)	6.8	6.5	6.7	6.6
Harmonised consumer prices (%)	17.2	9.1	1.7	2.4
Fiscal balance (% of GDP)	-4.7	-2.3	-2.9	-2.5
Public debt (Maastricht, % of GDP)	41.5	43.5	45.7	47.3

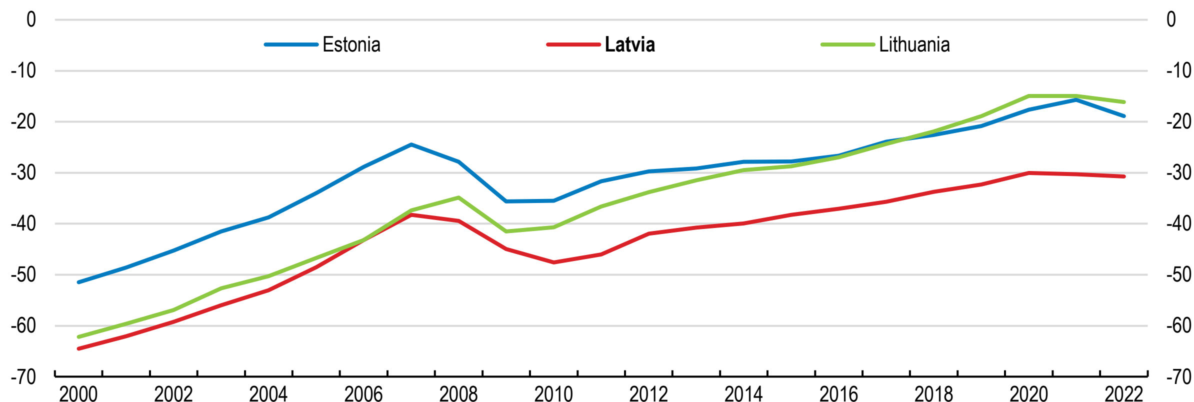
Source: OECD Economic Outlook 114 database and updates.

Falling headline inflation due to lower energy and food prices and rising nominal wages will support real incomes and raise private consumption in 2024 and 2025. Although tight financial conditions will weigh on private investment, the significant inflow of EU funds will boost public infrastructure investment over the next years. Export demand will slowly recover. Wage growth will remain strong due to skills shortages and planned increases in public sector and minimum wages, leading to sticky core inflation. Fiscal policy should be gradually tightened to reduce high fiscal deficits, lower inflationary pressures and stabilise public debt.

Since the global financial crisis, weak investment, skilled labour shortages and slow digital adoption have weighed on potential growth and public sector capacity. High risk aversion of banks, weak competition and shallow capital markets have reduced access to finance for firms. A strong fiscal adjustment and falling wages after the global financial crisis weighed on public sector capacity and the quality of public services, particularly in health care and education. Many high-skilled young adults have left to work abroad, which has exacerbated skilled labour shortages, particularly in STEM and ICT professions. In addition to a lack of digital skills, digital adoption has been hampered by the prevalence of many small firms with low training investment.

Figure 1. The pace of convergence in living standards has slowed

Gap in GDP per capita against OECD average, %



Note: Percentage gap to the OECD average in terms of GDP per capita (in constant 2015 PPPs).
Source: OECD National Accounts database.

Accelerating structural reforms is key to raise productivity and living standards. Reducing informality and barriers to competition and firm growth, particularly in services, would help strengthen business dynamism and innovation. Lowering informality requires reducing labour taxes for low-wage earners, improving tax enforcement and raising trust in institutions. Strengthening the powers of the Competition Council to enforce competitive neutrality of state-owned enterprises would help to reduce barriers to competition. Addressing skilled labour shortages will need facilitating skilled migration, improving the quality of health, education and training services as well as active labour market policies, and encouraging more girls to enter high-skilled occupations in short supply.

Strengthening public finances and the quality of public services to improve living standards

Financing rising spending needs in defence and health care and reducing old-age poverty will require raising tax revenue and spending efficiency and reallocating spending. The tax burden should be shifted from labour to other income, property, and environmental taxes.

High social security contributions, particularly for low-wage earners, reduce incentives to formalise work (Figure 2**).** The shadow economy has not decreased since 2012, which is mainly related to the practice of envelope wages, where workers earn the minimum wage and receive top-up payments in cash. Reducing the labour tax wedge for lower incomes while financing the reform through general tax revenue should be a priority.

Figure 2. The labour tax wedge is particularly high for low-wage earners

Average tax wedge decomposition in % of labour costs, by income level, 2022

Note: The tax wedge is the sum of personal income tax, employee plus employer social security contributions, minus social benefits as a percentage of labour costs. The tax wedge is shown for a single individual without children and by income level measured in percent of the income of the average worker (AW).
Source: OECD Taxing Wages database.

StatLink https://stat.link/a6eo9d

Further strengthening tax enforcement and the fight against corruption and money laundering can do much to reduce the shadow economy and broaden the tax base. Implementing the planned mandatory filing of an electronic income tax declaration for all taxpayers should be combined with making electronic payment of wages mandatory. Moreover, raising trust in institutions is key to improve the tax morale. Implementing a comprehensive lobbying register at all levels of government would help to raise transparency and reduce corruption.

Shifting the tax burden towards property taxes would improve municipal finances, reduce distortions and lower inequality. Raising revenue from recurrent taxes on immovable property by updating cadastre values with market prices, while continuing to provide tax reductions for the primary residence of poorer households, would stabilise local public finances and raise incentives for spending efficiency. Introducing inheritance taxes, while allowing for exemptions for low-value inheritances, could help decrease inequality and raise revenue.

Continuing to improve human resource policies is key to raise the quality of the public administration. High staff turn-over has led to losses in human capital and institutional memory with negative consequences for the quality and effectiveness of public policies and services and the efficiency of public spending. The recent public employment reform and wage increases should be combined with better training opportunities for public employees, with a particular focus on digital and management skills.

Digitalisation of public services has significantly improved, strongly reducing the administrative burden. However, the use of data for ex-ante and ex-post impact evaluation of regulation remains weak, particularly at the municipal level. This reduces the effectiveness and efficiency of public spending, for example in infrastructure planning. Centralising procurement for standardised goods and services, such as pharmaceutical drugs or IT and software equipment, would help raise spending efficiency. Setting unified transparency, accountability and performance standards for all SOEs and centrally monitoring their performance is also key to improve spending efficiency.

Carbon emissions remain high in transport and heating. Lowering tax expenditures for fossil fuel and establishing a metropolitan transit authority to prioritise investments in public transport and facilitate coordination among municipalities are important steps to reduce transport emissions.

Simplifying the administrative burden for support programmes and standardising technical documentations for renovations of similar multi-owner buildings would help reduce costs and support building renovations.

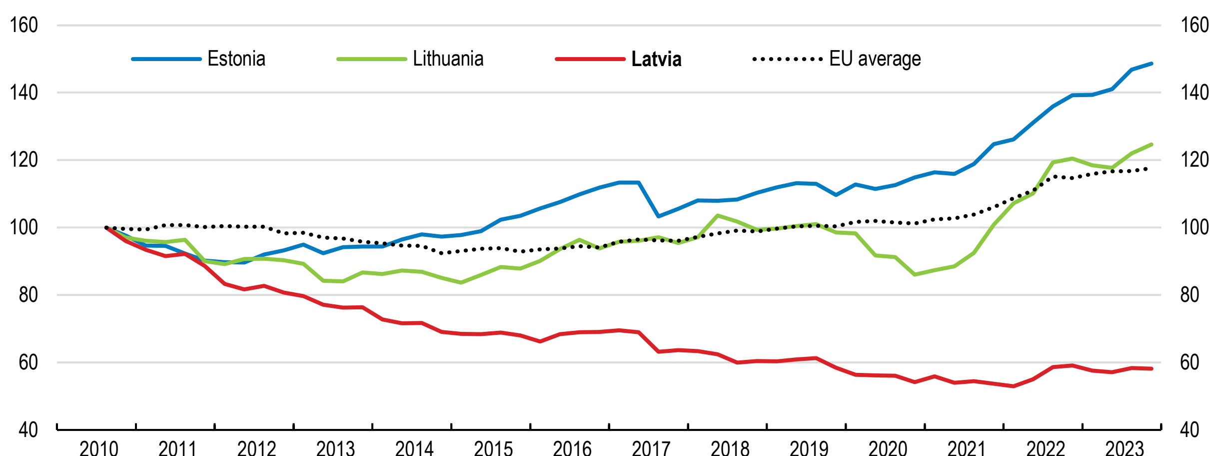
Raising investment to boost growth

Investment has slowed down since the global financial crisis. Credit supply decreased due to high risk aversion of banks, weak competition and shallow capital markets (Figure 3). High informality, barriers to competition and skilled labour shortages have weighed on business dynamism, innovation and investment demand.

Despite rising deposits and high profitability, banks have been reluctant to lend. Low customer mobility and weak competition in the banking sector have led to high borrowing costs and collateral requirements, reducing corporate borrowing (Figure 3). To improve access to finance it is key to foster competition in financial markets by raising transparency on deposit rates, commissions and fees, reducing switching costs for bank customers and strengthening competition enforcement.

Figure 3. Credit supply has decreased

Credit to non-financial corporations, 2010 Q3 = 100



Note: Credit refers to loans and securities other than shares.
Source: ECB Data Portal.

StatLink https://stat.link/x6rht4

High risk aversion of banks is related to low asset recovery and money laundering cases in the past. Recent reforms, including the establishment of a specialised Economic Court, have significantly improved insolvency procedures and the fight against corruption and money laundering. Expanding the remit of the Economic Court and establishing a deed register for all leased assets could further improve contract enforcement and ease collateral requirements. Reducing the administrative burden related to the implementation of anti-money laundering regulation and requiring regular training of financial sector employees could foster corporate lending while minimising money laundering risks.

Capital markets are shallow, limiting non-bank financing for firms. Listing minority stakes in large SOEs, providing low-cost creditworthiness information on smaller firms and fostering financial literacy would help increase the supply of securities traded in capital markets. Facilitating greater exposure of second-pillar pension funds to domestic securities would help to deepen capital markets.

Barriers to firm growth and competition and high informality hinder the reallocation of resources to more productive firms, while labour shortages are high. Many firms in Latvia stay small, partly operate in the informal economy and have low productivity due to weak management skills, low digital adoption and insufficient training provision for workers. Raising incentives to formalise work, strengthening tax enforcement and the fight against corruption, and lowering barriers to firm exit, such as high costs for filing insolvency, would increase allocative efficiency and foster business dynamism and investment demand. Entry barriers in services sectors should be lowered, including by strengthening the power of the Competition Council to enforce competitive neutrality.

Raising innovation requires more investments in human capital. To reduce high drop-out rates, particularly in ICT and STEM studies, university funding should better incentivise raising graduation rates and funding for students' living costs should increase. Improving coordination among firms and VET institutes in design and implementation of training is key to provide workers with the skills needed by firms.

MAIN FINDINGS	KEY RECOMMENDATIONS
Improving fiscal policy	
The fiscal stance will ease in 2024 and remain neutral in 2025, despite remaining inflationary pressures. The fiscal deficit is high and public debt is above the medium-term target.	Gradually tighten fiscal policy to reduce the fiscal deficit and lower inflationary pressures.
Spending needs for defence and internal security have increased due to the war in Ukraine, while the government committed to further raise education and health spending.	To stabilise debt, address rising spending needs by raising spending efficiency, reallocating spending and increasing tax revenue, including from income and property taxes and by reducing tax expenditures, including for fossil fuels.
Reforming the tax system	
High social security contributions for low- and middle-income earners reduce incentives for formalising work. Informality is high. The progressivity of personal income taxes remains low.	Reduce the labour tax wedge for low-income earners, for example by reducing social security contributions at lower incomes or raising progressivity of the personal income taxes.
Property tax revenue is low, while many municipalities depend on central government transfers for core spending priorities. Cadastral property values are not linked to market prices.	Raise recurrent taxes on immovable property based on regularly updated market values, while continuing to provide tax reductions for the primary residence of poorer households.
Since the early 2000s, total GHG emissions have not fallen due to low effective carbon prices in transport and building sectors, which are related to fossil fuel and other environmentally harmful subsidies and tax expenditures.	Gradually phase out environmentally harmful tax expenditures and subsidies, such as the ones for fossil fuels, and consider introducing carbon pricing for sectors not covered by the EU ETS.
Improving the capacity of the public sector, raising spending efficiency and fighting tax evasion and corruption	
High turnover, particularly for skilled professionals and managers, and the lack of digital and management skills has weakened institutional memory and the quality and effectiveness of public policies.	Continue to raise the attractiveness of public jobs and improve training of public employees, particularly in digital and management skills.
Ex-ante and ex-post policy impact analysis remain weak, reducing the quality of public services and spending efficiency. Capacity in local infrastructure planning is low.	Improve the data infrastructure and knowledge about methodologies for cost-benefit and impact analysis of policies and raise cooperation across the public sector.
Procurement of standardised goods, such as drugs or IT equipment and software, is still decentralised, despite large possible efficiency gains of centralised procurement.	Consolidate existing purchasing bodies, improve their IT and staff capacity and reduce legal exemptions that allow to opt out of mandatory centralised procurement.
Tax enforcement is hampered as not all taxpayers are required to file an income tax declaration. Under-declaration of income and wages is widespread.	Make the filing of an electronic income tax declaration mandatory, while continuing to reduce the administrative burden through pre-filling of declarations.
In contrast to many other OECD countries, plans for a centralised lobbying register to raise transparency and reduce undue influence of special interest groups have not yet been implemented.	Introduce a centralised lobbying register with a legislative and regulatory footprint.
Raising investment to boost growth	
Banks have not passed on lower funding costs to lending rates due to a market practice of setting a zero lower bound for the base rate for lending. Common ownership among banks, and between banks and other financial market institutions, is weakening competition in the financial system.	Strengthen the legal and investigative powers and tools of the Competition Council to monitor anti-competitive behaviour in financial markets.
Low customer mobility related to high fees and information asymmetries is reducing competitive pressures on banks. The household saving ratio is low and few households save in time deposits, partly due to low deposit rates.	Extend the platform on payment account commissions to include information on bank deposit rates as well as other fees, such as minimum fees charged for refinancing loans, and provide standard switching packages and contract templates for loans.
Stock market capitalisation is very small and none of the large SOEs are listed in the stock market, in contrast to other Baltic countries.	Accelerate current plans to list large SOEs.
Investments of pension funds, mostly in foreign assets, have yielded low returns, while many domestic firms have difficulties in accessing financing through domestic capital markets.	Raise investment and concentration limits of second-pillar pension funds for single issuer assets, real estate and private investment funds, while ensuring appropriate risk management and governance processes.
Insolvency proceedings remain long on average. The establishment of the Economic Court in 2021 has improved the efficiency of judicial proceedings concerning complex commercial disputes and large economic-crime, money laundering and corruption cases.	Expand the remit of the Economic Court, while raising its resources.
A lack of digital and management skills holds back digital adoption and innovation. Firm-provided training is weak due to poaching concerns and a lack of cooperation with VET institutes and training providers.	Establish a tri-partite training fund and improve cooperation in training design and implementation among firms and training providers.
The assessment of the impact of regulation and SOE presence on competition remains weak. Entry barriers in services sectors are high.	Increase the power of the Competition Council to conduct market investigations and initiate evaluations of regulations and state ownership rationales of SOEs to ensure competitive neutrality.

1 Key policy insights

The war in Ukraine has slowed the recovery from the pandemic and led to higher energy prices and disruptions in trade and supply chains, weighing on economic growth. Economic convergence had already slowed down before the pandemic, emphasising the need to accelerate structural reforms. To address rising spending pressures related to defence, internal security, health and old age poverty, there is a need to raise spending efficiency and tax revenue, while the tax burden should be shifted from labour towards other income, property, and environmental taxes. Continuing to improve the quality of public governance and public services, fostering investment and innovation and addressing skilled labour shortages are key for raising potential growth. High informality should be tackled by lowering labour taxes for low-wage earners, improving tax enforcement and continuing to fight corruption. Strengthening the powers of the Competition Council to enforce competitive neutrality of state-owned enterprises and challenge regulation that restricts competition would help to foster business dynamism and innovation. Addressing skilled labour shortages will require facilitating skilled migration and improving the quality of health, education and training services as well as active labour market policies.

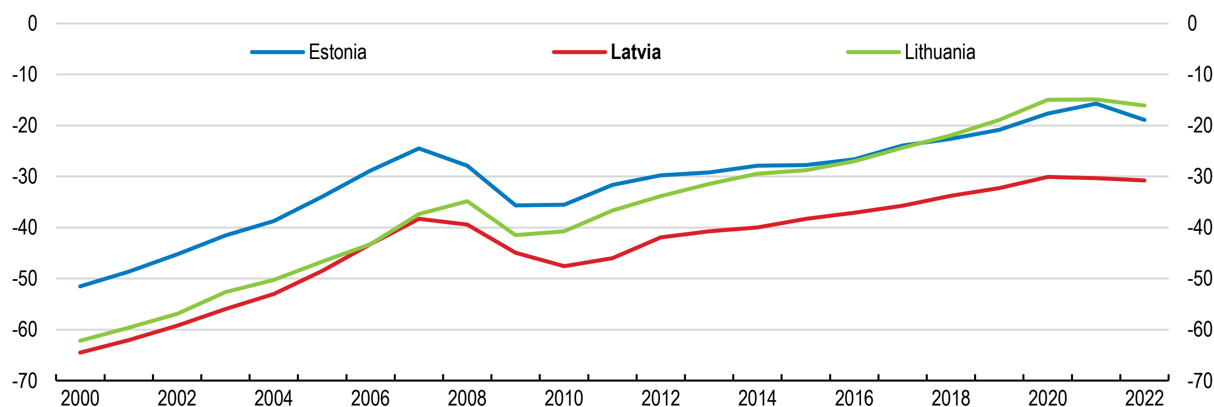
Slowing convergence in living standards and the effects of the war in Ukraine call for accelerating structural reforms

After a decade of slow growth following the financial crisis, a strong recovery from the pandemic was under way when Russia's war of aggression against Ukraine started. A spike in energy and food prices due to the war fuelled inflation and reduced the purchasing power of households. The war and related sanctions also disrupted supply chains and trade. This has affected the competitiveness of firms and increased uncertainty related to energy security, as Latvia has been highly dependent on energy imports from Russia. The government acted swiftly to secure energy supply and support households and firms facing record high energy prices. This strong government reaction has been enabled by ample fiscal space, which was generated due to successful reforms of the fiscal framework in the aftermath of the global financial crisis.

A deceleration of the income convergence process in the aftermath of the global financial crisis and the economic consequences of the war have emphasised the need for accelerating structural reforms (Figure 1.1). After a period of high growth with strongly rising investment and private consumption supported by a credit boom, the global financial crisis had hit the Latvian economy hard. Unemployment increased above 20% and wages dropped significantly, particularly in the public sector due to strong fiscal adjustments, reducing private consumption and increasing poverty rates (OECD, 2022[1]). Since then, growth rates have been much lower than before the crisis. Weak investment and skilled labour shortages exacerbated by a shrinking population have weighed on potential growth, and the competitiveness and export performance of Latvian firms (Figure 1.2). To raise productivity and economic growth it is key to improve access to finance, foster business dynamism and innovation, address skilled labour shortages and continue improving public governance. Accelerating the green transition would strengthen energy security and encourage the development of new business models. Implementing a comprehensive set of structural reforms would raise potential growth of GDP per capita by about 0.7 percentage points per year (Table 1.1).

Figure 1.1. The pace of economic convergence has slowed down

Gap in GDP per capita against OECD average, %



Note: Percentage gap with the OECD average in terms of GDP per capita (in constant 2015 PPPs).
Source: OECD National Accounts database.

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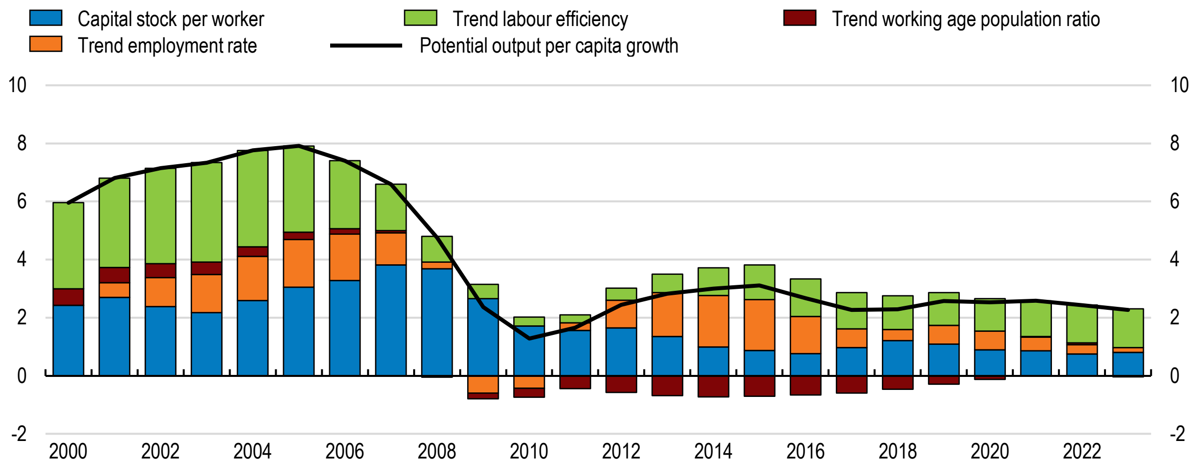
Weak credit supply has been a major factor for weak investment performance (see Chapter 2). Large losses during the financial crisis and several money laundering cases have strongly increased risk aversion of banks, leading to persistently low lending, despite rising deposits of firms and households and high profitability of banks. To increase access to finance for firms it is key to improve competition in the banking sector and deepen domestic capital markets, for example by listing minority shares of large state-owned enterprises (SOEs) and allowing pension funds to invest a larger share of their assets in domestic

securities. Continuing to improve insolvency procedures and raising trust in institutions would help to attract international investors.

Figure 1.2. Weak investment and a shrinking population have weighed on potential growth

Contribution to potential output per capita growth, in % points



Source: OECD Economic Outlook 114 database and updates.

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To strengthen innovation and investment demand of firms, it is crucial to lower informality, raise competition and business dynamism, and address skilled labour shortages. Many firms in Latvia stay small, partly operate in the informal economy and have low productivity due to weak management skills, low digital adoption and innovation, and insufficient training provision for workers. Due to costly insolvency procedures and specific tax regimes for small firms, there is too little reallocation of production factors to more productive firms. Lowering labour taxes for low-income earners and further strengthening tax enforcement is key for reducing under-declaring of income and wages, which has negative consequences on profitability and innovation incentives of formal and more productive firms. Entry barriers in services sectors should be lowered, including by strengthening the power of the Competition Council to enforce competitive neutrality of SOEs and to challenge regulation that restricts competition. At the same time, facilitating skilled migration and continuing to improve education, training and health policies would help to address skilled labour shortages.

To finance key policy priorities in defence, education and health, there is a need to raise tax revenue and increase spending efficiency. The tax burden stood at 30.2% of GDP in 2022, which is 4 percentage points below the OECD average. Improving public revenues would also make public investment and other current spending less dependent on EU funding, improve policy continuity, and strengthen accountability and incentives for spending efficiency (OECD, 2019[2]). A comprehensive tax reform should shift the tax burden away from labour towards corporate and personal income, property and inheritance taxes, which account for a lower share of revenues compared to other OECD countries, as well as reduce generous tax expenditures, including for fossil fuels. The reform should also redesign fiscal relationships with municipalities to ensure sufficient and stable revenue sources for the provision of public services at the local level and improve incentives for spending efficiency.

For a successful design and implementation of structural reforms it is crucial to continue improving the capacity and governance of the public sector. This is also key for implementing public investment plans and other support programmes that will be financed by EU funds during the next years. Since the financial crisis in 2009, the quality of the public administration has suffered from strong wage cuts and high staff turn-over, particularly for skilled professionals and managers. This led to losses in human capital and institutional memory with negative consequences for the quality and effectiveness of public policies and

services and the efficiency of public spending. A recent public administration reform aims to raise wages to at least 80% of private sector wages by 2027 and introduces more flexibility in wage setting for occupations that are in high shortage. This should be combined with expanding training opportunities for public employees, with a particular focus on digital and management skills, and continuing to improve recruitment procedures. Enhancing IT capacities as well as data exchange and analysis across the public sector is key for improving ex-ante and ex-post impact evaluation of laws, regulations and policy programmes, for example regarding cost-benefit analysis for infrastructure projects or competition assessment of regulation. Improving public procurement procedures and continuing the fight against corruption is key for raising spending efficiency and improving trust in institutions. It would also help create a level playing field to foster business dynamism and innovation.

Table 1.1. Structural reforms are key to raise productivity growth

Average yearly additional growth in GDP per capita during the next 15 years (in percentage points)

Structural reform	Additional GDP per capita growth per year (in percentage points)
Reducing barriers to competition, improving public governance and strengthening the rule of law	0.2
Increasing public investment in infrastructure and R&D	0.1
Reducing labour taxes, particularly for low-income earners	0.1
Expanding active labour market policies and improving the quality of training and adult learning	0.1
Improving the quality of education	0.1
Raising the effective retirement age, including by improving training, working conditions and health of older workers	0.1
Total	**0.7**

Note: The potential effects of structural reforms are quantified using the methodology of (Guillemette and Turner, 2021[3]). The set of structural reforms comprises: increasing public investment as a share of GDP by half of the distance to the average of the five top performers and R&D expenditure by half of the distance to the OECD average; improving the Product Market Regulation index by reducing distortions related to state involvement and the assessment of the impact of regulation on competition to the OECD average and the quality of public governance measured as the rule of law to the OECD average; a reduction in labour tax wedges by half of the distance to the OECD average; raising spending for active labour market policies to the OECD average and improving the quality of training and adult education to raise the average years of schooling of the working age population to the average level of other Baltic countries; improving educational quality to raise average PISA scores of students by half of the distance to Estonia; coupling the legal retirement age to life expectancy, while improving working conditions and training opportunities for older workers.
Source: OECD Long Term Model.

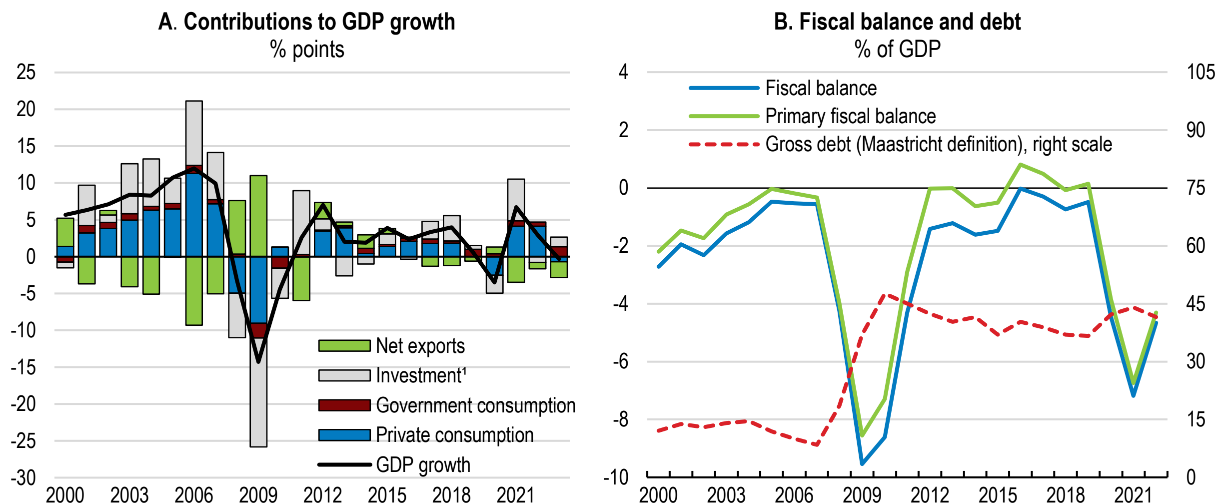
Against this background, the main messages of the Survey are:

- Gradually tighten the fiscal stance to reduce the high fiscal deficit and lower inflationary pressures. Conduct a comprehensive tax reform to help finance policy priorities in defence, health and education, shift the tax burden from labour towards other income, property, and environmental taxes, and ensure sufficient and stable revenue sources for municipalities.
- Continue improving the capacity of the public sector by expanding training and the use and exchange of data to improve ex-ante and ex-post policy impact assessment and raise spending efficiency. Improve governance of SOEs, infrastructure planning and public procurement, and continue to fight corruption.
- To raise credit supply, it is key to increase competition in the banking sector and deepen domestic capital markets. To strengthen innovation and investment demand of firms, it is key to lower informality, raise competition and business dynamism, and address skilled labour shortages by investing more in human capital and facilitating skilled migration.

A strong recovery from the pandemic was under way when the war started

When the pandemic hit, the government used its ample fiscal space to support households and firms with measures amounting to a total of 3.2%, 6.3% and 2% of GDP in 2020, 2021 and 2022, respectively (IMF, 2023[4]). This bolstered domestic demand, also supported by strongly rising public sector and minimum wages, underpinning a strong recovery from the pandemic (Figure 1.3). The introduction of job retention schemes and wage subsidies helped to stabilise employment relationships, particularly for high-skilled employees, in 2020 and 2021 (Benkovskis, Tkacevs and Vilerts, 2023[5]).

Figure 1.3. Ample fiscal space has been used to support the economy



1. Including stockbuilding.
Source: OECD Economic Outlook database.

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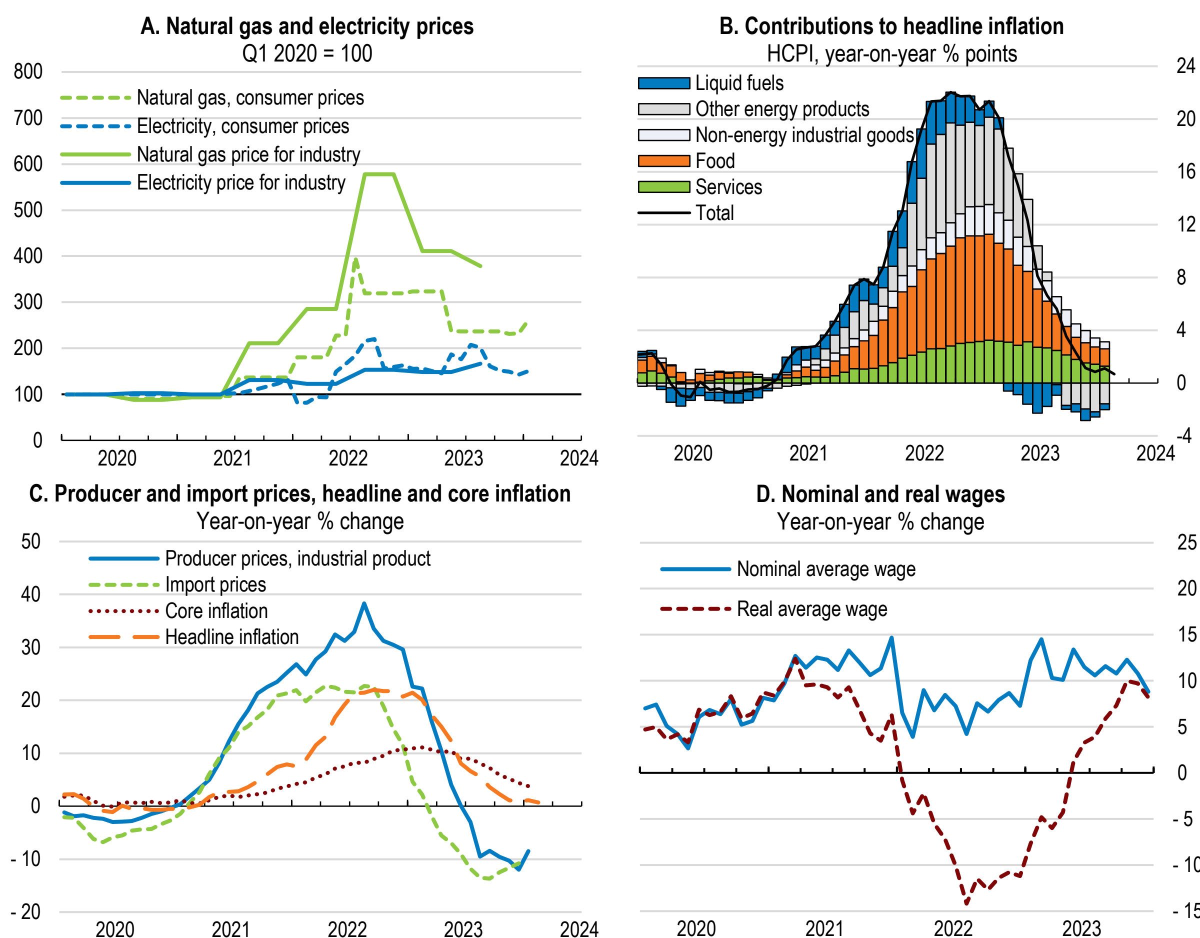
However, the large size of the support and weak targeting of some measures contributed to inflationary pressures, in the context of rising supply chain bottlenecks (Figure 1.4). As bankruptcies have strongly declined and are still about 60% below the level of 2019, untargeted firm support might have also hindered the reallocation of production factors to booming sectors and firms, thereby exacerbating existing labour shortages and capacity constraints, similar to experiences in other countries (Barnes et al., 2021[6]). In particular, generous grants that reimbursed a share of fixed costs depending on firm-specific revenue losses, amounting to a total of about 1.9% of GDP, have not only covered the aggregate pandemic shock, but potentially also firm-specific shocks. This could have been prevented by conditioning grants on sector-wide revenue losses and cost structures or focusing support on liquidity provision through subsidised loans and loan guarantees or tax deferrals (Demmou et al., 2021[7]; Bischof et al., 2021[8]).

Russia's war of aggression against Ukraine has interrupted the post-pandemic recovery. High inflation and plummeting consumer and investor confidence due to uncertainty about energy security weighed on private consumption and investment. Producer prices increased strongly due to soaring energy costs and supply chain bottlenecks, and the pass-through to consumer prices broadened inflationary pressures (Figure 1.4). Inflation was above 20% (y/y) from July 2022 until February 2023. The much higher inflation rates in Latvia compared to other EU countries were related to a higher share of energy and food in household consumption and the higher prevalence of short-term contracts in retail energy markets (IMF, 2023[4]). Real wages fell by 13% per annum in the third quarter of 2022, and by July 2023 were barely above where they were a year earlier, strongly reducing the purchasing power of households (Figure 1.4).

Figure 1.4. High energy prices and inflation led to a drop in real wages



Source: Central Statistical Bureau of Latvia; IEA Energy prices database; OECD calculations based on Eurostat database.

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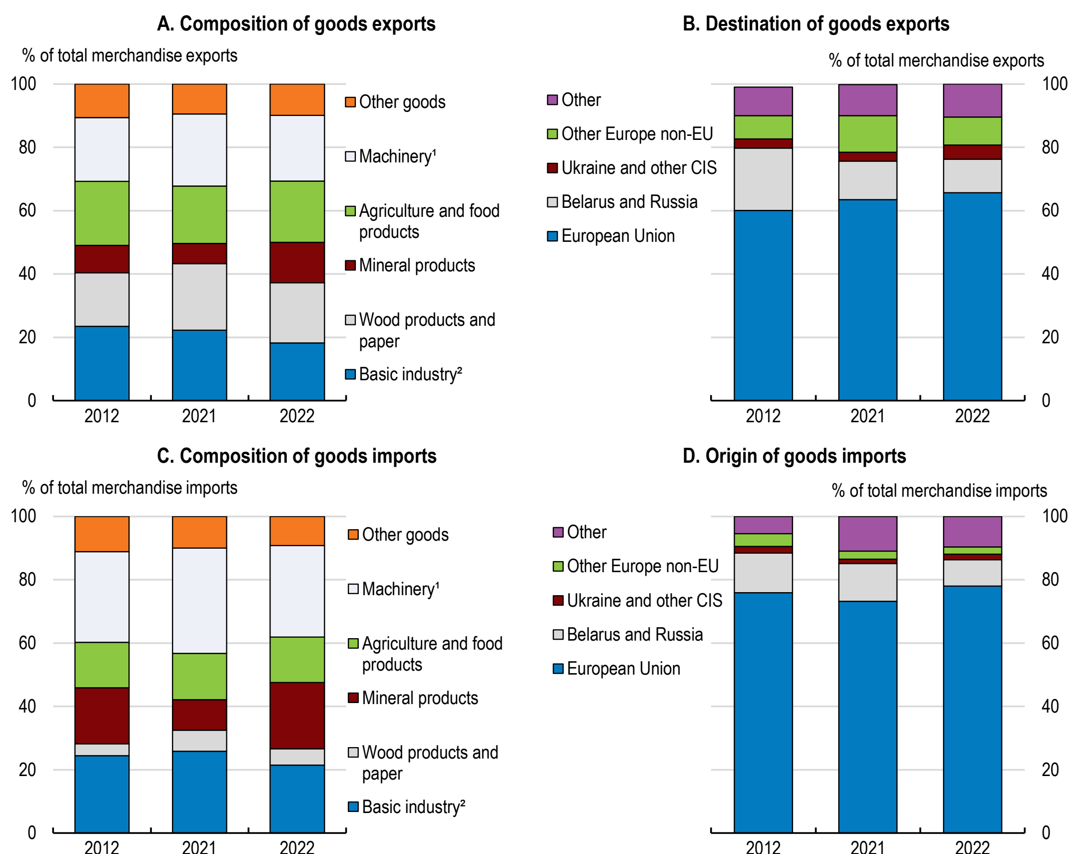
The government took bold actions to support households and firms, reduce uncertainty and secure energy supply. Expansion of the existing regional LNG infrastructure enabled a quick switching of gas imports to international suppliers, although this led to strongly rising gas prices (Figure 1.4). Measures to mitigate the consequences of higher energy prices for households and firms were introduced, such as untargeted price-caps, transfers to pensioners and low-income families, and grants to energy-intensive firms. The government has also provided crucial support to the more than 40 000 Ukrainian refugees (2.1% of Latvia's population) who entered Latvia in 2022.

The total fiscal cost of energy crisis related measures, which were phased out in April 2023, amounts to 1.9% and 1.3% of GDP in 2022 and 2023, respectively, which was lower than expected due to falling energy prices but is still high compared to other OECD countries (Hemmerlé et al., 2023[9]). More than 80% of these measures were untargeted, which increased fiscal costs and reduced energy saving incentives. To improve the targeting of household support in the future, it is key to improve the data infrastructure to better identify vulnerable households (see below). Developing short-term monthly indicators on the financial situation and cost structures of firms, for example based on data from the State Revenue Service, could help to better target firm support measures ex-ante (Bischof et al., 2021[8]). Early-warning systems to detect firms at risk of insolvency can help to target support during and after a crisis and have been implemented in Denmark and France (Moeller and Mukherjee, 2019[10]; Epaulard and Zapha, 2022[11]; Demmou et al., 2021[7]).

Although Latvia had already reduced its dependency on eastern neighbours since Russia's annexation of Crimea, the effects of the war and related sanctions on supply chains, trade and foreign direct investment (FDI) were still substantial. In 2021, exports and imports to Russia, Belarus and Ukraine accounted for 10% and 13% of total exports and imports, respectively, which decreased to 9% and 5% in the first half of 2023, respectively (Figure 1.5). Despite a rapid substitution by imports from other countries and domestic production, prices for some intermediate inputs strongly increased, particularly for wood, metal and mineral products. This has further reduced the competitiveness of manufacturing firms, besides higher energy costs, and led to strongly rising construction prices, weighing on housing investments and complicating the implementation of public infrastructure projects. Services exports to Russia and Belarus have strongly decreased since 2021. Due to their strong trade linkages with eastern neighbours, the border regions have been particularly affected by these disruptions. Before the war, Russia was the third largest country in terms of the stock of FDI, with investments concentrated in trade, financial services, real estate, energy and manufacturing (IMF, 2023[4]). Since then, the FDI stock from Russia has decreased by 29% or about 1.8% of GDP. However, this FDI outflow was more than compensated by increasing FDI inflows from other countries, mainly from the EU, as the total FDI stock increased by 10% since late 2021 (see Chapter 2). This indicates that geopolitical tensions also have the potential to benefit Latvia due to the near-shoring of manufacturing activities for the EU market.

Figure 1.5. Exports and imports have become more diversified



1. Includes mechanical appliances; electrical equipment; transport vehicles; optical instruments and apparatus (inc. medical); clocks and watches; musical instruments.
2. Includes products of the chemical and allied industries; plastics and articles thereof; rubber and articles thereof; and base metals and articles of base metals.

Source: Central Statistical Bureau of Latvia; IMF DOTS database.

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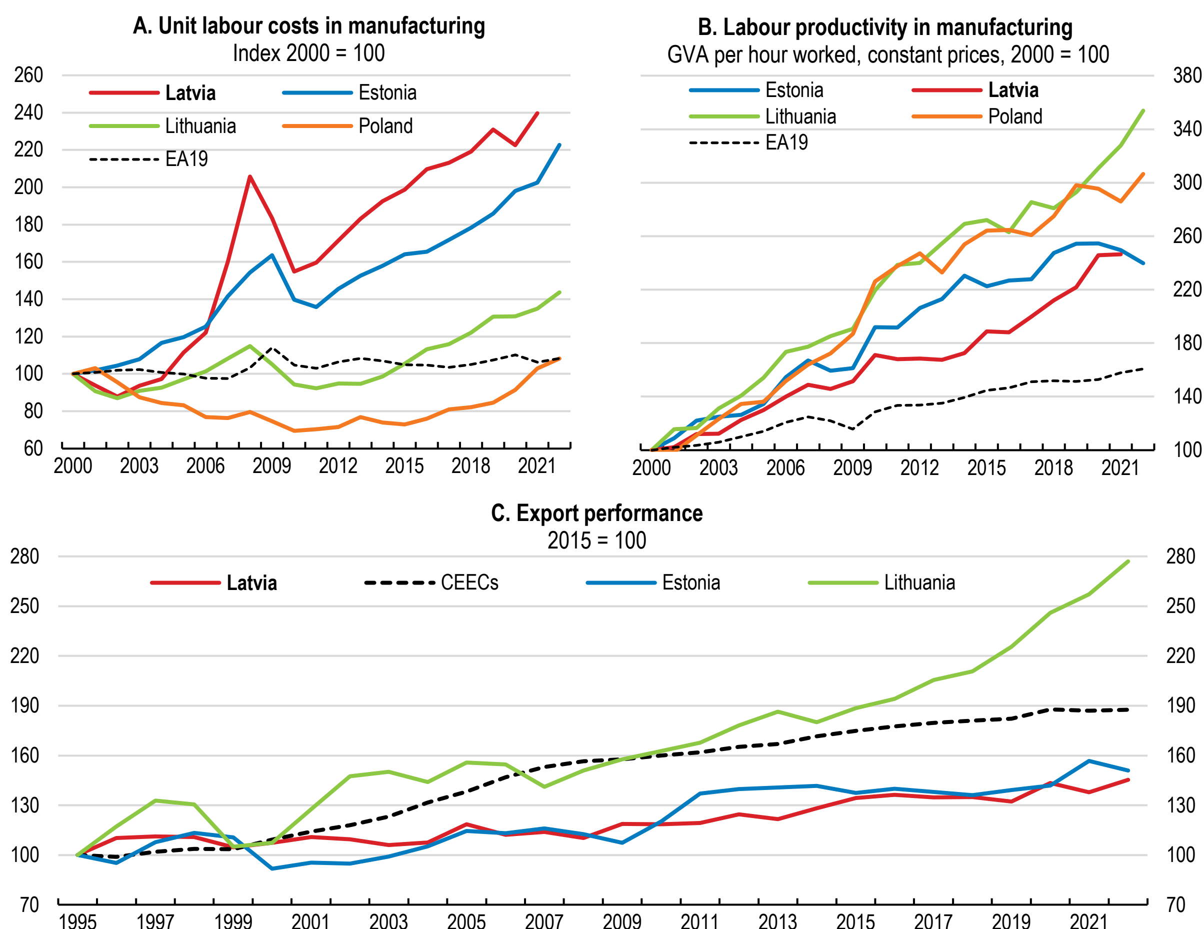
Although wholesale energy prices have fallen, energy prices for industrial consumers remain at much higher levels than before the war, weighing on the competitiveness of domestic manufacturing firms (Figure 1.4). Higher inflation rates than in the rest of the euro area have appreciated the real exchange rate since 2020 vis-à-vis Latvia's main export partners (IMF, 2023[4]). Since 2010, export competitiveness of manufacturing firms had already suffered from relatively weak productivity growth coupled with strongly rising real wages and unit labour costs (Figure 1.6). This was related to high emigration and a shrinking working age population, which exacerbated skilled labour shortages, as well as rising minimum and public sector wages (see below). As higher wages are important to retain young and highly skilled Latvians and attract skilled migrants, raising productivity by fostering business dynamism, competition and innovation and improving access to finance is key to improve competitiveness and export performance (see Chapter 2). Policies to address skilled labour shortages should focus on reducing skill mismatches and informality in the labour market, create the conditions for older workers to work longer and facilitate skilled migration (see below). Accelerating the green transition in the energy sector and connecting to the EU electricity grid is key to sustainably reduce energy prices for firms and households (see below).

Figure 1.6. Unit labour costs have risen faster than productivity, weighing on export performance



Note: Export performance is measured as actual growth in exports relative to the growth of the country's export market. Central and Eastern Europe is calculated as an unweighted average of Czechia, Hungary, Poland, Slovak Republic and Slovenia.
Source: OECD Productivity Database; OECD Economic Outlook database.

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The economy will recover on the back of rising private consumption and EU-funded investment

After a technical recession in the second and third quarter, GDP increased by 0.3% in the fourth quarter of 2023. Strong public investment related to the absorption of EU funds and rising private and public consumption have more than compensated for weak exports. Export demand has suffered from high inflation and weak investment in key export markets, particularly affecting exports of construction materials. Export values remained 10.4% lower in February than a year earlier, whereas annual imports fell by 3.1%. High interest rates due to monetary policy tightening and weak confidence have weighed on private investment and construction. Loan demand by firms has strongly decreased since early 2023 (see Chapter 2). Industrial production has been volatile in recent months and was 0.9% lower in February than a year earlier. Annual inflation has fallen rapidly to 1% in March, due to declining energy and food prices, but core inflation remains high at 3.8%, reflecting wage increases in the labour-intensive services sector (Figure 1.4). Gross wages rose by 11.6% year-on-year in the fourth quarter of 2023, with similar real wage growth due to rapidly falling inflation. The unemployment rate stood at 6.9% in February but the labour market remains tight with a vacancy rate of 2.5%, only 0.5 percentage points lower than its pre-pandemic value, indicating skill mismatch in the labour market (see below).

After a slight decline in 2023, real GDP will grow by 1.8% in 2024 and 2.9% in 2025, reflecting a rebalancing of growth towards domestic demand (Table 1.2). Falling inflation and rising nominal wages will support real incomes and raise private consumption over the next two years. Higher unit labour costs and weak export demand will restrain export growth. A gradual easing of financial conditions will support business investment, while significant inflows of EU funds will boost public infrastructure investment and spending on support measures for digitalisation and upskilling in small businesses. Grants from the EU Recovery and Resilience Facility will lead to yearly spending of about 1.6% of GDP in 2024-25 and do not influence the fiscal stance according to the national methodology (see below). According to the OECD methodology to compute the underlying primary balance, which includes the positive impulse from the EU Recovery and Resilience Facility grants in the fiscal stance, the fiscal stance is projected to ease in 2024 and remain broadly neutral in 2025 (Table 1.2). Wage growth was high in the second half of 2023 and will remain strong due to skills shortages and planned increases in public sector and minimum wages, leading to sticky core inflation. Thus, although the negative output gap will remain high in 2024, the fiscal stance should be tightened to reduce the high fiscal deficit and lower inflationary pressures (see below).

The main risks for the outlook relate to the geopolitical situation and are tilted to the downside. An escalation of the war in Ukraine, more aggressive behaviour of Russia towards its western neighbours or reduced international support for Ukraine could significantly affect risk premiums and the attractiveness of Latvia for foreign investors. Stricter sanctions against Russia and Belarus could hurt exports and supply chains. Domestic downside risks to the outlook relate to delays in the absorption of EU funds due to intensifying skilled labour shortages and weak capacity in infrastructure planning. Strong wage increases due to intensifying skilled labour shortages and strongly rising public sector wages could keep core inflation higher for longer, requiring a stronger fiscal adjustment weighing on growth. On the upside, a quicker easing of monetary policy in major export markets would raise export demand.

Table 1.2. Macroeconomic indicators and projections

Annual percentage change, volume (2015 prices)

	2020 Current prices (billion EUR)	2021	2022	Estimates and projections 2023	2024	2025
Gross domestic product (GDP)	**30.1**	**6.7**	**3.0**	**-0.3**	**1.8**	**2.9**
Private consumption	17.2	7.3	7.2	-1.3	2.3	3.3
Government consumption	6.1	3.5	2.8	7.0	3.2	0.7
Gross fixed capital formation	6.8	7.2	0.6	8.2	4.9	3.5
Housing	0.8	10.4	-11.4	11.1	2.0	1.9
Final domestic demand	30.0	6.4	4.8	2.3	3.1	2.8
Stockbuilding[1]	-0.3	4.1	-0.9	-0.5	-0.9	0.0
Total domestic demand	29.7	10.3	3.7	1.8	2.3	2.9
Exports of goods and services	18.3	9.0	10.3	-5.9	-0.2	3.1
Imports of goods and services	17.9	15.1	11.1	-2.8	0.5	3.0
Net exports[1]	0.4	-3.5	-0.9	-2.1	-0.5	-0.1
Other indicators (growth rates, unless specified)						
Potential GDP	. .	2.1	2.4	2.5	2.4	2.4
Output gap[2]	. .	1.0	1.6	-1.2	-1.8	-1.3
Employment	. .	-3.3	2.6	-0.2	-0.5	0.2
Unemployment rate (% of labour force)	. .	7.6	6.8	6.5	6.7	6.6
GDP deflator	. .	3.8	11.8	5.4	1.9	2.3
Harmonised consumer price index	. .	3.2	17.2	9.1	1.7	2.4
Harmonised core consumer price index[3]	. .	1.9	7.6	8.4	2.9	2.3
Household saving ratio, net (% of disposable income)	. .	1.9	-7.2	-3.9	-1.5	-0.8
Current account balance (% of GDP)	. .	-3.9	-4.8	-4.0	-4.4	-4.3
General government financial balance (% of GDP)	. .	-7.2	-4.7	-2.3	-2.9	-2.5
Underlying government primary financial balance[2]	. .	-7.2	-4.9	-1.8	-2.9	-2.9
General government gross debt (% of GDP)[4]	. .	57.8	50.5	52.4	54.6	56.2
General government gross debt (Maastricht, % of GDP)		44.0	41.5	43.5	45.7	47.3
General government net debt (% of GDP)	. .	19.6	16.6	18.1	20.4	21.9
Three-month money market rate, average	. .	-0.5	0.3	3.4	3.7	2.8
Ten-year government bond yield, average	. .	0.0	2.3	3.8	3.4	3.3

1. Contribution to changes in real GDP.
2. Percentage of potential GDP.
3. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 114 database and updates.

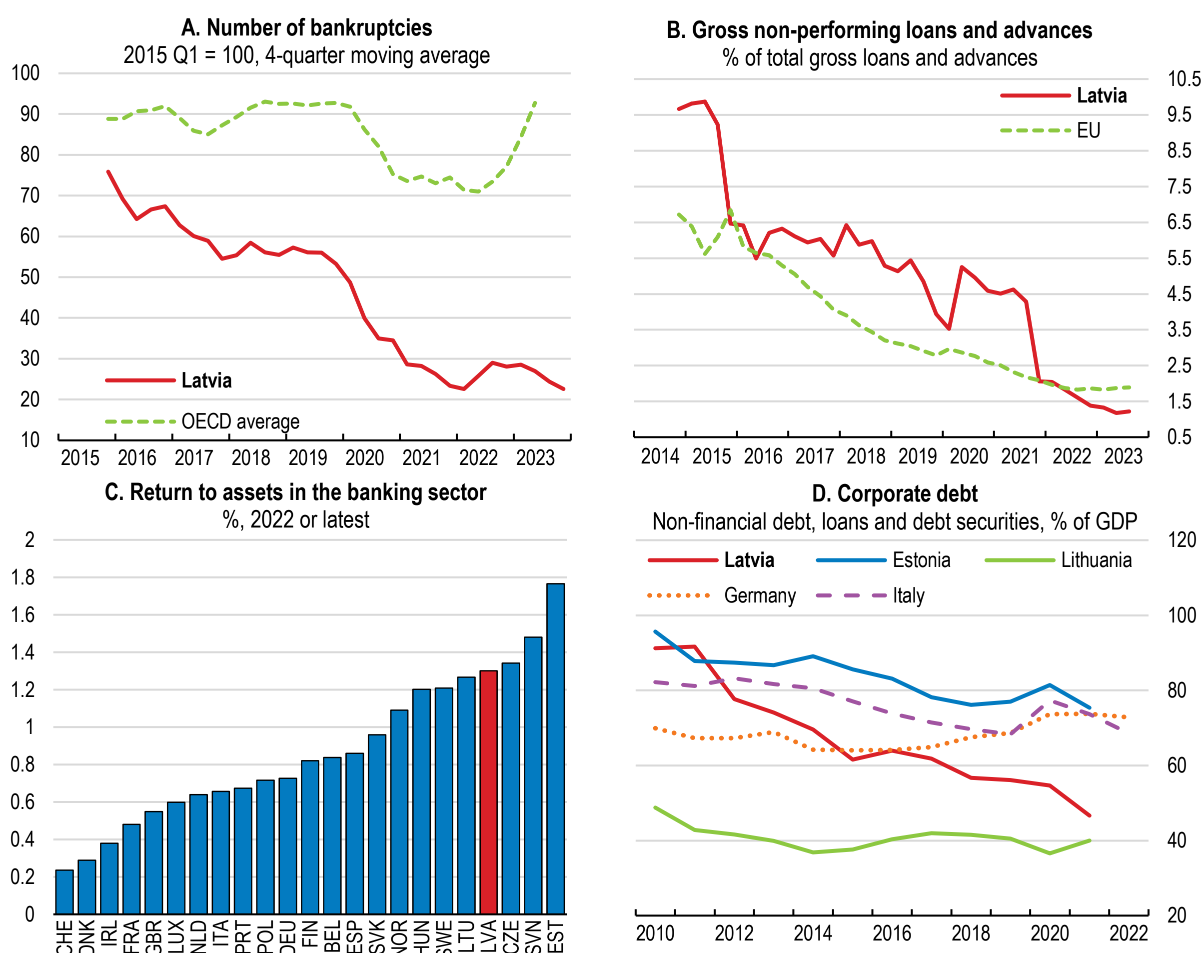
Table 1.3. Events that could lead to major changes in the outlook

Risks	Possible outcomes
Disruptions in global energy markets due to an escalation of conflict in the Middle East or a particularly cold winter.	Higher energy prices would raise inflation, reduce the purchasing power of households and private consumption, and weigh on the competitiveness of domestic manufacturing firms.
Further increases in trade barriers and other trade distorting measures, such as subsidies and local-content rules, globally.	A new wave of protectionism, trade distorting subsidies and local-content rules would lower export demand and disrupt global supply chains. Near-shoring of production could, however, benefit Latvia, which provides access to the EU market.
Abruptly rising bankruptcies or falling house prices lead to a rise in non-performing loans.	Banks may further restrict new lending, weighing on investment and domestic demand.

Financial market risks have risen but remain contained

Vulnerabilities in financial markets remain contained. The banking system is well capitalised and highly profitable, with a stable deposit base and low levels of non-performing loans (Figure 1.7) (ECB, 2023[12]). Corporate deleveraging in the aftermath of the global financial crisis has improved corporate balance sheets and reduced financial vulnerabilities. Also due to strong energy price support, the increase in bankruptcies in 2022 was limited to sectors that were strongly affected by sanctions against Russia and Belarus. Nevertheless, the evolution of the non-performing loans ratio should be carefully monitored. Rapid monetary tightening in the euro area and reduced real disposable income due to high inflation have increased the debt burden of corporate and mortgage borrowers, as most corporate loans have a short maturity and most mortgage loans have a variable interest rate (see Chapter 2). High inflation has also led to one of the largest declines in the real pension plan returns in the OECD, suggesting that the risk diversification of the pension funds should be improved.

Figure 1.7. Vulnerabilities related to corporate debt remain contained



Source: OECD Timely Indicators of Entrepreneurship database; Central Statistical Bureau of Latvia; ECB; IMF Financial Soundness Indicators.

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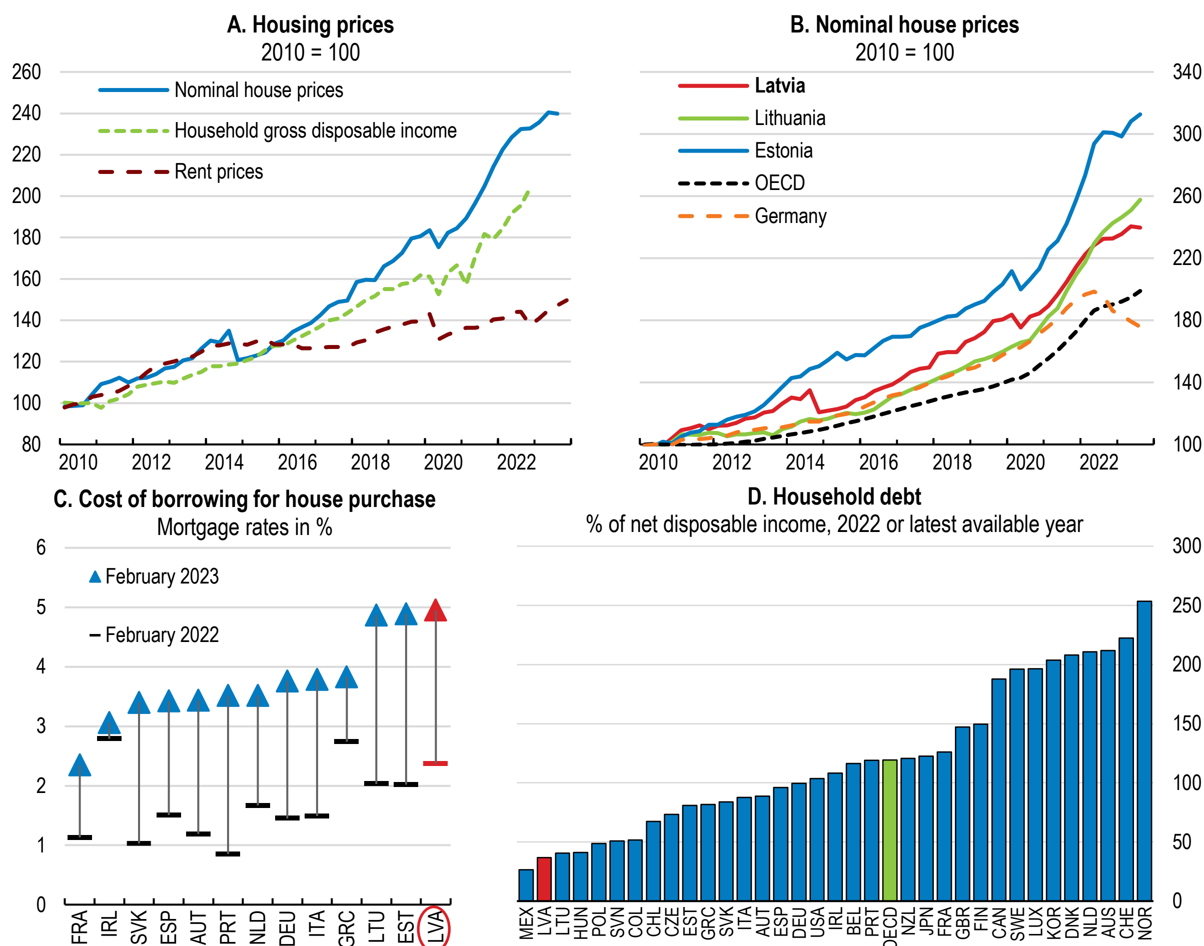
Rising mortgage rates could lead to sharp corrections in house prices, increasing risks associated with the indebtedness of poorer households and restricting the availability of credit to SMEs. Many SME owners pledge their personal real estate as collateral. House prices have increased faster than in OECD countries and have significantly outpaced rents and household income since 2015 (Figure 1.8). The high prevalence of variable-rate mortgages has led to the sharpest increase in interest rates on new mortgages in the euro area and reduced housing affordability (Figure 1.8) (Swedbank, 2023[13]). As a result, the issuance of new

loans for house purchases has started to decline. On the upside, low total household indebtedness and the fact that a large share of the outstanding housing loans is held by higher-income households limit the mortgage credit risk for the banking system (Figure 1.8) (Bank of Latvia, 2023[14]). However, about 40% of households are unable to save due to high inflation and higher interest payments for other loan products such as leasing, which increases the risk of insolvency for poorer households (Bank of Latvia, 2023[15]). This has increased risks for other lending institutions, such as leasing companies. The evolution of the household loan-to-value ratio, which is already higher than in the other Baltic countries, should also be carefully monitored, as a sharp correction in house prices from high levels could further increase the balance sheet vulnerability of highly indebted households (IMF, 2023[16]). Given the low level of household debt and limited mortgage credit risk for the banking system, the central bank's recent decision to transition to a positive neutral counter-cyclical capital buffer approach and to increase the counter-cyclical capital buffer rate to 0.5% in December 2024 and 1% in June 2025 is welcome. However, the authorities should stand ready to increase the counter-cyclical capital buffers further if house price-related risks continue to build up.

Figure 1.8. Housing market-related risks have increased



Source: OECD Analytical House Price database; Eurostat; ECB; OECD National Accounts database.

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Recent stress tests indicate that the financial system is resilient to adverse shocks. The stress tests showed that only one credit institution would fall below the regulatory capital requirements and that significant credit institutions, which are directly supervised by the ECB, would be resilient to weather a stress scenario (Bank of Latvia, 2023[15]). The Bank of Latvia has for the first time applied a growth-at-risk

methodology to its stress testing framework to assess the impact of tail events, such as a sharp decline in the GDP growth rate, on the resilience of the financial system. The variable-at-risk methodology should also be applied to the other macroeconomic variables, such as house prices or government borrowing costs, given the accumulation of risks in the housing sector and the rapid rise in global interest rates in the past two years. The stress-testing framework is also extended to include profit and loss provisioning projections in the baseline and stress scenarios, and to examine the resilience of the financial sector to climate change and green transition risks.

Table 1.4. Past recommendations and actions taken on financial markets

Previous recommendations	Action taken
Build a more investment-intensive culture by, for example, better financial literacy for all age groups and greater competition in the financial sector from non-banks, notably fintech firms.	The National Strategy for Financial Literacy has been adopted in 2021 with the Bank of Latvia being its coordinating institution since 1 January 2022. For FinTech firms, the existing regulatory sandbox was expanded to include testing crowdfunding and crypto-asset services and technology solutions for regulatory compliance and to increase the efficiency of the insurance industry. The Bank of Latvia has launched the Innovation Hub in 2023, which provides free expert advice to FinTech companies on compliance with licensing, supervision and regulatory requirements.
Allow creditors to initiate restructuring and introduce early warning mechanisms of financial distress.	The EU Restructuring and Insolvency Directive 2019/1023 has been adopted, but it is yet to be fully implemented.
Explore the potential to improve the financing of micro-enterprises such as developing this function in the credit unions sector, which would require changes in regulatory requirements and supervision.	A draft bill to amend the Law on Savings and Loan Associations is currently discussed in the parliament.

Strengthening public finances and the quality of public services

Addressing rising spending pressures is key to ensure debt sustainability

After a decade of low fiscal deficits and contained public debt, the fiscal balance turned negative due to strong fiscal support during the pandemic and the energy crisis (Table 1.5). With the phase-out of energy price support measures, the fiscal deficit declined to 2.3% of GDP in 2023, but under current budget plans the fiscal stance measured as the underlying primary balance will ease in 2024, and remain broadly neutral in 2025 (see above). As the strong inflow of EU funds adds to domestic demand, core inflation is still high and wages will continue to rise strongly, further fiscal tightening is needed to reduce inflationary pressures. Reducing the fiscal deficit is also needed to keep public debt on a sustainable path given rising spending needs in defence, health and education as well as the need to reduce old-age poverty (see below).

Table 1.5. The large fiscal deficit is reduced gradually

General government, % of GDP

	2015	2016	2017	2018	2019	2020	2021	2022	2023[2]	2024[2]	2025[2]
Total revenues	**37.2**	**37.5**	**37.9**	**38.5**	**37.9**	**38.0**	**37.5**	**36.3**	**37.7**	**39.8**	**41.5**
Taxes on production and imports	13.6	14.1	14.1	14.4	14.1	14.0	13.7	13.9	14.2	14.4	14.4
Taxes on income and wealth	7.7	8.1	8.4	7.2	6.8	6.9	7.1	7.1	7.8	8.2	8.3
Social contributions	8.6	8.5	8.7	9.5	10.0	10.3	10.0	9.8	10.3	10.3	10.3
Other revenues	7.4	6.7	6.7	7.4	6.9	6.8	6.7	5.4	5.4	7.0	8.6
Total expenditures	**38.7**	**37.5**	**38.2**	**39.3**	**38.4**	**42.5**	**44.7**	**40.9**	**40.0**	**42.7**	**44.1**
Social protection	11.8	11.8	11.7	11.6	12.1	13.3	13.6	13.4	..	..	..
Education and health	9.6	9.2	9.3	9.8	9.9	10.5	12.1	10.2	..	..	..
General public services	5.0	4.3	4.1	4.1	3.9	3.9	3.9	3.3	..	..	..
Economic affairs	6.1	5.6	5.9	6.1	5.3	7.1	7.5	7.1	..	..	..
Other[1]	6.2	6.6	7.3	7.6	7.2	7.8	7.6	6.9	..	..	..
Net lending	**-1.5**	**0.0**	**-0.3**	**-0.7**	**-0.5**	**-4.5**	**-7.2**	**-4.7**	**-2.3**	**-2.9**	**-2.5**
Primary balance	-0.5	0.8	0.5	-0.1	0.1	-3.9	-6.7	-4.3	-1.9	-2.3	-1.8
Gross debt	**47.2**	**50.9**	**48.0**	**46.6**	**47.9**	**54.4**	**57.8**	**50.5**	**52.4**	**54.6**	**56.2**
Gross debt, Maastricht definition	**37.0**	**40.3**	**38.9**	**37.0**	**36.7**	**42.2**	**44.0**	**41.5**	**43.5**	**45.7**	**47.3**
Net debt	13.8	13.2	11.6	9.9	11.0	15.7	19.6	16.6	18.1	20.4	21.9

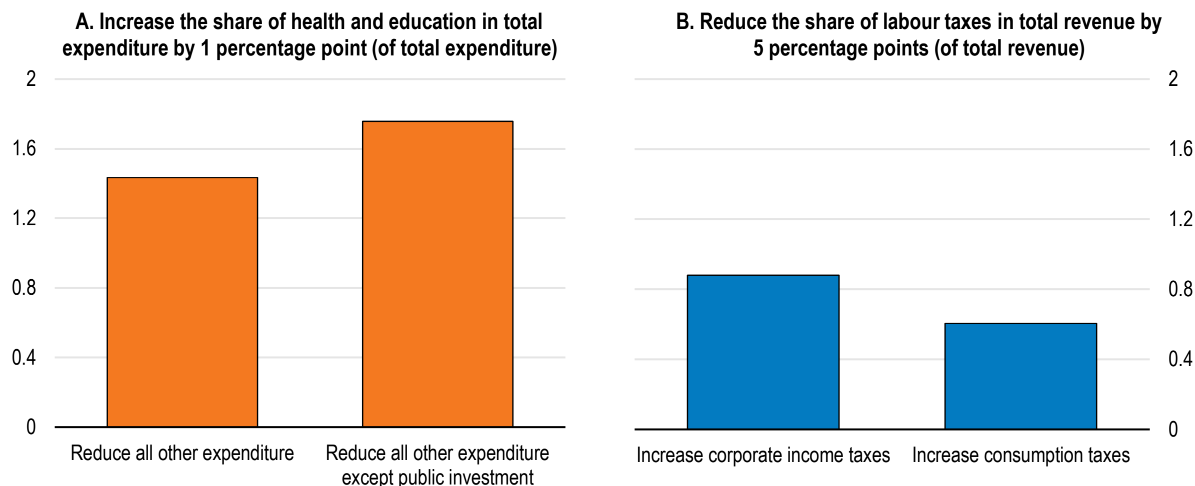
1. Defence; public order and safety; housing and community amenities; recreation, culture and religion; environment protection.
2. OECD estimates and projections from the OECD Economic Outlook 114 database and updates.
Source: OECD National Accounts database; OECD Economic Outlook 114 database and updates.

Planned increases in health and education spending are important to improve human capital and potential growth but should be financed by increasing spending efficiency and tax revenue. Analysis for this survey shows that raising expenditures towards health and education by increasing their share in total expenditures by 1 percentage point, while reducing other expenditures, would increase GDP per capita by 1.4% in the long term due to improved human capital (Figure 1.9, Box 1.1). When keeping public investment constant and only reducing other expenditures, the effect would increase further to 1.8%. In the 2024 budget, spending for health and education will increase by 0.9% and 0.4% of GDP, respectively, in line with recommendations of the previous OECD Economic Survey. To address national security concerns related to the war in Ukraine, internal security and defence spending will be raised by 0.5% of GDP in 2024.

During the next years, spending pressures will further rise due to increasing interest payments, which are estimated to reach around 1% of GDP by 2025, and planned increases in defence spending from around 2.4% of GDP in 2024 to 3% of GDP by 2027. Moreover, reducing old-age poverty in line with recommendations from the previous OECD Economic Survey of Latvia has become even more pressing due to the war in Ukraine, as more support may be needed to re-integrate many poorer elderly persons in border regions, who had accepted Russian citizenship in the past to receive Russian pension payments (OECD, 2022[1]). Reducing old age poverty, which is particularly high for women, by half of the distance to the OECD average would increase spending by about 0.5% of GDP. Raising investments in the green transition, which would improve energy security, and making public investments, fiscal support for private investments and other programmes more independent from EU funding cycles to ensure policy continuity will also require further fiscal resources (OECD, 2019[2]).

Figure 1.9. Shifting expenditures towards health and education and the tax structure away from labour taxes would raise GDP per capita

Percentage point change in long-term real GDP per capita resulting from compositional shifts in the expenditure or revenue structure, holding total government revenue and expenditure in terms of GDP constant



Note: Simulations are obtained from a dynamic general equilibrium model calibrated using the average structure of government expenditure and revenue in Latvia over the period 2000-19. Both the baseline and each policy change follow a balanced budget assumption. The policy changes are government size neutral, so that the ratio of total government revenue-to-GDP remains unchanged across the simulations. In Panel A, "other expenditure" refers to the sum of three expenditure items: public investment, government consumption and government transfers. Thus, in the simulation denoted by the first bar, all three items decrease in proportion to their size before the policy change to compensate for the increase in health and education expenditure. In the simulation denoted by the second bar, only government transfers and government consumption decrease. In Panel B, consumption taxes refer to VAT and excise duties. Labour taxes refer to the sum of taxes paid by employees and employers. Raising corporate income taxes (CIT) by 5 percentage points of total revenue to compensate for the decrease in labour tax revenue implies raising CIT revenue from 1.6% of GDP to the OECD average over the period 2000-19 of 2.9% of GDP. See Box 1.1 for further details.
Source: (Sunel, forthcoming[17]).

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Box 1.1. Growth and welfare effects of compositional shifts in government expenditure and revenue: A dynamic general equilibrium approach

The study conducted for this Survey calibrates a dynamic general equilibrium model to the Latvian economy and complements previous empirical work on the effects of compositional shifts in government expenditure and revenue (Fournier and Johansson, 2016[18]; Akgun, Cournède and Fournier, 2017[19]; Bloch et al., 2016[20]). The model assumes a closed-economy environment with a representative household, a representative firm and a government. The household maximises preferences over consumption flows and leisure, earns wage, dividend and transfer income, and decides how much to save in firm shares. The representative firm maximises the present value of future dividend flows by deciding how much to invest and demand labour. The government taxes wage and dividend income, household consumption and corporate profits. Each of these taxes affects the optimal decisions of private agents and finances spending on government consumption, which does not influence the production of goods, public investment, investment in education and health, and transfers to households. A balanced budget is assumed throughout. Spending on health and education increases human capital measured as the efficiency of the hours of labour supplied. Public investment increases the public capital stock, which increases the productivity of the private factors of production used by firms.

The model is calibrated with Latvian data to reflect the various main macroeconomic variables averaged over the period 2000-19. In the next step, policy experiments are run in which the government expenditure or revenue structure (defined by the shares of budget items in total expenditure/revenue) is changed, while the total size of government (the ratio of total expenditure or revenue to GDP, as a balanced budget is assumed) is fixed at its level in the initial state of the economy. In the expenditure side experiments, the revenue structure is fixed at its initial level, and vice versa. The policy experiments lead to a change in the level of GDP per capita or welfare in the long term, because, for example, a change in the structure of government spending affects how much expenditure is split between more productive and less productive expenditure. Similarly, a change in the structure of government revenue, implying changing labour, corporate and consumption tax rates, affects the consumption, saving, labour supply and investment decisions of the private sector.

Source: (Sunel, forthcoming[17])

To address these important spending needs, more tax revenue should be raised. The tax burden stood at 30.2% of GDP in 2022, which is 4 percentage points below the OECD average and more than 2 percentage points lower than in Estonia. As the tax structure is already heavily skewed towards labour and consumption taxes, higher tax revenue should be raised by increasing corporate and personal income, property and inheritance taxes (see below). Medium-term budget plans foresee a slight increase of tax revenue by about 0.5 percentage points by 2026, among other factors due to taxing undistributed profits of credit institutions, a gradual increase of reduced VAT rates for fruits and vegetables, and increases in excise tax rates for tobacco and alcoholic beverages. Dividends from large SOEs also significantly contribute to the budget, with about 0.8% of GDP on average from 2018 until 2021. Gradually reducing state ownership in larger SOEs, which would help deepen capital markets and improve competition (see below and Chapter 2), would lower dividend revenue, which could be compensated by raising tax revenue further. Implementing structural reforms recommended by this survey would raise growth of GDP per capita by 0.7 percentage points and lead to an increase in tax revenue by 1.8% of GDP, which is sufficient to address rising spending needs and reduce public debt (Table 1.1; Table 1.6; Figure 1.10, Panel A).

Table 1.6. Table on fiscal effects of recommendations

Recommendation	Fiscal impact (in percentage points of GDP)
Tax revenue related recommendations	
Reduce the labour tax wedge, in particular for low-income earners	-1.1
Raise the progressivity of personal income taxes, in particular for higher incomes.	1.1
Introduce gift and inheritance taxes, while allowing for exemptions for low-value inheritances and instalments for tax payments	0.2
Update cadastre values to better link property taxation to market values of assets and raise revenue, while continuing to provide tax reductions for the primary residence of poorer households.	0.4
Strengthen tax enforcement and reduce VAT expenditures	0.7
Abolish excise tax expenditures for fossil fuel, alcohol and tobacco	0.5
Total fiscal impact tax revenue measures	**1.8**
Spending related recommendations	
Raising defence and health spending and reduce old-age poverty by raising targeted transfers to the elderly.[1]	-1.5
Strengthening spending reviews in budgeting procedures and raise spending efficiency through better impact evaluation and policy targeting at all levels of government [2]	0.6
Improving public procurement procedures at all levels of government [3]	0.5
Expand active labour market policies and improve adult education	-0.4
Raise public investment in infrastructure and R&D	-0.5
Improve educational quality	-0.3
Total fiscal impact spending related measures	**-1.6**
Total fiscal impact of revenue and spending related measures	**0.2**

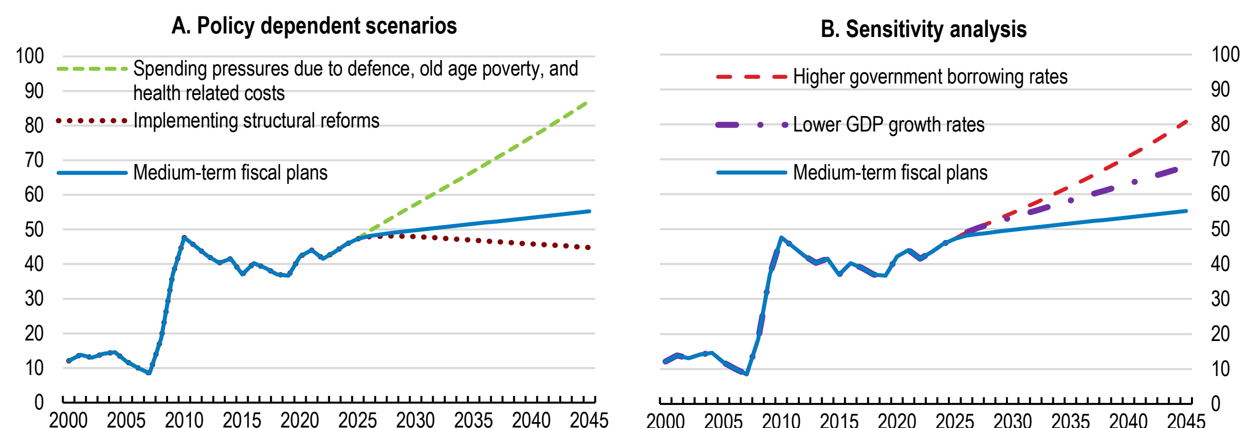
1. The estimate for rising spending needs assumes that defence spending increases by 0.6% of GDP, that old-age and survivors' cash benefits are increased by 0.5% of GDP to reduce old-age poverty by half of the distance to the OECD average, and that health care spending is increased by 0.4% of GDP to reach the OECD average.
2. The effects of reforms related to prioritising spending and raising spending efficiency at all levels of government are difficult to quantify using available methodologies, but would significantly contribute to increasing fiscal space. In 2021 and 2022, the existing spending review process has led to savings of about 0.5% of GDP, respectively.
3 The estimate for the fiscal impact of improved public procurement procedures is related to an OECD study which has estimated the gains in spending efficiency to be about 1 percentage point of GDP in Germany, if risk assessment and analysis of market capacity for infrastructure contracting decisions are improved across all levels of government by applying the OECD Support Tool for Effective Procurement Strategies (STEPS) (Makovšek and Bridge, 2021[21]; OECD, 2021[22]).
Source: OECD calculations.

Due to larger fiscal deficits since 2020, government debt has increased to 43.5% of GDP and is expected to further increase over the next two years to about 47% of GDP, which is significantly above the medium-term target of 40% (Table 1.5). Moreover, if rising spending needs in defence and internal security, health and targeted social transfers to the elderly are not addressed by raising tax revenue and spending efficiency or reducing other spending, public debt would grow further (Figure 1.10). Addressing these spending needs while ensuring public debt sustainability will require significant policy action. According to medium-term fiscal plans detailed in the Stability Programme for Latvia 2023-2026, the structural fiscal deficit will need to be reduced from 2.2% of GDP in 2024 to 1% of GDP in 2027 and maintained at that level thereafter, which would slow the increase of public debt. This implies a need to turn a structural primary deficit of 1.5% of GDP into a surplus of 0.2% of GDP by 2027, as interest payments are expected to rise from 0.7% of GDP in 2024 to 1.2% of GDP in 2027. Implementing the comprehensive set of structural reforms recommended in this Survey would allow to achieve these objectives, stabilise public debt and create additional fiscal buffers, which could be used in the case of future emergency situations. Rising risk premia due to an escalation of the war in Ukraine, a more aggressive behaviour of Russia towards its western neighbours or reduced international support for Ukraine would lead to higher interest payments and a rising trajectory of government debt (Figure 1.10, Panel B). Lower GDP growth rates due

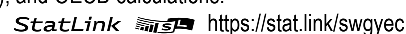
to higher trade barriers or disruptions in global energy markets would also result in higher public debt-to-GDP ratios.

Figure 1.10. Implementing structural reforms and addressing rising spending pressures is key for debt sustainability

Government gross debt, Maastricht definition, as a percentage of GDP



Note: The "Medium-term fiscal plans" scenario is based on medium-term budget plans detailed in the Stability Programme of Latvia 2023-2026. It uses the projected real growth and interest rate paths from the baseline of the OECD Long-term model and assumes that the structural budget deficit reaches 1% of GDP in 2027 and remains constant thereafter. This requires that the structural primary surplus reaches 0.2% of GDP in 2027 and approaches 1% of GDP over the projection horizon. The scenario "Spending pressures due to defence, old-age poverty, and health related costs" uses the same projected real growth and interest rate paths, but assumes that defence spending increase by 0.6% of GDP, that old-age and survivors' cash benefits are increased by 0.5% of GDP to reduce old-age poverty by half of the distance to the OECD average, and that health care spending is increased by 0.4% of GDP to reach the OECD average; all this additional spending is assumed to be debt financed, leading to a deterioration in the primary balance of 1.5 percentage points of GDP compared to the "Medium-term fiscal plans" scenario. The "Implementing structural reforms" scenario shows the impact on government debt of a comprehensive set of structural reforms and recommendations (Table 1.1, Table 1.6), which lead to higher nominal GDP growth over the projection period relative to the baseline scenario of the OECD Long-term model and result in additional fiscal savings of 0.2% of GDP (Table 1.6). In the "Higher government borrowing rates" scenario, interest rates increase by 200 basis points over the projection period relative to the baseline scenario of the OECD Long-term model. In the "Lower GDP growth rates" scenario, nominal GDP growth is lowered by 1 percentage point over the projection period relative to the baseline scenario of the OECD Long-term model. Following the OECD Economic Outlook guidelines, the ratio of general government financial assets to GDP is assumed to remain at its 2023 level in all scenarios.
Source: OECD Economic Outlook 114 database and updates; OECD Long-term model (2023[23]); and OECD calculations.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Deviations from the EU accounting practices reduce transparency and the credibility of the fiscal framework, further emphasising the need to tighten the fiscal stance. The national fiscal framework treats COVID-19 support measures, energy support measures, increased funding for defence and internal security, and support for Ukrainian refugees as one-off expenditures, which amount to about 2.5% of GDP in 2023, and does not include them in the structural fiscal balance (Ministry of Finance, 2023[24]). According to the national accounting methodology, the structural fiscal balance stood at 0.2% of GDP in 2023, while according to the EU accounting methodology it stood at -2.3% of GDP (Ministry of Finance, 2024[25]). The reclassification of some energy support expenditures from 2023 to 2022 and the recognition of some state budget expenditures as advance payments to be made in 2024 have led to a better-than-expected budget outturn in 2023 (Ministry of Finance, 2024[26]). The higher deficit in 2022 together with a lower-than-expected nominal GDP growth outcome in 2023 has increased the general government gross debt-to-GDP ratio in 2023 by three percentage points to 43.5%. As the escape clause will be deactivated in 2024, the current EU fiscal rules would require reducing the high fiscal deficit according to the EU methodology by 0.5 percentage points of GDP per year until it falls to 1% of GDP in the medium term. To increase transparency and maintain the credibility of the fiscal framework, structural and durable expenditure in key policy areas such as defence and internal security, which would increase the public capital stock and public

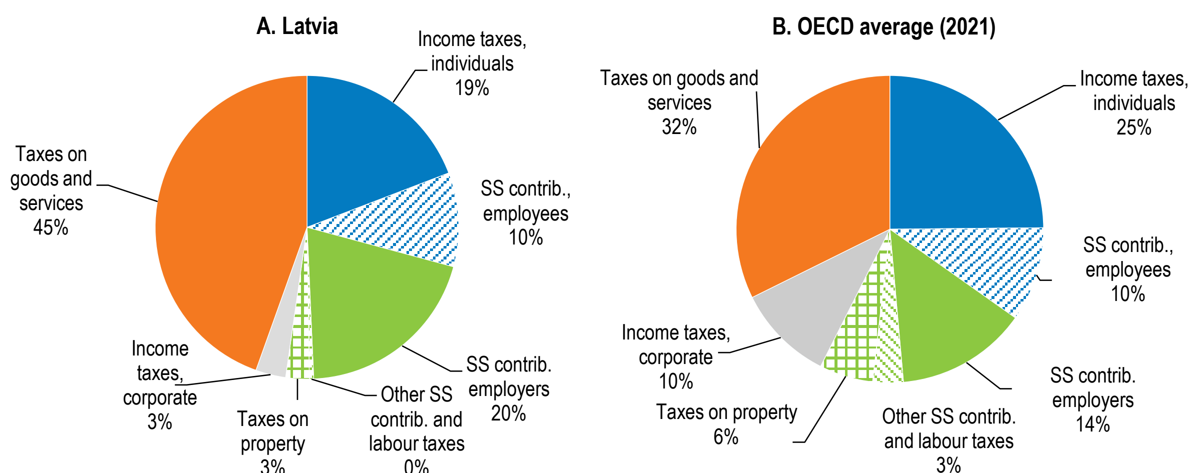
employment, and support measures that are spread over several years, should be gradually included in the structural fiscal balance and not be counted as one-offs.

A comprehensive tax reform is needed

A comprehensive tax reform should shift the tax burden away from labour towards corporate and personal income, property and inheritance taxes, which account for a lower share of revenues than in other OECD countries (Figure 1.11). Lower labour taxes, particularly for low-income earners, would help to raise formal labour supply and reduce persistently high informality, which is a major factor for weak productivity growth, low access to finance for firms, and weak training opportunities and social protection for many workers (see Chapter 2) (OECD, 2022[1]). Analysis for this Survey shows that financing a decrease in the share of labour taxes in total revenue by 5 percentage points (of total revenue) by raising corporate income taxes (CIT) would raise GDP per capita by 0.8% (Figure 1.9). This would imply raising CIT revenue from 1.6% of GDP to the OECD average over the period 2000-19 of 2.9% of GDP. When further raising high consumption taxes to finance the decrease in labour taxes, the positive effect on GDP per capita would be smaller, as incentives for raising labour supply to finance consumption would be indirectly mitigated by higher consumption taxes.

Figure 1.11. The tax structure is skewed towards labour and consumption taxes

General government tax revenue, % of total, 2022



Source: OECD Revenue Statistics.

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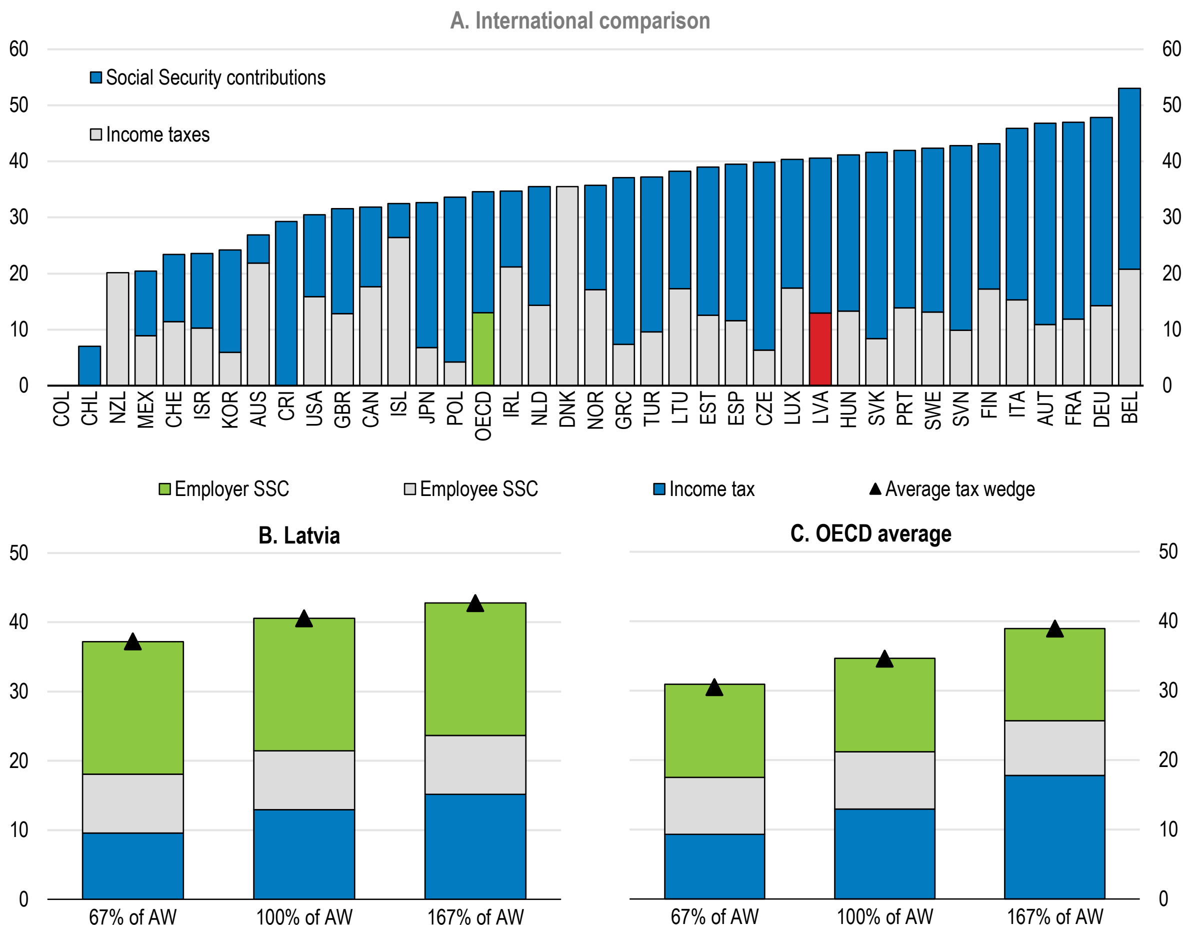
High labour taxes for low- and middle-income earners reduce incentives for formalising work. The shadow economy has not decreased since 2012 and stood above 20% of GDP in 2022 (Sauka and Putnins, 2023[27]; Schneider, 2022[28]). High labour taxes are due to high and flat social security contributions of 34.09% of the gross wage, with 23.59% paid by the employer and 10.5% by the employee, and which apply from the first Euro of labour income until a threshold of EUR 78 100 (Figure 1.12) (OECD, 2023[29]). Pension contributions account for 24% of the gross wage. Given the relatively low labour productivity and wages in Latvia, such high marginal tax rates present a major obstacle to the formalisation of workers (see Chapter 2) (World Bank, 2017[30]) (OECD, 2022[31]). Experiences from other countries such as Colombia show that lowering social security contributions for lower incomes and making them increase progressively with incomes, while maintaining social security benefit levels and financing the reform through general tax revenue, can significantly improve labour supply incentives and the formalisation of low-skilled workers (Arnold et al., 2023[32]). Reducing the labour tax wedge for low-income earners should be financed by making personal income taxes more progressive at higher incomes and raising revenue from corporate and capital income, inheritance and property taxes. Lithuania has recently started to fund its minimum

pension partly through general tax revenue, which has allowed lowering social security contribution rates (OECD, 2022[31]). As the minimum pension is financed out of the social security fund in Latvia, financing it through general tax revenue could be one way to enable reductions of social security contributions rates for low-income earners.

Figure 1.12. The labour tax wedge is high compared to other countries, particularly for low-wage earners

Average tax wedge decomposition, % of labour costs, 2022



Note: The tax wedge is the sum of personal income tax, employee plus employer social security contributions, minus social benefits as a percentage of labour costs. The tax wedge is shown for a single individual without children. Panel B and C show the tax wedge by income level measured in percent of the income of the average worker (AW).
Source: OECD Taxing Wages database.

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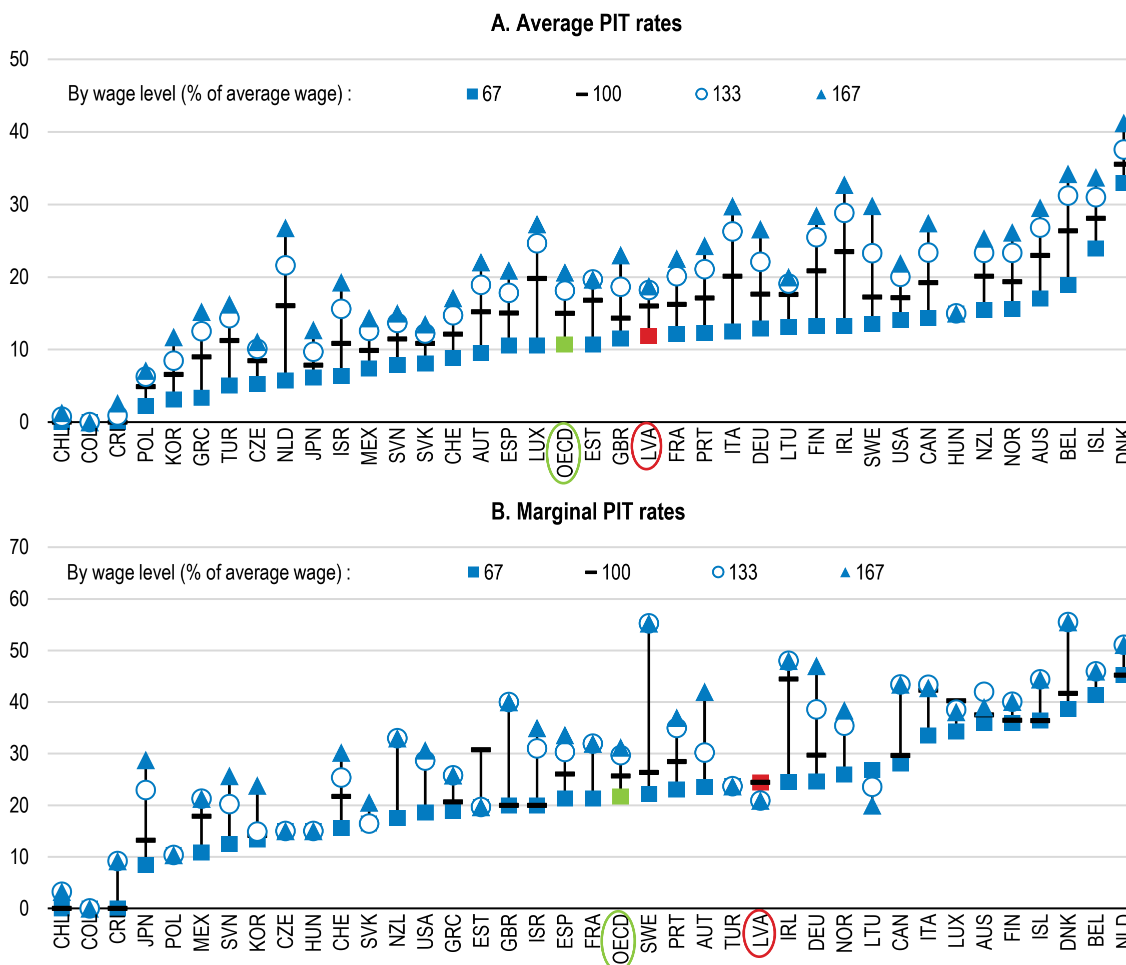
Despite the introduction of differential tax rates, the progressivity of personal income taxes remains low (Figure 1.13). The tax rate is 20% for the first bracket of yearly income until EUR 20 004, 23% for the second bracket ending at EUR 78 100, which is almost five times the average yearly gross wage income in Latvia, and 31% thereafter (OECD, 2023[29]). As income inequality in Latvia is among the highest across the OECD and the share of personal income taxes in total tax revenue is relatively low, the progressivity of the personal income tax should be increased by applying the maximum tax rate of 31% at a lower income threshold (Figure 1.11) (OECD, 2022[1]). A differentiated tax allowance, which is EUR 500 below a monthly income of EUR 500 and then decreases to zero until a monthly income of EUR 1 800, has introduced some additional progressivity since 2018 but leads to steep marginal tax rates at low incomes, raising incentives to underreport wage income above the minimum wage (OECD, 2022[31]). To reduce underreporting of

income and incentivise take-up and expansion of formal employment, the existing tax allowance could be replaced with a refundable earned income tax credit which increases with income above the minimum wage until a certain threshold. Above this threshold, the tax credit should be gradually phased out to maintain sufficient incentives for further expanding labour supply (Eissa and Liebman, 1996[33]; OECD, 2022[31]).

Figure 1.13. Progressivity of the personal income tax is low

Percentage of gross wage earnings, 2022



Note: Data refer to single person without dependant.
Source: OECD Tax database.

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A comprehensive tax reform to strengthen incentives for formal labour supply should be closely coordinated with the design of social benefit programmes. The withdrawal rate of social benefits with rising income has been shown to strongly affect incentives for low-income earners to raise labour supply and formalise work (Pritadrajati, 2023[34]; OECD, 2022[31]). The guaranteed minimum income (GMI) has been raised to EUR 125 in July 2023 and is planned to be indexed to 20% of the median wage starting in 2024, with a regular review of this threshold, which is welcome as poverty and inequality are high in Latvia (OECD, 2022[1]). However, to reduce inequality and at the same time improve labour supply incentives it is crucial to better target the GMI to vulnerable households, while phasing it out more gradually when these vulnerable households start earning more income (OECD, 2022[31]). The substantial heterogeneity of living costs across regions should also be taken into account in benefit calculations, as undifferentiated nation-wide transfers might lead to stronger disincentives for formal labour supply in regions with lower living

costs and where labour shortages are already large. The government is currently working on improving its data infrastructure to better target social benefits to vulnerable households. Other benefits, such as child benefits, should be well coordinated with the guaranteed minimum income to strengthen labour supply incentives (Lippold, 2019[35]). Conducting a comprehensive review of the tax and transfer system could help to design an efficient, growth friendly and equitable tax system.

To finance decreases in labour taxes, there is scope to raise revenue from the corporate income tax (CIT), which is low compared to other OECD countries (Figure 1.11). Since 2018, corporate profits are only taxed at a rate of 20% when they are distributed to shareholders. This created strong incentives to keep profits within the company to avoid taxation, leading to a strong decrease of CIT revenue by more than 1.5 percentage point of GDP from 2017 to 2019, although revenue has recovered since then. The purpose of this measure is to stimulate investment by incentivising higher firm equity, reducing incentives to under-declare profits and improving access to finance. However, experiences from a similar reform in Estonia show that effects on investments in productive assets are weak, as firms prefer to accumulate excess liquidity instead of investing in productive assets (Hazak, 2009[36]; Masso, Meriküll and Vahter, 2013[37]). Moreover, OECD research indicates that the elasticity of investment to effective corporate income tax rates has fallen since 2009 (Hanappi, Millot and Turban, 2023[38]). The government has recently decided to subject profits of banks and other credit providers to direct taxation irrespective of profit distribution. This step could be expanded to include all other economic sectors, as the non-taxation of retained earnings is costly and budget resources are scarce. Moreover, the international agreement on the global minimum tax on corporate profits will require adjustments in Latvia's CIT system, which should be taken as an opportunity to evaluate and redesign the system, and raise revenue from CIT.

Special tax regimes for small businesses reduce tax revenue and can hinder firm growth and the allocation of capital and labour to more productive firms, thereby contributing to weak aggregate productivity growth (see Chapter 2) (World Bank, 2017[30]). The Microenterprise tax regime introduced in 2010 provided strong incentives for firms to stay small or split into smaller units to avoid growing above the eligibility threshold (OECD, 2019[2]). This effect was most pronounced in sectors with high labour costs, such as professional services, and led to an increase in the number of firms registered under the regime to over 47 000 in 2017, which employed around 85 000 workers or 14% of private sector employees (OECD, 2019[2]). Since then, eligibility conditions have been tightened, but about 7 600 firms still remain in the system. From 2024, the single tax rate is 25% on turnover, which includes social security contributions and personal income tax for the micro-enterprise owner. Firms can remain in the system without time restrictions, as long as their annual turnover remains below the threshold of EUR 50 000. Since 2021, any employee needs to be fully registered with the general tax system, which has led to a decrease of registered microenterprise employees by 75% to about 17 000 employees in 2021 and zero employees in 2022, likely increasing informal employment. Although this tax regime might have facilitated the formalisation of small firms, it hinders firm growth and provides an incentive to under-declare revenue above the turnover-threshold (see Chapter 2). It also hinders reallocation of firm owners and potentially informally employed workers to more productive firms, which suffer from strong labour shortages. Although tax revenue foregone from owners of firms under the microenterprise tax regime is estimated at only 0.1% of GDP in 2021 (Ministry of Finance, 2021[39]), the loss of efficiency due to such threshold-induced distortions can be significant and has been estimated at around 3.5% of GDP in the case of France (Garicano, Lelarge and Van Reenen, 2016[40]). The regime should be evaluated and redesigned to allow microenterprises to grow and flourish under the general tax system.

There is scope to reduce tax reductions and exemptions, which amount to 8.6% of GDP or a quarter of all public revenues in 2021 (Ministry of Finance, 2021[39]). Special economic zones (SEZ), such as the free ports in Riga and Ventspils and the SEZ in Rezekne, Latgale, and Liepaja, provide reductions or complete exemptions in VAT, CIT, property and fuel taxes to attract international and domestic firms (Næss-Schmidt et al., 2020[41]). Even a share of salary payments can be deducted from tax payments in Rezekne and Latgale. While such support can stimulate foreign direct investment (FDI) and foster knowledge spill-overs

to the local economy, the continuous evaluation of these incentives is key to ensure effective use of public resources (Grundke and Cassimon, 2022[42]). This is particularly important, as the introduction of the global minimum tax on corporate profits might allow other countries to tax the exempted corporate income. Several studies indicate that the performance of Latvian SEZs in terms of employment and FDI has been much weaker than in other countries (Næss-Schmidt et al., 2020[41]). An important function of SEZs is also to provide organisational and administrative support and facilitate cooperation with local firms and suppliers as well as vocational and educational training (VET) institutes to equip the local workforce with the skills needed by firms. Simplifying regulation and improving management of SEZs, which are operated as local state-owned enterprises (SOEs), could help to make SEZs more effective.

Various tax reductions and exemptions in value added and excise taxes also contribute to high tax expenditures. For example, excise tax expenditures for fuels, alcoholic beverages and tobacco amount to 0.6% of GDP (Ministry of Finance, 2021[39]). Reducing these tax expenditures and establishing transparent criteria and regular evaluations for the remaining ones would improve tax fairness and raise revenue (OECD, 2020[43]) (OECD, 2022[44]). Moreover, it would support health and environmental policy objectives by reducing the consumption of alcohol and tobacco and the use of fossil fuel and environmentally harmful substances in production (see below). This should be combined with raising carbon taxes in the building and transport sector until the EU ETS 2 is introduced in 2027. To support vulnerable households, which might be relatively more affected by the reduction of VAT expenditures and increases in carbon taxes, the guaranteed minimum income should be expanded and better targeted.

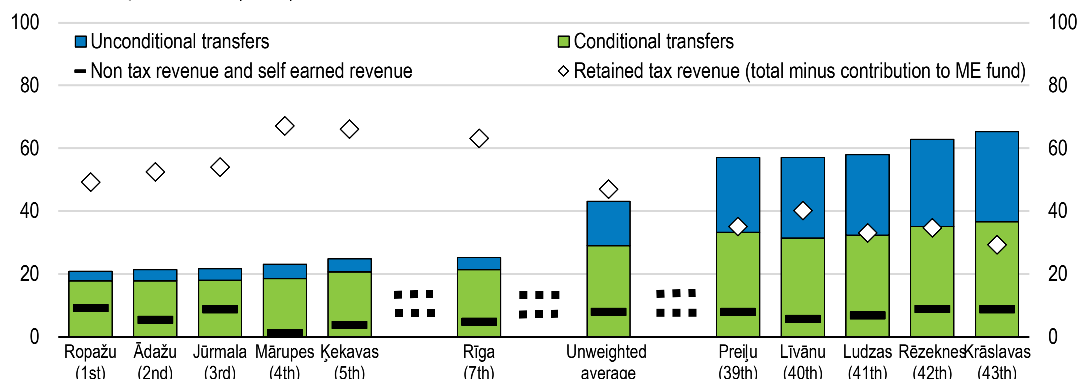
As the progressivity of the personal income tax is low, the authorities should also consider introducing gift and inheritance taxes to raise revenue and reduce inequality. Latvia already taxes the inheritance of real estate through estate and notary fees, but revenues from wealth transfer taxes as a share of total tax revenues are less than half of the OECD average (OECD, 2021[45]). Distortive effects of inheritance and gift taxes on savings and investment behaviour and work efforts of wealthy taxpayers are found to be much smaller compared to labour or capital income taxes, while the effects on labour supply of the heirs are significantly positive (OECD, 2021[45]) (Guvenen et al., 2023[46]). When combined with an exemption for low-value inheritances, recipient-based inheritance taxes can significantly lower wealth inequality and contribute to the equality of opportunities. Experience from other countries show that for inheritance and gift taxes to be effective, it is key to ensure a broad tax base, particularly avoiding too generous exemptions for business assets, and set lower tax rates for the average household (OECD, 2021[45]). To address concerns about forced liquidation of family-owned firms, instalments for tax payments could be introduced. Another option to raise revenue while reducing inequality could be to tax capital gains and dividend income in line with the PIT schedule.

Improving intergovernmental fiscal relations

Many municipalities lack sufficient revenue sources to finance their autonomous functions and are dependent on conditional and unconditional transfers from the central government to fulfill these functions (Figure 1.14). Latvian municipalities are responsible for providing a broad range of public services from education, health and social services to infrastructure and land planning, issuance of commercial permits and licenses, law enforcement, utilities, transport infrastructure, public transport, housing and economic development policies. They receive 75% of PIT revenues and 100% of real estate taxes of residents in their jurisdiction as their main income sources. However, these revenues make up only 47% of their total expenses on average across municipalities in 2022, while 43% is financed by conditional and unconditional transfers (Figure 1.14). Compared to the average between 2011 and 2019, tax revenue received by municipalities has decreased by about 2.3 percentage points of total tax revenues in 2022 according to OECD data. On the other hand, spending pressures for municipalities have strongly increased since early 2022, mainly due to increases in energy prices, public sector wages, the guaranteed minimum income threshold, interest rate expenses and the additional costs for integrating Ukrainian refugees, further increasing the dependency on central government transfers.

Figure 1.14. Many municipalities are dependent on transfers from the central government

Municipalities, share of retained tax revenue, other revenue, conditional and unconditional central government transfers in total expenditure (in %), 2022



Note: Retained tax revenues are computed by subtracting contributions to the municipal equalisation (ME) fund from total received tax revenue, which includes personal income tax and property tax revenues. Unconditional grants are grants received through the municipal equalisation fund as well as additional unconditional grants for particularly poor municipalities and discretionary grants allocated during the annual budget negotiations. Conditional transfers include transfers to finance base salaries of teachers, salaries of medical and elderly care staff, investment projects, road maintenance, public transport, and social protection. Non-tax revenue and self-earned revenue include fees and dividend income from public companies owned by the municipalities. The unweighted average across municipalities does not account for the size of municipalities.

Source: Ministry of Finance; State Treasury.

Financing a high share of local expenditure with central government transfers might reduce incentives for spending efficiency, as local populations might have less incentives to scrutinise local governments for their spending decisions (Herrmann, 2022[47]; Blöchliger and Kim, 2016[48]). This is a particular problem for conditional grants, which make up around 29% of municipal expenditures on average and comprise transfers to finance base salaries of teachers, wages of medical and elderly care staff, investment projects, road maintenance, public transport, and social protection. Such earmarked grants tend to reduce incentives for spending efficiency, in particular if they do not require co-funding by the municipality receiving the grant (Bergvall et al., 2006[49]). Although there is a complex formula to compute grants for teacher wages based on the number of students, their age structure and the remoteness of the school, grants do not go to the school directly but are managed by municipalities who can decide on the allocation across schools. This contributes to strong variation of student to teacher ratios and teaching quality across schools, although one objective of these conditional grants is to reduce differences in public education quality across municipalities.

Some of the existing non-earmarked transfers from the central government are not automatic and are negotiated each year in the preparation of the national budget. This introduces high uncertainty in budget planning for municipalities and complicates longer-term spending commitments, for example for infrastructure projects. It might also blur incentives for spending efficiency, as municipalities might expect a bail out by the federal government (OECD, 2016[50]). The equalisation fund is designed to reduce the difference of municipal revenue per capita to the average revenue per capita across municipalities by 60%, whereby differences in spending needs due to differences in population age structure and territorial size are accounted for. However, the payments from richer municipalities to the fund do not fully cover the transfers to poorer municipalities, and the central government has to step in every year to cover the difference, which was 34% of payments to poorer municipalities in 2022. In addition, further unconditional grants are disbursed each year, amounting to 44% of equalisation fund disbursements in 2022. The government provides municipalities with a tax revenue forecast for the next three years and guarantees forecasted personal income tax revenues to municipalities for each current year to reduce budget

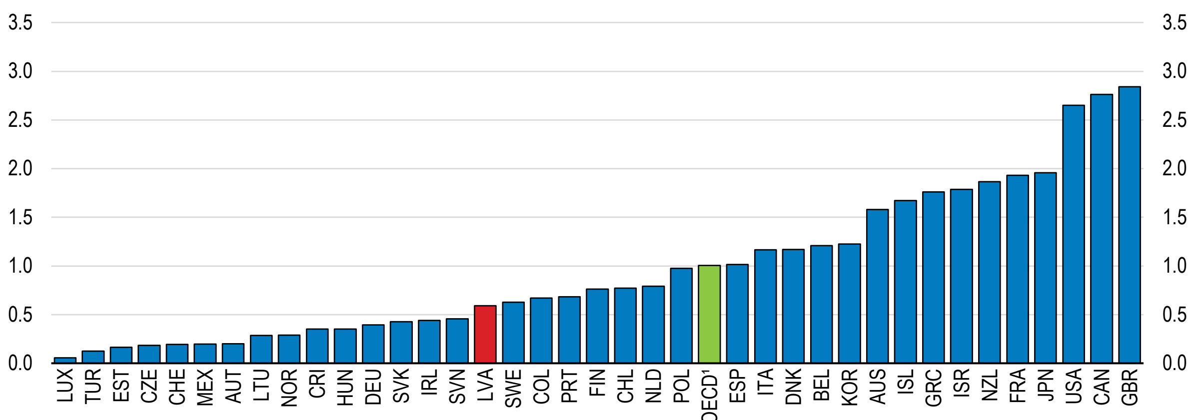
uncertainty for municipalities. However, government transfers to cover the deficit in the municipal equalisation fund are still decided each year during the state budget negotiations.

To improve the quality of public services and spending efficiency at the local level, it is key to provide the municipalities with sufficient automatically allocated tax revenue, which should preferably be directly linked to local economic activity. As revenue from recurrent taxes on immovable property is low in international comparison (Figure 1.15), it is a key priority to update cadastral values with market prices of properties and raise revenue for municipalities, while continuing to provide tax reductions for the primary residence of poorer households. A lack of a systematic methodology to determine cadastral values of property and low capacity of the responsible central government agency have led to a situation, where raising property tax rates could exacerbate inequalities. Modernising the cadastre system and regularly updating cadastral values with market prices would significantly contribute to reduce high wealth inequality. A larger weight for property taxes in revenues would also make municipal finances less sensitive to business cycle fluctuations and provide more planning certainty for longer-term infrastructure projects (Kim and Vammalle, 2012[51]). To prevent detrimental tax competition, national minimum property tax rates should be raised, while giving municipalities more flexibility to introduce top-up rates. This could be combined with allocating a higher share in PIT revenue or sharing parts of national VAT and CIT revenues with municipalities, which would increase with the reforms proposed in this Survey. Municipalities could also be allowed to introduce top-up tax rates on PIT above the national rate, as for example done in the U.S. (Blöchliger and Kim, 2016[48]).

Linking municipal tax revenue more to local economic activity is key for incentivising the local population to hold local governments accountable, which in turn should motivate local governments to improve public service quality and spending efficiency (OECD, 2016[50]). However, as economic differences across municipalities are large, the equalisation fund needs to continue redistributing resources from richer to poorer municipalities but should be based on transparent and stable allocation criteria and independent from further financial transfers from the central government. The equalisation formula should use measures for municipal tax capacity, for example based on a measure of average updated cadastral values in the case of property taxes instead of projected tax revenue based on past revenues, to calculate contributions and transfers, as using actual revenue provides incentives to not fully use local tax revenue potential (Bergvall et al., 2006[49]). Improving the incentives for municipalities to develop their tax base and raise spending efficiency is particularly important, as the scope for municipalities to issue debt in international and domestic markets has been expanded.

Figure 1.15. Revenue from recurrent taxes on immovable property is low

Recurrent taxes on immovable property, % of GDP, 2022 or latest available year



1. Unweighted average.
Source: OECD Revenue Statistics.

Table 1.7. Past recommendations and action taken on fiscal and tax policies

Previous recommendations	Action taken
Raise additional tax revenues in a growth-friendly and progressive manner, through residential property, environmental and capital taxation	The 2024 budget envisages an increase in excise duty rates on diesel and kerosene used in SEZs and free ports. In 2024, a corporate tax surcharge of 20% on undistributed profits will be imposed on credit institutions and consumer finance companies.
Gradually withdraw benefits targeted at low-income earners when they take up a job.	The State Employment Agency covers the transport or rent costs of newly hired workers for 4 months if the worker earns up to 3 minimum wages in her new job.
Decrease the labour tax wedge for low-income earners	The non-taxable income threshold has been raised from 350 EUR to 500 EUR in 2022 corresponding to the increase in the minimum wage.
Phase out the microenterprise tax regime	From 2024, a single tax rate of 25% applies to turnover, which includes social security contributions and personal income tax for the micro-enterprise owner. Since 2021, any employee needs to be fully registered with the general tax system. Firms with an annual turnover of less than EUR 50 000 can remain in the regime without time restrictions.
Raise excise taxes to curb alcohol consumption and smoking, and better inform the public of the benefits of improving diets and exercising.	The 2024 budget foresees increases in excise duties on tobacco products, e-liquids, tobacco substitutes and alcoholic beverages. EU structural funds have been used to launch dissemination campaigns at national and local level, covering areas such as improving nutrition, physical activity and reducing the use of addictive substances.
Ensure that local governments are sufficiently resourced and autonomous by increasing their tax revenues, reducing the share of earmarked revenues, and improving the equalisation system	No action taken.

Improving the capacity of the public administration and raising spending efficiency

Effective enforcement of property rights and implementation of laws and regulations facilitate economic transactions and provide firms and households with the planning certainty needed for longer term investments. Rising complexity of bureaucratic processes can hinder such effective enforcement and implementation and act as an administrative burden for firms and households. However, recent empirical research has shown that given the same level of regulatory complexity on product and labour markets, the quality of the public administration is a key determinant of firm growth across OECD countries (Kritikos, Amoroso and Herrmann, 2023[52]). For example, public planning and approval procedures for infrastructure investments can be simplified to a certain extent but will always keep a certain level of complexity due to the many different stakeholders and concerns involved in such projects. To ensure that these processes are effective and do not act as a barrier to investments, it is crucial to ensure a high capacity of the public administration (Becker, Egger and von Ehrlich, 2013[53]).

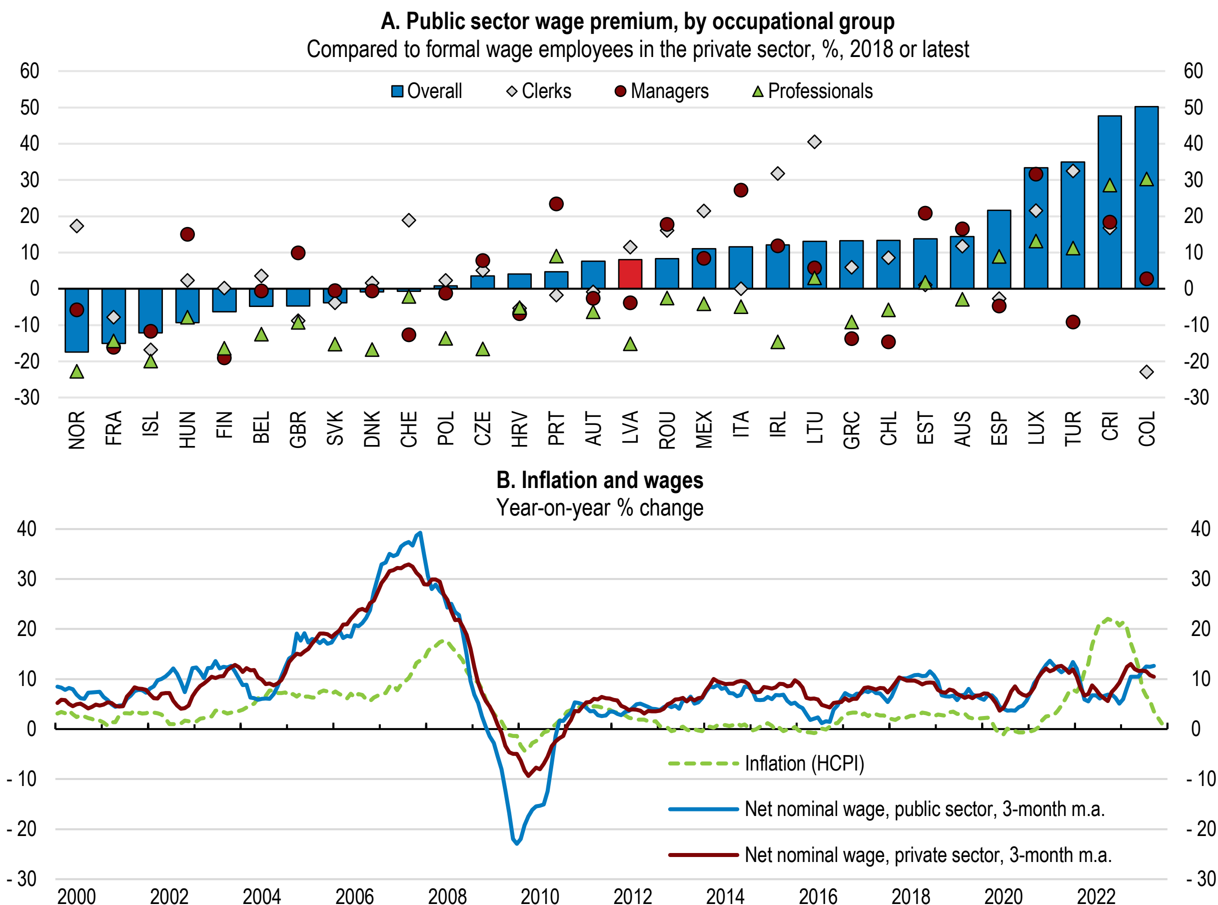
Continuing to improve public employment policies is key for raising public sector capacity

In Latvia, the quality of the public administration had suffered from strong wage cuts in the aftermath of the financial crisis in 2009. Public sector wages have decreased by over 22% from 2008 until 2010, while private sector wages only decreased by 5% (Figure 1.16). This strong decrease in relative wages between the public and the private sector coupled with rising skilled labour shortages in the Latvian labour market caused many experienced employees to leave the public sector and strongly increased staff turnover, as it remains difficult to retain newly hired talent (OECD, 2015[54]). This is a particular issue for management positions and skilled professionals, and less so for occupations with lower skill requirements, such as clerks (Figure 1.16). In many parts of the administration, institutional memory has been weakened and capacity lost, with negative consequences for the quality and effectiveness of public policies and services and the efficiency of public spending. Low public sector wages also facilitate corruption. The government has started to address this issue with a public administration reform in 2022, which aims at raising public sector wages to at least 80% of private sector wages for comparable jobs by 2027. It also introduces more flexibility in wage setting for occupations that are in high shortage and indexes public wages to past GDP

growth rates. As the public sector wage premium for clerks is already relatively high, there is scope to finance higher wages for managers and skilled professionals by slowing wage increases for clerks and evaluating options for consolidating the workforce. Recent wage increases for other parts of the public sector not covered by the recent reform, for example judges, employees in law enforcement, teachers and medical staff, are welcome, but more flexibility in wage setting should also be considered for these occupations.

The recent public administration reform should be combined with improved human resource policies to enhance the skills and motivation of public employees and further raise the attractiveness of public jobs through non-monetary benefits. Training for public employees should be expanded and its quality improved, with a particular focus on digital and management skills. Expanding performance-related pay and fostering employee engagement, better defining career paths and job profiles and improving public sector branding is necessary to attract and retain qualified personnel (European Commission, 2020[55]). Improving non-monetary benefits, such as providing more flexibility regarding part-time and remote work, increasing the number of vacation or paid sick days or longer notice periods, can also play an important role to raise the attractiveness of public jobs. In addition, centralising public recruitment procedures would bundle resources and raise the quality of recruitment, and facilitate mobility across institutions, thus improving peer-learning, coordination and cooperation across different parts of the government (OECD, 2023[56]). Expanding recruitment activities to attract external and international candidates, including from the Latvian diaspora, could significantly improve management skills sets and organisational quality in the public sector. This would help make the administration more agile and client-oriented, for example concerning the use of digital tools for programme evaluation and better cooperation and data exchange across the government.

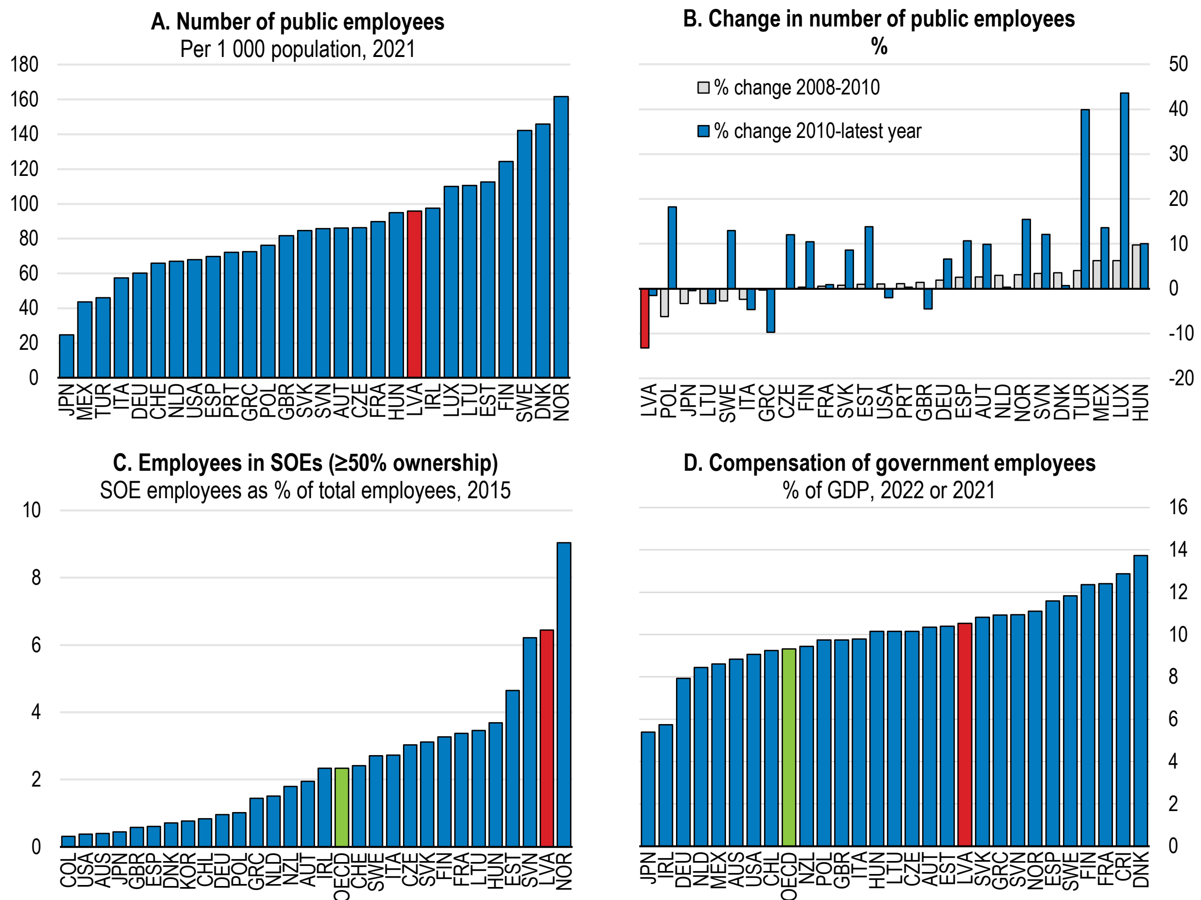
Figure 1.16. Public sector wages strongly decreased after the financial crisis and are not attractive for skilled professionals and managers



Source: World Bank, Worldwide Bureaucracy Indicators (WWBI); and Central Statistical Bureau of Latvia.

To finance more attractive conditions for working in the public sector, there is scope for further consolidation in the public sector. The public wage bill relative to GDP is above the OECD average, which is due to an above average public workforce and relatively high wages for occupations with low skill requirements (Figure 1.16, Figure 1.17). The relatively large public workforce is related to the fact that Latvia is a small country with a broad set of responsibilities for its many relatively small municipalities (see above) (OECD, 2019[2]). A recent territorial reform has reduced the number of municipalities from 119 to 43 in 2021, providing scope for the realisation of returns to scale in public services provision and a consolidation of the public workforce, but the implementation of this administrative reform will take some time. The ongoing reform of the school network will also likely lead to a more efficient employment of public resources in education services, creating larger schools with higher student to teacher ratios, better equipment and better teacher training and monitoring. A relatively large number of local state-owned enterprises also contributes to relatively high public sector employment with room for rationalisation (see below). There is also room for consolidation within the central government. Duplication of agencies and responsibilities is a problem that not only consumes public resources and reduces returns to scale, but also increases coordination costs within the government and raises the administrative burden for the private sector (OECD, 2019[2]).

Figure 1.17. Public employment has decreased but remains relatively high



Source: OECD (2023), Government at a Glance 2023; OECD Economic Outlook database; and OECD calculations based on OECD National Accounts database and OECD (2017), The Size and Sectoral Distribution of State-Owned Enterprises, OECD Publishing, Paris, https://doi.org/10.1787/9789264280663-en.

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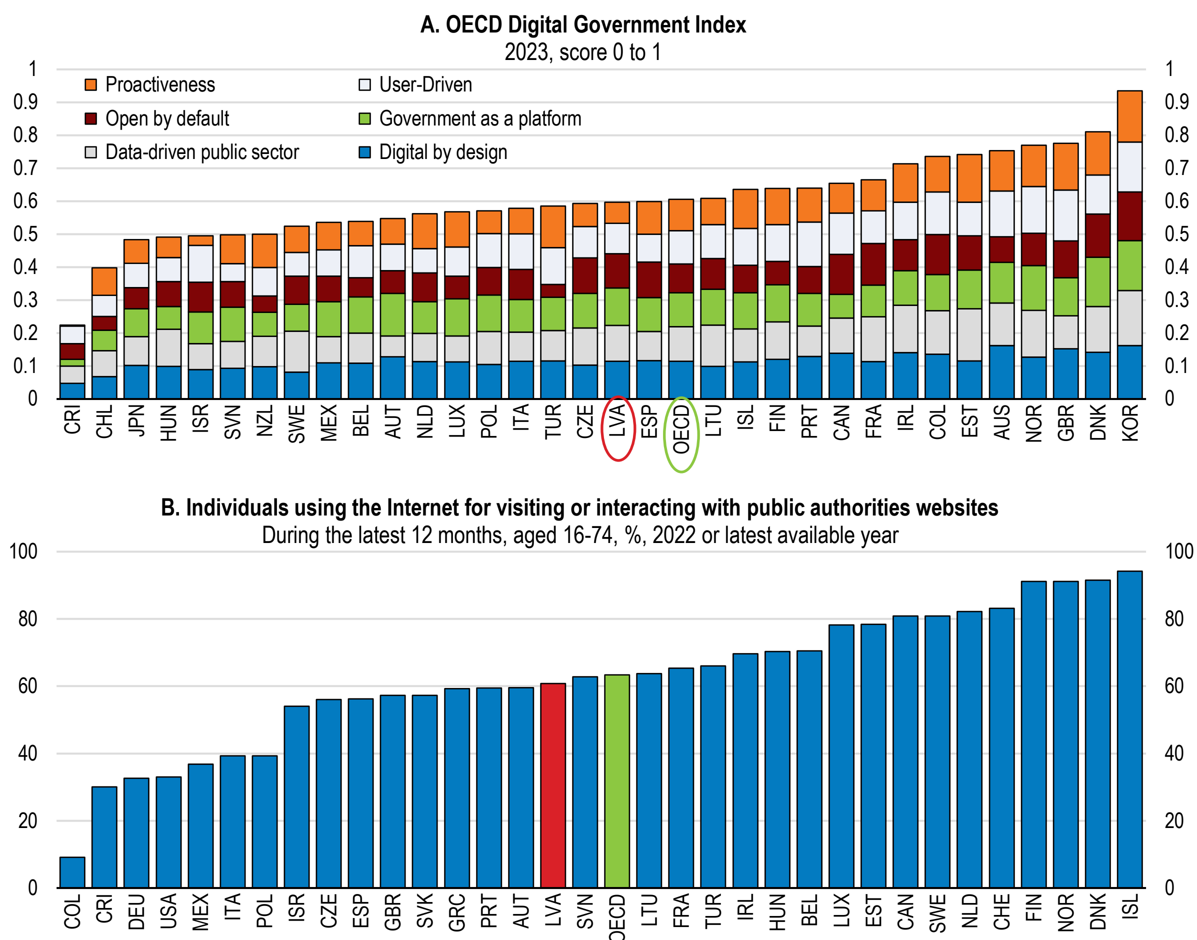
Continuing the digitalisation of the public sector to improve policy impact assessment and raise spending efficiency

Digitalising administrative procedures is key to improve public sector capacity in the context of rising skilled labour shortages. Latvia has made important progress in digitalising administrative procedures for firms and households and has increased transparency of the public sector (Figure 1.18, Panel A). The share of individuals using the internet to interact with the government is close to the average OECD country (Figure 1.18, Panel B). This has contributed to a strong reduction in the administrative burden, for example for starting a company or receiving an operating license or a construction permit (Figure 1.19). The introduction of an online one-stop-shop for setting up a company has strongly reduced the administrative burden for start-ups. However, data sharing and analysis for policy planning and impact assessment, which is measured by the sub-indices on "government as a platform" and "data-driven public sector" in Panel A of Figure 1.18, has still room for improvement. The administrative burden for internal government processes remains high (OECD, 2023[57]). Proactiveness and stakeholder involvement in the design of public policies through digital technologies could also be improved (OECD, 2021[58]).

Figure 1.18. Digitalisation of the public sector has focused on interaction with citizens



Note: In Panel A, data are not available for Slovakia, Switzerland and the United States. The OECD Digital Government Index (DGI) is based on the six dimensions of the OECD Digital Government Policy Framework (DGPF): digital by design, data-driven, government as a platform, open by default, user driven and proactiveness. It measures the capacity of the public sector to deliver a coherent and human-centric digital government transformation, as well as the strategic approaches, policy levers, implementation, and monitoring mechanisms in place to deliver the digital government strategy. Thus, it captures much more than just digitising analogue processes.

Source: OECD Survey on Digital Government 2.0. OECD ICT Access and Usage by Households and Individuals database.

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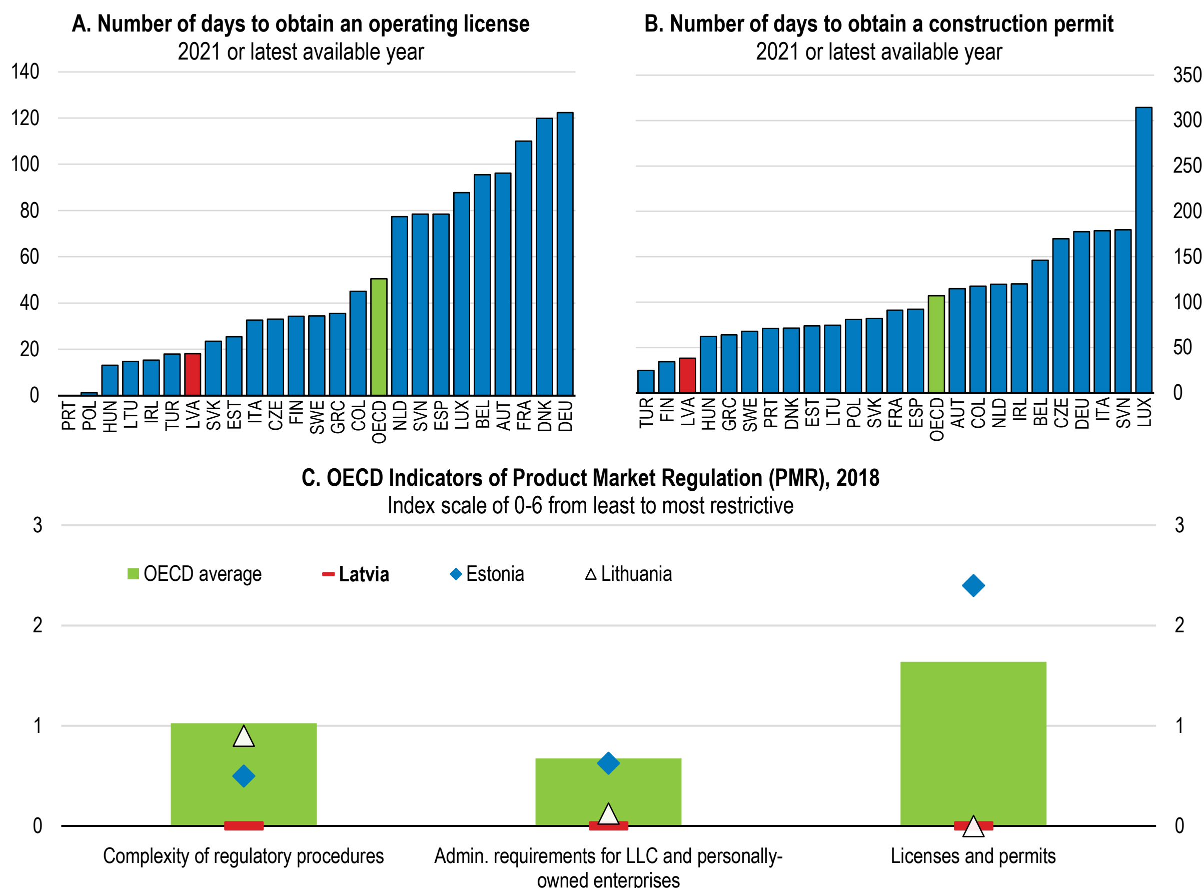
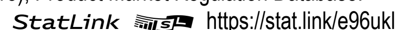
Although digitalisation has progressed at the level of the central government, digitalisation of public services at the municipal level is still lagging due to weak financial capacity and a lack of management and digital skills (OECD, 2021[59]; VARAM, 2022[60]). It is key to better incentivise municipalities to conduct joint ICT and software procurement initiatives to lower costs and foster the harmonisation and digitalisation of administrative procedures as well as the exchange and analysis of data across municipalities and within the central government. Common IT standards and data formats should be developed and made mandatory for all levels of government, including obliging all IT services providers to develop products for the public administration in conformity with these standards (OECD, 2023[61]). Incentivising compliance with the existing guidelines for good public service delivery and setting a timeline to provide public services digitally for firms could help to accelerate progress at the municipality level (OECD, 2021[59]; VARAM, 2022[60]). This needs to be complemented with expanding targeted training to public employees in the use of digital technologies and the design of digital services, which has been introduced in 2023 as one EU recovery fund project. Fostering peer-learning across the public sector through workshops and online courses and the certification of successfully digitalised government services would also help (OECD, 2021[59]).

Figure 1.19. The administrative burden has been reduced



Source: The World Bank Group, Enterprise Surveys, www.enterprisesurveys.org; and OECD (2018), Product Market Regulation Database.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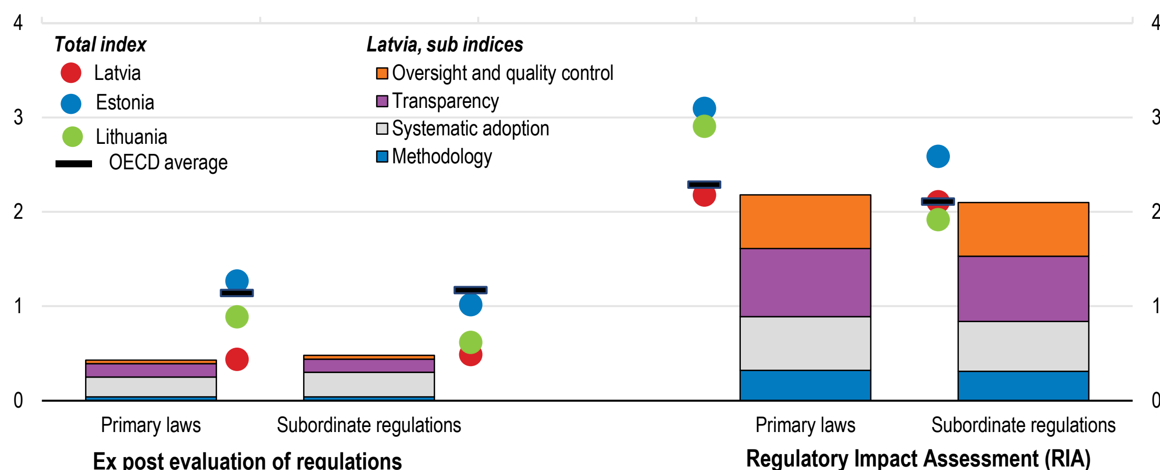
Despite progress in digitalising public services, there is room to improve digital tools for ex-ante as well as ex-post evaluations of laws, regulations and policy programmes (Figure 1.20). Ex-ante impact assessment of laws and regulations helps to prevent that legislation is changed too frequently, as it raises regulatory quality and ensures ex-ante that legal action meets the expected policy objectives, while reducing economic, social and environmental costs (Brenner and Fazekas, 2021[62]). This contributes to legal certainty, which is key for raising long-term investments of households and firms. Ex-post evaluations allow monitoring the effects of regulations and policy programmes and adjusting them if policy objectives are not met. Both types of impact assessment require a good quality of data and analytical capacities and close cooperation with relevant stakeholders. Since 2021, regulatory impact assessment is mandatory when developing new primary laws and subordinate regulations. However, there is room for improving analytical methodologies and knowledge on cost-benefit analysis and the quality, exchange and analysis of data across the public sector(Figure 1.20) (OECD, 2021[58]). Implementing the planned single electronic identifier for firms and natural persons is key for linking and analysing data and reducing the administrative burden within the government. The oversight and quality control for ex-post evaluations of regulations should be improved and reviews of regulatory stock, which mostly focus on reducing the administrative burden, should be expanded to also analyse the effects of regulation on competition (see Chapter 2).

Figure 1.20. Impact evaluation of policies and regulations need to improve

OECD Indicators of Regulatory Policy and Governance (iREG, higher value indicating better performance), 2021



Source: OECD (2021), OECD Indicators of Regulatory Policy and Governance (iREG).

Better impact assessment of policies through better data and digital tools would also help prioritising expenditures and raising spending efficiency. Latvia has introduced medium-term and performance budgeting based on spending reviews, but weak impact assessment capacities complicate their successful implementation. Many performance indicators for budget programmes exist and are published in the annual state budget law. However, they have little consequences in budget negotiations for the allocation of resources across programmes (OECD, 2016[63]). Incentives for public bodies to conduct critical evaluations to identify fiscal space and to strengthen impact assessment capacities should be improved. This is a particular problem at the municipality level, where impact assessment capacities are weaker than in the central government administration. Improving these capacities and allowing for accessing, linking and analysing administrative data across levels of government, including by implementing the planned single electronic identifier for firms and individuals, would enhance peer learning opportunities, facilitate evidence-based policy making, reduce the administrative burden and raise spending efficiency. Better impact assessment would also help to improve the targeting of policy measures to particular groups. For example, the energy price support measures could not be targeted at vulnerable households or particularly affected firms, as the necessary data infrastructure to identify these households and firms remains to be established.

Improving public procurement and investment planning

Latvia has considerably improved procurement procedures and their transparency by introducing an electronic procurement platform, the use of which is mandatory for all levels of government for tenders with a value above EUR 10 000 for supply and service contracts and EUR 20 000 for public works. This reduces information asymmetries and lowers barriers to bidder participation, particularly for smaller and younger firms, fostering competition and reducing costs (Fazekas and Blum, 2021[64]). It also facilitates joint procurement across the public sector to take advantage of economies of scale and gains from specialisation (Allain-Dupré, Hulbert and Vincent, 2017[65]). Centralised procurement has been found to significantly reduce costs compared to local procurement, for example in Italy by 60% in pharmaceuticals (Fazekas and Blum, 2021[64]; Baldi and Vannoni, 2015[66]). However, in Latvia, the procurement of many standardised goods and services that could gain from centralised purchase is still conducted at the municipal level, for example ICT and software services or drugs and medical equipment. Within the central government, joint procurement across Ministries, public agencies and SOEs is also rather the exception than the norm. Despite the legal requirement to purchase standardised goods and services centrally, the

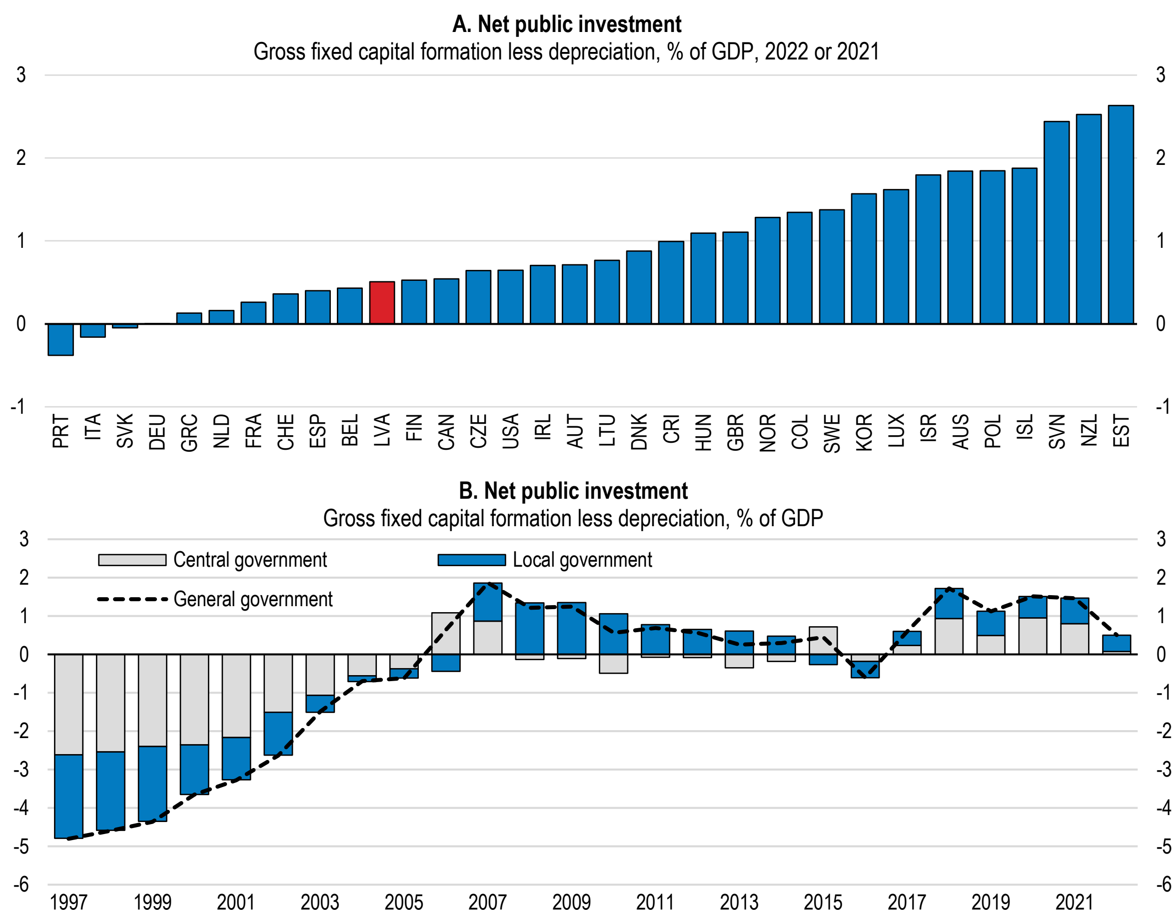
weak capacity of existing central or cross-municipal purchasing bodies and legal exemptions for cases where requested products and services are not offered by the central purchasing body hinder centralised procurement. Spending efficiency should be improved by consolidating existing purchasing bodies, improving their IT and staff capacity and reducing legal exemptions that allow to opt out of mandatory centralised procurement.

Data from the e-procurement platform should be better used to identify risks for bidder collusion and raise spending efficiency. So far, the existing red flag system is hampered by the limited availability of information, such as the lack of bidding prices of other bidders than the final contractor. Collecting and including data on public tenders below the threshold for mandatory e-procurement in the red flag system would allow to investigate strategic splitting of procurement projects to avoid mandatory e-procurement and could help to raise transparency and fight corruption. In addition, the threshold for mandatory e-procurement should be lowered, while reducing the administrative burden for setting up tenders and publishing documents and data in the system. Moreover, the three stages of procurement, bid design, bid evaluation and contract execution, should not be conducted by the same person to reduce corruption risks. Fostering e-procurement and improving the red flag system to reduce the scope for corruption can significantly reduce costs (Veljanov and Fazekas, 2023[67]; Abdou et al., 2022[68]).

Municipalities are responsible for a high share of public investment (Figure 1.21). As there will be a significant inflow of EU funds during the next years, it is crucial to improve investment planning capacities at the local level to ensure effective and cost-efficient implementation of infrastructure projects (IMF, 2023[4]; Becker, Egger and von Ehrlich, 2013[53]). The recent territorial reform has consolidated municipalities leading to potentially larger investment and procurement projects, which reinforces the need to up-skill public employees in local planning and procurement agencies. Improving ex-ante cost-benefit analysis, risk assessment and analysis of market capacity for contracting decisions is key to raise spending efficiency, as exemplified by the OECD Support Tool for Effective Procurement Strategies (STEPS) (OECD, 2021[22]). Implementing STEPS to improve public procurement procedures related to infrastructure projects across all levels of government has been found to yield spending efficiency gains of more than 1% of GDP in Germany (Makovšek and Bridge, 2021[21]). Better cooperation across municipalities in infrastructure planning, including joint procurement, can also significantly reduce costs and improve effectiveness of implementation (Allain-Dupré, Hulbert and Vincent, 2017[65]).

Also, land planning and construction licensing procedures for private investments need to be improved at the local level. Improving digital tools for spatial development planning would support decision-making processes and increase their transparency. In some regions, the share of firms complaining about issues related to land access, business licenses and corruption, particularly related to construction permits, is higher than in other regions and more than double the share than in other Baltic countries (World Bank, 2019[69]; OECD, forthcoming[70]). In some cases, conflict of interests might play a role, if local businessmen get elected for public office or participate in procurement committees without sufficiently separating private from public interests. To reduce barriers for competition and investment as well as scope for corruption, it is key to improve internal control and audit systems and increase transparency at the local level. Conflict of interest situations should be managed by better enforcing existing regulation on transparency of income and assets and external activities of public officials. For example, as members of procurement committees are not always appropriately declared as public officials by their heads of institutions to the State Revenue Service, the regulation is not always effectively enforced for all persons involved in public procurement and spending decisions. This is also the case for some public agencies and SOEs at the national level, for example related to decisions on the allocation of EU funds. Ensuring that the existing strict transparency regulation for public officials is enforced for all persons involved in procurement and spending decisions is key for raising transparency and reducing the scope for corruption.

Figure 1.21. Net public investment has been weak



Source: OECD National Accounts database.

Improving the governance of state-owned enterprises

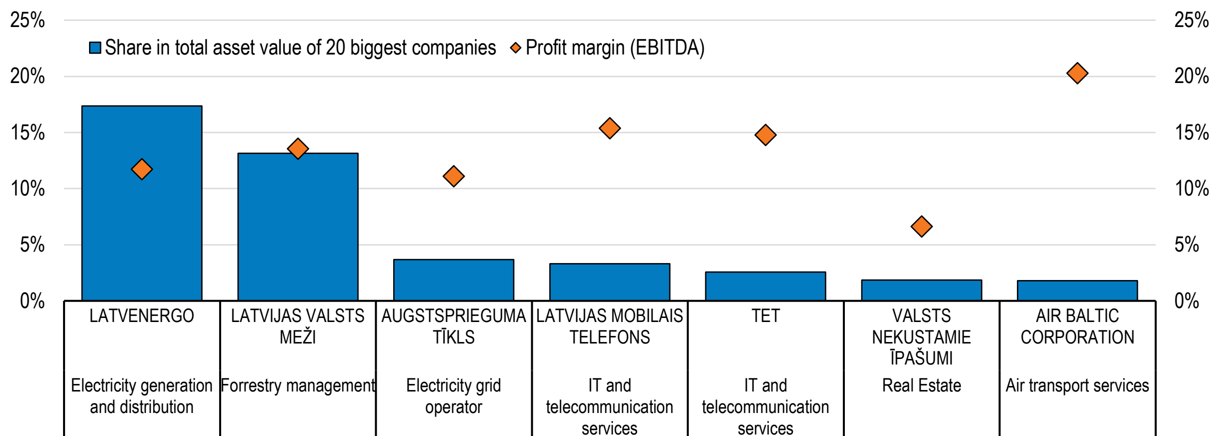
In Latvia, state-owned enterprises (SOEs) play a larger role in the economy than in other OECD countries (OECD, 2022[1]). About 7% of the workforce is employed in SOEs, which is triple the OECD average (Figure 1.17). Seven of the largest 20 companies in Latvia are state-owned with 42% of total assets of the largest 20 companies (Figure 1.22). Profits (measured as EBITDA) of the seven biggest SOEs amount to 2.8% of GDP in 2022, significantly contributing to the central government budget through dividend payments. The sectoral scope of SOEs is relatively broad compared to other OECD countries, indicating room for reducing the presence of SOEs in commercial activities (Box 1.2).

Although Latvia follows OECD best practices and assesses the rationale of state-ownership every five years, the ownership structure of SOEs has not changed much since 2015 despite the broad scope of SOEs. According to the law, SOEs that do not correct market imperfections or serve strategic and national security purposes should be divested, but criteria for justifying state-ownership remain relatively vague (OECD, 2021[71]). Better defining assets, goods and services of strategic interest and conducting in-depth analysis on the presence of market failures and the consequences of state-ownership on competition is key for making decisions on the rationale for state-ownership more transparent and improving social welfare (IMF, 2019[72]; OECD, 2021[73]). The SOEs that so far have been excluded from the assessment, such as the post, railroad, airport, television, radio and theatre companies, should be included in future reviews. For those SOEs that remain public, ensuring that ownership is entirely separated from the state's

other roles as regulator and policy maker is key to ensure competitive neutrality and foster business dynamism and innovation.

Figure 1.22. Major SOEs are active in various markets and are highly profitable

Share in total asset value of 20 biggest companies (in %, 2023) and profit margins measured as earnings before interest, tax, depreciation and amortisation (EBITDA) as a share of total turnover (in %, 2022)



Source: Data portal on state ownership in Latvia: http://www.valstskapitals.gov.lv/lv/.

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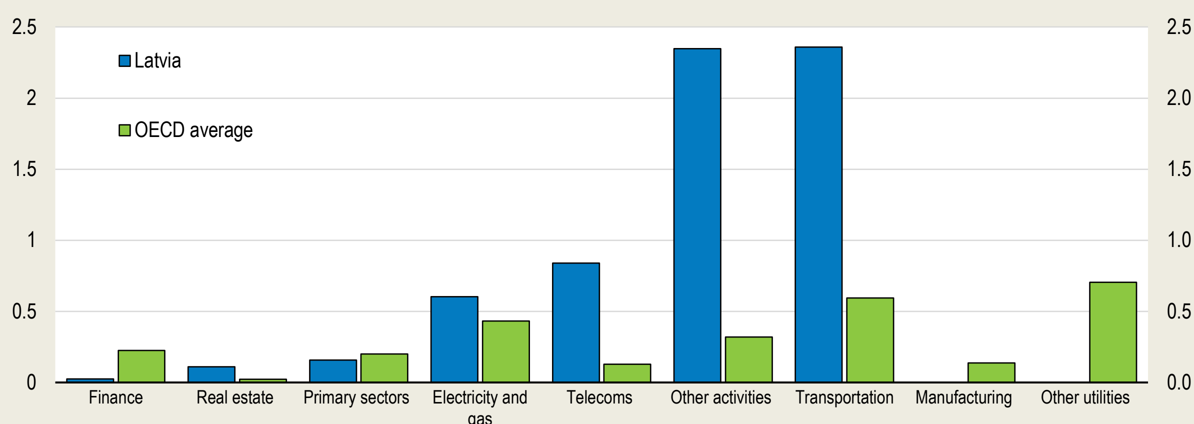
Box 1.2. The sectoral scope of SOEs is relatively broad in Latvia

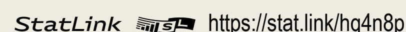
Overall, there are 65 fully owned and four majority owned SOEs managed by the central government, which are active in air, rail and road transport, telecommunications, logistics, energy generation and distribution, including electricity and natural gas, construction, forestry, real estate as well as consumer services, such as gambling or cultural activities (OECD, 2021[71]). Moreover, about 330 SOEs are owned by 43 municipalities, operating in areas such as utilities, public transport, construction but also in health services, sport, or cultural activities. Employment in local SOEs represents about 40% of total employment in SOEs (OECD, 2019[2]). Compared to other OECD countries, the share of SOE employment in transport and IT and telecommunication services, energy generation and distribution, real estate as well as other commercial activities, such cultural activities, health services and media, is high in Latvia (Figure 1.23).

Figure 1.23. The presence of SOEs is strong in many markets

SOEs employees, % of total employees, 2015



Note: OECD average is an unweighted average of 33 OECD countries. “Other activities” for Latvia include healthcare, culture, education and sports, public media, environment and legal services sectors.
Source: (OECD, 2017[74])

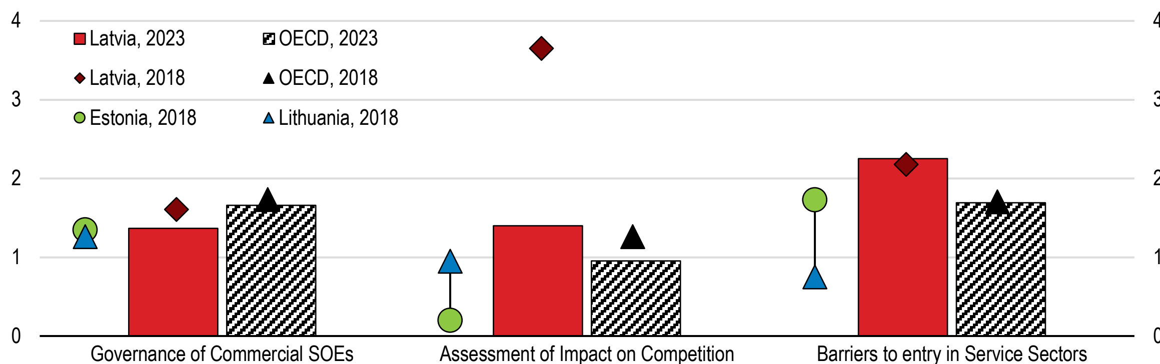


The Competition Council should be further strengthened and play a central role in evaluating the presence of market failures and the consequences of state ownership on competition and market outcomes. As many SOEs act as an income source for the government, there is a potential conflict of interest between revenue generation and competition enforcement. Although there has been some improvement since 2018, Latvia still ranks below the OECD average in the competition assessment of regulation according to the 2023 OECD Product Market Regulation Indicator (Figure 1.24). At the same time, market entry barriers in services sectors, where SOE presence is high, are still among the highest across the OECD, reducing business dynamism, innovation and productivity (see Chapter 2). A 2020 law established the principle of competitive neutrality for SOEs. Legislation also requires the central government and municipalities to ask the Competition Council for an evaluation of their SOEs regarding justification of their ownership. However, not all SOEs have been evaluated so far, as many municipalities have not requested an assessment. Due to its advisory role, the Competition Council can only act upon request of a public body and cannot mandate any regulatory changes, but only provide advice. The same is true for the assessment of the effects of new and existing regulations on competition. The Competition Council should receive the power to start market investigations on the competition effects of regulation and state ownership rationale of SOEs to ensure competitive neutrality. In other OECD countries, such as Italy, Spain or Romania, the competition authority can also challenge administrative decisions and regulations issued by public bodies in case it finds that they hamper competition, which is not the case in Latvia (see Chapter 2) (OECD, 2016[75]) (Whish, 2020[76])

(Motta and Peitz, 2021[77]) (OECD, 2021[78]). Latvia is one of the few OECD countries that has not yet conducted an OECD review of the competition policy framework. Conducting such a review, including financial market regulation, could help to identify and implement the necessary policy changes to improve competition enforcement.

Figure 1.24. Competition assessment of regulation has improved but remains weaker than in other OECD countries

OECD Indicators of Product Market Regulation (PMR), index scale of 0-6 from least to most restrictive (higher values indicate worse performance)



Note: OECD average for 2023 includes all OECD countries, apart from Belgium, Hungary, Mexico, the Netherlands, and the United States for which data collection is still ongoing. PMR values for Estonia and Lithuania for 2023 will only be released in Summer 2024.
Source: OECD (2023), Product Market Regulation Database (forthcoming).

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There is also room to continue to improve the governance of SOEs (Figure 1.24). Currently, public ownership of SOEs is dispersed across 13 ministries, one public agency and one SOE functioning as a public asset manager. The Cabinet of Ministers sets strategic objectives for SOEs, while the capital-shareholding ministries and supervisory boards, which exist only for larger SOEs, set annual financial and non-financial objectives. Although the State Chancellery located under the prime minister's office is tasked to coordinate policies related to SOEs and evaluate their performance, standards in terms of transparency, accountability and performance are not unified across SOEs (OECD, 2022[1]). Following the 2015 OECD Guidelines on Corporate Governance of SOEs and centralising all SOEs into a single holding entity could help clarify their objectives, unify transparency, accountability and performance standards and better monitor performance (OECD, 2015[79]).

There is no centralised performance evaluation for municipal SOEs, and transparency on financial statements, employment, wage payments and public subsidies remains relatively weak. A website exists, where most municipalities publish some information on their SOEs online, but comparability of the data is weak (Delna, 2021[80]). Many of these SOEs have a larger labour share and weaker productivity than private firms with similar turnover, contributing to factor misallocation and raising prices and potentially reducing quality of inputs for private firms (IMF, 2019[72]) (see Chapter 2). Softer budget constraints of local SOEs, due to weak incentives for spending efficiency of local governments (see above), might distort competitive neutrality and present a fiscal risk (IMF, 2019[72]). This is particularly problematic as bond issuance of municipal SOEs is planned to be facilitated (Cabinet of Ministers, 2023[81]). A rigorous evaluation of the effects of SOE presence and fiscal and procurement relations with municipalities on competition and market outcomes is key and should be facilitated by improving data availability and transparency, including for external researchers, and making separate accounting for commercial and other activities of SOEs mandatory (see Chapter 2). Expanding the role of the State Chancellery to also set performance standards for local SOEs and monitor their performance would be an important step to improve their governance, as for example done in Lithuania (OECD, 2021[71]). Supervisory boards should be made mandatory for all commercially oriented SOEs and the nomination process coordinated by the

State Chancellery. At least 50% of the board members should be independent according to the law, but "independent" should be better defined to reduce political influence (OECD, forthcoming[82]).

Listing minority shares of larger SOEs could also help improve governance, foster competition and attract foreign investors to domestic capital markets (see Chapter 2). The listing can improve data transparency and the separation of commercial activities and activities pursuing public policy goals, including those of statutory natural monopolies, thereby strengthening the enforcement of competitive neutrality (OECD, 2021[78]; OECD, 2019[83]). In OECD countries, 45% of all SOEs by equity value and 25% of all SOEs by employment are listed enterprises, while in Latvia there is so far no listed SOE (OECD, 2017[74]). Thus, there is scope for listing SOEs in Latvia, particularly larger SOEs in commercial activities, such as telecommunication and transport services, energy generation and distribution or real estate. However, to safeguard competitive markets, independent and well-resourced regulators and a well-functioning competition enforcement are key conditions for listing SOEs (OECD, 2019[83]).

Table 1.8. Past recommendations and action taken on improving public sector capacity and spending efficiency

Previous recommendations	Action taken
Modernise human resource management by further developing results-oriented pay	A 2022 reform aims to reduce the public sector pay gap to the private sector and introduces more pay flexibility according to employee qualification and job performance evaluation.
Simplify the application procedure for EU funds and streamline the regulations on the management of EU-funded projects	No action taken
Improve cost-benefit analysis and the selection process for new infrastructure projects, prioritising road safety.	New rules for impact assessment of infrastructure projects were introduced in 2022.
Strengthen the transparency of public procurement by ensuring the independence of institutions in charge of combating corruption and by providing practical guidance on conflicts of interest	An e-procurement platform has been introduced that is mandatory for all levels of government and tender values above EUR 10,000 for supply and service contracts and EUR 20 000 for public works.
Centralise the SOEs' ownership model. Increase participation of private investors in SOEs.	SOEs were asked to identify financing needs for enterprise growth strategies, but no decisions on listing of SOEs have been taken.
Extend the monitoring framework for state-owned enterprises to large commercially-oriented municipality-owned enterprises	No action taken.
Strengthen the authority of the Competition Council to intervene against anticompetitive behaviour by state-owned and municipal enterprises.	No action taken.

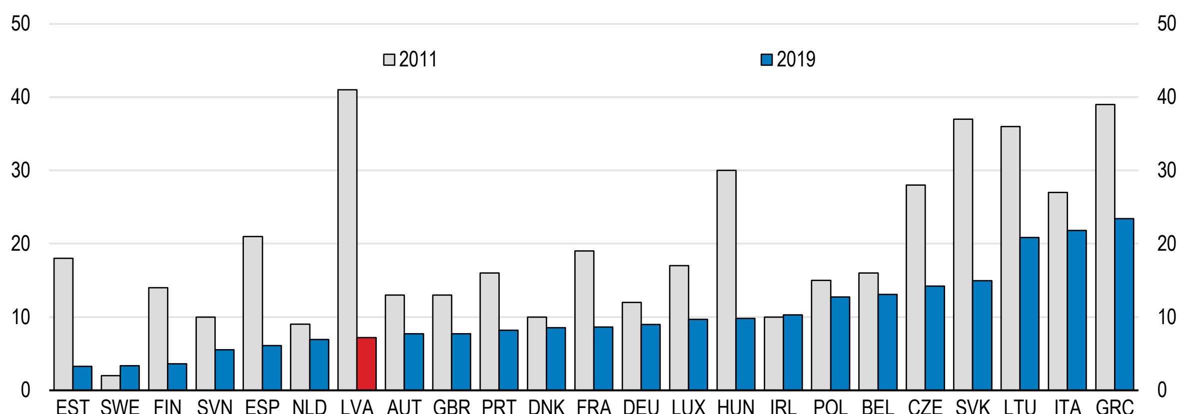
Fighting tax evasion, corruption and money laundering

Further improving tax enforcement and reducing informality

Since 2011, Latvia has made impressive progress in reducing VAT evasion (Figure 1.25). This is related to a range of measures, such as the introduction of automatic exchange of information on sellers on digital platforms, cash-payment restrictions in the construction sector, reverse charging procedures and the use of data and digital technologies to better target inspections. However, the size of the shadow economy has not decreased and is still above 20% of GDP in 2022 (Sauka and Putnins, 2023[27]; Schneider, 2022[28]). The most common form of informality is underreporting of hours worked and wages, whereby workers are formally employed at the minimum wage and the unreported wage income is paid out in cash through the so-called envelope wages (Gavoille and Zasova, 2023[84]). In 2022, the share of unreported wages in total wages was estimated at about 25% on average, with higher shares in construction, retail and other services sectors, strongly reducing revenue from personal income tax and social security contributions (Sauka and Putnins, 2023[27]). Around 11% of employees are estimated to be working without any contract and 16% of total business profits to be unreported.

Figure 1.25. VAT enforcement has considerably improved

VAT gap, % of VAT Total Tax Liability (VTTL)



Note: The VAT GAP is the overall difference between the expected VAT revenue and the amount actually collected.
Source: European Commission, Directorate-General for Taxation and Customs Union, VAT gap in the EU : report 2021, Study to quantify and analyse the VAT gap in the EU-27 Member States : report 2013.

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The reasons for informality and tax evasion are manyfold and addressing them requires a cross-cutting strategy, but strengthening enforcement should play a key role. First, high effective marginal tax rates reduce incentives to raise formal labour supply, particularly for low-income earners, which should be addressed by a comprehensive reform of the tax and transfer system (see above). Second, low trust in institutions and weak quality of public services also contribute to low tax morale and informality (Putniņš and Sauka, 2015[85]; Sauka and Putnins, 2023[27]). This should be addressed by improving the capacity of the public sector to deliver high quality public services, continue the fight against corruption and better inform citizens about the benefits of the social security system and public services (see below). However, this needs to be combined with strengthening enforcement efforts, as the detection probability and the level of negative sanctions significantly affect tax compliance (Putniņš and Sauka, 2015[85]).

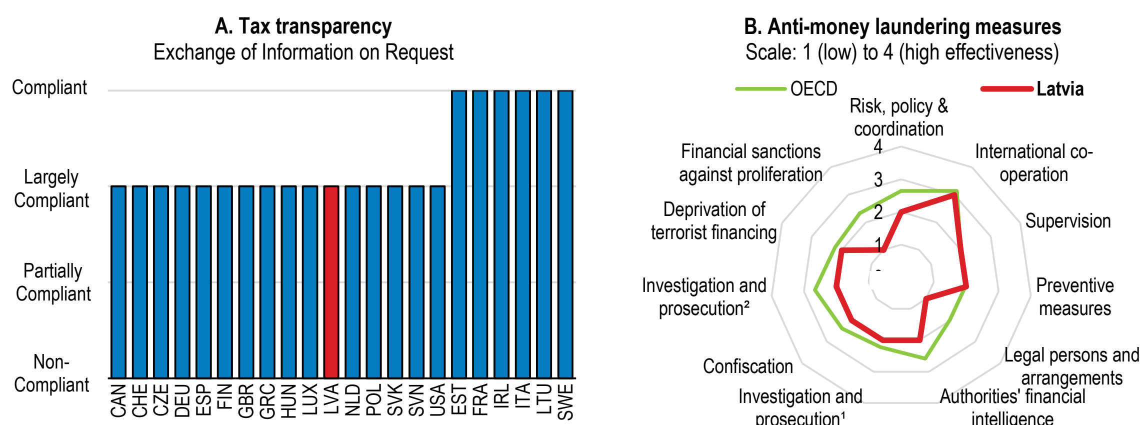
To reduce tax evasion, it is key to make electronic payment of wages and filing of an income tax declaration mandatory and better enforce strict economy-wide limits for cash payments. So far, the state revenue service (SRS) only disposes of a limited amount of information on taxpayers to guide its inspections, as not all of them are required to file an income tax declaration. Implementing existing plans for the mandatory filing of an electronic tax declaration for all taxpayers, while continuing to reduce the administrative burden by pre-filling declarations with information from previous years, should be a key priority. The abolishment of a labour law provision that allows for paying wages in cash should be combined with better enforcing economy-wide maximum thresholds for cash-payments, while at the same time fostering financial inclusion in remote regions (see Chapter 2). Introducing withholding taxes on payments to sub-contractors would help to reduce tax evasion in sectors where sub-contracting is widespread (World Bank, 2017[30]). As for a high share of minimum wage earners wage income is underreported, raising minimum wages can also reduce informality, although there are some negative effects on compliant firms and workers that slightly earn above the minimum wage (Gavoille and Zasova, 2023[86]).

Moreover, it is key to make e-invoicing mandatory and better enforce the recently introduced obligation to use electronic cash registers to fight underreporting of income and revenue by firms and further reduce VAT evasion. The annual turnover threshold below which self-employed workers and firms do not have to pay the VAT will be raised to EUR 50 000 in 2024, which is relatively high compared to other OECD countries. This should be carefully evaluated to ensure efficient use of public resources.

These measures should be combined with further strengthening the capacity of the SRS through raising its budget resources and improving human resource policies and the IT infrastructure. Better cooperation

and data exchange with other law enforcement agencies and public bodies are key to improve the risk-based approaches to guide inspections, which would also strengthen the fight against money laundering (Figure 1.26). For example, introducing the mandatory electronic registration of workers on construction sites has been an important step, but enforcement has suffered from an insufficient number of inspectors and the inability to link registered workers and wage payments with firm revenue, tax, social security, bank account and planned construction cost data to detect inconsistencies and successfully guide inspections. Moreover, as recommended by the previous OECD Economic Survey of Latvia, heavy penalties for tax evasion should be effectively enforced to deter criminal behaviour. Improving whistleblowing procedures would also help. This should be combined with continued efforts to raise tax morale by providing advisory services to taxpayers and rewarding compliance (World Bank, 2017[30]). The SRS has recently introduced a public scoring system based on the compliance history of taxpayers to guide procurement decisions and reward compliance through reputation effects. Providing advisory services is particularly important for new firms, for which the likelihood that non-compliance is related to a lack of knowledge is higher.

Figure 1.26. Financial intelligence and cooperation across enforcement agencies need to improve



Note: Panel A summarises the overall assessment on the exchange of information in practice from peer reviews by the Global Forum on Transparency and Exchange of Information for Tax Purposes. Peer reviews assess member jurisdictions' ability to ensure the transparency of their legal entities and arrangements and to co-operate with other tax administrations in accordance with the internationally agreed standard. The figure shows results from the ongoing second round when available, otherwise first round results are displayed. Panel B shows ratings from the FATF peer reviews of each member to assess levels of implementation of the FATF Recommendations. The ratings reflect the extent to which a country's measures are effective against 11 immediate outcomes. "Investigation and prosecution[1]" refers to money laundering. "Investigation and prosecution[2]" refers to terrorist financing. Data for Latvia is based on Moneyval's 5th-round evaluation report on Latvia published in 2018 and does not reflect institutional changes since 2018.
Source: Panel A: OECD Secretariat's own calculation based on the materials from the Global Forum on Transparency and Exchange of Information for Tax Purposes. Panel B: OECD, Financial Action Task Force (FATF).

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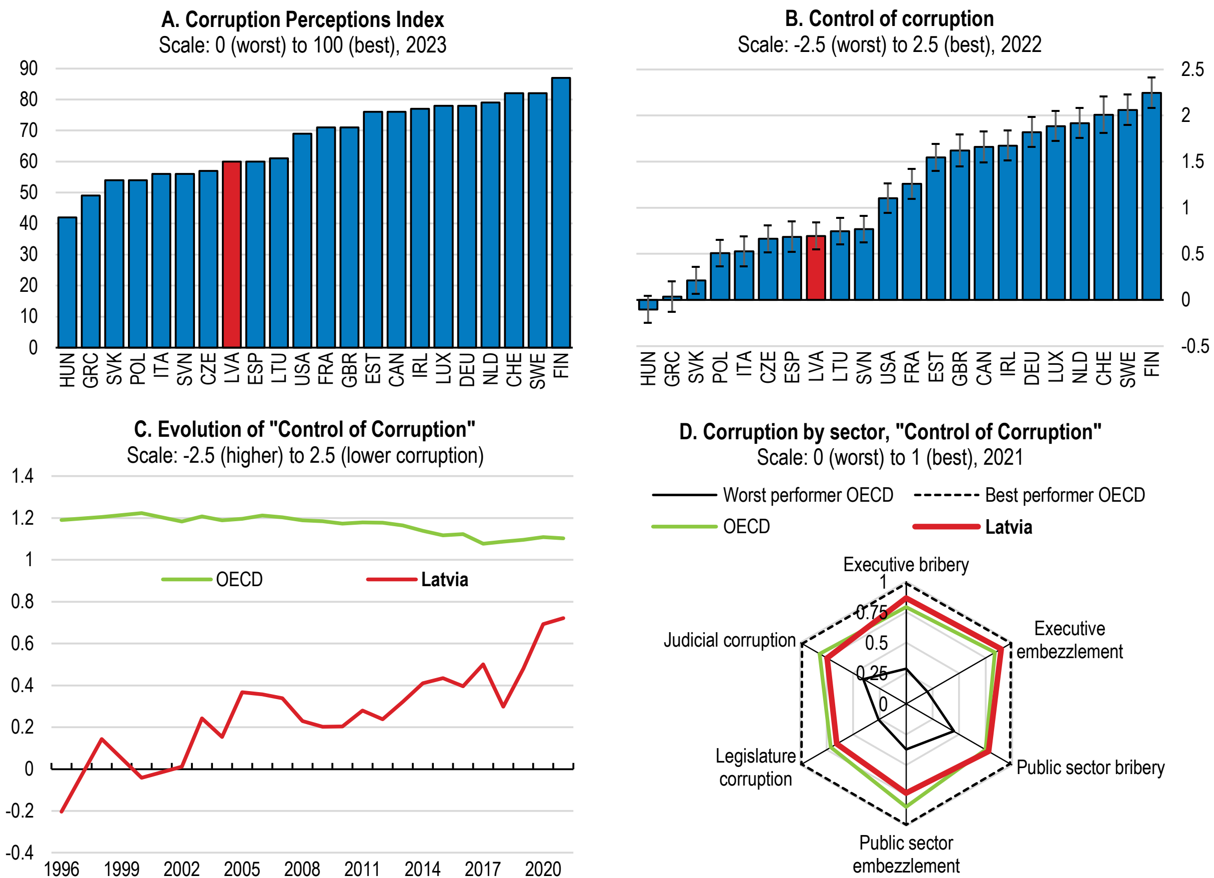
Continuing the fight against corruption and money laundering

Since 2017, Latvia has significantly stepped up the fight against corruption and money laundering (Figure 1.27). Several cases of large-scale money laundering through banks and corruption cases have strongly reduced trust in political institutions, raising awareness among policy makers and leading to the effective implementation of a wide range of measures (Figure 1.28). Resources for the anti-corruption agency (KNAB) have been increased and coordination with other law enforcement agencies improved. Public disclosure of the financial situation of public officials has been made mandatory and a two-year cooling-off period applies to higher officials leaving the public sector. The implementation of a comprehensive transparency registry of beneficial ownership has greatly facilitated financial intelligence related to money laundering and tax crimes as well as asset recovery. Moreover, amendments to the law on party financing created a transparent mechanism of resource allocation to parties and established strict limits for donations and their immediate public disclosure (Figure 1.28). Anti-money laundering regulation

has been implemented successfully, strongly reducing deposits held by foreigners, although there is scope to reduce the administrative burden for firms and households (see Chapter 2).

However, there is still a long way to go to bring back trust in institutions to the OECD average (Figure 1.27, Figure 1.28). A recent opinion survey of the KNAB found that better enforcing the existing heavy penalties against corruption and economic crimes, as recommended by the previous OECD Economic Survey of Latvia, would be the most effective way to combat corruption and raise trust in institutions (KNAB, 2022[87]). Lengthy court proceedings, particularly in complex cases against top public officials, and many verdicts not fully applying penalties foreseen by law cause dissatisfaction with the judiciary (OECD, 2022[1]). To address this issue, recent amendments to the criminal law broaden the definition of corruption and lower the burden of proof for conviction by expanding the definition of harmed interests related to the criminal offense. To shorten procedures, the recent establishment of the Economic Court, which is a specialised court for complex cases related to corruption, money laundering and economic crimes, has improved efficiency and quality of judicial procedures and its remit should be expanded (see Chapter 2).

Figure 1.27. The fight against corruption has been improved



Note: Panel B shows the point estimate and the margin of error. Panel D shows sector-based subcomponents of the "Control of Corruption" indicator by the Varieties of Democracy Project.
Source: Panel A: Transparency International; Panels B & C: World Bank, Worldwide Governance Indicators; Panel D: Varieties of Democracy Project, V-Dem Dataset v12.

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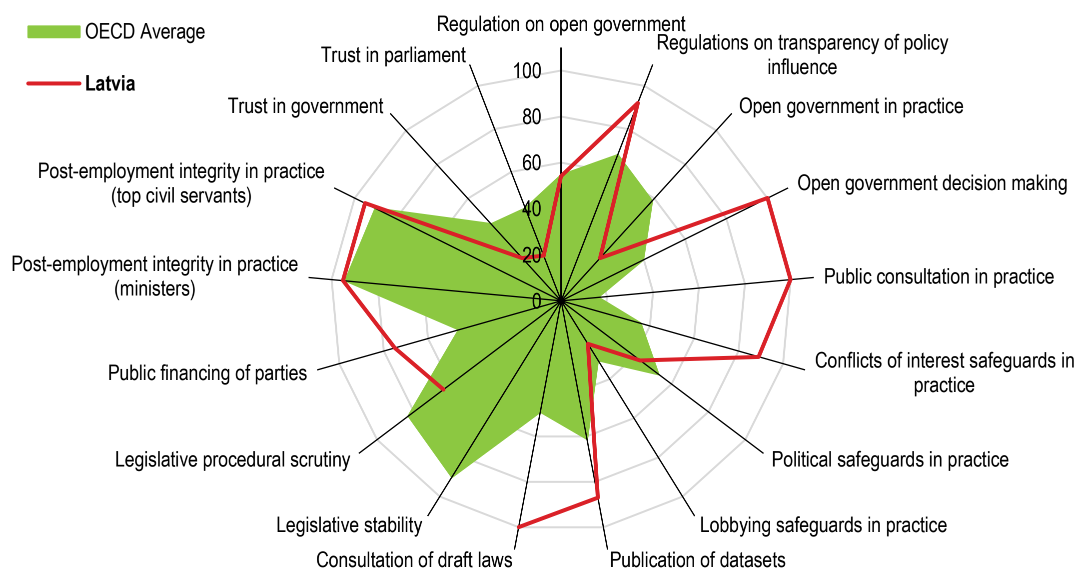
Figure 1.28. Transparency concerning political lobbying needs to improve to foster trust in institutions

OECD Public Integrity Indicators (OECD PII), 2022



Source: OECD Public Integrity Indicators, https://oecd-public-integrity-indicators.org/.

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To raise transparency and integrity in lobbying and reduce undue influence of special interest groups it is key to implement and enforce the planned lobbying register as a comprehensive and centralised transparency register with a legislative and regulatory footprint (Figure 1.28). Latvia has yet to create a publicly available lobbying register, which already exists in more than half of OECD countries (OECD, 2023[88]). Including all contacts with public bodies in a centralised register, including at the municipal level, is key for effectively raising transparency, as for example done in Ireland (OECD, 2020[89]). Municipalities are responsible for around 30% of public spending and the share of firms reporting issues with corruption is much higher in some of the more remote regions compared to the national average (OECD, forthcoming[70]). The legislative footprint, which links lobbying activities to their legislative outcomes, should be complemented with a regulatory footprint to include lobbying to influence the drafting of regulation. For the register to be effective, an independent supervisory body with sufficient resources and investigative powers should be responsible for its enforcement and sanctions should be applied for non-compliance. Regulations related to party financing as well as asset and income disclosure of public officials are strong, but more could be done to ensure that all political parties submit their required financial statements on time and the KNAB should employ the services of certified auditors to verify the content of these financial statements (OECD, forthcoming[90]) (Delna, 2021[80]). Better enforcing compliance with access to information regulation and facilitating data linkage and analysis for external researchers would raise transparency and compliance. In addition, side activities of public officials should be made transparent more quickly to prevent conflicts of interest, particularly at the municipal level.

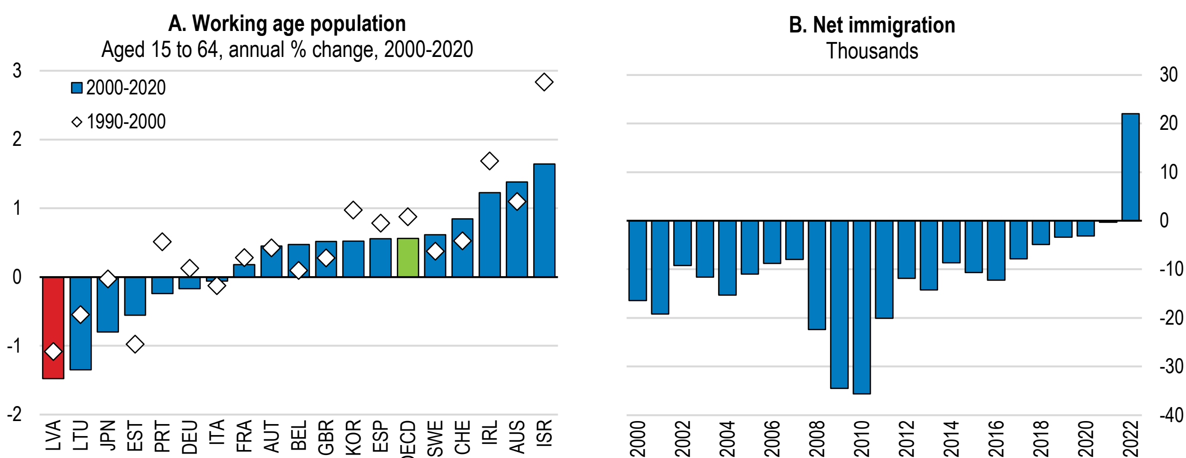
Table 1.9. Past recommendations and action taken on fighting tax evasion, money laundering and corruption

Previous recommendations	Action taken
Continue to fight corruption, increase transparency in public procurement processes, and enforce the heavy penalties for tax evasion and bribery that existing legislation allows.	Recent amendments to the criminal law broaden the definition of corruption and lower the burden of proof for conviction by expanding the definition of harmed interests related to the criminal offense. An app was introduced to facilitate whistle-blowing. A lobbying register is planned, but implementation is still ongoing.
Ensure the accountability of judges, including by extending the deadlines for dealing with disciplinary cases.	Amendments have been made to extend the imposition of a disciplinary penalty on judges, as well as extending the statute of limitations for disciplinary liability from two to four years.
Offer sufficiently high wages to attract qualified personnel in law enforcement agencies.	Salaries have increased in recent years, but there is still a gap compared to the private sector.

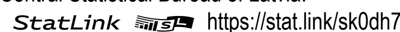
Improving investment in human capital and raising migration to address skilled labour shortages

Large emigration and a falling working age population have weighed on potential growth and have exacerbated skilled labour shortages (Figure 1.29, Figure 1.2). Unemployment has steadily fallen since the global financial crisis and the number of unfilled job vacancies has strongly increased (Figure 1.30, Panel A). However, regional heterogeneity in labour market tightness is large (Figure 1.30, Panel B). Most vacancies are concentrated in the metropolitan area of Riga and Pieriga, where unemployment rates are low. In regions further away from Riga, unemployment rates are much higher and vacancy rates lower. Thus, raising regional labour mobility and expanding remote work opportunities is one key policy lever to reduce mismatch in the labour market. Improving transport infrastructure and digital connectivity in remote areas and providing mobility subsidies and affordable housing are key and have been discussed in earlier Economic Surveys of Latvia (see Chapter 2) (OECD, 2019[2]; OECD, 2017[91]; OECD, 2022[1]). However, this must be combined with policies to reduce skills mismatches and improve human capital. It is key to raise the quality of education and training to equip current and future workers with the skills required in the labour market, improve health outcomes to enable experienced workers to work longer and facilitate skilled migration.

Figure 1.29. Large scale emigration has reduced the working age population



Source: United Nations (2022), World Population Prospects: The 2022 Revision, Online Edition; Central Statistical Bureau of Latvia.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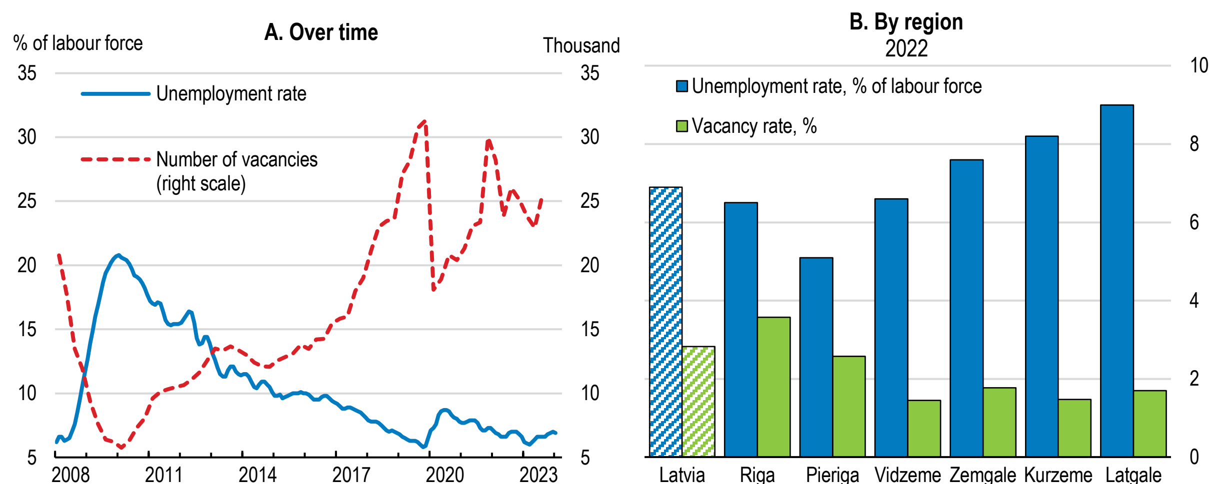
Although major steps to consolidate the VET school network and improve the quality of VET have been made, important challenges remain. The accreditation of new courses or changes of existing curricula is centralised at the national level, which might hinder the timely adaptation of training content to skill needs in local labour markets. Although social partners participate in the centralised accreditation procedures through the sectoral expert council (SEC), more than half of all firms, and particularly smaller ones, are not organised in employer associations, reducing the responsiveness of the SEC to skill demands in local labour markets (OECD, 2022[92]). Giving regional VET institutes more power to coordinate the content of VET programmes with local employers and facilitating accreditation procedures, as foreseen by amendments to the VET law in 2022, is key to better adapt training content with skill needs in local labour markets (OECD, 2019[2]). This should be combined with improving coordination among firms of the same sector, for example by making membership in the business association mandatory, to increase incentives for firms to participate in VET design and implementation and provide on-the-job training (see Chapter 2).

Figure 1.30. The labour market has tightened, but unemployment remains high in some regions



Note: The vacancy rate in Panel B refers to the share of vacancies in the total number of jobs, which is the sum of occupied jobs and vacancies.
Source: Central Statistical Bureau of Latvia; and Eurostat.

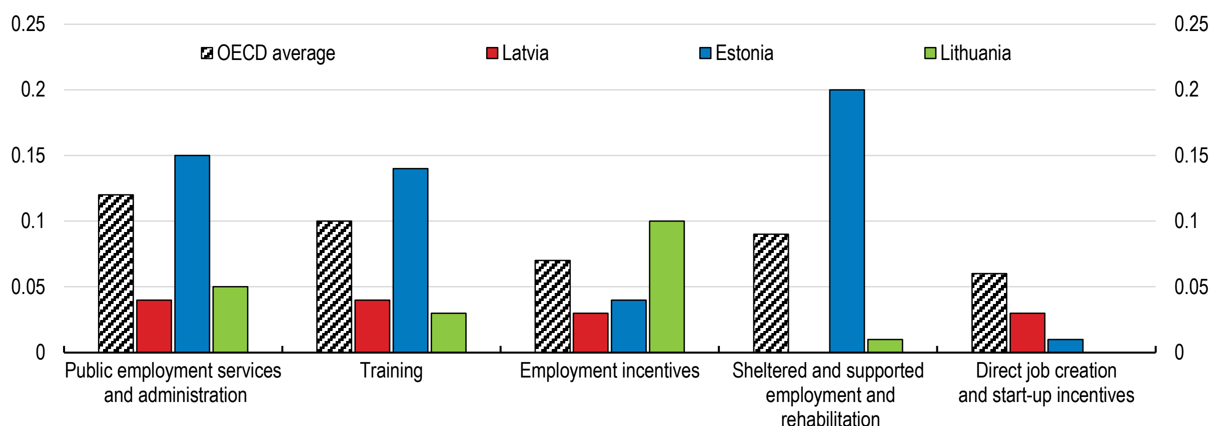
Although active labour market policies have been improved with the help of EU structural funds, spending on active labour market policies remains weak, particularly given the relatively high unemployment rates in some regions (Figure 1.31, Figure 1.30). Better cooperation with VET institutes is needed to provide adult education and VET courses that help the unemployed acquire the skills that are needed in local labour markets, including digital and Latvian language skills. As recommended by the 2019 Economic Survey of Latvia, the hiring of more counsellors and the expansion of successful training programmes should be financed by domestic resources to provide more continuity in public employment services, as the strong dependence on EU structural funds has complicated the continuity of successful programmes in the past (OECD, 2019[2]). Moreover, only about half of the unemployed receive unemployment benefits and duration of benefits is low, which reduces matching quality in the labour market and forces many unemployed to accept low-wage job offers (OECD, 2022[1]). Increasing the eligibility of unemployment benefits, as recommended by the previous Economic Survey of Latvia, coupled with the provision of re- and up-skilling opportunities linked to skill needs in local labour markets would help to reduce skill mismatches (OECD, 2022[31]). Germany has recently expanded the eligibility conditions for unemployment benefits for unemployed persons enrolling in a VET programme (OECD, 2023[61]).

Improving health outcomes is key to enable experienced workers to work longer and raise domestic labour supply (Figure 1.32). About a third of the unemployed has been without a job for more than a year, which is mainly related to poor health conditions (OECD, 2022[1]). As discussed by the previous OECD Economic Survey of Latvia, access to health services is hampered by long waiting times, high out-of-pocket payments

and low supply of primary and home care. The recently announced increases in health spending, which is currently much lower than the OECD average, are welcome and will help to raise wages of doctors and other medical staff and reduce skilled labour shortages. However, improving working conditions, for example by reducing the number of patients per nurse, shortening work shifts or improving career paths and broadening responsibilities for nurses, is also key to make these professions more attractive. Further consolidating the hospital network and fostering digitalisation and the provision of digital health services are also key to mitigate labour shortages (OECD, 2022[1]). Including all hospitals and primary care units in the centralised digital e-platform would help prevent duplication of check-ups and laboratory tests, the cost of which has strongly increased in latest years. High drug prices can be reduced through centralised procurement procedures (see above). Focusing on preventive measures, such as promoting sport activities and improving road safety to reduce accidents, and further raising taxes for alcohol and tobacco are also key to improve health outcomes (OECD, 2022[1]).

Figure 1.31. Spending for active labour market policies is low

Public expenditure on active labour market policies, % of GDP, 2021

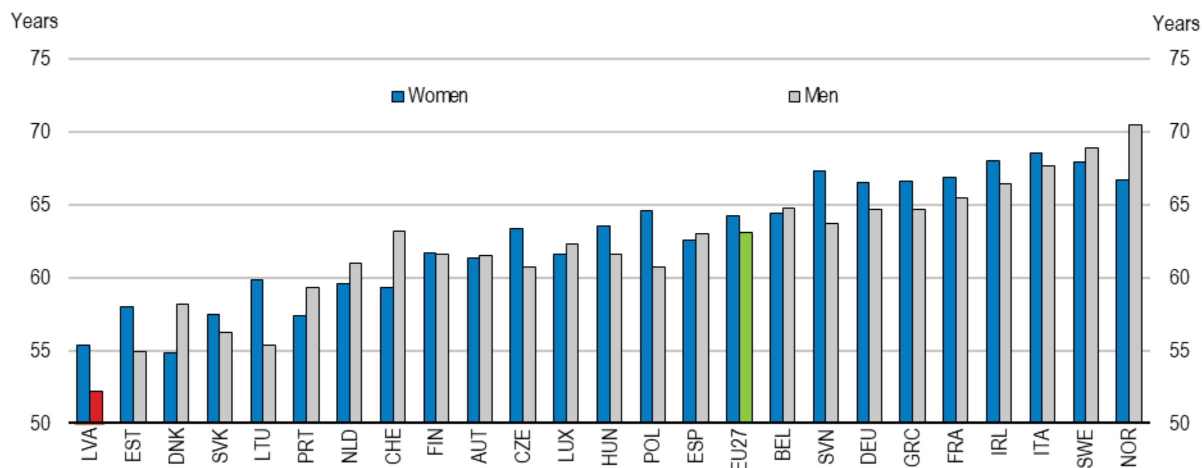


Note: Data exclude temporary employment maintenance.
Source: OECD Labour Force Statistics.

The average Latvian students performed slightly better than the OECD average in PISA 2022, notably in science and mathematics, and educational inequality is relatively low. However, the best performing students lag their peers in other countries (Figure 1.33). This can be a problem in the long term, as labour shortages in many high-skilled occupations such as STEM and ICT professionals are high in Latvia. The implementation of a comprehensive reform of learning standards and curricula in early-childhood, primary and secondary education is ongoing, focussing on transversal, digital and ICT skills as well as improving the quality of STEM and foreign language teaching. Additional nation-wide exams will be introduced in primary and lower secondary education to monitor the implementation of the new curricula, better target support to students with difficulties and evaluate school performance. Publishing these results is important to raise incentives for municipalities to improve teaching quality, as municipalities have received more responsibilities for allocating resources across schools. Further consolidating the school network and using fiscal savings to continue raising teacher wages and improving working conditions, for example by reducing the high share of teaching in total hours or hiring teacher assistants for classes with many disadvantaged students, is key to address teacher shortages and improve teaching quality. This would also facilitate teacher training, which is particularly important for implementing the objective of educating all children in Latvian from 2025, as many older teachers can still improve their Latvian language skills.

Figure 1.32. Health outcomes are weak

Healthy life years at birth, 2021 or latest available year



Source: Eurostat.

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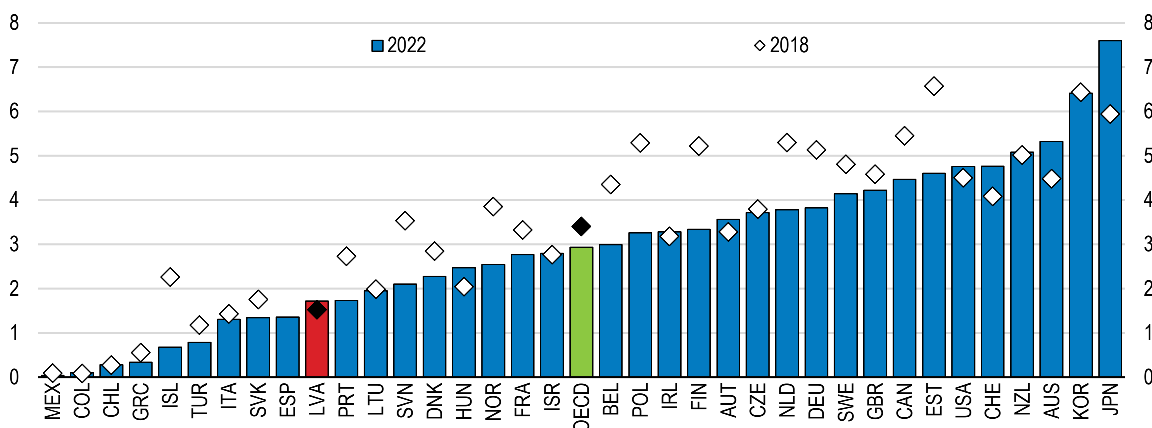
Figure 1.33. Education quality should be improved

Top performers in science, mathematics and reading, % of 15 year-old students



Note: Top performers in science, mathematics and reading are students who achieved the highest level of proficiency (i.e. Levels 5 and 6) on the OECD's PISA assessment.
Source: OECD (2020), PISA 2018 Results (Volume I); OECD (2023), PISA 2022 Results (Volume I).

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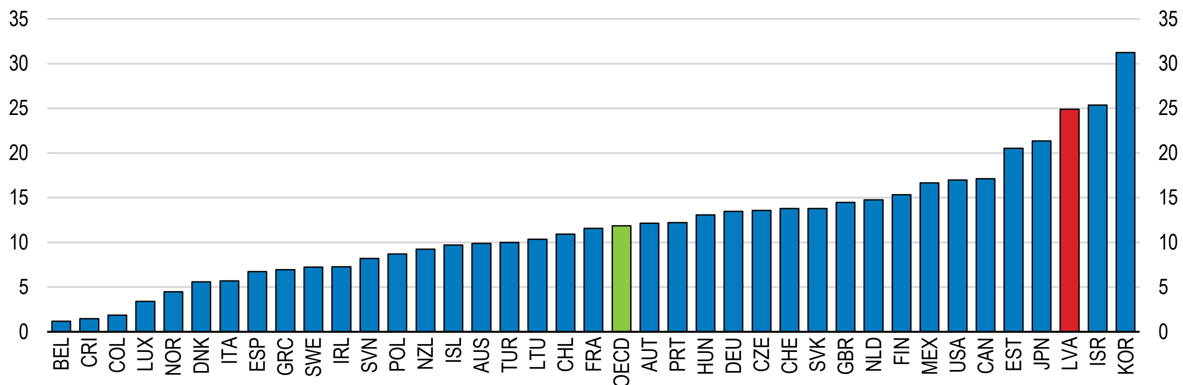
Encouraging more women to participate more intensively in the labour market would help to address labour shortages. In 2022, the female employment rate was 2.5 percentage points higher and the difference to the male rate 10.1 percentage points smaller than in the average OECD country. However, the gender pay gap for formal full-time employees is very high compared to other OECD countries (Figure 1.34). This partly reflects a misallocation of female talent into occupations and economic sectors with on average lower wages (Figure 1.35). Although more women than men attain tertiary education, the share of women graduating in STEM and other study fields with high labour market returns is much lower. Promoting role models can help tackle gender stereotypes and encourage girls to enter high-skilled occupations which are in short supply. Better informing lower secondary students about labour market trends could also help.

Figure 1.34. The gender wage gap for full-time employees is high

Gender wage gap, % of men's wage, 2022 or latest available year



Note: Figures report the difference between men and women's median gross earnings as a share of men's median gross earnings for full-time dependent employees; OECD refers to the simple average of 38 Member countries.
Source: OECD Employment and Labour Market Statistics (database).

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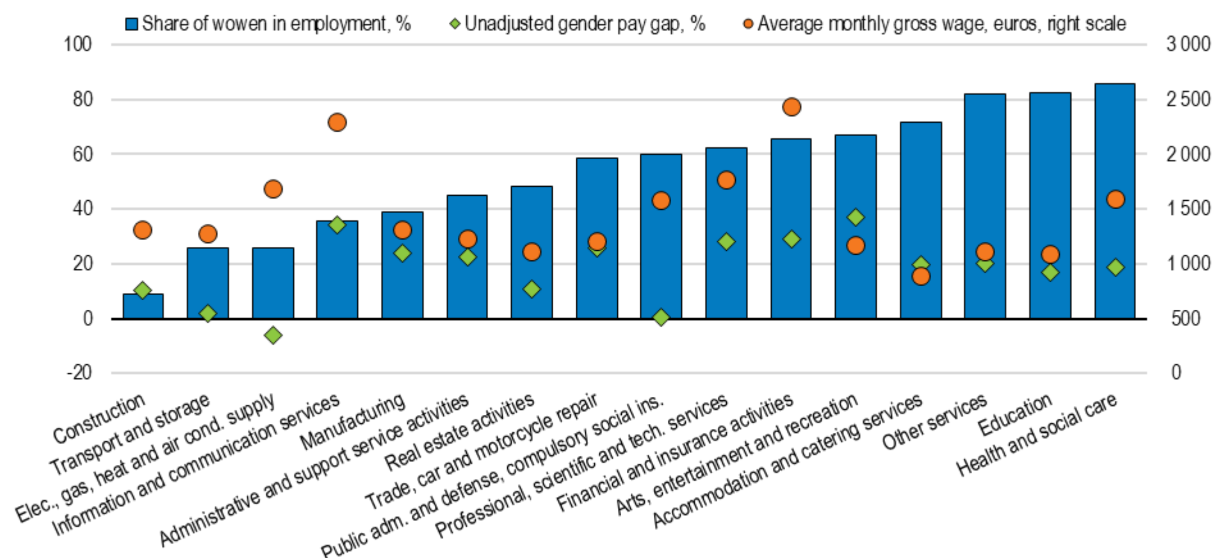
The gender wage gap is particularly high for workers between 25 and 44 years, which is related to the motherhood penalty (Latvian Statistics Institute, 2023[93]). Labour market participation rates for women in this age group are significantly lower than for men due to child caring activities. The higher engagement of women in childcare may be related to cultural reasons but is also strongly linked to incentives in the social transfer system. Before 2023, paid parental leave did not include any restrictions on who takes the leave, resulting in an average of 49 weeks for women and 1 week for men according to the OECD family database. From 2023, 2 months of the available paid parental leave duration have to be taken by the second parent or will be deducted from the total duration. This is a welcome step in the right direction, but a further increase in the compulsory sharing of parental leave among parents should be combined with limiting the parallel parental leave time to incentivise fathers to engage more in child caring activities.

Improving access to childcare is also key for improving labour market outcomes of women. About 36% of all families with children are single-mother families, who particularly suffer from weak access to childcare services. Costs for childcare are very low in international comparison, but weak infrastructure and high labour shortages complicate access to childcare, which is a core function of municipalities (see above). Continuing to provide funding to municipalities to raise investments in childcare facilities and addressing labour shortages through expanding training and flexible work arrangements is key for securing a sufficient supply of high-quality childcare services and reducing long waiting lists. Since 2020, state budget grants are provided to municipalities to raise investments in childcare facilities, and EU funds will further support these efforts during the next years. Continuing to improve access to childcare and further raising other child-related benefits could also help increase the low birth rate (OECD, 2023[94]). However, the design of child-related benefits should be closely coordinated with other features of the tax and transfer system to ensure sufficient incentives for parents to increase labour supply (see above).

Relatively high gender wage gaps in economic sectors where women form a large part of the workforce, indicate that discrimination also plays a large role in explaining why men in Latvia earn more than women (Figure 1.35) (Ciminelli, Schwellnus and Stadler, 2021[95]). According to labour force data in 2022, only 31% of higher management positions were filled by women, despite 56% of all mid-level managers being women. Only 23% of board members in Latvia's largest companies are women (EIGE, 2023[96]). To increase the share of women in top management positions, the introduction of a gender quota for the composition of managing and supervisory boards of companies could be introduced like in Germany, where this measure has led to an increase in the share of female top managers (Kirsch, Sondergeld and Wrohlich Katharina, 2023[97]). Moreover, making pay transparency mandatory in the private sector could help reduce wage discrimination, as increasing public attention and peer pressure at the firm level could

improve the negotiation power of women (OECD, 2021[98]). Conducting gender pay audits and closer monitoring of pay levels by gender could also help to reduce the gender wage gap. Since 2018, public employers are required to report monthly on their pay levels by gender, but no such obligation exists for private employers.

Figure 1.35. Women work in economic sectors and occupations with lower average wages



Source: Central Statistical Office.

Besides raising the domestic labour supply potential, further facilitating skilled migration is key to address skilled labour shortages in the short run. This is particularly important for preventing further increases in construction costs and ensuring the timely implementation of important infrastructure and green investment projects. Although application procedures for work permits and visa have been facilitated and digitalised, specific requirements for exercising occupations related to education and competences, including language proficiency, as well as wage thresholds still act as a barrier for raising migration. The share of occupations, including for managers, professionals and technicians, that can be exercised in English is among the lowest across OECD countries (Marconi, Vergolini and Borgonovi, 2023[99]). To facilitate skilled migration, it is key to foster the use of English and other languages of the European Union at work and lower occupation specific restrictions for migrants upon entry, while requiring attendance and successful completion of Latvian language courses after a certain time period. Moreover, as wages differ significantly across sectors, minimum wage thresholds for receiving work permits, which are set at the national average wage, have acted as a barrier to raise migration. A recent tri-partite agreement has introduced wage thresholds that are differentiated according to sectoral average wage levels, which will help facilitate labour migration To improve enforcement, a unique electronic identifier for work permit and visa holders should be established and data exchange should be improved across all public bodies. So far, information on employment and wages is missing for many work visa holders as they are not registered at the State Labour Inspectorate and data exchange with the visa authorities is insufficient. This facilitates posting of workers and wage dumping in other EU countries.

Further raising diaspora remigration can help reduce skill shortages and foster entrepreneurship, investment and innovation. Although more than 50 000 people have remigrated to Latvia in the last nine years, the diaspora remains large with a population of more than 370 000. In 2021, only a quarter of those returning to Latvia held a tertiary degree and around half of remigrants returned to the Riga region. Within the Plan for Work with Diaspora, the State Employment Agency manages programmes to raise awareness and provide information to members of the diaspora about work opportunities and living conditions in

Latvia, as well as the administrative steps involved in remigration. LIAA's regional business incubators and support units of LIAA have also been opened to expatriates to help them set up new businesses. Coupling these measures with temporary wage subsidies for highly skilled returnees in regions where there is a shortage of such workers and promoting support programmes for remigrants to transfer their businesses to Latvia would help to raise remigration.

Table 1.10. Past recommendations and actions taken on labour market, education and training and health policies

Previous recommendations	Action taken
Promote joint training offers involving several firms.	No action taken
Plan for the financing of EU funded training beyond the current EU budgetary cycle, if necessary from national sources.	No action taken
Expand eligibility for unemployment benefits.	No action taken
Provide schools with more flexibility in setting teacher wages to address recruitment difficulties for some subjects.	Minimum wages have increased for teachers in 2023 and municipalities can top up wages of teachers with own resources.
Boost student financial aid and provide appropriate financial incentives for tertiary institutions to increase their graduation rates.	Student stipends have been slightly raised but remain significantly below the minimum wage (140 EUR).
Facilitate issuing of work permits for construction employees from outside the EU, and support the adoption of digital technologies that help alleviate labour shortages.	Procedures for Approval of Invitations and Drawing up of Written Requests have been facilitated in December 2023.
Shed more light on gender pay gaps by sector and employer, notably in public firms, and continue efforts in addressing gender-specific perceptions and enforcing anti-discrimination legislation.	The employer confederation and Bank of Latvia have published research on the gender pay gap, but no policy action was taken so far.
Boost public health-care spending, and improve access to state-funded medical services and drugs to cut out-of-pocket expenses.	The health budget has increased by 16% in 2024 (0.4% of GDP), including additional financing to lower out-of-pocket expenses for medical drugs. Access to state-funded medical services remains restricted.
Consolidate the hospital network, and make greater use of digitalisation in the health-care sector.	Funding of EUR 140 million has been allocated to strengthen the hospital network and improve its human resources. An integrated palliative care service has been introduced and a unified digital oncology register has been developed. A nationwide laboratory prescription system, linking doctors with patients, is being developed.
Increase health-care spending on preventive measures, primary and home care, mental health treatment and long-term care.	Amendments have been made to the laws restricting advertisement of the marketing of tobacco and alcohol. Medium-term budget plans envisage increases in excise tax rates for tobacco and alcoholic beverages, however tax expenditures on these items remain high.

Accelerating the green transition

Latvia is among the OECD countries that have reduced greenhouse gas emissions the most compared to 1990 (-59% by 2021, excluding land use, land-use change and forestry, LULUCF). Nonetheless, almost all of the reduction happened in the early 1990s due to a decline of GDP by about 50% during the country's transition to a market economy (Zvidrins, 1998[100]). Since the early 2000s, Latvia has succeeded in decoupling GHG emission growth from GDP growth, but total GHG emissions have remained broadly constant, against the trend in the EU and mainly due to high emissions in transport, agriculture and residential buildings (Figure 1.36). In addition, there is a long-term increase in emissions in the LULUCF sector related to the conversion of forest land into settlements, cropland and grassland.

High costs due to climate change emphasise the need to accelerate emissions reductions. The number and frequency of extreme weather events have increased, and the share of built-up areas exposed to river flooding is the highest in Europe (OECD, 2023[101]). Estimated at EUR 164 million in the last decade for the forestry sector alone, Latvia's climate-related damages are already significant. Adaptation policies, therefore, should be mainstreamed in all government activities (IMF, 2023[4]). In 2019, the government adopted the Climate Change Adaptation Plan 2030, which outlined multiple adaptation strategies to reduce

social, economic, and biological risks. A monitoring website was created aiming to improve coordination between climate adaptation projects and track adaptation activities. Hydrologic, temperature, precipitation and drought statistics are available at national and sub-national levels. Going forward, changes in the intensity and frequency of floods from the Daugava River should be closely monitored, and national and sub-national climate risk assessment should be updated to quantify climate change effects on key sectors and better target the EU funds allocated to municipalities. Other OECD countries, such as Chile and Greece, could serve as examples in the development of climate risk maps (OECD, 2023[102]). Forward-looking land use policies and interventions could help reduce costs due to rising sea levels (IMF, 2023[4]).

Figure 1.36. Greenhouse gas emissions have not decreased since 2005

A. GHG emissions (production-based)
2005 = 100

B. A decomposition of CO_2 emissions trends for Latvia
2005 = 100

C. GHG emissions by sector
% of total, 2021

D. Net effective carbon rate
EUR per tCO2e, by sector, 2021

Note: In Panel B: CO2 emissions from fuel combustion in Latvia. GDP per capita refers to GDP USD PPP at 2015 prices divided per population, energy intensity refers to total energy supply per unit of GDP (USD PPP at 2015 prices), and CO2 intensity of the energy mix refers to CO2 emissions per unit of total energy supply.

Source: IEA Greenhouse gas emissions from energy database; OECD (2023), Green Growth Indicators, OECD Environment Statistics (database); IEA (2023), IEA World Energy Statistics and Balances (database); OECD (2022), Pricing Greenhouse Gas Emissions: Turning Climate Targets into Climate Action, OECD Series on Carbon Pricing and Energy Taxation, OECD Publishing, Paris, https://doi.org/10.1787/e9778969-en.

Carbon pricing should be strengthened to reduce emissions

Carbon prices in transport, buildings and agricultural sectors should increase to lower emissions. The EU Emissions Trading System (ETS) maintains strong incentives to reduce emissions and invest in clean technologies in the electricity and industrial processes sectors, which account for about a quarter of overall emissions in Latvia, a lower share than in most OECD countries (Figure 1.36, Panel C). However, more measures are needed to reduce emissions in the effort-sharing sectors, which the EU-ETS does not cover. Current policies are projected to reduce emissions in the effort-sharing sectors by 10% relative to 2005 levels in 2030, which is 7 percentage points lower than the required reduction according to the EU Fit-for-55 objective. Currently, effective carbon prices in the road traffic, buildings and agricultural sectors are considerably lower than the EU average (Figure 1.36, Panel D). The planned emission trading system at the EU level for road transport and buildings (from 2027) and the increase in green investment planned as part of Latvia's Recovery and Resilience plan would help to reduce emissions. Until the European trading system for road transport and buildings starts operating, a carbon price for all sectors not covered by the EU ETS should be introduced. As poorer households suffer more from higher carbon prices, because emission intensive goods account for a higher share of their consumption expenditures, additional revenues from carbon pricing should be partially recycled back to lower-income households as a lump-sum transfer (OECD, 2023[61]).

The Latvian tax system is fairly green, with environmental taxes at 3% of GDP in 2021, compared to only 1.4% in the OECD average, even though they deteriorated by ¾ percentage point of GDP from their peak in 2016. Nonetheless, the effectiveness of environmental taxes in reducing emissions is hindered by fossil fuel and other environmentally harmful tax expenditures and subsidies in many economic sectors (European Commission, 2023[103]). Examples include the excise duty reliefs on diesel used for agriculture and aquaculture, and the excise tax exemption and tax relief for natural gas for industrial consumers. The government should systematically screen all existing subsidies, tax exemptions and reduced rates for fossil fuels and gradually phase them out.

Accelerating emission reductions will also require significant investments to lower abatement costs and to reduce the social costs of the green transition. Public investment will need to increase to help crowding in private investment, which has been week for many years (see Chapter 2). Latvia plans to spend 42% of the EU RRF fund to support climate objectives. For example, the plan supports the green transition with investments to overhaul the Riga Metropolitan area transport system and incentivises clean transport and sustainable mobility (EUR 295 million). Likewise, EUR 472 million are dedicated to improving energy efficiency in private, public and commercial buildings.

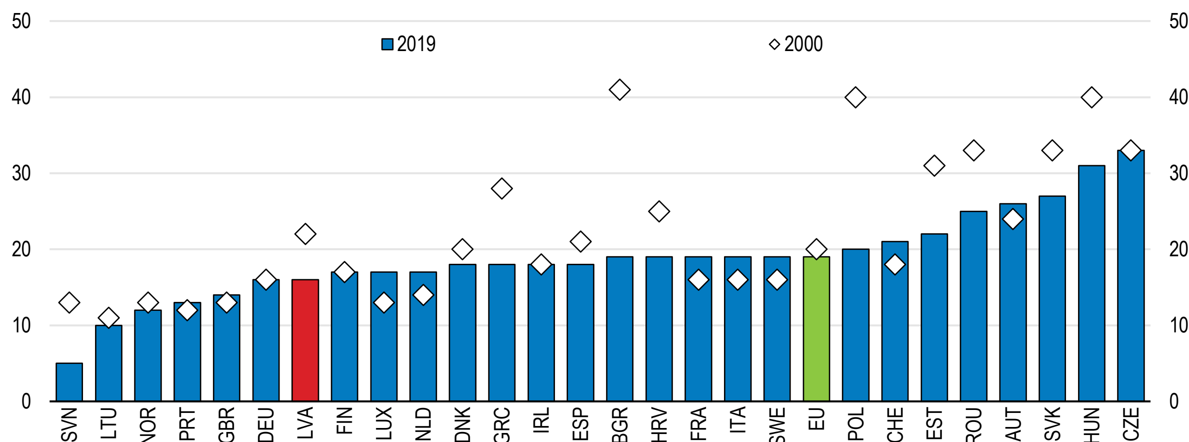
The attractiveness of public transport needs to improve

Greater reduction of emissions in the transport sector is a main priority. Transport is the largest source of emissions in Latvia; 30% of GHG emissions emanate directly from transport, for example, when burning fuel to run an internal combustion engine car. The car fleet renews only slowly, likely reflecting the limited financial resources of households and businesses to purchase cars, and buying used cars run by diesel is common. As a result, Latvia has one of the oldest car fleets among OECD countries. The average age of passenger cars is 14.3 years, with 75% of cars in the fleet being older than 10 years (ACEA, 2022[104]). In addition, the share of battery-electric vehicles (4.6% in 2022) is much lower than the EU average (12%) (European Commission, 2023[103]). Moreover, the trend towards low-density development in the suburbs and the concentration of high-wage jobs in Riga city contribute to high emissions due to increased commuting (OECD, 2019[2]). This is exacerbated by the prioritisation of cars in urban planning, underdeveloped public transport infrastructures and cooperation issues in the Riga metropolitan area, leading to a decline in the use of public transport and an increase in private car use (Figure 1.37). This has also raised pollution and congestion, exacerbating mismatches in the labour market (OECD, 2022[1]).

Better coordination between Riga and municipalities in the Pieriga region and improved urban planning, which focuses on densification, is needed to make public transport and shared mobility more attractive and cost-effective. Currently, each municipality is responsible for its own transportation system, causing inefficient public transport connections, schedules, and ticketing systems. As recommended in previous Economic Surveys of Latvia, establishing a metropolitan transit authority could help to prioritise investments and facilitate coordination. Subsidising loans for purchasing low-emission cars, as done in several OECD countries, could address financial constraints by overcoming the high upfront costs of electric vehicles with moderate fiscal costs compared to direct purchase subsidies. Although price gaps between electric and combustion engine cars have declined, used combustion engine cars are likely to remain cheaper in the next years. At the same time, expanding charging points should be prioritised, as this is key for expanding the use of electric vehicles. The administrative burden for installing charging stations in older multi-apartment buildings is high, as the land is usually not owned by apartment owners as a result of the privatisation process in the 1990s (Zelmenis, 2023[105]). Facilitating planning and approval procedures for installing charging stations where land and buildings are in shared ownership is key to accelerate the expansion of the charging infrastructure. Likewise, Latvia should modify how it taxes benefits arising from personal use of company cars so that it discourages excessive use of private vehicles and long-distance commuting (OECD, 2019[106]). It should also increase taxation on diesel, which is lower than gasoline, even though the CO2 emissions per litre of diesel are higher (OECD, 2022[107]). To reach the government's goal of increasing rail electrification from the current 13.4% to 24.2% by 2027, a substantial rise in investment in rail is needed. Investment in rail declined in the last decade, and no progress has been made in improving electrification in the last five years.

Figure 1.37. The use of public transport has decreased

Ratio between the number of passengers using public transport (bus, train, metro, tram) and the total number of road and rail passengers, %



Source: Odyssee-Mure database.

StatLink https://stat.link/bc7yps

Emission reduction in the building sector needs to accelerate

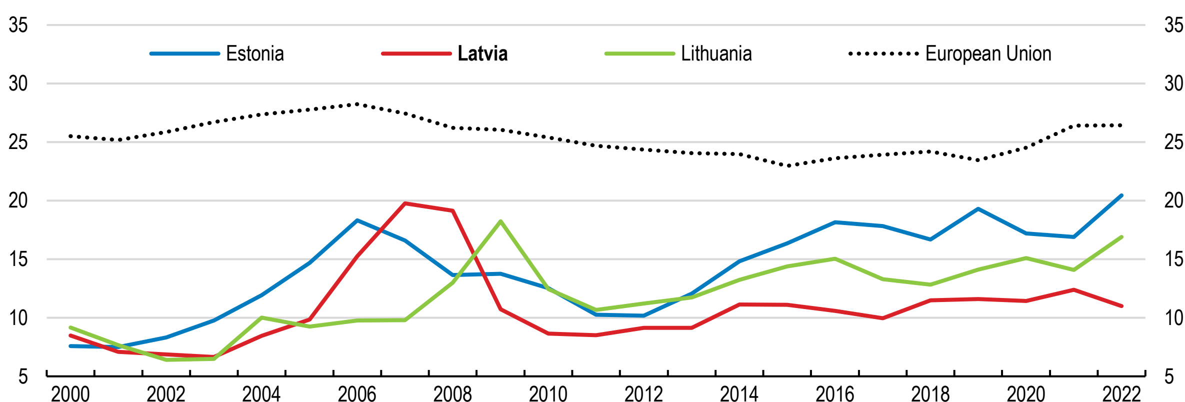
About 15% of Latvia's GHG emissions are from the residential sector, driven by outdated heating systems and poor insulation (Figure 1.36). Modernising the housing stock is challenging as the share of households owning their apartment is among the highest across the OECD, and many homeowners are reluctant or are not able to undertake costly renovations. Housing investment has been low for many years and even declined in recent years despite increases in real estate value (Figure 1.38) (OECD, 2023[108]). About 90% of residential buildings are older than 20 years, and 96% of apartment buildings are older than 30 years (European Commission, 2020[109]). Co-owned apartment buildings are common and concentrated in the

capital and other large cities. The energy efficiency of multi-apartment residential housing is often poor, with the average heating consumption in 2019 being 125 kWh per square meter, while the new National Construction Standard ceiling for new buildings and renovated ones has been set at 40-60 kWh/m2 and 90-100 kWh/m2, respectively. Coordination problems between apartment owners hamper renovations of these buildings. Latvia's Long-term Strategy for Renovation of Buildings aims for 8 100 residential apartment buildings to be renovated by 2040, yet only 627 multi-apartment building renovation projects have been undertaken between 2016 and 2023 with government co-financing (ALTUM, 2023[110]).

Higher energy prices due to the war in Ukraine are strengthening incentives for renovation and shifting to lower-emission heating systems. However, a large backlog in housing investment, the difficult financial situation of many homeowners and high construction costs complicate an acceleration of emission reductions. As part of the EU RRF funds, ALTUM provides grants and loan guarantees with a budget of EUR 57.2 million to cover up to 49% of the cost of renovating around 170 buildings. In the past, funding from similar programmes was often not fully allocated, as a high administrative burden and uncertainty due to frequent changes in funding conditions acted as a burden for house owner. In addition, coordination issues among owners in multi-apartment buildings and a lack of awareness of the need for renovation have added to low demand for these programmes. Simplifying procedures for receiving support for renovation and providing higher certainty regarding support conditions, also by making funding less dependent on EU funds, could help raise energy-efficiency investments. The standardisation of technical documentation for renovating similar multi-owner buildings could facilitate coordination among apartment owners and help reduce construction costs by limiting the scope for contractors to introduce more expensive solutions. The government could also consider increasing financial support targeted towards vulnerable households and for heat pump purchases, but this should be considered against tools to reduce emissions in other sectors that might be more cost-effective to reach overall emission targets.

Figure 1.38. Housing investment has been much lower than in peer countries

Investment in dwellings, % of total gross fixed capital formation



Source: OECD National Accounts database.

https://stat.link/ro14ts

Expanding wind and solar is key for greening the energy mix and raising energy security

The electricity generation sector accounts for 13% of GHG emissions, mainly from natural gas, which, along with hydropower, is responsible for almost all electricity generation in Latvia. Shifting to rely more on wind and solar could lower emissions in the building and transport sectors through electrification. It would also help reduce dependency on fossil fuel imports and improve energy security and the trade balance. Expanding wind power should be the priority due to Latvia's comparative advantage in wind (IMF, 2023[4]) (Child, Bogdanov and Breyer, 2018[111]). However, expanding solar energy is also important as together with decentralised storage it can help to stabilise demand and supply, particularly in the context of changing

weather conditions. Due to reduction in regulatory burden and fiscal support measures, solar energy supply has significantly increased in recent years.

However, wind park development in Latvia is lagging behind that of other Baltic countries. In 2022, the government approved a joint venture of two state-owned enterprises (Latvian Wind Parks) to develop high-capacity wind farms of up to 800 MW each, which is a step in the right direction. However, regulatory and administrative barriers are hampering private investments. Data on maritime spatial planning and cooperation and cost-sharing mechanisms between municipalities are lacking, and land planning and licensing procedures need to become faster and more transparent. Consolidating and simplifying the existing regulation for wind farm developments could help reduce these barriers and create a level playing field. Awareness campaigns should be extended and tax revenues from wind power generation could be shared with municipalities to lessen local resistance. Facilitating leasing of land owned by the state could help to attract private investors to expand wind power generation.

A rapid expansion of wind and solar energy and higher electricity demand because of electrification will pose challenges for the transmission network. An Estonian-Latvian off-shore wind farm project has been announced for 2030 and is currently in the impact study phase, with procurement process initiation expected by 2026. Projects for investment in electricity transmission systems are in place, supported by the EU Resilience and Recovery Funds, where EUR 510 million will be deployed to connect Latvia with the EU energy system until 2033. A swifter connection of wind and solar projects to the grid and a better balance of supply to variations in demand are needed, for example by expanding the roll-out of smart meters, introducing time-variable grid charges and developing storage solutions (OECD, 2023[102]). A faster integration into the European electricity grid would facilitate the pooling of renewable energy from a large geographical area.

Table 1.11. Past recommendations and actions taken on environmental policies

Previous recommendations	Action taken
Gradually raise effective carbon tax rates in sectors not covered by the EU-ETS, phasing out natural gas subsidies and redistributing revenues towards the poor	No action taken.
Encourage greater use of renewables in electricity generation and increase system inter-connection in both electricity and natural gas.	The SOE Latvian Wind Parks has been established to support wind park developments. Regulatory changes have incentivised the installation of solar capacity for residential buildings.
Consider using congestion pricing mechanisms to minimise the use of private cars and to finance improved public transportation	No action taken.
Introduce means-tested tax incentives for the refurbishment of basic amenities.	No action taken.

Table 1.12. Recommendations table

MAIN FINDINGS	RECOMMENDATIONS (Key recommendations in bold)
Improving fiscal and macro-economic policies	
The fiscal stance will ease in 2024 and remain neutral in 2025, despite remaining inflationary pressures. The fiscal deficit is high and public debt is above the medium-term target.	**Gradually tighten fiscal policy to reduce the fiscal deficit and lower inflationary pressures.**
Spending needs for defence and internal security have increased due to the war in Ukraine, while the government committed to further raise education and health spending.	**To stabilise debt, address rising spending needs by raising spending efficiency, reallocating spending and increasing tax revenue, including from income and property taxes and by reducing tax expenditures, including for fossil fuels.**
The exclusion of structural and durable expenditures in key policy areas such as defence and internal security in the calculation of the structural balance reduces transparency and the credibility of the fiscal framework.	Gradually include structural and durable expenditures in key policy areas such as defence and internal security in the structural balance.
Insolvency of households may rise due to high inflation and steep increases in lending rates. Risks have risen in the real estate market.	Carefully monitor the household loan-to-value ratio and stand ready to further increase counter-cyclical capital buffers.
Reforming the tax system to reduce informality and inequality and raise revenue	
High social security contributions for low- and middle-income earners reduce incentives for formalising work. Informality is high. The progressivity of personal income taxes remains low.	**Reduce the labour tax wedge for low-income earners, for example by reducing social security contributions at lower incomes or raising progressivity of the personal income taxes.**
Tax expenditures for VAT and excise taxes are costly and introduce distortions, but a comprehensive impact evaluation is missing.	Carefully evaluate the impact of tax expenditures and reduce their overall size.
Revenues from wealth transfer taxes, comprising estate and notary fees, are low. Inheritance taxes are less distortionary than other taxes and can help reduce high inequality.	Consider introducing inheritance taxes, while allowing for exemptions for low-value inheritances and instalments for tax payments.
Property tax revenue is low, while many municipalities depend on central government transfers for core spending priorities. Cadastral property values are not linked to market prices.	**Raise recurrent taxes on immovable property based on regularly updated market values, while continuing to provide tax reductions for the primary residence of poorer households.**
Municipalities are dependent on government transfers to fulfil their responsibilities. Many grants are earmarked and some non-earmarked transfers are not automatic and negotiated each year, reducing incentives for spending efficiency.	Provide municipalities with sufficient resources by increasing their shares in tax revenue.
Improving the capacity of the public sector and raising spending efficiency	
High turnover, particularly for skilled professionals and managers, and the lack of digital and management skills has weakened institutional memory and the quality and effectiveness of public policies.	**Continue to raise the attractiveness of public jobs and improve training of public employees, particularly in digital and management skills.**
Due to skilled labour shortages, recruitment of public employees will become increasingly challenging. Cooperation across agencies and ministries could be improved by higher mobility of staff.	Centralise recruitment procedures and expand recruitment activities to attract external and international candidates, including from the diaspora.
The digitalisation of public services at the municipal level remains weak due to low resources, weak management and digital skills and a lack of mandatory common IT standards.	Incentivise municipalities to harmonise and digitalise administrative procedures and introduce mandatory IT standards and data formats.
Ex-ante and ex-post policy impact analysis remain weak, reducing the quality of public services and spending efficiency. Capacity in local infrastructure planning is low.	**Improve the data infrastructure and knowledge about methodologies for cost-benefit and impact analysis of policies and raise cooperation across the public sector.** Implement the planned common electronic identifier for firms and individuals to facilitate linking databases across public bodies.
Procurement of standardised goods, such as drugs or IT equipment and software, is still decentralised, despite large possible efficiency gains of centralised procurement.	**Consolidate existing purchasing bodies, improve their IT and staff capacity and reduce legal exemptions that allow to opt out of mandatory centralised procurement.**
E-procurement is only mandatory above EUR 10 000 for supply and service contracts and EUR 20 000 for public works, which creates incentives to split up tenders and reduces transparency. Investigations of irregularities are hampered by limited information in the existing red flag system.	Reduce the threshold above which e-procurement is mandatory, while reducing the administrative burden, and improve available information on tenders and bids in the existing red flag system.
There is no centralised performance evaluation for the more than 330 municipal SOEs and data transparency remains weak.	Set unified performance standards for all SOEs (state and municipal), centrally monitor their performance and improve transparency.
Criteria for justifying state ownership could be made more specific. Some SOEs have been excluded from the regular assessment of the rationale for state-ownership.	Include all SOEs in the regular evaluations, better define assets, goods and services of strategic interest, and conduct in-depth analysis on the presence of market failures.

The assessment of the impact of regulation and SOE presence on competition remains weak. Entry barriers in services sectors are high.	**Increase the power of the Competition Council to conduct market investigations and initiate evaluations of regulations and state ownership rationales of SOEs to ensure competitive neutrality.**
Improving tax enforcement and the fight against money laundering and corruption	
Tax enforcement is hampered as not all taxpayers are required to file an income tax declaration. Under-declaration of income and wages is widespread.	**Make the filing of an electronic income tax declaration mandatory, while continuing to reduce the administrative burden through pre-filling of declarations.**
Wide use of cash facilitates tax evasion and money laundering.	Consider making electronic payment of wages mandatory and improve enforcement of existing maximum thresholds for cash payments.
In contrast to many other OECD countries, plans for a centralised lobbying register to raise transparency and reduce undue influence of special interest groups have not yet been implemented.	**Introduce a centralised lobbying register with a legislative and regulatory footprint.**
Internal control and audit systems and transparency at the local level are relatively weak. Conflicts of interest for public officials with close ties to local businesses might raise barriers for competition and investment.	Better enforce existing regulation on transparency of income and assets and external activities of public officials and ensure it applies to persons involved in procurement and spending decisions.
Addressing skilled labour shortages	
The accreditation of new VET courses is centralised at the national level, hindering the timely adaptation of training content to skill needs in local labour markets.	Give VET institutes more power to coordinate the content of VET courses with local employers and facilitate accreditation procedures.
Skilled labour shortages are high. Requirements for exercising certain occupations act as a barrier for raising skilled migration.	Lower requirements for working in occupations facing labour supply shortages.
Although more women than men attain tertiary education, the share of women graduating in STEM and other study fields with high labour market returns is much lower. Skilled labour shortages in these jobs are high.	Promote role models and encourage girls to enter occupations with high skill requirements and labour market returns.
The gender gap in labour force participation and wages is high for workers between 25 and 44 years. Parental leave is taken almost exclusively by women and access to childcare is weak.	Expand the supply of childcare by investing more in childcare facilities and addressing labour shortages through better working conditions. Require the second parent to take a larger share of the paid parental leave.
Accelerating the green transition	
Since the early 2000s, total GHG emissions have not fallen due to low effective carbon prices in transport and building sectors, which are related to fossil fuel and other environmentally harmful subsidies and tax expenditures.	**Gradually phase out environmentally harmful tax expenditures and subsidies, such as the ones for fossil fuels, and consider introducing carbon pricing for sectors not covered by the EU ETS.**
Emissions in the transport sector are high due to frequent commuting by car, while the use of public transport has significantly declined.	Establish a metropolitan transit authority to prioritise investments and facilitate coordination among municipalities.
The share of old and more polluting cars is higher than in other OECD countries. The administrative burden for installing charging stations for electric vehicles in older multi-apartment buildings is high.	Facilitate planning and approval procedures for installing public charging infrastructure for electric vehicles.
High administrative costs, uncertainty due to cyclical EU funding sources and coordination issues in multi-owner buildings act as a barrier for accelerating housing renovations.	Simplify administrative procedures and increase domestic funding for housing renovation support. Standardise technical documentation for renovating similar multi-owner buildings.
Private investment in wind energy generation is weak due to high regulatory and administrative barriers and a lack of cooperation between municipalities.	Consolidate and simplify the existing regulation for wind farm developments and facilitate the leasing of state-owned land for wind parks.

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2 Raising investment to support growth

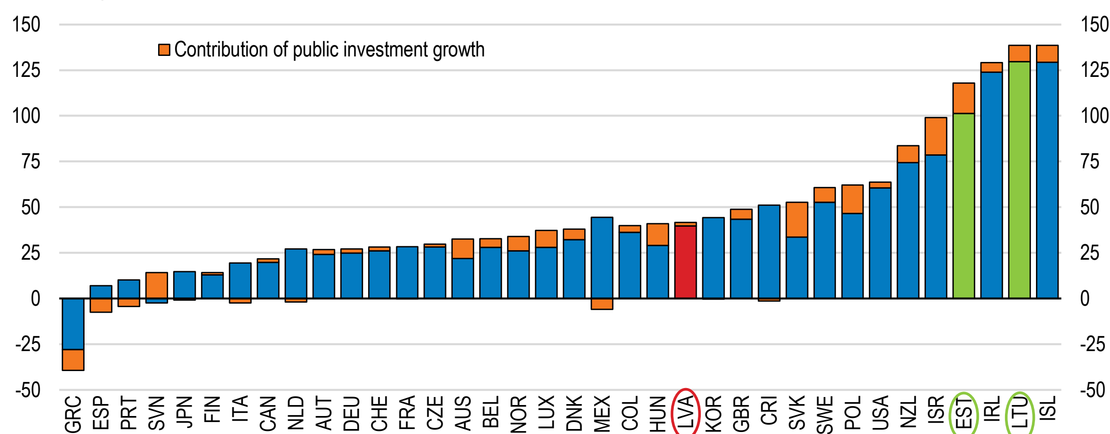
Weak investment has weighed on the convergence process towards higher living standards. Limited access to finance coupled with high informality, costly insolvency procedures, skilled labour shortages and weak competition have hampered business dynamism and innovation, weighing on productivity growth. To reduce high credit costs, it is key to foster competition in financial markets by reducing information asymmetries and switching costs for bank customers and strengthening competition enforcement. As capital markets are shallow compared to other euro area countries, listing of large state-owned enterprises and facilitating greater exposure of pension funds to domestic securities could help attract investors and raise access to finance. Improving contract enforcement and fostering the reallocation of resources to more productive firms will require reducing the cost of filing insolvency, expanding the remit of the Economic Court and continuing to fight corruption. This will also help raise the low level of trust in institutions, which is key to reducing high informality. As training provided by firms is among the lowest across EU countries, better cooperation among firms and with training providers in the design and delivery of training is needed. Further strengthening the resources and investigative powers of the Competition Council would help improve the enforcement of competitive neutrality, reduce the high barriers to entry and competition, and foster business dynamism and innovation.

Weak investment has held back growth

Investment growth in Latvia has been relatively weak since the global financial crisis (Figure 2.1). This has weighed on potential growth and slowed down the convergence in living standards towards the OECD average (see Chapter 1). Residential net investment has even been negative, and public investment made only a modest contribution. Raising investment is key to tackle the challenges of the demographic, green and digital transformations, and address a significant infrastructure backlog, particularly in housing and transport.

Figure 2.1. Latvia's investment performance has been weak compared to neighbouring countries

Growth in real gross fixed capital formation in 2023 compared to 2009, %



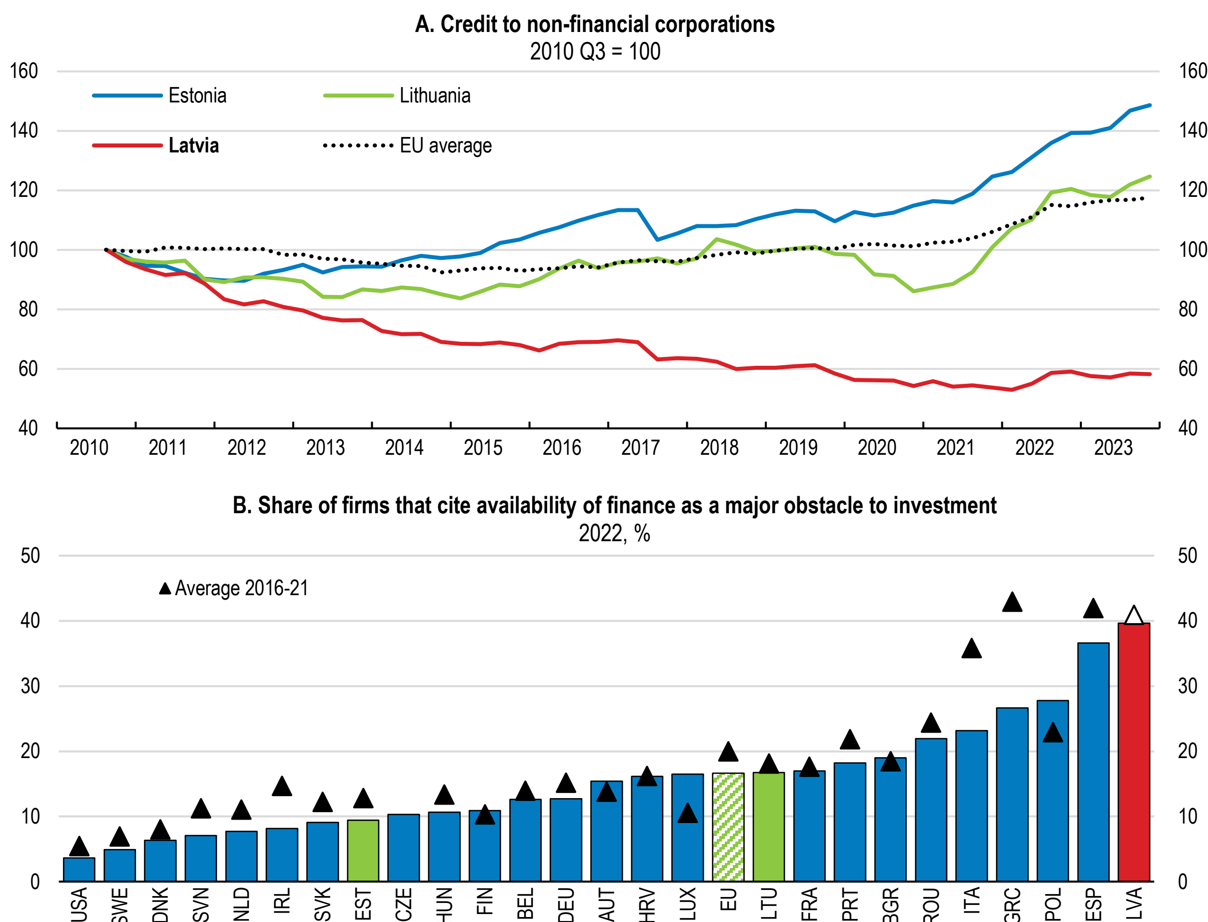
Note: For countries where volumes for public real gross fixed capital formation do not exist, volumes are obtained by dividing values for public gross fixed capital formation based on appropriation accounts by the gross fixed capital formation deflator.
Source: OECD Economic Outlook database; and OECD calculations.

https://stat.link/ompez0

Constrained access to finance is a serious barrier to business investment. After the global financial crisis, which ended a period of excessive lending, the economy has undergone severe deleveraging, mainly due to high credit and reputational risk aversion in the banking sector. In addition, weak competition in the financial sector has led to high lending rates and stringent collateral requirements, severely restricting access to credit (Figure 2.2), especially for smaller firms. Shallow corporate equity and bond markets and the lack of institutional investors limit non-bank sources of corporate finance.

In addition to limited access to finance, domestic investment is discouraged by factors that weaken the business environment. Latvia has attracted large amounts of foreign direct investment, thanks to its integration into the EU market, low business taxes, an efficient customs system and a low administrative burden for foreign investments (OECD, 2022[1]). However, around 40% of firms face issues related to the effectiveness of legal protection of investments, due to opaque administrative conduct, difficulties in challenging administrative decisions in court and frequent changes in legislation (European Commission, 2023[2]). Transport infrastructure remains poor, and digital adoption is constrained by weak management and digital skills. Many firms remain small and are reluctant to borrow even when financially healthy (OECD, 2019[3]). Resource allocation towards more productive firms is hampered by inefficiencies in the insolvency regime that allow insolvent firms to continue operating, weak competition and persistently high informality.

Figure 2.2. Weak credit supply hinders investment



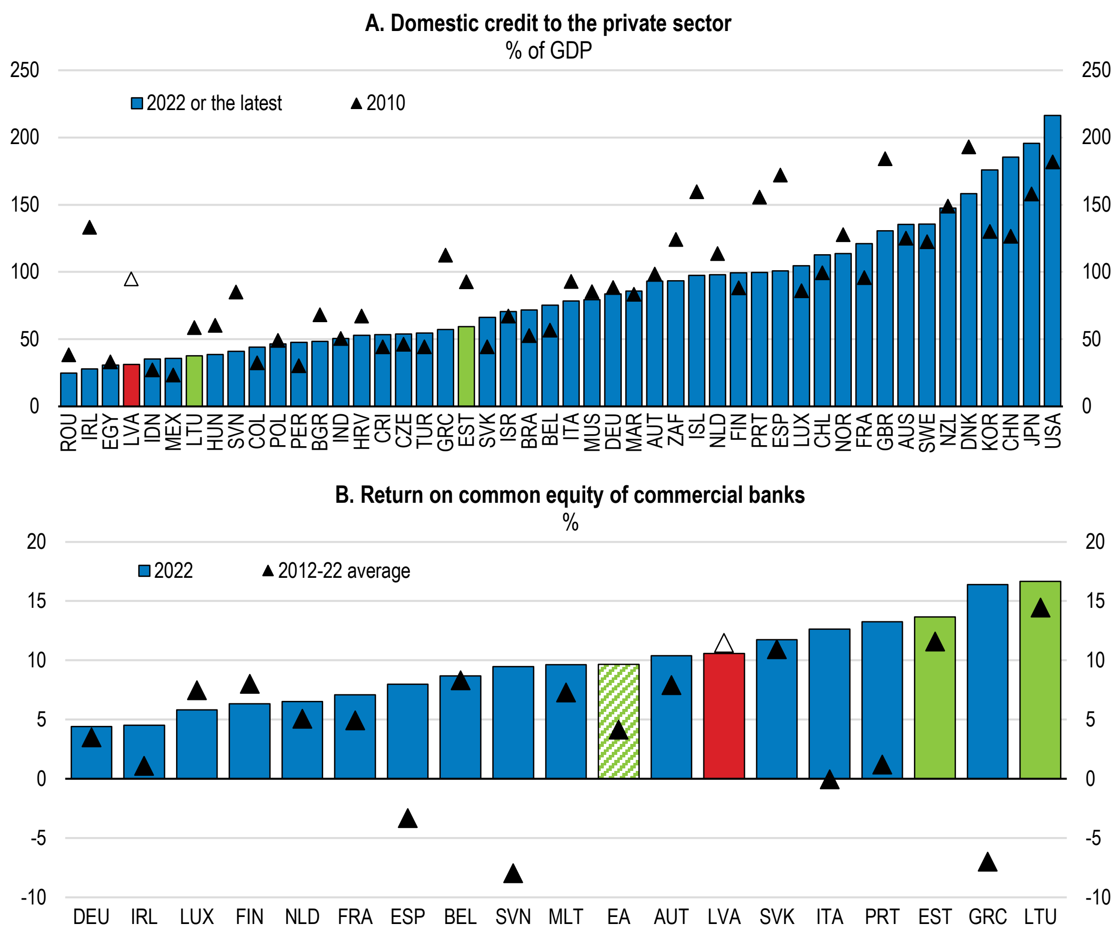
Note: Credit in Panel A refers to loans and securities other than shares.
Source: ECB Data Portal; EIB Investment Survey Country Overview 2022: Latvia; and OECD calculations.

StatLink https://stat.link/tdpomy

Improving access to credit to boost investment

Despite being healthy and profitable, banks are hesitant to lend (Figure 2.3). Deposits from firms and households have steadily increased since the global financial crisis and the share of loans that are in arrears or non-performing have decreased (see Chapter 1); (Bank of Latvia, 2023[4]). Nevertheless, only a small proportion of bank deposits are converted into loans (Figure 2.4), in contrast with other OECD countries, where higher banking sector profitability has been associated with higher credit-to-GDP ratios (Richter and Zimmermann, 2018[5]). One main explanation is high risk aversion due to experience during and after the global financial crisis, which had led to large bank losses, soaring non-performing loans and low asset recovery rates due to dysfunctional insolvency procedures (OECD, 2016[6]). The capital adequacy ratio of the Latvian banking system is very high, with a system-wide average Common Equity Tier 1 ratio of more than 22% in 2022, around 3 percentage points above the EU average and about three times the regulatory minimum (Bank of Latvia, 2023[7]). Sufficient capital in the banking sector is essential to absorb large losses in case of a banking crisis and prevent a bail-out by tax payers, but excessive capitalisation in the banking system could also impair financial intermediation and reduce access to finance (OECD, 2011[8]).

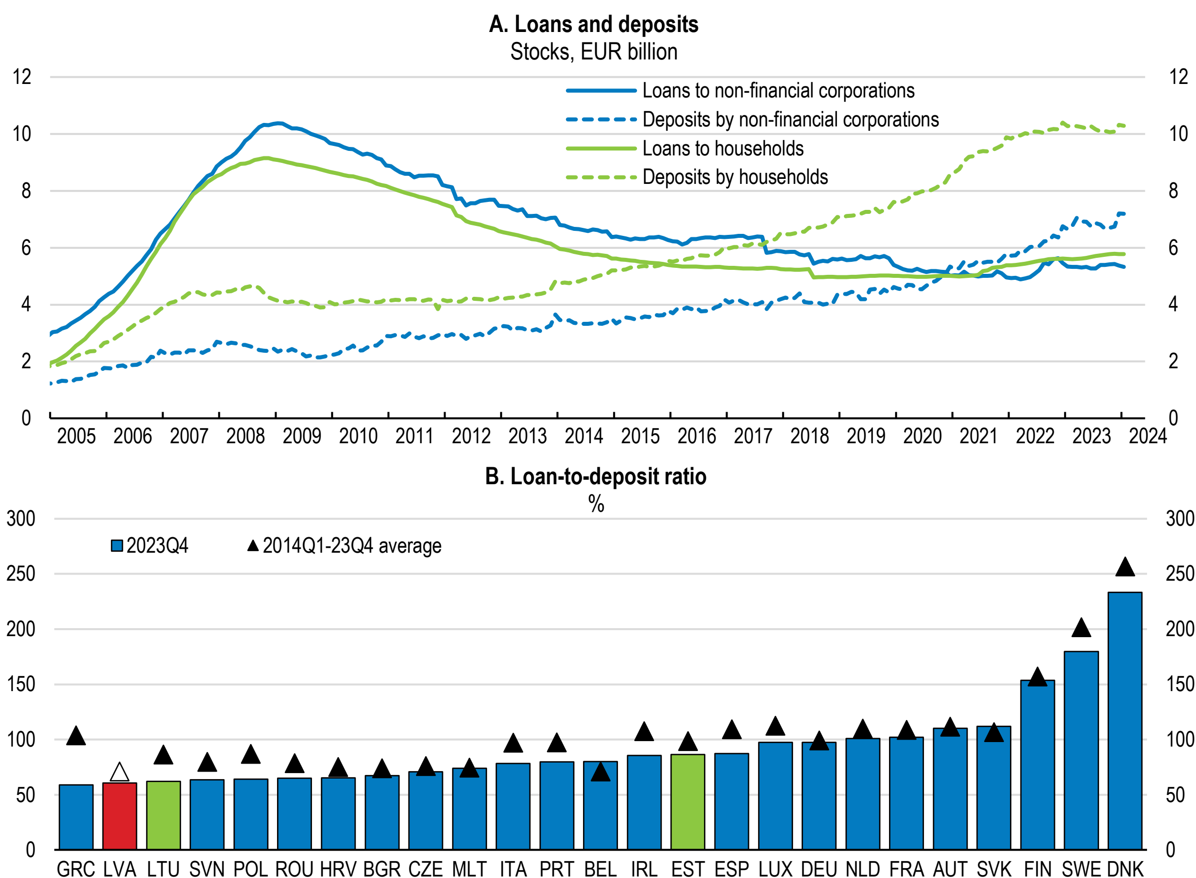
Figure 2.3. Lending is weak despite high profitability of banks



Note: In Panel A, 2014 data is the earliest available for New Zealand. Panel B shows unweighted country averages for a total of 147 major euro area banks, representing about 83% of total assets of monetary and financial institutions excluding the Eurosystem of central banks.
Source: World Bank World Development Indicators database; Bloomberg; and OECD calculations.

StatLink https://stat.link/7kihqf

Figure 2.4. Bank lending has decreased despite rising deposits



Source: Bank of Latvia; Risk Assessment Indicators at the ECB Data Portal; and OECD calculations.

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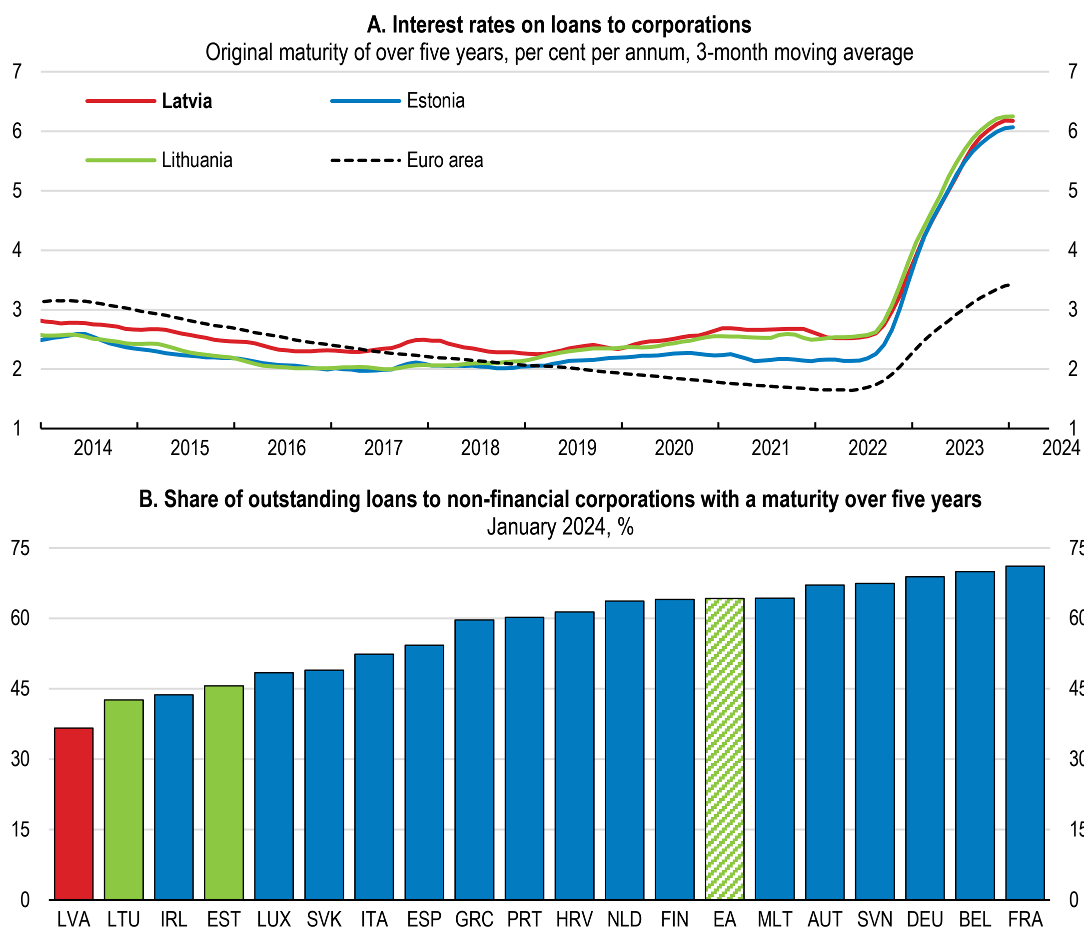
Interest rates are much higher than in other European countries and the share of long-term loans is very low (Figure 2.5). Easing financing conditions in the euro area over the past decade did not result in lower interest rates on loans to households and non-financial corporations in Latvia. Although real interest rates have recently declined due a rise in inflation in 2021-22, they remain among the highest in the euro area (see below and Chapter 1). Long-term borrowing rates for corporations have also diverged significantly from the rest of the euro area, making it difficult for firms to finance investment over long time horizons. As shorter debt maturities discourage business investment over a medium-term horizon and more so for firms with higher profitability and growth, the lack of access to longer-term loans hampers the overall growth potential of the economy (Hong, Hou and Nguyen, 2023[9]).

Figure 2.5. Lending rates are high and the share of long-term loans is low



Note: Panel A shows the bank loan rate on outstanding amounts. Panel B covers loans by monetary and financial institutions excluding the Eurosystem of central banks.
Source: MFI Interest Rate Statistics and Balance Sheet Items at the ECB Data Portal; and OECD calculations.

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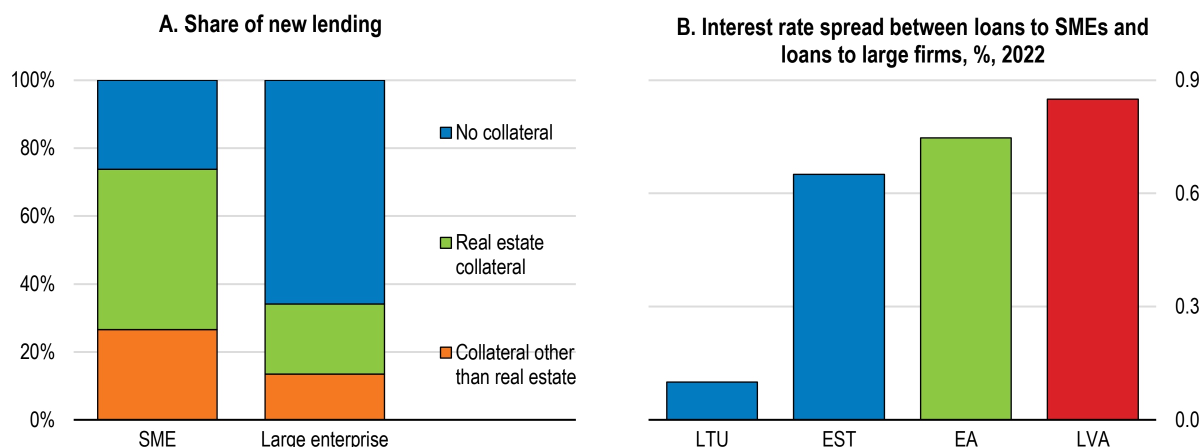
Access to finance is especially weak for smaller firms (Figure 2.6). More than 80% of loans require collateral and requested collateral values are very high (Figure 2.7). This is a particular issue for smaller and younger firms, which have less assets to offer as collateral. In addition to higher collateral requirements, they also pay significantly higher interest rates than larger firms (Figure 2.7). This is related to the fact that the most common collateral requested from small and medium sized firms (SME), real estate, has a low valuation in many regions and the cost of resolving insolvency and recovering assets is still high, which leads to a low pre-contractual value of collateral. Moreover, smaller firms often have higher levels of accumulated arrears and untested business models, leading banks to charge higher interest rates to compensate for the credit risk. Smaller firms in manufacturing and agriculture face relatively low collateral requirements but higher interest rates (Figure 2.7), as their main source of finance is leasing from non-bank providers to meet their relatively higher demand for machinery and equipment.

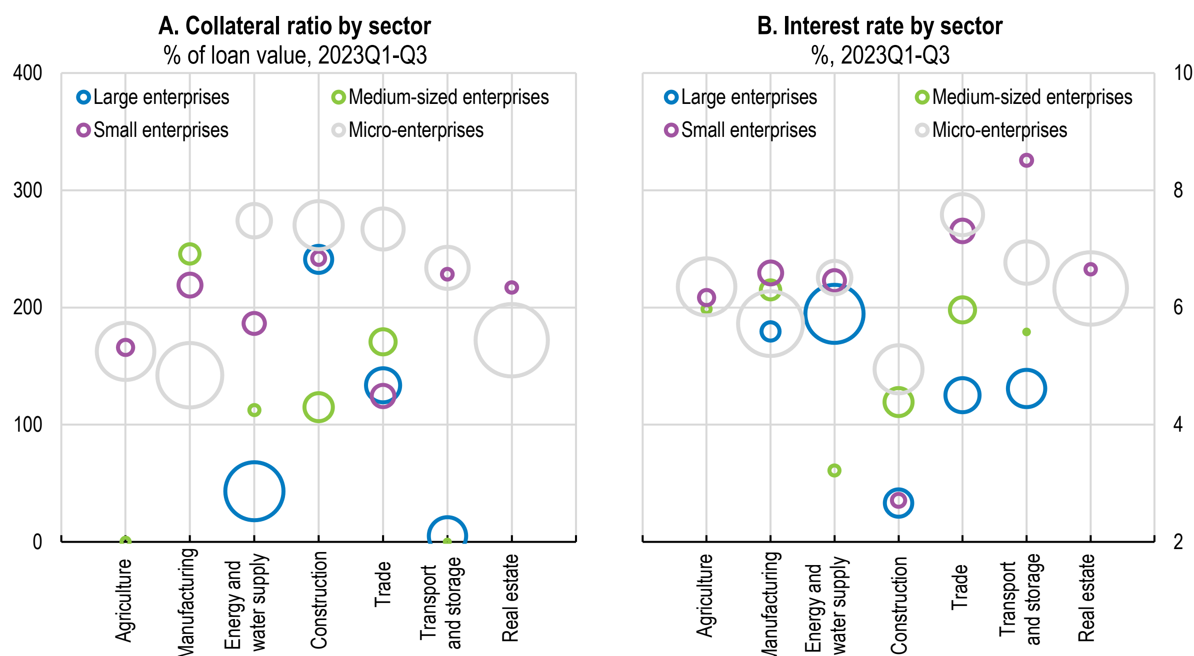
About two-thirds of non-financial enterprises in Latvia have no access to credit. These partly include inactive firms that remain on the business register but also those that may not be able to provide complete income statements or employee records or may have negative equity, which in many cases is related to partly operating in the shadow economy, making it impossible for them to even apply for a loan (Bank of Latvia, 2023[4]). Some enterprises are financially viable but cannot obtain a bank loan. Given the high prevalence of smaller firms in Latvia, limited access to finance severely limits the ability of smaller firms to grow (see below) (OECD, 2021[10]).

Figure 2.6. SMEs face stricter collateral requirements and higher lending rates than larger firms



Source: Bank of Latvia calculations using firm-level credit register data; and Financing SMEs and Entrepreneurs 2024: An OECD Scoreboard.

Figure 2.7. Tight credit conditions restrict bank lending to smaller firms in some key sectors

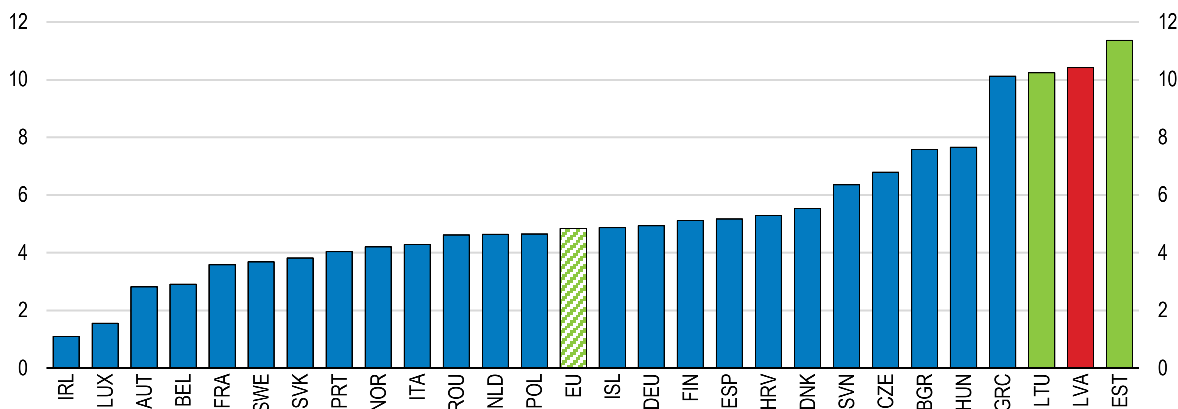


Note: The size of the bubbles corresponds to the volume of bank loan. Collateral ratios and interest rates are weighted averages. Values for certain enterprise size-sector pairs are not shown if the number of loans granted is lower than 10.
Source: Bank of Latvia calculations using micro data at the credit register.

Besides the high cost of credit, the willingness to borrow is also low due to high risk aversion of firms. Only a small share of the population borrows from a financial institution and many firms operating in the formal economy with strong balance sheets choose not to borrow (Bank of Latvia, 2023[4]). This is mainly due to the legacy of the global financial crisis, which led to many bankruptcies of over-leveraged firms, and the prevalence of many founder-managed firms that prefer to finance investments out of retained earnings (OECD, 2022[1]). Fear of possible rejection by banks, which is related to past negative experiences, and low levels of financial literacy also discourage firms from approaching banks for finance (Figure 2.8).

Figure 2.8. A significant share of firms are reluctant to apply for bank loans

Share of firms that did not apply for bank financing because of possible rejection, 2023, %



Source: 2023 SAFE Survey on the access to finance of enterprises.

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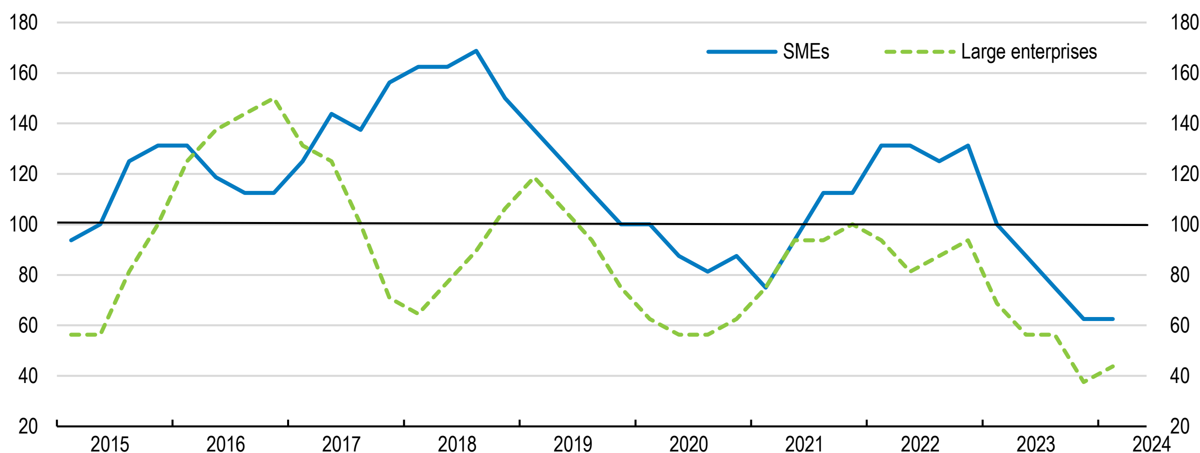
Demand for credit has been higher among smaller firms, partly because of existing tax incentives for retained earnings, which tend to benefit more profitable, larger firms (Figure 2.9). Undistributed corporate profits are not taxed, which strengthens the internal financing structure of more profitable, larger firms allowing them to finance investments out of retained earnings (see Chapter 1). Although SME demand for credit remains higher than that of larger firms, the rapid rise in bank lending rates following the recent monetary tightening has reduced credit demand for all firms. A reduced appetite for longer-term investment have also contributed to weak credit demand (Bank of Latvia, 2022[11]).

Figure 2.9. Demand for credit has been higher among smaller firms

Evolution of loan demand, 4-quarter moving average. An index level of 100 indicates neutral demand.



Note: An increase in the lines corresponds to a higher net percentage of banks which indicate that loan demand is increasing. The 4-quarter moving average is backward looking. Raw indices from 2014Q2 onwards are normalised.
Source: ECB Euro Area Bank Lending Survey; and OECD calculations.

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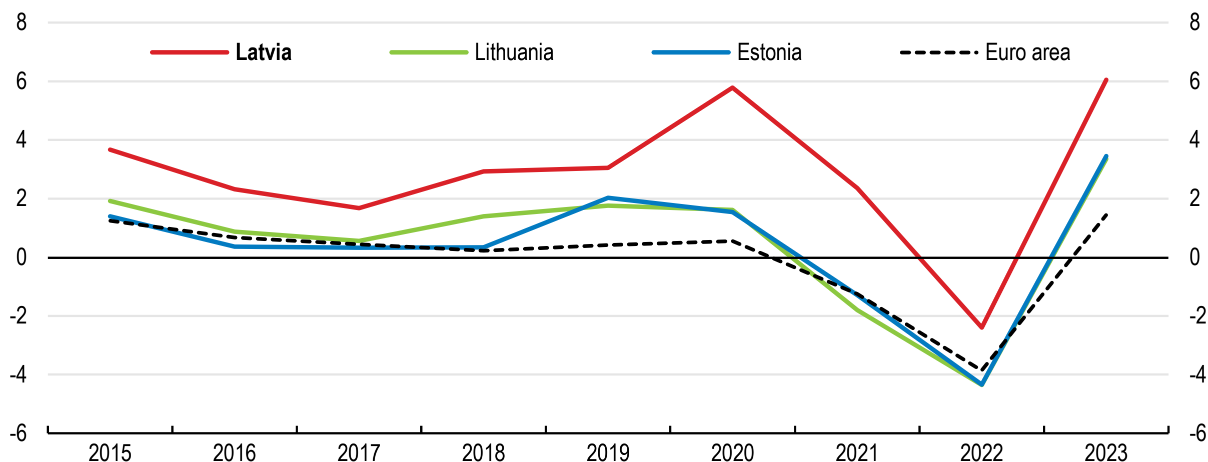
The low level of credit provision in Latvia is likely to be more related to constrained supply conditions rather than reduced demand. Supply constraints lead to lower credit availability and higher borrowing costs. Conversely, weak demand would lead to both reduced credit volumes and borrowing costs. Real lending rates in Latvia, which represent the equilibrium price in credit markets, have been persistently higher than those in the euro area and other Baltic countries to a similar extent over the past decade (Figure 2.10).

Given the lower level of loan origination in Latvia compared to the peer group over the same period (Figure 2.3), the constrained supply conditions in the Latvian credit markets are likely to have outweighed the weak demand conditions.

Figure 2.10. The real cost of credit has been persistently higher than in peer countries

Real cost of loans to non-financial corporations and to households for house purchase, % per annum



Note: Real lending rates are calculated by adjusting the nominal cost of loans to non-financial corporations and to households for house purchase for one-year ahead annual inflation expectations.
Source: MFI Interest Rate Statistics at the ECB Data Portal; Consensus Forecasts; and OECD calculations.

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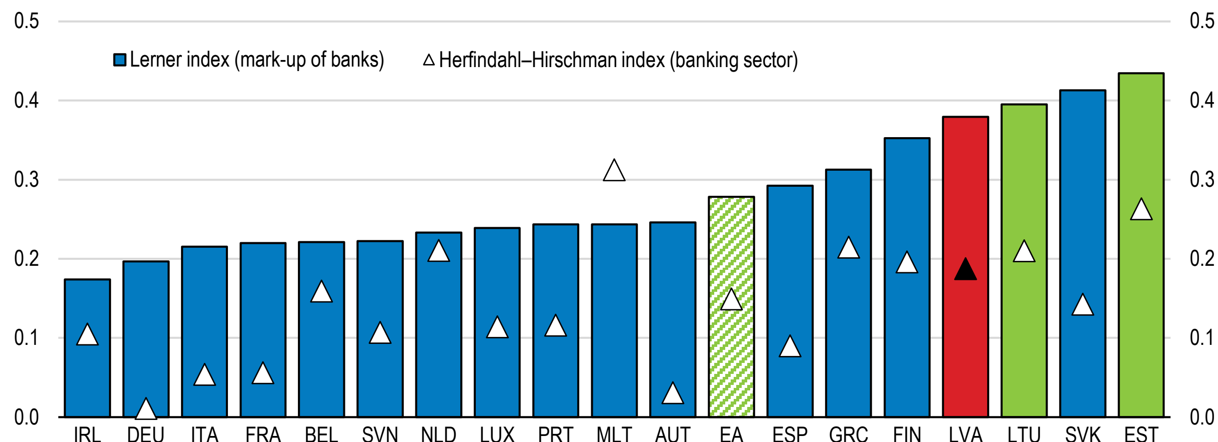
Improving bank credit provision

Weak competition in the banking sector may help to explain low supply and high cost of credit, in addition to high risk aversion. Four banks in Latvia account for about 80% of loans to enterprises and around half of bank customers have their banking relationship with a single bank (Competition Council, 2021[12]; Bank of Latvia, 2023[13]). As a result, the Herfindahl-Hirschman index, a common measure for market concentration, shows much higher values for the Latvian banking sector than for other EU countries (Figure 2.11). This high concentration of banks could be related to the small size of the Latvian economy and does not necessarily imply that banks do not behave competitively (Demirguc-Kunt and Martínez Pería, 2010[14]).

Figure 2.11. The local banking sector is concentrated and bank mark-ups are high

Local banking sector competition and concentration measures, 2012-22 average

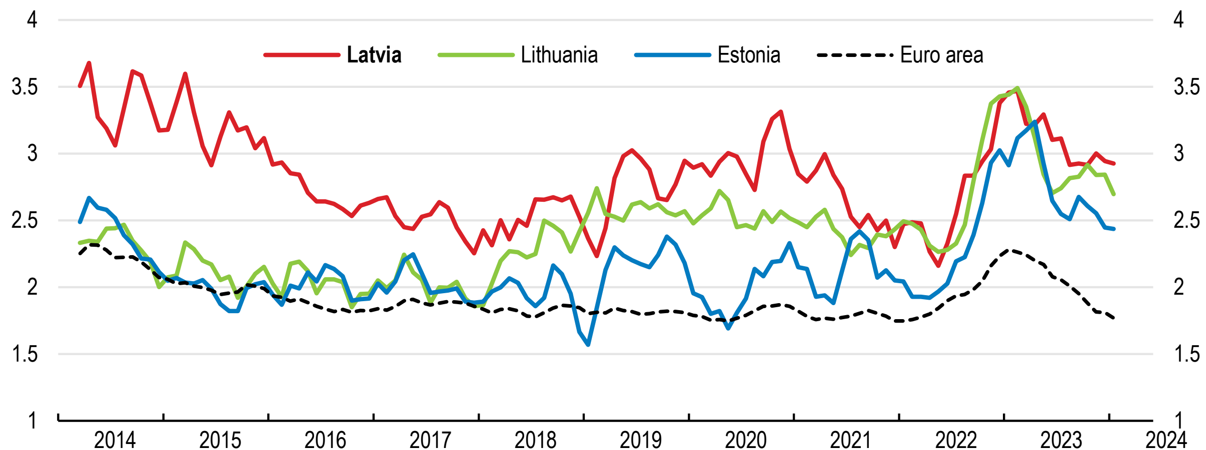


Note: The Herfindahl-Hirschman index (HHI) ranges from 0 to 1. Increasing values of the HHI correspond to higher market concentration in total lending. The bank-level estimates of the Lerner index, which is a direct measure of the price mark-up, follow closely (Demirguc-Kunt and Martínez Pería, 2010[14]) and are aggregated to the country level by taking unweighted averages across banks. See Box 2.1 for further details.
Source: Banking Structural Financial Indicators at the ECB Data Portal; Bloomberg; and OECD calculations.

However, the high concentration in the banking sector has also been accompanied by stronger pricing power in lending over the past decade, possibly indicating weak competition in the banking sector. The Lerner index, which measures competitive pressure based on the mark-ups charged by banks over their marginal costs and controls for time-invariant bank-specific factors as well as time-varying macroeconomic variables, has been higher than in many other EU countries over the last decade (Figure 2.11). Lower competitive pressures for banks could, for example, be related to lower threat of entry of new lenders, lower customer mobility or less competition from other financial market players. Moreover, spreads between bank lending and deposit rates are higher in Latvia than in other Baltic or EU countries, which can be related to the high concentration in the banking sector, but also to other factors such as higher borrower risk (Figure 2.12) (Benkovskis, Tkacevs and Vilerts, 2021[15]).These spreads also have been more volatile than in other EU countries, as the higher number of single-bank borrowing firms amplifies the impact of negative credit supply shocks on the availability of credit to firms (Degryse et al., 2019[16]).

Figure 2.12. Intermediation margins in the banking sector are high and volatile

Difference between lending and deposit rates, per cent per annum, 3-month m. a.



Note: The intermediation margin is defined as the difference between the weighted average lending and deposit rates of monetary and financial institutions, using business volumes as weights. Lending rates are for new loans to households for house purchase and new loans to non-financial corporations, both excluding revolving loans and overdrafts, convenience, and extended credit card debt. Deposit rates are for new deposits of households and non-financial corporations with agreed maturity.
Source: Risk Assessment Indicators at the ECB Data Portal.

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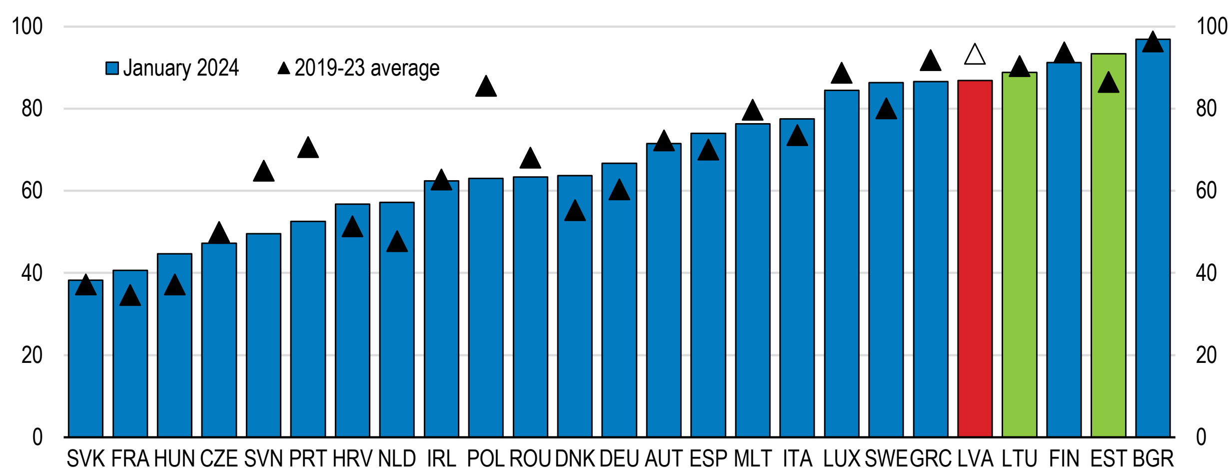
Strong pricing power and concentration, to the extent that they reflect weak competition in the banking sector, hamper the credit channel of transmission of euro area monetary policy. Also, in Latvia, most loans have either a variable interest rate or a rate fixation period of less than one year and use the six-month Euro Interbank Offered Rate (EURIBOR) as the base rate (Figure 2.13). However, although the six-month EURIBOR turned negative between 2014 and 2022, most banks in Latvia and the other Baltic countries set the effective base rate for lending at zero (Bank of Latvia, 2023[4]). As a result, average bank lending rates have remained relatively high during the monetary easing in the euro area over the past decade, weakening the pass-through of the ECB's monetary easing to lending rates (Figure 2.14). In contrast, when the ECB's policy rates turned positive, the high prevalence of variable interest rate loans allowed banks to raise their lending rates to fully reflect the monetary policy tightening and to do so very quickly (Figure 2.14). These developments suggest that there is an effective floor on bank lending base rates, which has deprived Latvia of the benefits of monetary policy easing and has contributed to hold back investment. To address this issue, the powers and tools of the Competition Council to investigate price setting coordination in financial markets should be strengthened. In Portugal, for example, the competition authority has imposed fines in 2019 in response to the concerted practice of exchanging sensitive commercial data in retail banking between 2002 and 2013 (OECD, 2020[17]). The infringement affected the setting of lending rates for mortgage, consumer and business loan products. Since then, banks in Portugal, where the share of variable-rate loans is higher than that of fixed-rate loans, as in Latvia, have used EURIBOR as the base rate for setting lending rates, regardless of whether it is below or above zero.

Figure 2.13. Most loans have a flexible interest rate

Share of loans with a floating rate or an initial rate fixation period of one year or less, %



Note: Calculations are for total new loans from monetary and financial institutions to households and non-financial corporations.
Source: Risk Assessment Indicators at the ECB Data Portal; and OECD calculations.

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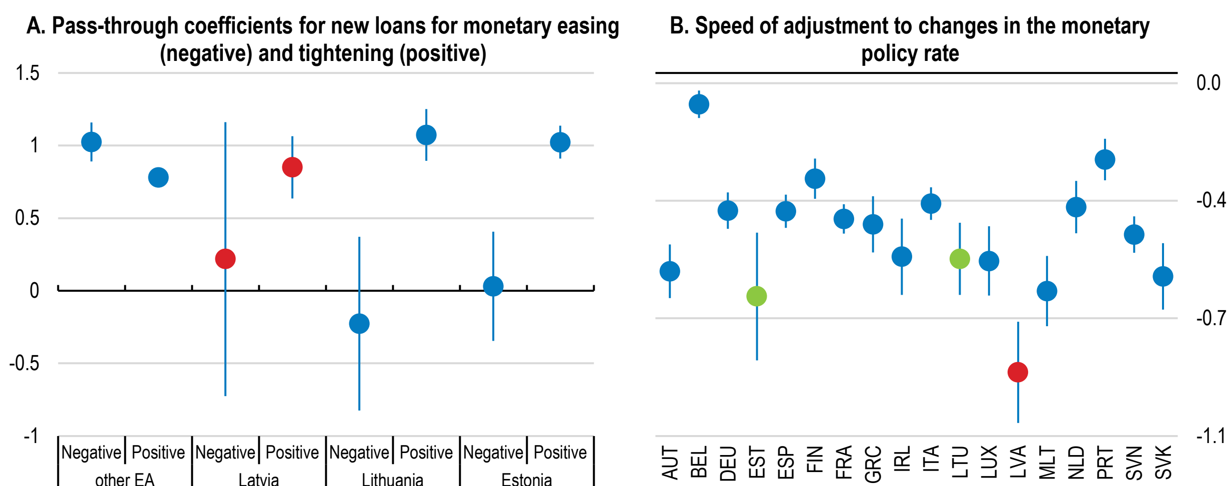
Figure 2.14. Monetary policy easing has not led to lower lending rates, while tightening strongly increased the cost of credit



Note: Estimates for the July 2007 – September 2023 period. The dots in Panel A are point estimates of the long-term adjustment of lending rates to non-financial corporations relative to a change in the monetary policy rate, distinguishing between the sign of the policy rate, and with higher values indicating stronger transmission and unity perfect transmission. "Monetary easing" refers to a level comparison between negative and positive policy interest rates, rather than a reduction in the policy interest rate. The point estimates shown in Panel B are the speed of adjustment to the equilibrium level of lending rates without distinguishing between the sign of the policy rate. A value closer to -1 indicates a faster pace of adjustment. The ranges around the point estimates in both panels are 95% confidence intervals. See Box 2.1 for further details.
Source: (Benkovskis et al., forthcoming[18]).

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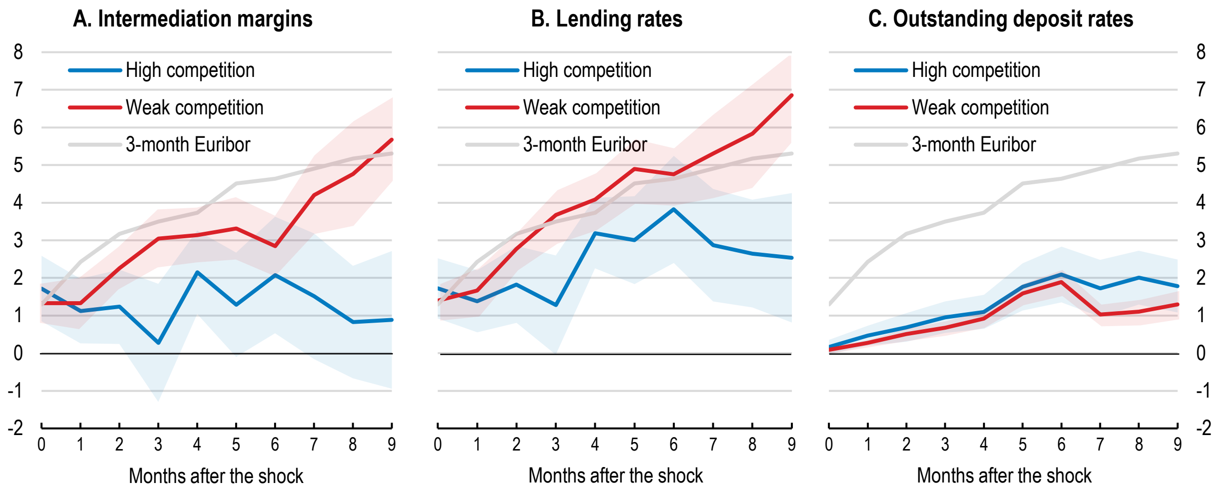
Competition needs to be strengthened to improve the functioning of credit markets. Empirical analysis conducted for this Survey shows that in less competitive markets, where banks have a stronger pricing power due to lower threat of entry, low customer mobility or less competition from other financial market players, the pass through of higher monetary policy rates to lending rates is much stronger and more rapid than on deposit rates. In response to an increase in the euro area monetary policy rate, euro area banks that have stronger pricing power raise lending rates significantly more and deposit rates less than banks operating in a more competitive market (Figure 2.15, Box 2.1) (Benkovskis et al., forthcoming[18]). As a

result, lending conditions in these less competitive markets are tighter and bank profitability is much higher, while depositors do not fully benefit from rising interest rates.

Figure 2.15. Weak competition increases credit spreads after a positive monetary policy shock

Response to an increase in monetary policy rates in the euro area



Note: Cumulative impulse responses are estimated using local projection methods (Jordà, 2005[19]). The intermediation margin is the spread between the lending rate for new loans to non-financial corporations (Panel B) and the outstanding deposit rate (Panel C). Impulse responses differ between banks that are below the first quartile (high competition) or between the first and the third quartile (weak competition) of the distribution of Lerner indices. Results are similar when comparing banks facing high competition with banks that are above the fourth quartile of the Lerner index distribution. The monetary policy shock following an ECB press release is the "target monetary policy surprise" mainly loaded on the one-month Overnight Index Swap rate, and its impact on the three-month Euribor rate is also shown (Altavilla et al., 2019[20]). Shaded areas indicate 90% confidence intervals. See Box 2.1 for further details.
Source: (Benkovskis et al., forthcoming[18]).

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Box 2.1. The role of banking sector competition in the transmission of monetary policy

The transmission of the ECB's monetary policy to financing conditions in euro area member states could be uneven due to differences in the financial frictions across member state banking systems. Financial frictions could arise from information asymmetries, limited commitment to the enforcement of debt contracts, high costs of asset recovery and imperfect competition in the banking sector (Gerali et al., 2010[21]). In markets with weaker competition, banking sector concentration could hinder the bank lending channel of monetary policy.

To make a preliminary analysis of the pass through of monetary policy on lending and deposit rates in the euro area, a study conducted for this Survey uses a bank-level panel error-correction model to regress the level of lending and deposit rates on the ECB's deposit facility rate, controlling for bank and year fixed effects. The sample covers the period from July 2007 to September 2023 and includes banks from 19 euro area countries. Country-specific results are then shown by interacting country dummies with the monetary policy rate. To analyse the asymmetric pass-through across countries, triple interactions of the policy rate with country dummies and dummies indicating the sign of the policy interest rate are included in the regression. In a second step, the speed of adjustment is estimated by regressing changes in the level of the lending and deposit rates on the lag of the error term obtained in the regression run on the full sample in the first step. The country-specific speed of adjustment term is obtained by interacting with country dummies.

To investigate the effects of competitive pressures for banks on the pass-through of monetary policy to lending and deposit rates, the Lerner index is used.[1] This index, which measures the mark-up over marginal cost at the bank-level, is a better measure for competition compared to indices of banking sector concentration, particularly for smaller economies like Latvia (Demirguc-Kunt and Martínez Pería, 2010[14]). For example, competition can be high in concentrated markets, if barriers to entry for new lenders and to exit for unprofitable institutions are low, and customer mobility is high. A lower level of the Lerner index indicates a higher price elasticity of demand and thus stronger competitive pressures and lower pricing power.

To analyse the effects of competition on the monetary policy pass-through, the impulse responses of the loan-deposit spread and the level of lending and deposit rates to a monetary policy shock are obtained for the sub-samples of banks facing high and weak competition. The method of local projections is used to address endogeneity concerns (Jordà, 2005[19]). Monetary policy shocks are obtained from market reactions around ECB Governing Council announcements, which can be assumed to be exogenous to the outcome variables and competition measures used in the single-equation regressions for each point of the impulse responses (Altavilla et al., 2019[20]).[2]

1. The Lerner index is estimated for about 140 euro area banks over the period 2012-22, which account for about 83% of the total assets reported by monetary and financial institutions over this period (excluding the Eurosystem of central banks). It is calculated as $L_{it} = (P_{it} - MC_{it})/P_{it}$, where the bank-level price P_{it} at time t is proxied by the ratio of total revenues to total assets and MC_{it} is the bank-level marginal cost. Marginal cost estimates are obtained from a panel estimation with bank fixed effects by fitting a trans-log total cost function over total assets and input prices for interest and non-interest expenses, as well as the quadratic terms of these regressors including their cross-interaction terms. The proxies for input prices are the ratio of interest expenses to the sum of total deposits and short-term debt and the ratio of non-interest expenses to total assets. Additional controls include time fixed effects.

2. The regressions control for bank-level and country-level variables. Bank-level controls include the share of deposits, the share of short-term loans, the liquidity ratio, the capital-to-assets ratio and the external liability ratio. Country-level controls include the GDP growth rate, the inflation rate, country-level credit default swap rates and the share of non-performing loans to non-financial corporations in the banking system. Additional controls include bank fixed effects and monthly dummies.

Source: (Benkovskis et al., forthcoming[18]).

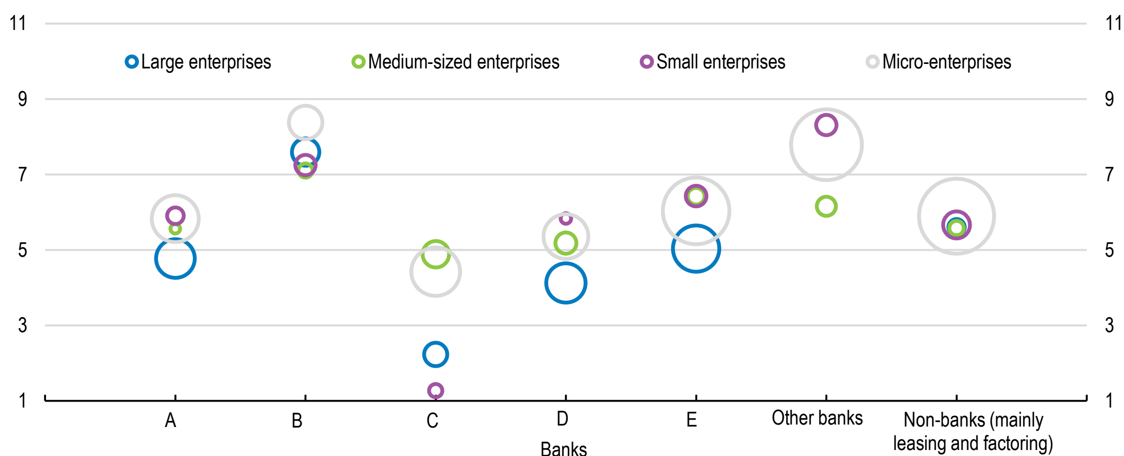
Increasing competition in the banking sector to reduce the cost of credit

Enhancing competition in the banking sector has great potential for reducing excessive intermediation margins and increasing the availability of credit. To improve competition enforcement, it is key to collect information on the ownership structure of banks and other firms to identify situations where firms competing in a market have common shareholders, typically an investor with a minority stake. Cross-shareholdings are commonly observed in countries with bank-based systems such as Germany, Japan and Italy and reduce banks' incentives to compete and increase the risks of coordination (OECD, 2008[22]). For example, the cost of losing customers to rivals is mitigated for a common shareholder if it also owns shares in competing rivals that win new customers. Another angle is the possibility of large industrial groups having ownership links with banks, which could reduce access to credit for firms that are not connected to these industrial groups. Even in the context of merger control, the Latvian Competition Council does not have the tools to assess the extent of minority shareholdings and has not yet made a specific assessment of common ownership between banks and its impact on competition in the banking sector. This also applies to ownership links with insurance firms and pension funds, which can similarly hamper banking sector competition (see below).

Low customer mobility related to high fees is reducing competitive pressure on banks. Lending rates differ substantially across lending institutions, indicating that customer mobility is low (Figure 2.16). This is mainly due to high commissions and fees, as indicated by their high share in the total banking sector income (Figure 2.17). High fees charged to customers who want to refinance their outstanding loans by switching to another bank discourage customers from switching to another bank (Competition Council, 2019[23]). More than 80% of customers in 2018 had a relationship with one of the big three banks, and three-quarters said they had not switched banks in the last five years, citing high switching fees as the main reason, especially if they had taken out a loan. These patterns are consistent with previous evidence suggesting that a significant proportion of the marginal value of a bank customer is related to switching fees, and that a large part of a bank's market share is explained by established bank-customer relationships (Kim, Kliger and Vale, 2003[24]). Such costs, combined with long-term loans, can lock customers into the same bank for long periods of time, allowing banks to enjoy a degree of protection from competitors even when market interest rates are falling (OECD, 2011[8]).

Figure 2.16. Loan rates vary across lending institutions

Interest rate on loans by firm size and lending institution, % per annum

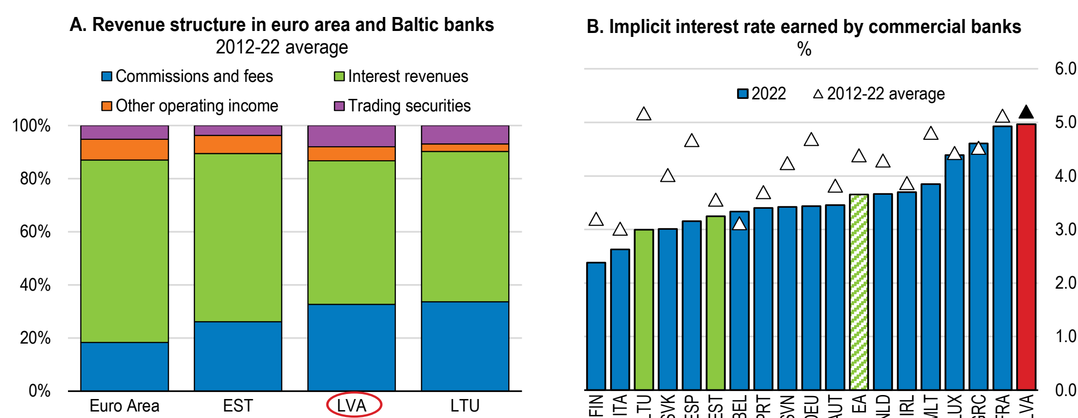


Note: Capital letters on the horizontal axis are used to anonymise the largest banks. The increasing size of the bubbles corresponds to higher loan volumes. Weighted averages for the interest rates over the period of 2023Q1-Q3.
Source: Bank of Latvia calculations using firm-level credit register data.

Encouraging banks to reduce the administrative costs of switching banks and refinancing a loan, including through regulation, would increase customer mobility and create incentives for banks to lower lending rates. The government has proposed amendments to the Law on Consumer Protection and the Law on Credit Institutions, to make it easier for customers to switch banks. In particular, the proposals introduce a cap on refinancing fees at 1% of the refinanced loan amount and allow borrowers to pay this fee in three instalments. Credit institutions will be required to provide information on the borrower to the lender refinancing the mortgage, and the refinancing process will take no more than 2 months and can be done online. Advertising restrictions for mortgage loans and loans for real estate construction or energy efficiency improvements will also be removed. Proposed amendments to the Insurance Contract Law will allow borrowers to unilaterally terminate their property insurance contract when refinancing. These are steps in the right direction and should be complemented by reducing administrative costs for refinancing loans, which are due to differences in contracts across banks, particularly concerning the registration and valuation of collateral. Requiring banks to provide standard contract templates and develop switching packages to simplify the administrative steps involved would further facilitate switching.

The introduction of regulation to directly reduce mortgage interest rates should be avoided. In December, the parliament adopted amendments to the Consumer Rights Protection Law, which introduced a levy on banks to provide mortgage interest rebates to borrowers. 30% of borrowers' interest payments will be rebated for loans of less than EUR 250 000 and granted before the end of October 2023, corresponding up to a maximum of 2 percentage points of the original lending rate charged to the borrower. Banks will make quarterly payments in 2024 of 0.5% of the outstanding balance of the specified loans to the State Revenue Service, which will transfer the rebates to mortgage borrowers. These transfers will be exempt from income tax and debt collection. No ex-ante impact assessment of the measure on distributional effects across households and future lending behaviour of the banking system has been conducted. As most mortgages are held by higher-income households, the policy is likely to benefit richer households more (Bank of Latvia, 2023[4]). Moreover, due to weak competition banks could pass on the cost of the rebate to customers through other commissions and fees and higher lending rates for newly issued loans.

Figure 2.17. Banking commissions and fees and implicit lending rates are high



Note: The euro area aggregate accounts for about 83% of the total assets reported by monetary and financial institutions excluding the Eurosystem of central banks and reflects the unweighted average of around 150 major euro area banks (the exact number varies according to data availability) in the calculations. Panel B shows the ratio of interest revenues to total assets.
Source: Bloomberg; bank-level financial statements; and OECD calculations.

Information asymmetries further increase switching costs and weaken competition among banks. Monthly maintenance fees for debit cards and fees for in-person transfers, including within the same bank, have increased significantly since 2012 (Competition Council, 2019[23]). Since 2019, the Consumer Rights Protection Centre has published the fees charged by major banks for services related to payment accounts, which is welcome as it contributes to reducing information asymmetries and increasing customer mobility.

However, some banking services are offered in bundles, making it difficult for customers to compare the fees of individual services across banks. Expanding the existing platform on payment account commissions to include fees and conditions for other services, such as minimum fees charged by banks for loan refinancing or the cost of debit cards and transfers, would significantly contribute to reducing information asymmetry and improve competition. This is particularly important to reduce switching costs for consumers whose level of financial literacy may not be high enough to make an informed comparison between banks and would help foster financial inclusion. This should be combined with improving access to financial education for vulnerable individuals, which would help them to manage their personal finances prudently. To this end, the National Strategy for Financial Literacy, led by the Bank of Latvia, is a step in the right direction.

The low number and uneven distribution and size of bank branch and ATM networks hinders customer mobility and competition (Figure 2.18) (OECD, 2011[8]). Low physical and digital accessibility and ease of use of banking services is the second most cited reason for low customer mobility (Competition Council, 2019[23]). The number of physical bank branches and ATMs has even decreased in recent years, resulting in Latvia ranking below the EU average in the availability of access points per inhabitant. This can lead to financial exclusion of older people as they tend to prefer branch banking compared to online or mobile banking (OECD, 2020[25]). Banks have agreed not to charge additional fees for other customers to use their ATM networks, which is an important step to mitigate this availability problem. However, regional heterogeneity in access to banking services remains high. Possible solutions include informing communities about the decision to close a branch, using mobile branches on accessible vehicles such as buses, or working with other service providers such as post offices or supermarkets to provide banking services in remote areas. It is also important to further incentivise online banking and better educate senior citizens to use mobile banking. Fees for online transfers are low, which has incentivised online banking for transfers and led to more frequent use of mobile banking than the EU average (Figure 2.18). Further reducing information asymmetries on fees and contract conditions and improving cyber security could help to develop online banking and improve competition. In this respect, the inclusion of IT security and outsourcing management in the Bank of Latvia's supervisory priorities for 2024 is a step in the right direction.

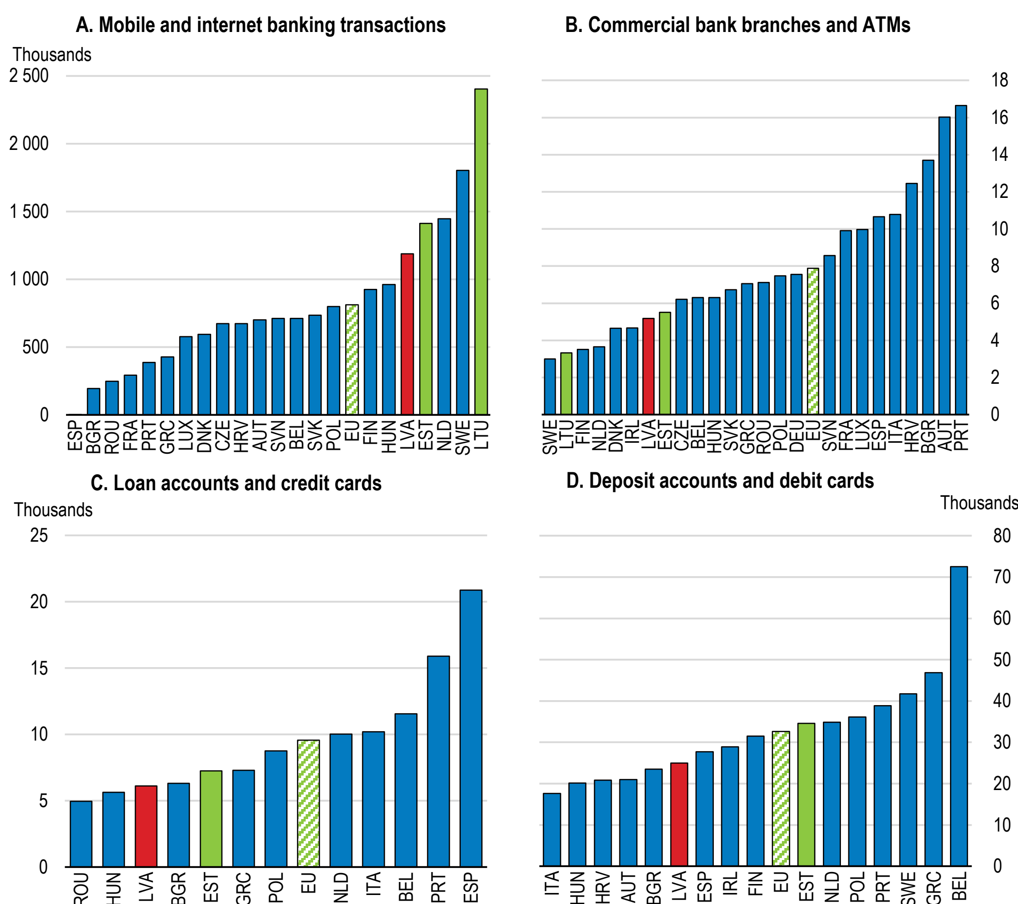
Foreign-owned banks focus their lending activities on larger cities and do less relationship lending, which limits lending in the regions (Havrylchyk, 2012[26]). Scandinavian banks have been important players in Latvia and other Baltic countries since the 1990s. Due to their extensive and complex organisational hierarchies and limited access to soft information on borrowers, they engage less than domestic banks in lending to SMEs, especially those operating in the hinterland (OECD, 2017[27]; OECD, 2019[3]). The restructuring of the second largest bank after the global financial crisis, which used to mainly serve borrowers in the hinterland, transferred a large share of its ownership to large foreign investors, further reducing relationship lending in the remote or lower population density regions (OECD, 2016[6]). Collecting information on the availability of banking access points and services at the municipal level would allow policy makers to analyse regional disparities in access to financial services, including borrowing (OECD, 2017[28]; OECD, 2020[29]). Information on borrowing activity is only available at the national level, and Latvia is below the EU average and its peers in terms of the number of loans and credit card holdings per inhabitant (Figure 2.18). In this respect, the efforts of the Ministry of Economy to establish a dataset on the number of credit operations at the municipal level by the second half of 2024 are welcome.

Increasing the role of credit unions could help to partially close the relationship lending gap. Credit unions have a comparative advantage in accessing soft information about their members and may be subject to a lower degree of moral hazard, as borrower members have an incentive not to damage their local credit union by defaulting on their loan. However, it has proved difficult to persuade credit unions to make more business loans, for example in the UK, as this has been perceived as very risky by credit union managers, since business lending is an area in which they lack expertise and skilled staff (Talbot, Mac an Bhaird and Whittam, 2015[30]). In the case of Latvia, credit union lending is very small, with a balance of around EUR

24 million in 2022, and more than half of the loan book being mortgage loans and almost all the rest being consumer loans. Allowing well-capitalised credit unions to lend to a wider community than their membership and provide small unsecured loans to microenterprises could increase the availability of credit in the regions, where bank collateral requirements are restrictive. Similar regulatory relaxation in addition to consolidation of small regional banks, has allowed a significant increase in business lending by credit unions in the US (Ely and Robinson, 2008[31]).

Figure 2.18. There is room to increase financial inclusion

Total number per 10 000 residents, 2022 or the latest



Note: Per capita concentration measures shown in Panels C and D are for commercial banks.
Source: IMF Financial Access Survey data; OECD Economic Outlook database; and OECD calculations.

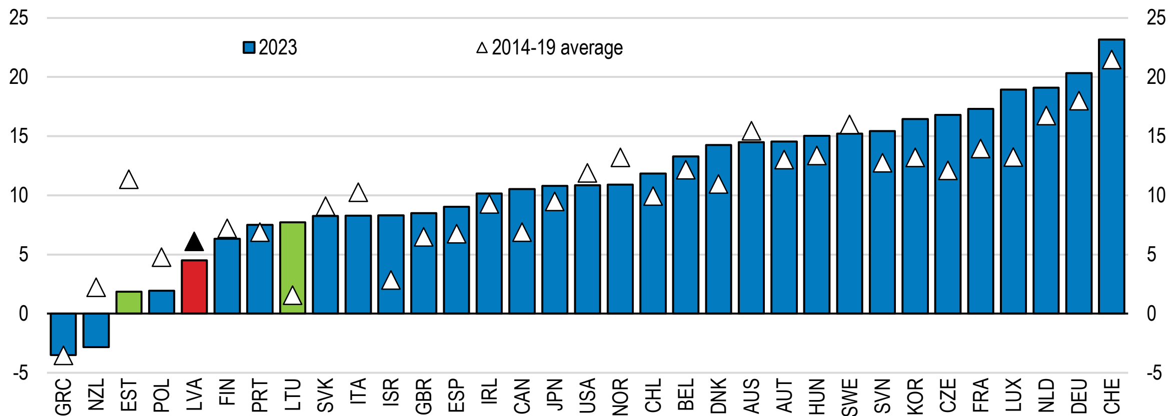
StatLink https://stat.link/1ojp5d

Low deposit rates and weak trust in banks have contributed to reduced customer mobility and partly explain why few households save in time deposits. Currently, around 80% of all deposits are in current accounts and the penetration of deposit accounts is lower than the EU average (Figure 2.18). The failure of Latvia's second largest bank during the global financial crisis led to deposit flight and a government takeover, which initially contributed to low trust in banks, although Latvian depositors have the same level of deposit guarantees as in the rest of the euro area (OECD, 2016[6]). The subsequent successful payout of guaranteed deposits has improved trust in banks, but relatively low deposit rates have continued to discourage customers from switching to interest-bearing time deposits, which are less liquid than current accounts. Although deposit rates have increased significantly in recent months, the weighted average annual deposit rate in the Latvian banking system in the first half of 2023 was around 40 basis points lower than in the euro area (Bank of Latvia, 2023[4]). As rising deposit rates tend to boost household saving more when overall interest rates are higher, it is important for Latvian banks to catch up with the rest of the euro

area to help lift the household saving ratio (Figure 2.19) and the funds available for investment (Felici, Kenny and Friz, 2023[32]). The Bank of Latvia has published the deposit rates offered by individual commercial banks since April 2023, which will help reduce information asymmetries among depositors, increase customer mobility and enhance competition among banks. This should be coupled with raised awareness of the deposit insurance scheme.

Figure 2.19. Bank deposit rates need to increase to foster household savings

Household gross saving ratio, %



Source: OECD Economic Outlook database.

Lack of external finance is a major barrier to entry for FinTech firms, which reduces the threat of contestability in the banking sector. The cost of entry is significant due to high capital requirements and licencing fees for lending activities, and sources of private external finance to fill this gap are limited. Latvia has only one angel investor network, which limits FinTech firms' access to venture capital funding at the pre-seed or seed stage. In addition, FinTech start-ups are not eligible for venture capital financing support schemes offered by the public development finance agency, ALTUM, as they are classified as financial intermediaries. Alternative investment funds also remain small, although they have been operating since 2014, following the adoption of the EU Alternative Investment Fund Managers Directive (Bank of Latvia, 2023[4]). Increasing the visibility of FinTech firms to alternative investment funds or making FinTech start-ups eligible for venture capital support by ALTUM, until private venture capital funding becomes more accessible, can help bridge the external financing gap for FinTech start-ups.

The coexistence of FinTech companies with the banking system reflects cooperation rather than competition. In Latvia, FinTech companies did not have direct access to the payment system until recently and are subject to high capital requirements. This makes larger SME lending infeasible, which is why they mostly provide small consumer loans at relatively high interest rates (Fintech Latvia Association, 2023[33]). In contrast, FinTech firms contribute to facilitating bank lending by providing online loan comparison platforms, credit scoring tools to facilitate the loan underwriting process and automation of payment collection to minimise manual intervention and help banks to monitor Anti-Money Laundering (AML) compliance (Berg et al., 2020[34]; Bank of Latvia, 2023[35]).

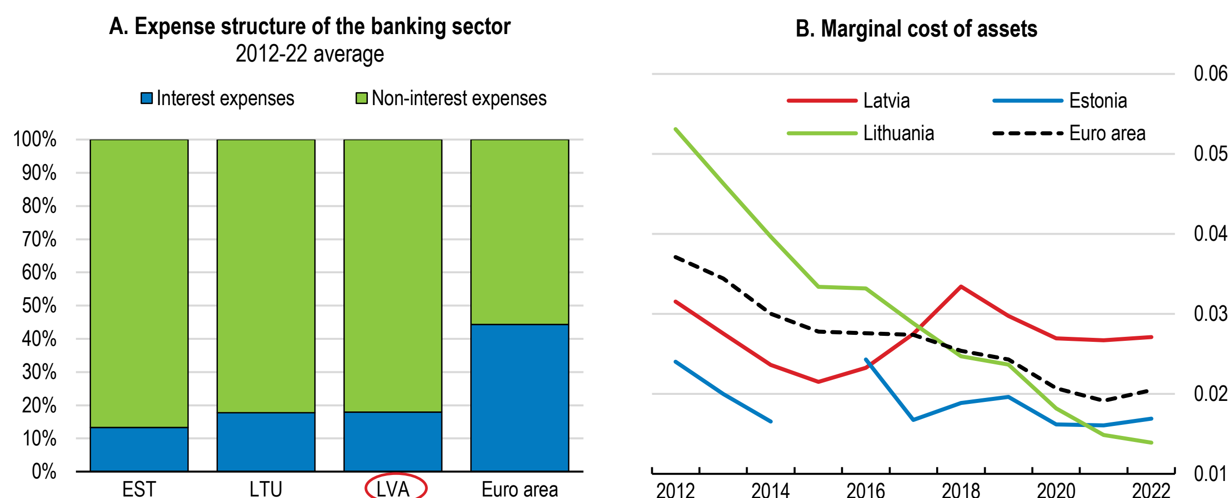
The introduction of a regulatory sandbox for FinTech firms was an important step to develop the sector but should be expanded gradually to include lending activities. Latvia was one of the few European pioneers to introduce a regulatory sandbox in 2018, which provides ample opportunities for potential market entrants to test innovative FinTech solutions and familiarise themselves with the regulatory framework (European Parliament, 2020[36]). While the initial scope of product testing was limited to electronic payment or e-money services, the areas of testing were later expanded to include crowdfunding and crypto-asset service providers, technology solutions for regulatory compliance and for increasing the efficiency of the insurance industry. The sandbox was accompanied by the establishment of the Innovation Hub, where the Bank of

Latvia provides free expert advice to FinTech companies on compliance of innovative financial products and new business models with licensing, supervision and regulatory requirements. The number of such consultations has steadily increased since the establishment of the hub (Fintech Latvia Association, 2023[33]). Extending the scope of testing in the regulatory sandbox to lending activities would facilitate the entry of FinTech firms into this market segment. To increase competition in the banking sector, Lithuania introduced a well-communicated toolkit for FinTech firms, including a simplified regulatory regime, a fast licencing process, direct access to the payment system, and an additional blockchain-based sandbox. This allowed the sector to expand in the areas of crowdfunding, digital currencies and fast data analytics, leading to one of the EU's largest FinTech industries, providing 15% of financing to businesses and accounting for 0.4% of country's workforce by the end of 2021 (OECD, 2022[37]).

Improving anti-money laundering (AML) risk management to preserve financial inclusion

Excessive aversion of banks to AML-related reputational risks has led to a high administrative burden, possibly putting upward pressure on the cost of loans. Following Russia's invasion and annexation of Crimea in 2014 and money laundering scandals related to several banks, including the resignation of senior managers related to AML/CFT (Counter-Terrorist Financing) compliance issues, AML/CFT measures have been appropriately strengthened, in line with previous OECD recommendations (OECD, 2016[6]). Accordingly, the share of non-resident deposits in the banking system and cross-border financial flows to and from high-risk jurisdictions have steadily declined (IMF, 2023[38]). Although the efforts to reduce AML/CFT risks are welcome, aversion to AML-related reputational risks in lending are also likely to have contributed to the increase in the non-interest costs of making loans (Figure 2.20). In fact, while costs of lending in the banking sector have declined in other Baltic countries and on average in the euro area, they have increased since 2015 and then remained relatively stable in Latvia (Figure 2.20) (van Leuvensteijn et al., 2013[39]). Due to weak competitive pressures, these costs have been passed on to borrowers, raising the cost of credit and contributing to excessive deleveraging.

Figure 2.20. Banking sector costs are skewed towards non-interest expenses



Note: The euro area aggregate accounts for about 83% of the total assets reported by monetary and financial institutions excluding the Eurosystem of central banks and reflects the unweighted average of around 150 major euro area banks (the exact number varies according to data availability). Marginal costs shown in Panel B relate to interest expenses and non-interest expenses, which include administrative burden. See Box 2.1 on the estimation of the marginal costs. For Estonia, bank-level data in 2015 are discontinued.
Source: Bloomberg; (Benkovskis et al., forthcoming[18]); and OECD calculations.

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AML risk aversion by banks has also increased barriers to market entry and costs for FinTech firms. FinTech companies surveyed by the Bank of Latvia indicate that it is difficult to open current accounts in banks in Latvia, pointing to AML risk aversion (Bank of Latvia, 2023[35]). Banks have increased fees for

FinTech companies due to the costs of conducting a thorough AML compliance audit, which increases prices for the customers of FinTech firms. These audits are likely to be more costly for payment or e-money FinTech firms that have not yet improved their AML/CFT risk management procedures (EBA, 2023[40]). A lack of understanding of the business model of FinTech firms by counterparty bank staff is also a commonly cited issue. In particular, FinTech companies owned by foreign investors face costly and lengthy document reviews. In December 2023, the Bank of Latvia and the Ministry of Finance have agreed on the principles for making the necessary regulatory changes to grant FinTech companies direct access to the Electronic Clearing System. The granting of the access to the national payments system is subject to the approval of the new regulatory framework until June 2024. This is a welcome step and its implementation in line with the EU Payment Services Directive 2 would maintain security and consumer protection and increase competition in lending.

Continuing to implement AML/CFT compliance measures while avoiding unwarranted de-risking is important to preserve financial inclusion. Unwarranted de-risking could result from refusing to establish or terminate a banking relationship with an individual or a whole category of customers based on AML/CFT compliance without due consideration to the risk profile of individual customers. Such a lack of due diligence is often related to a lack of relevant expertise to assess the risks associated with the business model, a risk appetite that is lower than the perceived reputational risk or a judgement that the cost of compliance would outweigh the benefits of providing the banking product. In fact, the European Banking Authority (EBA) has assessed that a range of customers including payment or e-money institutions have often been affected by de-risking in the European Union (EBA, 2022[41]). In the case of Latvia, surveyed firms pointed to banks' lack of expertise in distinguishing between transactions involving investors from Russia or Belarus and those involving counterparties from AML/CFT compliant countries. Unduly blocking some transactions in advance could result in diversion into the shadow economy, thus making the prevention of financial crime less effective.

Following the EBA guidelines on AML/CFT risk-based supervision would increase the effectiveness of financial crime prevention, while preserving the availability of credit (EBA, 2021[42]). A risk-based approach to due diligence, while distinguishing between lower and higher risk situations, would also reduce unwarranted de-risking. Such lower-risk situations would include public company borrowers that are listed on a stock exchange and therefore are subject to appropriate disclosure of beneficial ownership, or customers operating in countries which are identified by credible sources as having effective AML/CFT systems, or low levels of corruption or criminal activity. However, it is important to ensure that risk-based due diligence legislation does not pre-determine entire countries or products or services as low risk (OECD, 2022[43]). Continuously requiring financial institutions to record the results of customer due diligence in cases of refusal or termination would help supervisors to assess whether unwarranted de-risking is common (EC, 2021[44]). Outcomes of AML/CFT risk management have improved in recent years, as the share of assets held by high-risk institutions has been declining (Bank of Latvia, 2023[45]). However, to continue improving AML/CFT risk-management of banks, while ensuring financial inclusion, it is necessary to better define low-risk cases, assess the current degree of de-risking, and better train financial sector employees.

Improving the governance of financial regulation and supervision

The financial regulation and supervision agency has been merged with the central bank to reduce costs and address skilled labour shortages in the public sector. The former financial regulator, the Financial and Capital Market Commission, was dissolved on 1 January 2023 and the Bank of Latvia took over all its powers and functions, in accordance with a parliamentary decision adopted in September 2021. Besides economies of scale, other benefits of merging macroprudential policy, microprudential banking supervision and bank resolution functions with the central bank include easier access to information and the benefit of the central bank's independence, which is guaranteed by law (D'Hulster and Unsal, 2019[46]).

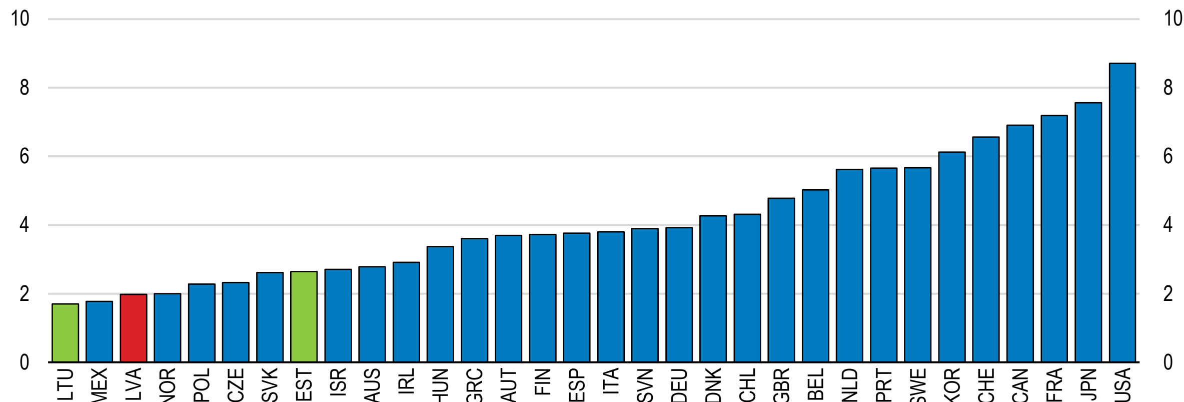
Risks to the governance of financial sector policies should be carefully monitored. For example, macroeconomic stability objectives could lead to prioritise the macroprudential dimension of policy and de-prioritise the objectives of microprudential banking supervision. To avoid such conflicts of objectives, the current separation of reporting and budget lines, as well as staffing arrangements between the two functions, should be maintained (D'Hulster and Unsal, 2019[46]). The framework for crisis preparedness and management should clearly assign mandates to the different departments of the central bank through legislation. To better address competition issues in the financial sector, the central bank should make better use of the expertise of the Competition Council, especially in assessing the effects of common ownership among banks, leasing companies, privately managed pension funds and insurance companies.

Deepening capital markets to create alternative sources of financing

Expanding non-bank financing sources can do much to improve access to credit and enhance competition in the financial system. Currently, banks in Latvia account for about two-thirds of the total assets of the financial system and corporate bond and equity markets are very thin, contributing to low corporate leverage (Figure 2.21) (Bank of Latvia, 2023[4]). Efforts to improve competition and risk management in the banking system should be accompanied by the promotion of non-bank financing alternatives. In May 2023, the government set medium-term policy priorities for capital market deepening until 2027, which is a step in the right direction. These priorities include facilitating the listing of SMEs on the stock market, conducting Initial Public Offerings (IPOs) for some large state and municipal SOEs, raising awareness of capital markets among domestic retail investors and expanding the domestic investment opportunities for institutional investors.

Figure 2.21. Non-financial corporate leverage is very low

Non-financial corporations debt-to-profit ratio, 2022 or latest



Note: Debt is an aggregate measure and refers to the sum of the following liability categories: currency and deposits, debt securities, loans, insurance, pensions and standardised guarantee schemes and other accounts payable. Profit refers to aggregate gross operating surplus.
Source: OECD National Accounts at a Glance database.

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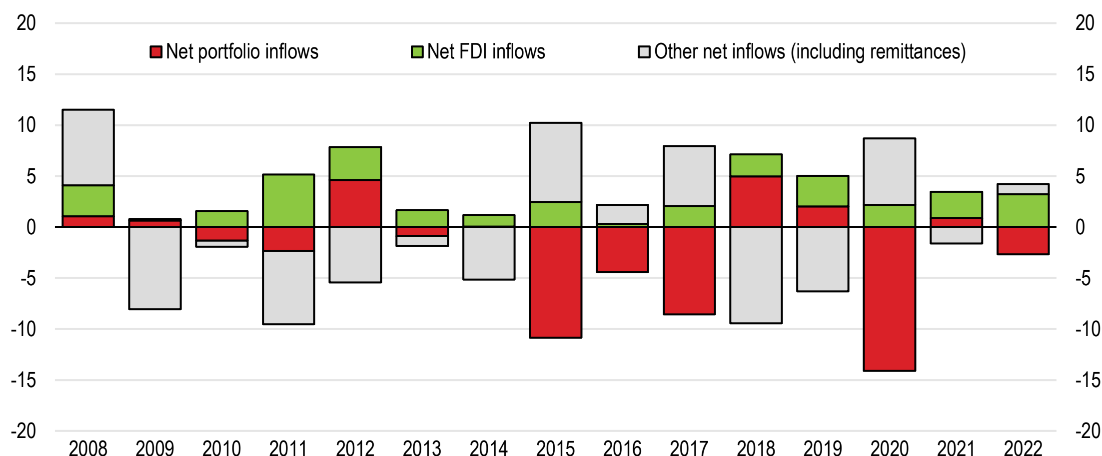
Although Latvia receives significant foreign direct investment, portfolio inflows are limited. A well-designed regulatory environment has strongly contributed to attracting FDI inflows, but they are not sufficient to compensate for low domestic savings. Attracting portfolio inflows can be an important way to boost investment for countries with low saving rates, such as Latvia. However, net portfolio inflows have been negative since the global financial crisis (Figure 2.22). Remittances inflows from the diaspora are sizeable but very volatile. It is important to create synergies between investors returning to Latvia and incentives for them to start their own businesses to ensure a steady inflow of funds from the diaspora (OECD, 2022[1]). In this respect, the business incubation programme of the Investment and Development Agency, LIAA,

which encourages remigration and assists returning investors in the idea development and implementation phases, is a welcome step.

Figure 2.22. Net portfolio inflows are weak

In per cent of GDP



Note: Foreign capital inflows in US dollars are converted into local currency units using average annual market exchange rates.
Source: OECD Economic Outlook database; OECD Monthly Capital Flows dataset; and OECD calculations.

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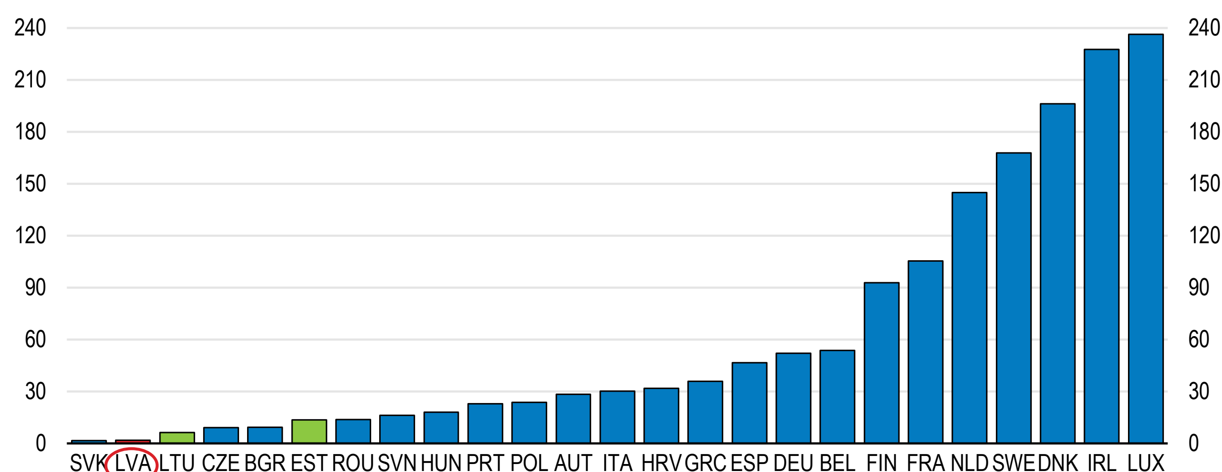
Developing stock markets to improve access to finance

The stock market is very shallow by international standards (Figure 2.23). Latvian companies are small with a concentrated ownership structure, which reduces the visibility and availability of traded stocks in international financial markets. Stock market listing is relatively very costly for many companies due to the administrative burden of corporate compliance, reporting and legal document preparation. Currently, only 14 stocks are traded on the Latvian stock exchange and stock market turnover rates are much lower than in Lithuania and Estonia (Bank of Latvia, 2023[4]). The European Bank for Reconstruction and Development in cooperation with the European Commission, Nasdaq Baltic and the finance ministries of Estonia, Latvia and Lithuania, has led an initiative to create a single index combining the three Baltic capital markets, and introduced the MSCI Baltic index in August 2023. The initiative aimed to raise the profile of the region, and Latvia should benefit most as its stock market capitalisation is the smallest in the whole euro area. The inclusion of the Latvian stock exchange in the benchmark indices will also increase the visibility of Latvian stocks among international investors seeking to diversify their portfolios.

Figure 2.23. Stock market capitalisation is among the smallest in the euro area

Outstanding amount of listed shares in February 2024, % of 2023 GDP



Source: ECB Data Portal; OECD Economic Outlook database; and OECD calculations.

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The listing of large SOEs would help deepen capital markets and improve their governance (see Chapter 1). Latvia has not listed any of its large SOEs in the stock market, in contrast to the other Baltic countries, where SOEs account for about one third of stock market capitalisation. The listing of minority stakes in SOEs has also helped to attract domestic investors to capital markets in other European countries and Israel, and improved access to finance for SMEs (Box 2.2). The Latvian authorities are currently considering the listing of airBaltic, the national commercial airline, which is now almost wholly owned by the state following its recapitalisation during the COVID-19 crisis. A wind farm, *Latvijas vēja parki*, is also being considered for listing as its internal resources and the planned bond issue are not sufficient to cover total investment plans of around EUR 1 billion. The government has also asked the Riga City Council to study the possibility of issuing minority shares in SOEs owned by the municipality of Riga. According to preliminary estimates, the listing of these SOEs, including two large ones with a market capitalisation of around EUR 1 billion, would increase the capitalisation of the stock market from its current level of less than 2% of GDP to around 9% of GDP by 2027. Timely implementation of these plans and considering the listing of additional SOEs would help to increase net portfolio inflows, attract domestic institutional and retail investors and strengthen the governance of listed SOEs (OECD, 2022[47]; OECD, 2021[48]; OECD, 2022[1]). SOEs that do not meet the size criteria for a prime market listing could be consolidated or listed in the lower segments (OECD, 2021[49]).

Box 2.2. Listing of SOEs to deepen capital markets: The case of Romania

Latvia can draw policy lessons from the Romanian case, as the current proposals in Latvia on initial public offerings (IPOs) for SOEs and SMEs have been among the key features of the Romanian stock market (2022[47]). The stock market capitalisation in Romania has increased from around 5% of GDP to 12% of GDP over the past two decades, while the stock market capitalisation in Latvia has been stagnating below 4% of GDP during the same period. The development of the Romanian stock exchange has crowded in domestic investors in addition to attracting foreign investors. Simplified listing procedures and post-listing requirements tailored to SMEs have also facilitated Romanian SMEs' access to non-bank finance and improved their corporate governance.

In 2015, the Bucharest Stock Exchange (BVB) launched the secondary segment, AeRO Market, dedicated to SME listings. At the end of 2020, about three-quarters of the BVB's share capital was owned by Romanian institutional investors, while one-fifth of the share capital was owned by Romanian private individuals and the remaining shares were owned by foreign institutional investors. The BVB's upgrade from Frontier to Secondary Emerging market status in 2019 has increased the visibility of the exchange and reduced the country's risk premium.

The BVB consists of a Main Market, where listed companies are joint stock companies with a minimum market capitalisation of EUR 1 million, with at least one quarter of their shares publicly traded and a financial reporting history of at least three years. Listing conditions in the AeRO Market are more relaxed, with a minimum capital requirement of EUR 250 000, a minimum ratio of traded shares of 10% or a minimum of 30 shareholders. Companies in the AeRO Market should also be a joint stock company prior to listing. Companies listed on the Main Market are required to submit quarterly financial reports and to comply with the Corporate Governance Code, which regulates the independence of the board of directors, risk management and internal audit of the listed companies, on a comply-or-explain basis. Companies traded on the AeRO Market, on the other hand, are required to file annual and half-yearly reports and are only obliged to comply with a specific set of Principles of Corporate Governance.

The listing of SOEs has significantly increased the depth of the Romanian stock exchange. During 2000-19, 18 IPOs on the BVB raised a total of EUR 1.3 billion, with 5 SOE issues in the utilities and energy sectors raising about 90% of the total proceeds. 95% of the equity is held by domestic investors, with domestic corporate investors holding significant stakes in telecommunications and industrial companies, beyond SOE equity. In contrast, foreign corporate investors concentrate their holdings in healthcare, financials, energy, consumer non-cyclicals and basic materials industries.

Source: OECD Capital Market Review for Romania (2022[47]).

For small companies, the administrative burden for listing on the Nasdaq Baltic stock exchange is high. While a higher burden for SMEs is not unusual across countries, the costs for a listing can be as high as half a million euros, which represents a high barrier to entry for small firms. The Ministry of Economy is planning a support programme to cover part of the costs of listing for SMEs. To further facilitate SMEs' access to non-bank finance, it would be important to simplify listing procedures to shorten the time to raise equity capital and provide direct or indirect financial support for advisory fees associated with listing (OECD, 2022[47]). Designing mechanisms for companies listed in the Baltic Secondary List, the growth market, to transfer to the Main List would help already listed SMEs to scale up (OECD, 2021[10]).

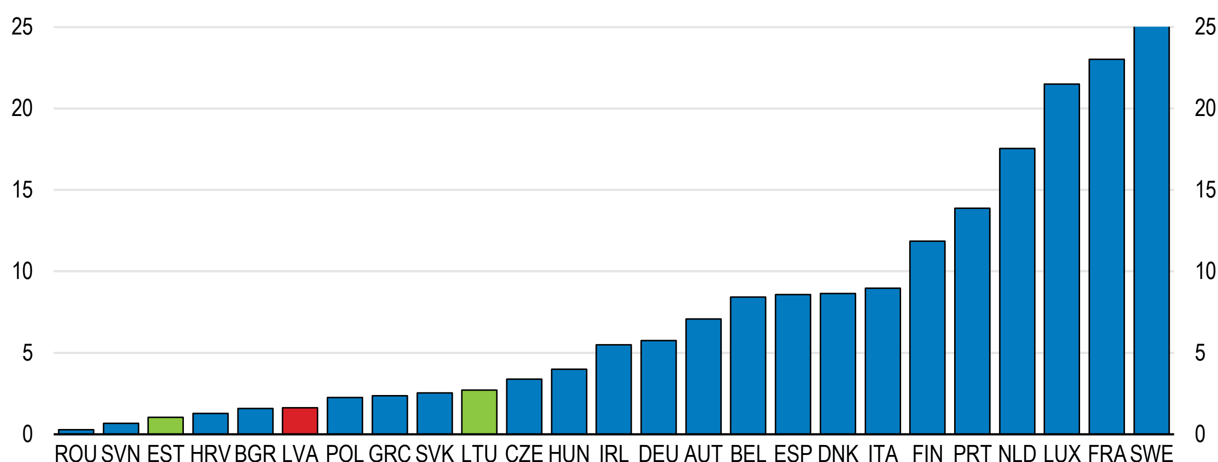
Developing corporate bond markets as an alternative source of financing

Corporate bond issuance can help to improve access to finance and corporate governance. The main advantage of corporate bond financing is its lower collateral requirements and longer maturities compared to bank loans, two aspects that limit SMEs' access to bank finance in Latvia (see above). Moreover, like shareholders, corporate bond holders can exit by selling their portfolios and express their concerns when

initiating bond contracts, which improves corporate governance and external monitoring (Çelik, Demirtaş and Isaksson, 2015[50]). Although corporate bond issuance has grown rapidly around the world since the global financial crisis, it remains very limited in Latvia compared to the euro area (Figure 2.24) (Çelik, Demirtaş and Isaksson, 2020[51]). In Latvia, the main obstacles to corporate bond issuance include the high costs for companies to prove their creditworthiness, and the difficulty of finding institutional investors on the demand side of the corporate bond market.

Figure 2.24. The corporate bond market is very thin

Outstanding amounts of debt securities by non-financial corporations in February 2024, % of 2023 GDP



Source: ECB Data Portal; OECD Economic Outlook database; and OECD calculations.

Some steps in the right direction have been taken to reduce the administrative costs of corporate bond issuance, but more needs to be done to promote corporate bond markets. Given the low leverage ratio and the healthy profitability of companies that operate in the formal sector, firms that are able to issue bonds are likely to receive higher credit ratings and enjoy lower rates on newly issued corporate bonds compared to bank loans (Bank of Latvia, 2023[4]; Ayres and Blank, 2017[52]). As the costs for obtaining credit assessments add to barriers to bond issuance, the Bank of Latvia or the State Revenue Service could support the development of bond markets by providing low-cost creditworthiness information on SMEs. They have the capacity and necessary detailed firm-level data available to provide credit assessments at low cost. For example, the German Bundesbank uses annual financial statements and provides credit ratings for companies, which are free of charge and can be compared within the applicant's sector and over time (Deutsche Bundesbank, 2022[53]). The Banque de France provides corporate credit ratings through its FIBEN database, which significantly reduces the cost of issuing bonds for French companies (OECD, 2022[47]). These efforts should be accompanied by increasing the financial literacy of potential corporate bond issuers, as the Banque de France is doing.

Corporate bond issuance should be further facilitated by easing issuance conditions and broadening the buyer side of the corporate bond market. In Italy, for example, mini-bonds can be issued by unlisted companies with less stringent administrative requirements, which has improved access to finance particularly for medium-sized manufacturing firms (Box 2.3). However, such corporate bonds can only be traded on the stock exchange by institutional or qualified retail investors (OECD, 2020[54]). This is similar to the private placement market in the US, Germany and France, where bonds are sold to a select group of institutional investors who can assess the creditworthiness of the issuer, so that the cost of issuance is lower and the disclosure requirements are more relaxed. A major difficulty in the case of Latvia is the small size of companies, which reduces the demand for individual corporate bond issues by large institutional investors. To make Latvian corporate bond issues marketable to large institutional investors, cooperation

between firms and banks specialising in arranging corporate bond issues should be strengthened by facilitating securitisation. For example, Italian mini-bonds have been securitised four times since 2016, making them available to the European Investment Bank. In this respect, the adoption of the Securitisation Law in June 2023, in line with EU Regulation 2017/2402 on simple, transparent and standardised securitisation, is a welcome step.

Box 2.3. The Mini-bond market in Italy supports non-bank financing for SMEs

The Italian government introduced legislative changes in 2012 to facilitate non-bank financing for unlisted SMEs. Easing restrictions on company size and tax liability for corporate bond issuance led to the introduction of "mini-bonds", which could be issued by companies with more than 10 employees and an annual turnover and/or assets of more than EUR 2 million. Although mini-bonds could be issued by unlisted firms, some issuances in the mini-bond market still had the characteristics of public debt offerings by being traded in a multilateral trading facility and providing publicly available information sheets. Between 2013 and 2018, the number of issuers in the mini-bond market increased steadily, with average proceeds of EUR 14 million, and in 2018 average maturity of issuance for small and large non-financial corporations stood at 3.8 and 6.3 years, respectively. Increased bond issuance was mainly driven by medium-sized manufacturing firms.

Source: OECD Capital Market Review for Italy (2020[54]).

Attracting institutional investors to deepen capital markets

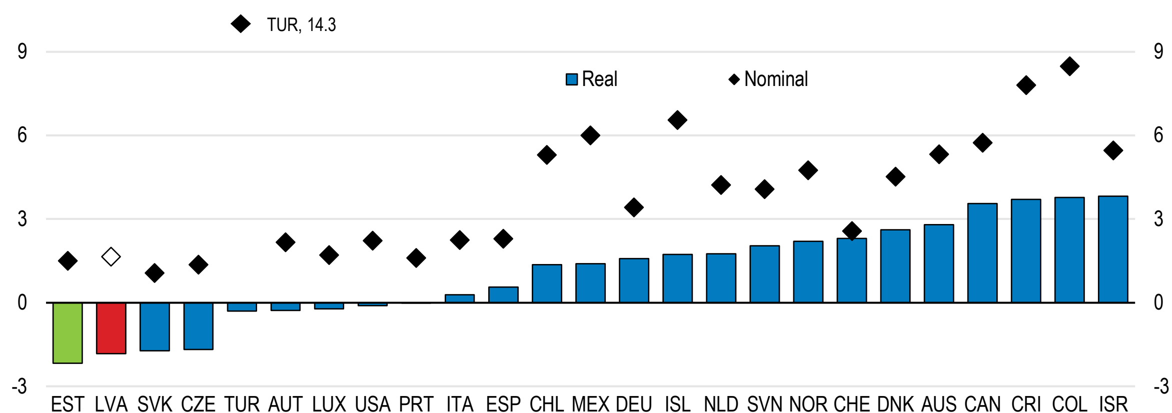
Attracting Latvian institutional investors such as pension, insurance and investment funds, which manage and invest other savers' money, to the domestic capital markets is key for improving companies' access to finance. The total asset base of pension schemes is equivalent to almost half of total domestic credit to the private sector and represents a large potential buyer of equity or debt instruments that could be newly issued by Latvian companies. However, only about 10% of all mandatory pension funds are invested in Latvia. This provides ample room for expansion without undermining the need for risk diversification in investment decisions of these institutions. Latvia has two mandatory earnings-related pension schemes and one voluntary pension scheme. The mandatory schemes comprise a pay-as-you-go notional defined contribution scheme (first pillar) and a funded defined contribution scheme (second pillar), where contributions to the second pillar are privately managed, involving a custodian bank for the investment funds managed by banks. Total contributions to the mandatory schemes amount to 20% of gross wages, of which 30% is allocated to the second-pillar pension funds. The mandatory pension scheme investment plans cover almost the entire working-age population and accounted for over 16% of GDP in 2022 (OECD, 2023[55]). The funds accumulated in voluntary schemes only represent about a tenth of those in the second-pillar schemes.

Changing pension fund regulations to facilitate increased pension fund investments in domestic private assets could improve portfolio returns and help to deepen capital markets (Figure 2.25). In Iceland, for example, pension funds are large investors in the domestic equity market (OECD, 2023[56]). In a regional comparison, while only about a quarter of pension assets in Estonia and Lithuania are invested in fixed income assets, the portfolio share of bills and bonds is about half for Latvian pension assets, indicating a more conservative and mostly foreign investment profile as the local corporate bond market is shallow (OECD, 2023[55]). The recent relaxation of the rules governing the management of second-pillar pensions in Latvia to allow greater exposure to private assets is welcome. Equity allocation of private pension funds has increased to 44% by 2022, which is not low by international standards. The portfolio limit for equity investments was increased to 100% for plans that have been registered since 2018, and new participants are automatically assigned to 100% equity portfolios as the default option. However, more can be done to make the investment rules less conservative. For example, equity investment limits for plans registered before the end of 2017, and private investment fund limits are 50% and 25%, respectively, and second-

pillar pension management companies cannot invest directly in real estate and face low concentration limits on equity holdings (OECD, 2023[57]). Investment limits in single issuer instruments are also low in all asset categories. In Australia and Denmark, where asset-backed pension investment fund returns have been higher than the OECD average over the past two decades, these limits are either set at 100% for direct investments or there is no specific limit at all. Allowing second-pillar pension funds to invest also in viable real estate instruments, facilitating greater exposure to private investment funds and raising low investment limits in other instruments would help to close the investor gap in the corporate bond market, given the strict EU rules on the conditions for individual qualified investors (European Parliament and Council, 2014[58]). Expanding the universe of investable assets of Latvian pension funds would also increase their real returns, which have underperformed those of other OECD countries' pension funds over the past 15 years, with an average annual real return of -1.9% (Figure 2.25). In 2022, the real return strongly decreased to 30%, the lowest return of all OECD countries after Lithuania, which is related to the comparatively high domestic inflation in 2022 (OECD, 2023[55]). As private assets tend to be complex and risky investments, the pursuit of increased investment in private assets should be accompanied by appropriate risk management and governance processes (OECD, 2022[59]).

Figure 2.25. Pension fund returns have been low

Geometric average annual rate of return on pension plan investments over the last 15 years as of 2022



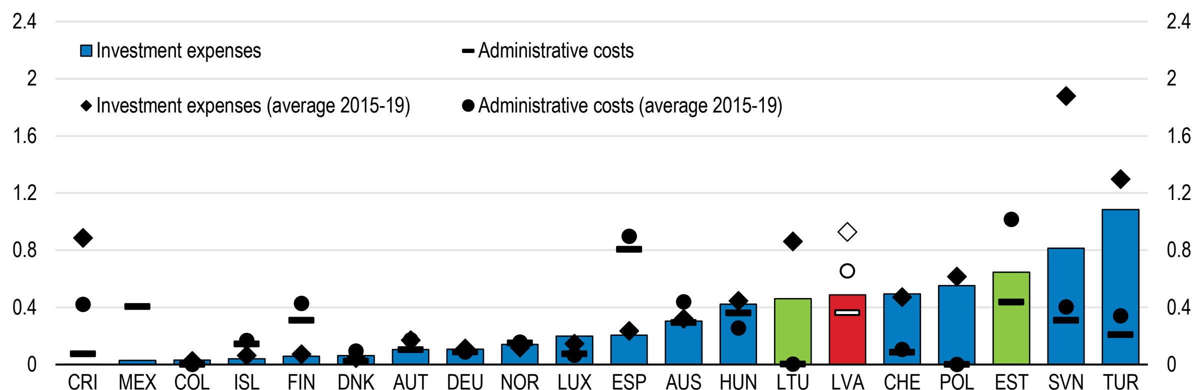
Source: OECD Pension Markets in Focus 2023.

Although pension fund operating expenses, including administrative costs and investment expenses, have declined in recent years, they remain high by international standards, which reduces pension asset returns for participants and limits incentives to save in voluntary pensions (Figure 2.26). High operating expenses are linked to higher fees collected by asset managing companies. In general, charging fees is necessary for asset managers to reward expertise in market analysis for investing in search of risky returns. However, high fees charged for passively managed investment funds risk reducing returns for clients, without contributing to the deepening of domestic capital markets. The authorities should consider limiting fixed fees for passive investment strategies, while allowing higher performance-related fees only for active investment portfolios that outperform a passively managed portfolio. This should be accompanied by addressing information gaps among pension plan holders, as complex fee structures can also make it difficult for individuals to choose between available options and can hinder competition. In fact, many pension plan participants do not monitor their plans and about half of them have never changed their plan (Viluns, 2023[60]). In this respect, the government's *My pension* website has already gone a long way in providing complete and comparable information on privately managed second-pillar pension plans and their historical investment performance. Further improving the design of key information documents and aggregating information on both investment performance and fees charged when offering pension management plans would contribute to a level playing field for asset managing companies that are not

subsidiaries of banks (OECD, 2018[61]). If total management fees vary significantly between market participants, existing caps on administrative fees could further be tightened (Box 2.4).

Figure 2.26. Pension fund operating expenses are high

Pension fund operating expenses, % of assets under management, 2021



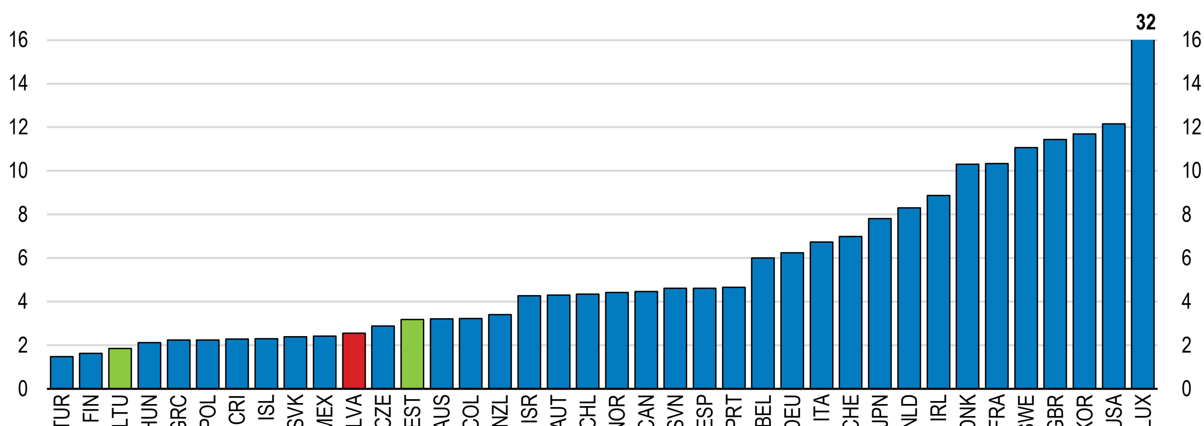
Note: Investment expenses data for Estonia over 2015-19 are not available. Data on administrative costs are also not available for Mexico over 2015-19. For the remaining countries, historical averages use the available data over 2015-19. "Administrative costs" are mainly related to the voluntary third-pillar pension funds in Latvia.
Source: OECD Funded Pensions Indicators.

Measures to better inform workers about the performance of their pension plans are welcome but should be limited to increasing competition between asset managers while preserving the depth of the second pillar. Recent fluctuations in global asset prices have affected second-pillar pension assets for older clients shortly before retirement. This has led the Ministry of Welfare to submit a proposal to parliament to allow plan holders to transfer their funds managed under the second pillar to the first pillar during the five years before reaching retirement, which would guarantee them the public pension under the first-pillar scheme. This could lead to large capital losses for individual pension plans due to short-termism by less informed pensioners and, in the tail event that redemptions outweigh inflows, curb the development of capital markets by reducing the funding base of private institutional investors. Instead, further fostering the prevalence of life-cycle investment plans by improving information on pension plans and increasing competition among pension asset managers would be a preferable solution. The government has made an important step into that direction by amending the regulations on the management of second-pillar pension funds – to come into force in July 2024 – requiring asset managers to inform clients about the investment performance of their plans, and the suitability of their pension plans for their age and investment preferences.

Strengthening insurance markets could help deepen capital markets. Insurance companies invest mainly in bonds, followed by collective investment schemes, cash, deposits and equities (Çelik and Isaksson, 2014[62]). However, the pool of premiums collected by insurance companies is very small in Latvia, which limits their contribution as potential buyers of securities in private capital markets (Figure 2.27). Health insurance coverage is weak, and medical practitioners often do not have malpractice insurance (OECD, 2022[1]). Life insurance funds are also small compared to OECD countries due to low household savings and competition from voluntary contribution (third pillar) pension funds, which are mostly managed by large bank subsidiaries (OECD, 2023[63]). However, insurance penetration is relatively high in the transport sector, supported by the compulsory civil liability insurance for vehicle owners, which covers damage to both property and persons. Making home insurance also compulsory and facilitating the leasing of high-value and non-movable assets, such as machinery (see below), would be steps in the right direction to close the funding gap of insurance companies. Strengthening enforcement efforts to reduce informality in the construction sector would also increase insurance penetration as civil liability insurance is compulsory for contractors (see Chapter 1) (OECD, 2016[64]).

Figure 2.27. Insurance penetration is low

The ratio of direct gross premiums to GDP, 2022 or the latest, %



Note: Data as of 2018 for Canada and as of 2021 for New Zealand.
Source: OECD Insurance Indicators database.

Common ownership between institutional investors and banks weakens competition and the development of capital markets in a small economy such as Latvia, and reduces asset returns for clients. Although two new non-bank entities have recently entered the pension market, four of the eight existing second-pillar asset management companies are owned by banks, with a market share of more than 80% in terms of both assets and participants. Two out of six insurance companies are also owned by banks. Brand recognition and the convenience of using different financial services, such as loans, pension savings and insurance products within a single institution, could pose a challenge and hinder contestability for potential new entrants that are not bank subsidiaries (OECD, 2018[61]). In addition, as asset management companies pay fees to their custodian bank – the parent bank in the case of common ownership – banks may steer their clients towards the pension or insurance plans for which they are custodians. Common ownership could also lead to conflicts of interest as parent banks are often a major shareholder in the subsidiary pension or insurance fund and have a say in the appointment of its board members. Latvia should learn from Israel's experience and reduce common ownership between institutional investors and banks by mandating a reduction in bank's share in pension and insurance funds. This would increase competition in the financial system and reduce possible conflicts of interest (Box 2.4).

Box 2.4. Reducing bank involvement in the management of investment funds and allowing more active investment portfolios for pension funds: The case of Israel

Until the mid-1990s, Israel's capital markets were characterised by a lack of competition due to the dominant position of leading banks and heavy state involvement. Operating as universal banks, commercial banks managed long-term savings instruments offered to households such as mutual funds and provident funds, while controlling subsidiaries that underwrote risky lending and mortgages. Pension funds, on the other hand, were owned by the largest employee organisation *Hahistadrut*, which primarily invested in government bonds. In 2003, the pension funds were sold to four insurance companies, and other private institutions were allowed to initiate new pension funds. However, these early reforms were not enough to raise competition, as banks continued to be the predominant institutional investors. Under weak competition, this led to conflicts of interest as banks enticed customers to use their financial instruments. For example, investment funds owned by banks performed significantly worse than the market, with a portfolio bias towards companies that also borrowed from the parent bank. In addition, bank-owned investment funds accumulated excessive cash deposits, in contrast to the cash position of other funds.

The combination of high concentration, poor investment performance, and conflicts of interest led the Israeli parliament to pass a comprehensive reform in 2005, known as the Bachar reform. The reform banned banks from owning mutual funds and prohibited companies owned by the banks to manage these funds, and restricted underwriters from providing services to entities which owed them capital. The series of reforms have also allowed increased exposure of pension funds to corporate bonds and equity. These reforms have increased competition in the Israeli long-term savings market and improved the allocation of funds in the economy. In particular, the reforms fostered the non-bank credit market, which was a milestone in the Israeli financial markets, as the share of commercial banks in credit generation fell from 96% in 2004 to 76% in 2010. The reforms also allowed large companies to issue more bonds and to raise more funds from the mutual funds and mandatory pension funds, which were introduced in 2008, whereas prior to the reform, bank-owned investment funds often invested in cash, mainly to improve the liquidity position of the banks. Concerns about the reform included an increase in pension management expenses. In fact, there was a sharp increase in management fees following the implementation of the reforms, however, fees returned to pre-reform levels over a few years, due to regulatory intervention in fee structures, which imposed caps on fees.

Source: (Goldwasser et al., 2007[65]); (OECD, 2011[66]); (Avramov, Dressler and Metzker, 2021[67]).

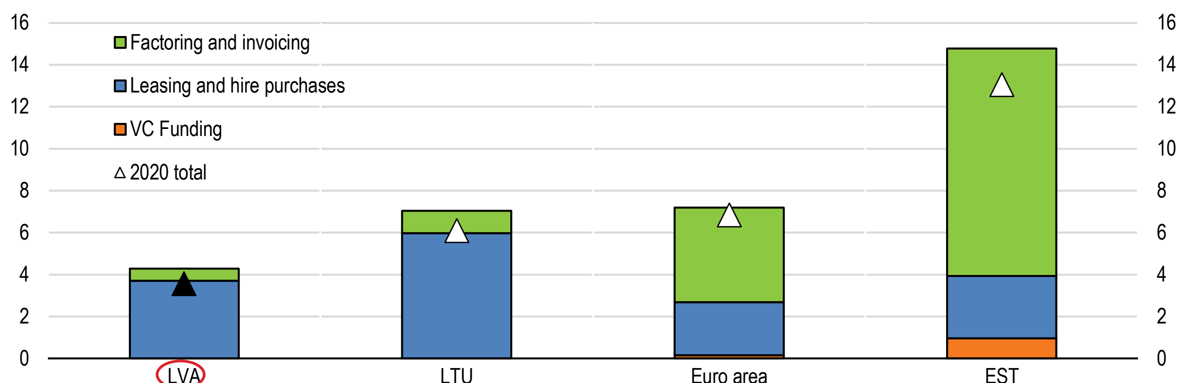
Facilitating leasing and start-up financing opportunities

There is ample scope to boost leasing and start-up financing such as venture capital (VC) or invoice factoring to improve access to finance for SMEs (Figure 2.28). Although leasing is fairly common for the purchase of movable assets, leasing of non-movable assets is weak, limiting the investment possibilities of SMEs. Most of the leasing contracts are for private consumption and firms in the agriculture, forestry and fishery sector. In its latest review of the Latvian financial system, the OECD has recommended to expand the leasing portfolio towards machinery as a non-movable asset to improve access to finance of SMEs (OECD, 2016[6]). However, the share of machinery in leased assets has remained stable since 2017, with cars or commercial vehicles accounting for more than half of all leased assets (Finance Latvia Association, 2023[68]). Improving the implementation of asset recovery laws to reduce the costs of asset recovery (see below) would boost leasing in the use of non-movable assets, such as machinery. Compulsory insurance when leasing these high-value assets would further increase insurance premium payments and thus the assets managed by insurance companies and help deepen capital markets. Moreover, common ownership between large banks and leasing companies could prevent a level playing field for new entrants in the leasing market, as brand recognition could be a barrier to entry for potential

new entrants (OECD, 2018[61]). Assessing whether the ownership structure in the sector preserves contestability could help enhance competition and reduce high interest rates, which currently prevent many small firms from using leasing as a source of finance.

Figure 2.28. Access of SMEs to non-bank finance is lower than in the other Baltic countries

Non-bank financing for SMEs, 2016-19 average and 2020, % of GDP



Source: Financing SMEs and Entrepreneurs 2022: An OECD Scoreboard; and OECD calculations.

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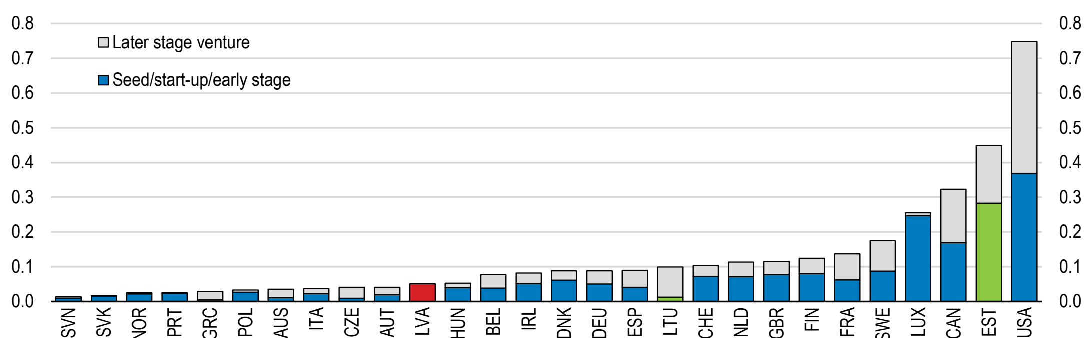
Despite some recent improvements, venture capital funding, which is critical for young SMEs without collateral and credit history, remains low (Figure 2.29). Latvian start-ups are active in various fields such as BioTech, cybersecurity, FinTech, eCommerce and others. However, the small size of the market and a lack of sectoral start-up clusters prevent them from building a strong reputation and sectoral expertise, making it difficult to attract large international venture capital funds. The lack of viable exit strategies for start-up investors, such as listing or selling the start-up, due to shallow domestic capital markets and the small network of angel investors, also limits access to private capital.

Figure 2.29. Venture capital investments are weak

Venture capital investments, % of GDP, 2022 or latest available year



Source: Venture capital investments (Edition 2022), OECD Structural and Demographic Business Statistics.

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Improving the governance of public support programmes could help to attract more venture capital financing. Despite significant risk-sharing with the private sector through government and EU structural fund support, only 364 deals were completed in 2011-23, raising only 40% of funds raised in Estonia and putting Latvia behind OECD economies in terms of the size of the venture capital market. The government currently provides tax relief to eligible start-ups and wage subsidies to their highly qualified employees. Additional annual funding of EUR 400 000 is planned in the 2024-26 budgets to finance international exhibitions, investment advice for early-stage start-ups and sessions to attract investors. The start-up visa scheme to facilitate skilled migration, the introduction of the FinTech regulatory sandbox (see above) and

incubator programmes to support the pre-seed, seed and growth stages of start-ups are steps in the right direction to attract venture capital funds. However, high staff turnover and a lack of institutional memory have reduced the capacity of the public sector (see Chapter 1). Government involvement in investment decisions of firms receiving government funds limits the extent to which private managers can use their skills to make investment decisions and reduces the effectiveness of the co-invested funds (Matisone and Lace, 2020[69]). Moreover, application and reporting requirements for support programmes are very stringent, resulting in a heavy administrative burden for fund managers. Additional staff capacity building in ALTUM's investment teams and simplification of registration and reporting requirements for venture capital funds, in line with EU regulation, would reduce the administrative burden.

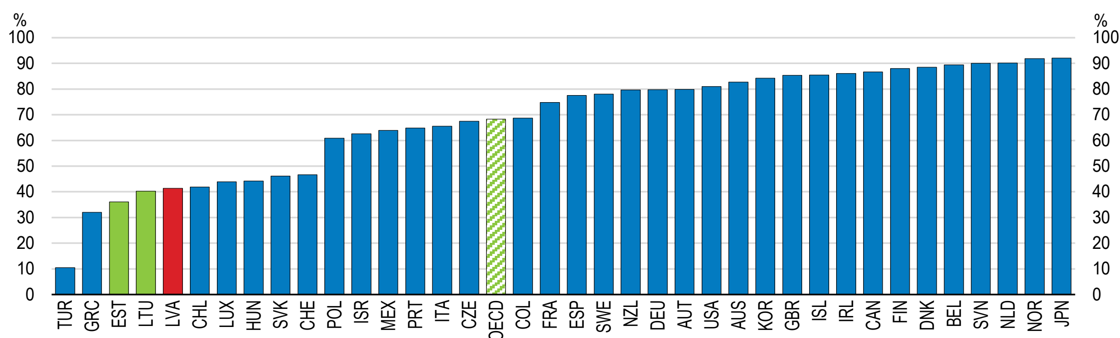
Regulation of the licencing of crowdfunding platforms has improved and could help to improve access to finance for SMEs. In addition to serving as an alternative financing option, such as venture capital, crowdfunding offers additional benefits to businesses, such as validating a business concept, providing entrepreneurs with access to a diverse pool of investors, and serving as a promotional tool. In France, for example, funds of more than EUR 1 billion raised through crowdfunding financed close to 14000 SMEs in 2020 (OECD, 2022[70]). In November 2023, the Bank of Latvia issued a licence to Latvia's second crowdfunding service provider, following the adoption of the EU regulation on crowdfunding (2020/1503) in November 2021. The implementation of the new regulations will improve licencing and transparency requirements, strengthen investor protection, and increase the role of crowdfunding platforms in financing investments of Latvian companies (OECD, 2019[3]).

Continuing to improve contract enforcement and reduce the administrative burden for investors

Past weaknesses in the insolvency regime have led to high collateral requirements and financial frictions (OECD, 2022[1]; OECD, 2022[70]). One reason why lenders impose collateral requirements on borrowers is to secure the debt contracts, as ownership of the pledged collateral may be transferred from the borrower to the lender in the event of default. However, lengthy and inefficient insolvency procedures as well as asset hiding and fraud had led to lower debt recovery rates in Latvia compared to other OECD countries, reducing the effectiveness of the collateral regime (Figure 2.30). To compensate for these lower asset recovery rates, banks have imposed even stricter collateral requirements, which rationed borrowers and made their balance sheets more vulnerable to asset price volatility (OECD, 2019[3]).

Figure 2.30. Asset recovery rates have been weak

Average recovery rate, 2020



Note: The recovery rate calculates how many cents on the dollar secured creditors recover from an insolvent firm at the end of insolvency proceedings.
Source: World Bank, Doing Business 2020 database.

StatLink https://stat.link/kr8wvh

The insolvency regime has improved significantly in recent years, especially after the adoption of the recent judicial reform to further align the insolvency law with the EU Restructuring and Insolvency Directive

2019/1023. According to the OECD Insolvency indicator, the asset recovery rate for secured creditors has increased, reaching 52% by 2023, and the cost of insolvency proceedings has decreased. However, the average duration of insolvency proceedings was 2.1 years in 2023, which is still long by international standards. The establishment of a specialised Economic Court has helped to train judges and improve the efficiency of judicial proceedings concerning commercial law, including insolvency cases but also economic crimes, money laundering and corruption cases. However, its remit is confined to larger and complex commercial disputes. Expanding its remit, while raising its resources, could help to further improve the efficiency of judicial proceedings, improve contract enforcement and help raise trust in institutions. Salaries for judges and insolvency administrators have risen strongly, helping to recruit and retain skilled staff and potentially reducing the scope for corruption Full implementation of the EU Restructuring and Insolvency Directive 2019/1023 will foster out-of-court restructuring and help reduce the burden on the judiciary and the length of remaining insolvency proceedings.

Court fees for filing insolvency proceedings are high, even for small claims. In addition to an upfront fee charged to the debtor (EUR 70) or the creditor (EUR 355), a deposit of EUR 1 440 must be paid to the insolvency administrator, which is the only source of compensation for the insolvency administrator if the debtor has no assets to recover. This discourages non-viable small business owners from filing for insolvency, and prevents the reallocation of labour and capital to more productive firms, hampering business dynamism, innovation and productivity growth (see below). The State Revenue Service has the right to initiate insolvency procedures as a creditor of tax debts for companies with negative equity, but it often does not exercise this right due to a lack of financial resources. The income threshold for the eligibility of natural persons for legal aid has increased in recent years, but is still below the poverty line, leaving many debtors without the opportunity to access legal services (European Commission, 2023[2]). In this respect, the project on the promotion of mediation and legal aid services, co-funded by the European Union and the Council of Europe, will help Latvia get closer to best practices in European countries (CEPEJ, 2023[71]). The second phase of the project includes a pilot programme to provide primary legal aid in seven locations in Latvia and aims to increase the awareness of mediation as a method of conflict resolution. This should be complemented by reducing the cost of filing insolvency for low-income debtors, including small firms, so that fees do not act as an upfront barrier to file insolvency, while compensating insolvency administrators out of general tax revenue.

The effectiveness of the collateral framework could be further increased by improving the property registry. Latvia’s property registry is well streamlined, with a small number of procedures that take relatively little time and cost less than in higher income OECD countries. However, property registries are only established for large immovable assets, such as land and real estate. This creates uncertainty for leasing companies about the ownership of other leased assets, as two-thirds of the leasing portfolio is financial leasing, where the borrower becomes the owner of the asset only after full repayment (Finance Latvia Association, 2023[68]). In fact, interviewed medium-sized companies in the electronics manufacturing sector indicated that their machinery is not accepted as collateral, which may reflect a reluctance on the part of banks due to the uncertainty of ownership. The introduction of a deed register for all leased assets would prevent lessors from repledging leased assets as collateral, facilitate the collateral framework and significantly increase the access of smaller and younger firms to bank finance (Love, Martinez Pería and Singh, 2015[72]; OECD, 2016[6]).

Considering the high granularity of available credit information, collateral requirements seem excessive. Collateral requirements help to distinguish between creditworthy and risky borrowers. However, the credit registry in Latvia covers 97% of all adults with the highest available score for the depth of credit information, while the average credit registry coverage in the high-income OECD economies is around 25%. The credit register, which is maintained by the Bank of Latvia, contains detailed information on individual loans and is shared with lending institutions so that they can develop their own internal credit assessment frameworks. Lenders also benefit from the services of two licenced credit bureaus, which complement the information provided by the central bank in assessing credit risk. For consumer credit providers, the

Consumer Rights Protection Centre has also published detailed guidelines on credit assessment (CRPC, 2021[73]). As a result, information gaps on borrowers' creditworthiness cannot be a precursor to excessive collateral requirements in Latvia.

Assessing the role of subsidised loans and loan guarantees in addressing market failures

Development finance is provided in a wide range of areas, but on a small scale. ALTUM provides support for business start-ups, particularly in the areas of venture capital financing, business development, export facilitation and competitiveness enhancement. ALTUM also supports regional development projects and provides guarantees for loans granted to households for energy efficiency improvements and home purchases. The balance of loans provided by ALTUM in the first half of 2023 accounted for about 3% of all loans granted to non-financial corporations and households (Bank of Latvia, 2023[4]). However, the subsidised loan and loan guarantee programmes of ALTUM have so far not been evaluated by ex-post impact assessment, which is important as there is evidence of a gap between the objectives and results of the programmes.

Loan guarantees provided by ALTUM have not led to a significant reduction in the cost of loans for house purchase and are not well targeted. Approximately, 40% of all newly issued mortgage loans for house purchase come with a guarantee from ALTUM. However, the guarantee received only helps to reduce the cost of transferring the change in ownership status to the property register (Bank of Latvia, 2023[4]). In addition, most mortgage loans are held by higher-income households, which are more likely to be offered lower interest rates by banks. While larger mortgage guarantees for households with more children are welcome, they should be accompanied by an increase in the effective guarantee amounts for lower-income households, which would reduce the credit risk for banks and facilitate a lower lending rate. This is a better policy option than the recently imposed levy on banks to finance lower lending rates for all mortgage borrowers, which is regressive and likely to increase non-interest costs of credit. Another option is to provide low-interest loans up to a fixed amount for mortgage borrowers whose income is below an income threshold, as in the case of the *Prêt à taux zéro* programme in France (OECD, 2023[74]).

Although ALTUM's loans to enterprises partly ease collateral requirements for SMEs, more could be done to ease borrowing conditions for smaller firms. Surveyed companies indicate that ALTUM loans, which are top-up loans subordinated to bank loans, are granted with relaxed collateral requirements, but usually for small amounts and at a higher interest rate compared to more secured bank loans. As smaller SMEs, particularly those operating in rural areas, have difficulties to pledge valuable real estate as collateral, these top-up loans could also accept machinery and other movable assets as collateral. In addition, the interest rates on such loans could be set below the corresponding bank lending rate, which would reduce the overall cost of credit. ALTUM also plans to offer loans with a capital discount for medium or large companies to foster large-scale investments in technology-intensive sectors. The capital discount will be granted after the project meets specific performance criteria, which will be monitored by the LIAA. With around EUR 423 million (1.1% of GDP) foreseen for these loans until 2026, it is crucial to ensure effective management and monitoring procedures.

Development finance should also play a more active role in improving the collateral framework for innovative start-ups. Innovative start-ups have difficulties to raise external finance because lenders are often unable to evaluate their intangible assets or the future cash flows of their projects (OECD, 2022[1]). This hampers innovation and productivity growth (Demmou and Franco, 2021[75]). Based on the Korean experience, ALTUM, in partnership with LIAA and universities, which are currently running business incubator programmes for science-intensive business ideas, could provide the service of intangible asset valuation for SMEs, while loans continue to be provided by commercial banks. The existence of US and European patent rights for companies could also be used as a first proxy for the valuation of intangible collateral (Box 2.5). Experiences from the valuation of intangible assets in many European countries, such

as Austria, Belgium, Luxembourg and Germany, should also be used for improving policy design, as in these countries development finance institutions have tried to fill the collateral valuation gap through guarantees for intellectual property financing (Brassell and Boschmans, 2022[76]).

The establishment of the IPO Fund as a joint initiative with the Lithuanian government will help deepen capital markets in Latvia. In June 2023, the Latvian government approved the establishment of the Baltic SME IPO Fund, co-financed by ALTUM, and the Lithuanian Investment and Business Guarantee Agency, INVEGA. The total financing of the fund is EUR 50 million, with each of the two development finance institutions contributing EUR 20 million and the remainder to be raised by the fund. The fund will support initial public offerings or private placements on Nasdaq Baltic and the alternative market First North and invest in Baltic SMEs in the pre-listing phase to guide them through the listing process over a period of approximately 12 to 18 months. The average investment will be up to 50% of the listing price. The IPO fund will increase the visibility of the recipient companies and contribute to the development of the stock market in Latvia. It may also help attract VC funds to Latvian start-ups by providing more viable exit strategies.

Box 2.5. Facilitating the pledging of intangible assets as collateral: The case of Korea

Legislation enacted in 2012 allowed the pledging of intangible assets, opening the way for increased lending secured by intangibles in Korea. Based on the legislation, a certificate can be issued for high quality and technology assets pledged by companies with a low risk of insolvency. If the valuation of the asset is successful but the quality is less certain, the lending institution is provided with a guarantee of between 85% and 100% of the loan granted. These procedures are overseen by the Korea Invention Promotion Association (KIPA), a subsidiary of the Korean Intellectual Property Office, which is responsible for developing and promoting IP valuation tools and accrediting valuers.

Guarantees are often provided by the Korea Technology Finance Corporation, which specialises in assessing the technology of SMEs. To date, KOTEC has completed around 700 000 ratings for 80 000 companies. KIPA has also provided tools for lenders to attach credit scores to some patents where company portfolios include US and European patent rights.

In December 2018, the Financial Services Commission of Korea and KIPO issued an announcement reviewing policy achievements and setting targets for the future. The announcement prioritised the targeting of companies at relatively early stages of IP commercialisation and included case study results showing that companies that received IP finance achieved sales growth of 16.5% and increased employment by around 6.5 employees on average. The future targets included increasing the share of valuations performed by the private sector from the historical norm of around 10% to 50% by 2022. Since 2019, Korean companies have been able to choose from four modular valuation models, which allows them to reflect heterogeneities in their IP asset type, maturity and associated loan amount.

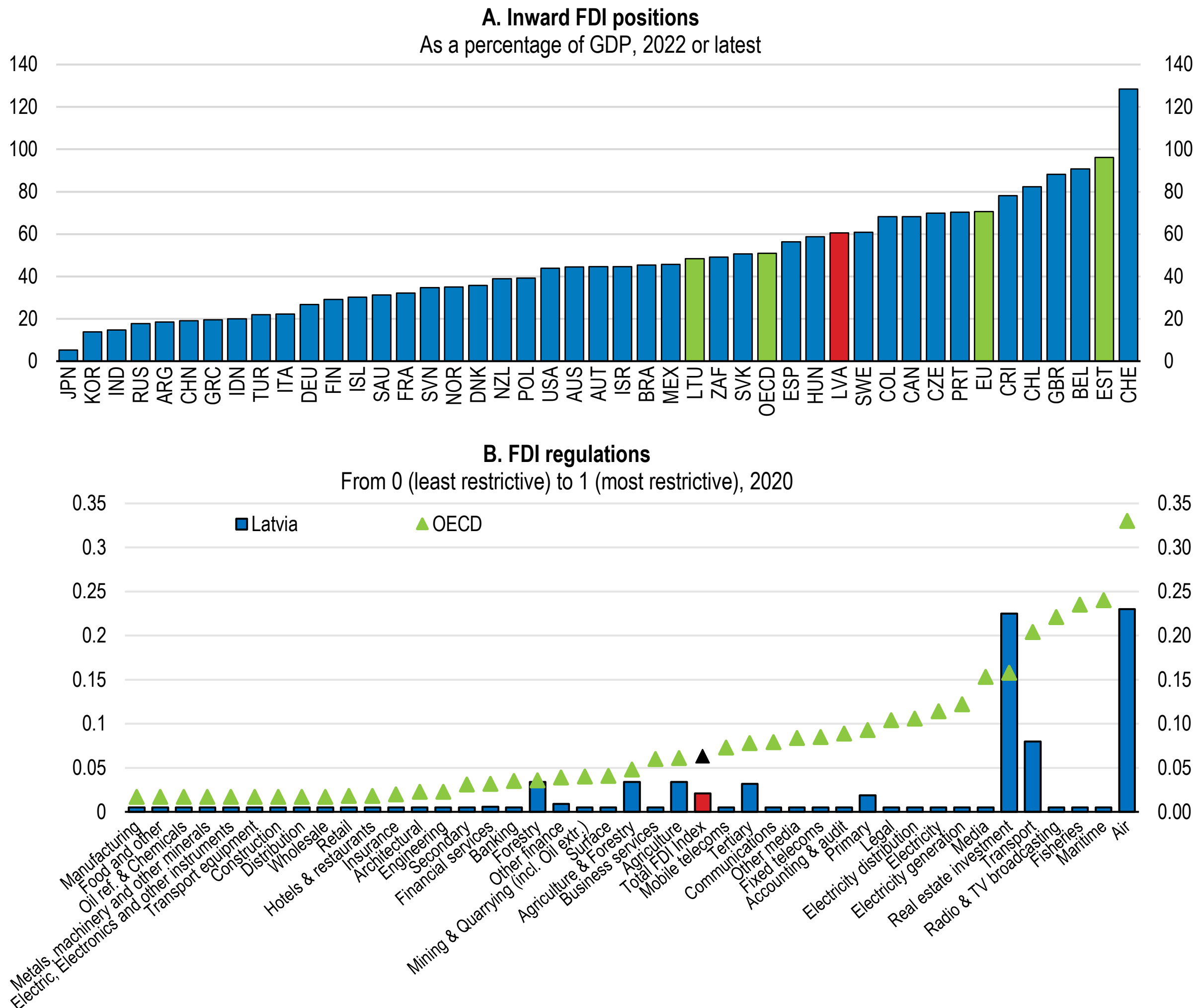
Source: OECD SME and Entrepreneurship Papers No. 33 (2022[76]).

Improving the business environment to raise investment demand

An appropriate combination of less restrictive regulations and investor-friendly policies has made Latvia an attractive destination for FDI. Inward FDI into Latvia is higher than in the average OECD country, as investors have benefited from access to the EU market, decreasing administrative burden, generous corporate tax incentives and an improving digital infrastructure (see Chapter 1) (Figure 2.31). Proximity to Russia and Belarus poses a downside risk to FDI inflows, but the reduction in flows from sanctioned investors has so far been compensated by other investors, mainly from Sweden and especially in technology-intensive industries (OECD, 2023[77]).

Rising FDI flows have benefited the Latvian economy, but room for improvement exists. FDI has positive spillover effects as it helps domestic suppliers to vertically integrate into global value chains and enhances domestic capabilities through knowledge exchange and the adoption of new technologies (Andrenelli et al., 2019[78]). However, the number and deal value of cross-border mergers and acquisitions remain low in Latvia, limiting vertical integration into global value chains (OECD, 2021[79]). Restrictions on foreign entry and competition in air and rail transport are high and should be reduced to facilitate investments (Figure 2.31). Moreover, skill shortages discourage potential foreign investors, which should be addressed by facilitating skilled migration, improving VET and the quality of basic and tertiary education to reduce skill mismatch in the labour market (see Chapter 1) (OECD, 2022[1]).

Figure 2.31. Latvia has attracted large FDI flows thanks to low FDI restrictions



Note: Countries such as Ireland, Luxembourg and the Netherlands with an FDI position above 250% of GDP are excluded from Panel A.
Source: OECD International Direct Investment Statistics database; and OECD FDI Regulatory Restrictiveness Index database.

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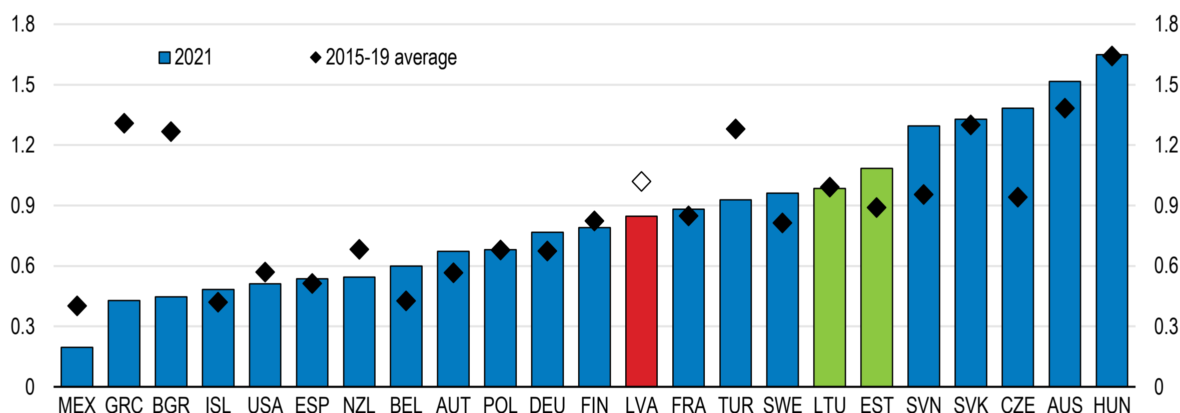
Attracting more FDI in the current geopolitical context requires large investments in transport infrastructure to better connect to the EU market. Funds from the Recovery and Resilience Plan have been used to build and improve 210 km of state regional and local roads, but the quality of inland transport infrastructure is well below the EU average and investment to improve it remains low (Figure 2.32) (OECD, 2022[1]). Only 14% of all existing railway lines are currently electrified, reducing the potential for emissions reductions in the transport sector (see Chapter 1). Funds from the Recovery and Resilience Plan will be used to increase the coverage of electrified railways in the Riga metropolitan area by 2026, but some infrastructure projects

have been delayed due to planning uncertainty regarding the replacement of diesel trains. In the past, transport infrastructure investments have focused on facilitating freight traffic with Russia, rather than passenger transport. In this respect, the Rail Baltica project, a greenfield investment to connect the Baltic states to the rest of the European rail network, provides ample opportunity to fill large investment gaps in the transport infrastructure, including accompanying investments in potential inland, airport and seaport connections, and the digital infrastructure, such as the fibre optic cable line along the railway. The Rail Baltica project will also contribute to the development of a dual-use transport infrastructure, including passenger transport. Boosting infrastructure investment planning capacities, making land acquisition more flexible, and improving public procurement procedures is key to raise high quality public investment and would also help crowd in more private investment (Chapter 1). In this respect, the government’s aim to promote public-private partnerships in infrastructure works is a step in the right direction and could help to reduce efficiency gaps in the management of these projects. Facilitating construction permit procedures and the migration of workers, such as civil engineers and crafts occupations, would lower construction costs and facilitate the implementation of much needed infrastructure investment (OECD, 2021[79]).

Figure 2.32. Investments to improve the low quality of transport infrastructure are inadequate

Total inland transport infrastructure investment per cent of GDP



Source: OECD Transport Infrastructure indicators database.

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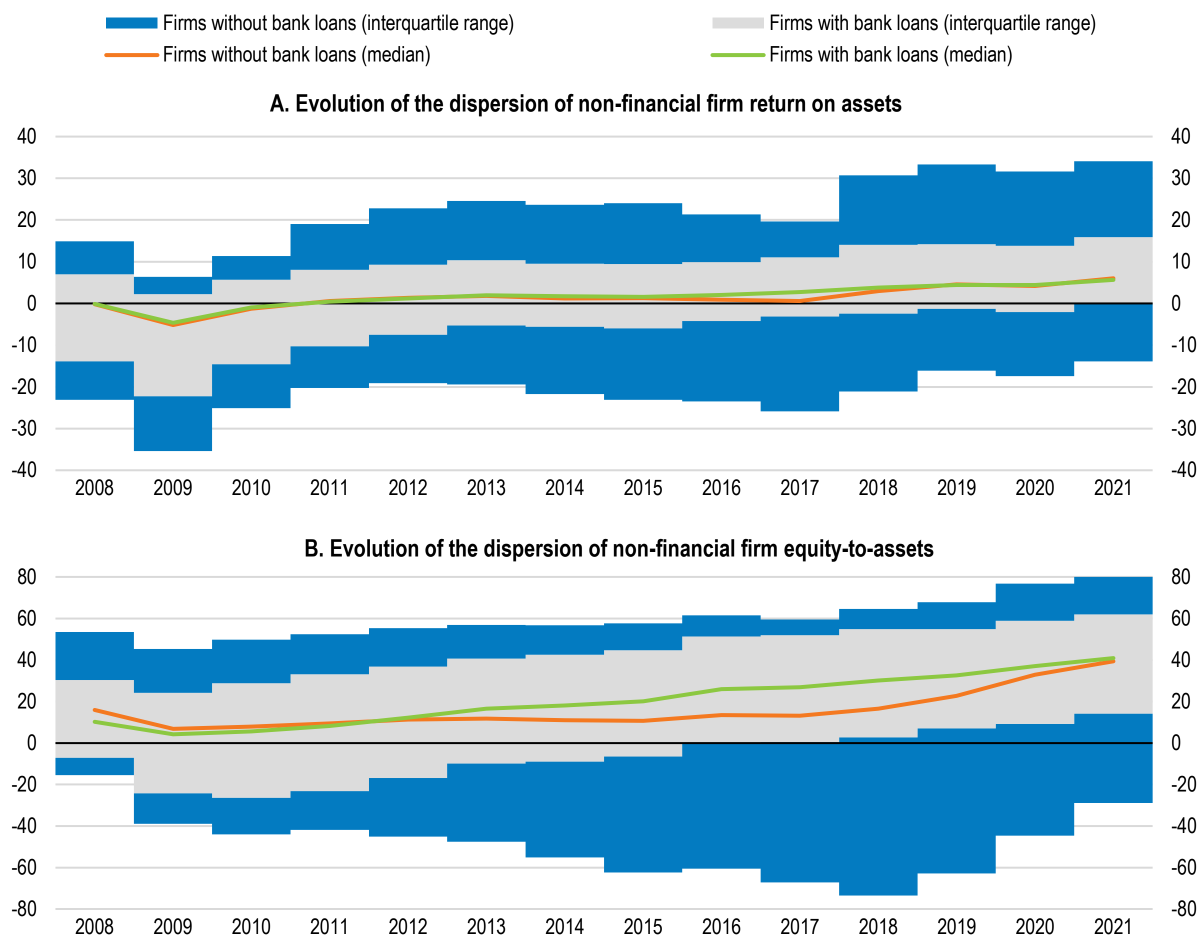
To reinvigorate Latvia's income convergence process, domestic investment should accompany FDI inflows. An important reason for the historically weak domestic investment demand is that many domestic firms are reluctant to borrow, even though they are highly profitable and financially sound. Latvia’s non-financial corporate sector is one of the least leveraged among OECD countries (Figure 2.21). Although non-bankable firms with a negative net worth – about one-third of all non-financial firms – contribute to low aggregate corporate leverage, there are many non-borrowing firms with very high profitability and strong capitalisation (Figure 2.33). The legacy of large failures during the global financial crisis has made firms less willing to borrow, and stronger balance sheets have allowed many firms to rely on internal financing. Cultural and demographic factors may also play a role, with first-generation owners reluctant to cede discretion over their firm’s decisions to external lenders (Karahan, Pugsley and Şahin, 2019[80]).

Figure 2.33. Many firms with stronger balance sheets do not rely on bank loans



Source: Bank of Latvia Calculations using firm-level data at the State Revenue Service.

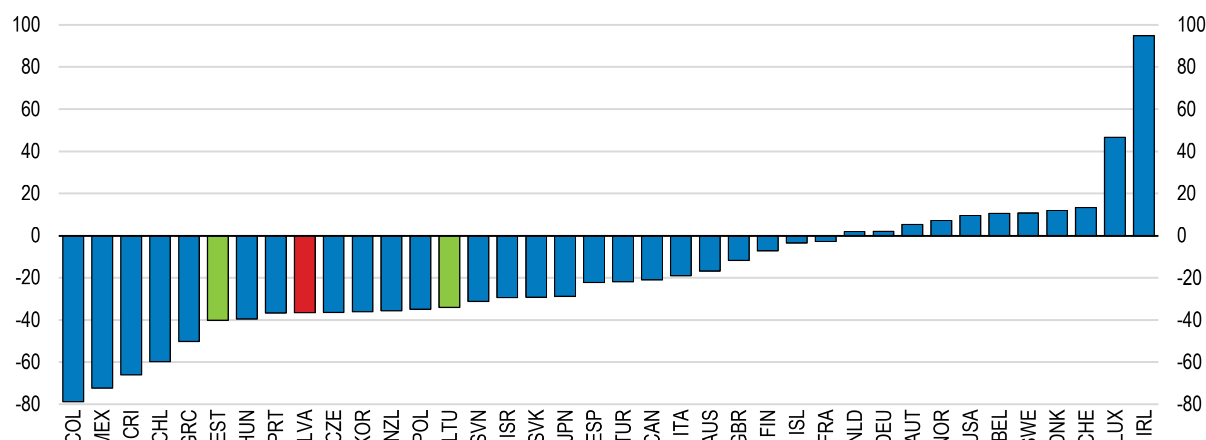
https://stat.link/nd6fq2

Promoting efficient resource allocation to increase investment demand

Despite high profit margins and healthy corporate balance sheets for some larger firms, investment returns have been relatively low on average, leading to low average capital intensity in production (University of Latvia, 2023[81]). The labour productivity gap with the best performing OECD countries remains large (Figure 2.34). As unit labour costs have risen faster than productivity over the past decade, especially in the manufacturing sector, the competitiveness of Latvian firms has deteriorated, weighing on net exports (see Chapter 1). To raise productivity and exports it is key to foster business dynamism, innovation, and digital adoption, facilitate the reallocation of production factors to more productive firms and improve the skills of the workforce.

Figure 2.34. Labour productivity is still weak

Gap in GDP per hour worked against 19 richest OECD countries, PPPs, population weights, in %, 2022



Source: (OECD, 2023[82]), Economic Policy Reforms 2023: Going for Growth, OECD Publishing, Paris.

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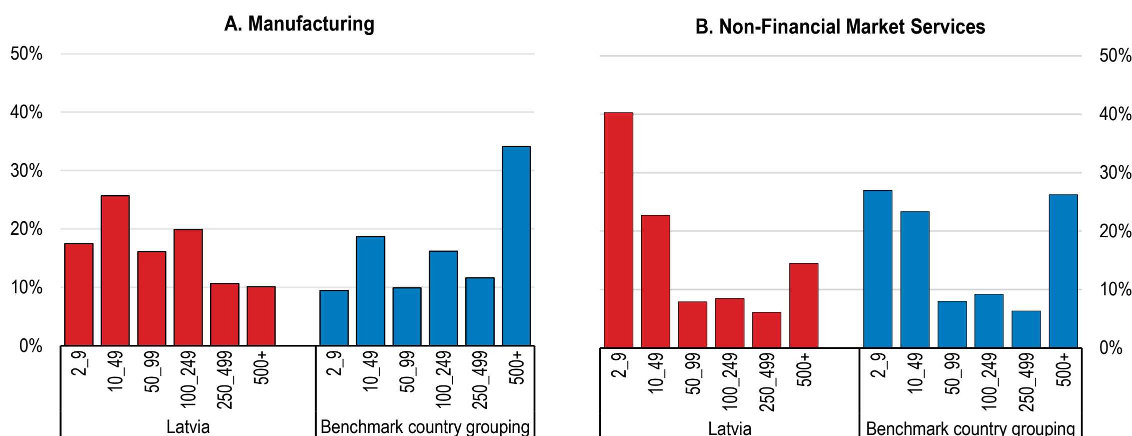
Although firm entry rates are high due to the low administrative burden of starting a business, many firms in Latvia remain small (Figure 2.35, Figure 2.36) (OECD, 2019[3]). This weighs on aggregate productivity as many small firms have lower productivity due to weaker management skills, low access to finance, lower digital adoption and innovation and less training provision for workers.

Figure 2.35. Employment is concentrated in small firms

Share of total employment by firm size, average over 2013-17



Note: The benchmark country grouping includes Belgium, Finland, Hungary, Croatia, Slovenia and Sweden.
Source: OECD DynEmp database.

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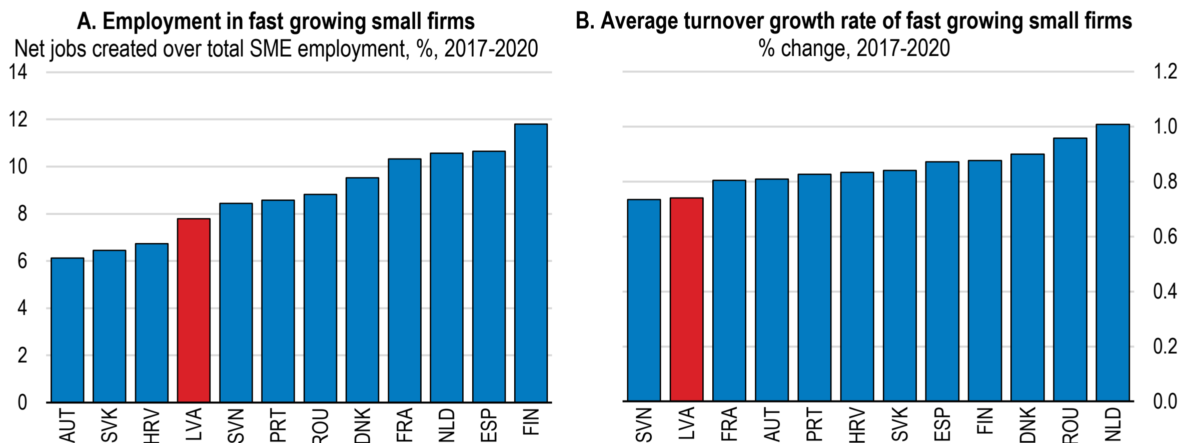
Figure 2.36. Small firms grow less than in other countries

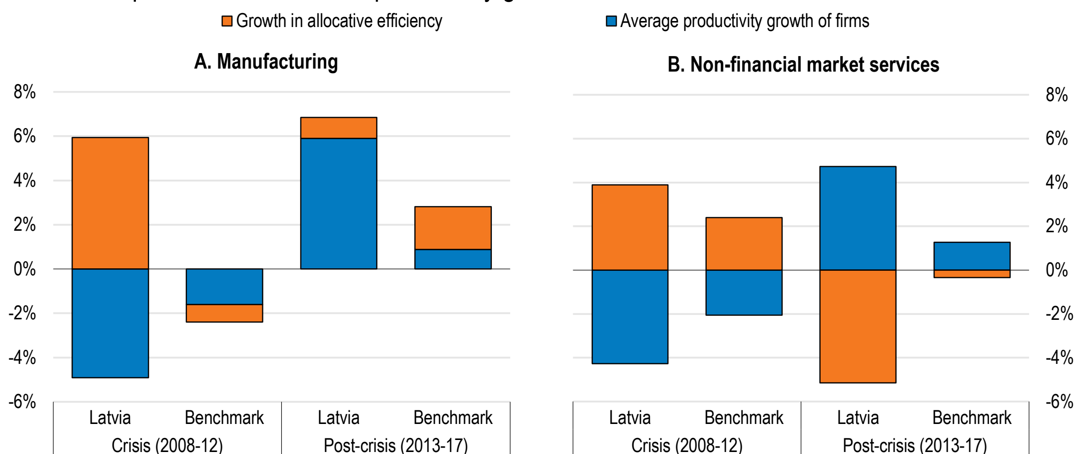


Note: Fast growing small firms are defined as SMEs with at least 10 employees that grow in employment or turnover by at least 10% per year, on average, over 3 consecutive years.
Source: OECD CFE Database on Scalers.

Inefficient and costly insolvency procedures and specific tax regimes for small firms have acted as barriers for the reallocation of production factors to more productive firms with high labour shortages, which weighed on productivity growth, particularly in services (Figure 2.37). Aggregate productivity growth in an economic sector depends on how fast the average productivity of firms grows and whether production factors can be efficiently reallocated from less productive to more productive firms, which can be measured by allocative efficiency (Olley and Pakes, 1996[83]); (Andrews and Cingano, 2014[84]). Decomposing productivity growth into these two components suggests that a strong deterioration in allocative efficiency has led to declining productivity growth in services sectors after the global financial crisis (Figure 2.37). This is related to the introduction of the microenterprise tax regime in 2010, which has incentivised firms to stay small and even split up to benefit from generous tax reductions, particularly in labour-intensive services sectors (see Chapter 1) (World Bank, 2017[85]). Although its conditions have been made less generous, this special tax regime still exists and its design should be evaluated to ensure that it does not hinder the reallocation of resources to more productive firms (see Chapter 1). Re-training micro-enterprise owners who exit the market could help to reduce labour shortages in more productive firms.

Figure 2.37. Resources are trapped in low productivity firms, particularly in services

Olley-Pakes decomposition of multi-factor productivity growth



Note: The benchmark country grouping includes Belgium, Finland, Hungary, Croatia, the Netherlands, Portugal, Slovenia and Sweden.
Source: OECD MultiProd database.

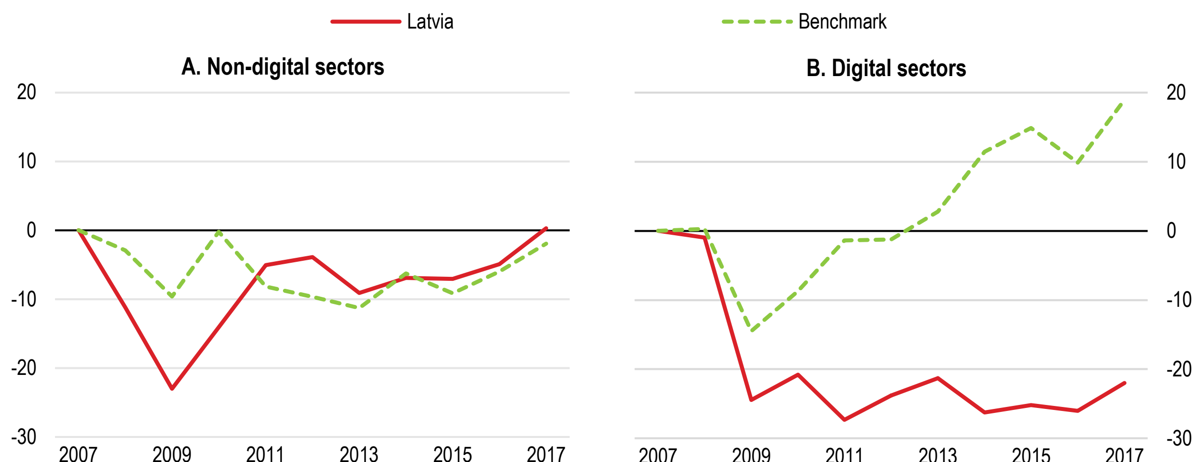
Improving restructuring procedures and reducing barriers to exit is key for increasing allocative efficiency. About one-third of non-financial firms have negative equity, and although these firms represent a small share of total corporate assets, they lock up labour and capital inputs that could have been used by more productive and viable firms (Bank of Latvia, 2023[4]). In 2022, only around 10% of restructuring applications were concluded, which reduces the chances of viable companies facing financial distress to survive and lowers the liquidation value of failing companies, resulting in low debt recovery (Adalet McGowan and Andrews, 2018[86]). Aligning restructuring procedures with the EU Restructuring and Insolvency Directive 2019/1023 is key to better differentiate between viable and failing firms early on and achieve a more efficient allocation of productive resources. Further reducing barriers to market exit, such as relatively high costs to file insolvency, would help ensure the smooth liquidation of unprofitable small firms (see above). For many of these firms, the distinction between corporate and personal balance sheets is relatively narrow and many owners use the firm to finance their living (World Bank, 2017[85]). Therefore, the liquidation of these firms may lead to their personal insolvency and should be accompanied by targeted social protection and active labour market policies to facilitate the move to new jobs in more productive firms (Demmou et al., 2021[87]). In line with the EU Directive on Insolvency and Second Chance, reducing the personal costs for failed entrepreneurs and the time to discharge, which have both remained stable over 2016-22 according to the OECD insolvency Indicators, would further help exiting firms during the transition.

Informality acts as another barrier to efficient reallocation and formal firm growth and is particularly high in construction and services sectors, such as retail and hospitality (Sauka and Putnins, 2023[88]). Informal firms are reluctant to grow, have weaker access to finance, lower digital adoption and training investments and are generally less productive than formal firms (OECD, 2019[3]). Moreover, by under-declaring income and wages these firms reduce their costs to compete with larger more productive formal firms, which in turn has negative consequences on profitability, innovation incentives and investment of formal firms (Amin and Okou, 2020[89]). This unfair competition can even act as a market entry barrier for foreign firms, which cannot compete with prices set by informal domestic firms, for example in the construction sector. Corruption is equally harmful as it helps well-connected incumbent firms to remain in the market and acts as a barrier for young, innovative and more productive firms. Therefore, tackling informality by stepping up tax enforcement, lowering labour taxes for low-income earners and raising the quality of public services while continuing to fight corruption and raise the trust in institutions is key to level the playing field and raise business dynamism and innovation (see Chapter 1).

Slow digitalisation in small firms and a lack of reallocation of resources to more productive firms in services sectors has hampered the adoption of digital technologies and productivity growth (Figure 2.38). Productivity growth in sectors that show a high degree of digitalisation in OECD countries, which comprise mainly services sectors, has stagnated in Latvia since the financial crisis, while it strongly increased in benchmark countries. This is due to a lack of adoption of digital technologies in many smaller firms, which do not have sufficient scale to shoulder the required fixed investments, have weak access to finance, are often informal, and miss the necessary management and workforce skills. Improving the reallocation of production factors to more productive firms is key to raise digital adoption and productivity growth. Moreover, high barriers to competition have contributed to weak innovation and productivity growth in smaller firms, particularly in services sectors, and should be reduced (see Chapter 1 and below).

Figure 2.38. Productivity has stagnated in sectors that are intensive in digital technologies

Percentage change in multi-factor productivity compared to 2007 (2007=0)



Note: The graph shows average multi-factor productivity of firms, normalised to zero in 2007. The benchmark country grouping includes Belgium, Finland, Hungary, Croatia, the Netherlands, Portugal, Slovenia and Sweden. Digital sectors are defined as sectors that are intensive in digital technologies and have a high share of ICT occupations on average across OECD countries.
Source: OECD MultiProd database.

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Fostering innovation and digital adoption

Although many formal firms use the internet and software, for example for human resource planning, there is room to improve adoption of more sophisticated digital technologies (Figure 2.39). One key policy lever is digital infrastructure, which has improved in recent years, although regional disparities remain (OECD, 2021[90]). Providing high-performance network connections to businesses is key to raise adoption of more sophisticated digital technologies, such as cloud computing or the use of big data. Using financing from the Recovery and Resilience Facility and the European Regional Development Fund, the fibre optic network is planned to be extended to regions where private investors are not expected to provide such infrastructure over the next three years. Improving digital infrastructure in homes and public buildings such as schools and hospitals is also part of the EU funding plans and will facilitate financial inclusion of households and the digitalisation of public administration and public services in municipalities (see Chapter 1).

Figure 2.39. There is scope to improve the adoption of more sophisticated digital technologies

A. Enterprises using specific digital technologies
Percentage of enterprises, 2023 or latest available year

B. Innovating SMEs
Percentage of all SMEs, 2021

Note: Data correspond to the share of businesses with ten or more employees with broadband connection (fixed or mobile); with a website or home page; using social media; using Enterprise Resource Planning (ERP) software; using Customer Relationships Management (CRM) software; purchasing cloud computing services; receiving orders over computer networks; sharing electronically information with suppliers and customers (SCM); using Radio Frequency Identification (RFID) technology; and having performed big data analysis.
Source: OECD ICT Access and Usage by Businesses Database; OECD 2021 Survey of National Innovation Statistics; and Eurostat Community Innovation Survey.

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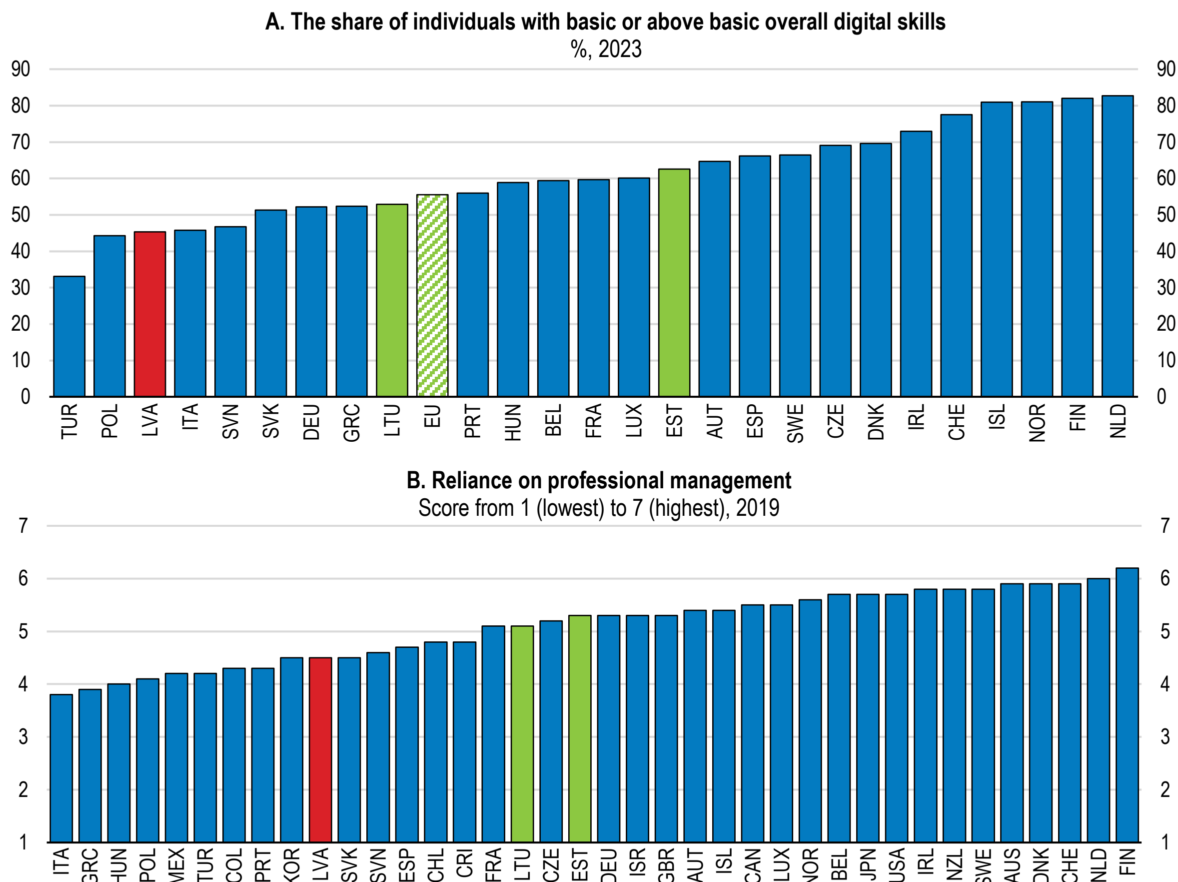
Improving digital and management skills is key to raise the adoption of digital technologies and innovation (OECD, 2022[1]); (European Commission, 2022[91]). Basic digital skills, such as navigating the internet and using the internal communication tools, as well as advanced digital skills, which require quantitative and technical proficiency, are relatively weak among Latvian workers (Figure 2.40). Management skills, such as ensuring efficient teamwork and communication between and within teams, also need to be improved to raise digital adoption (Pisu et al., 2021[92]). As part of its Recovery and Resilience Facility plan, Latvia is developing the Individual Learning Accounts, an EU initiative that aims to facilitate access to online learning opportunities to improve adult skills. Moreover, the Ministry of Economy will provide grants of EUR 30 million covering up to 70% of the total training costs, to improve the digital skills of the employees of more than 4 200 entrepreneurs over the period 2021-29. The grants will support programmes to improve basic digital skills, online courses on the use of digital business solutions, high-level training on cybersecurity, and AI and high-performance computing. However, the strong dependency on EU funds for these

programmes introduces uncertainty about their continuation as well as issues related to spending efficiency (see Chapter 1) (OECD, 2019[3]). Raising domestic resources to ensure continuity and expand measures that have proven effective is key.

Figure 2.40. Digital and management skills are weak



Note: Scores shown in Panel B are based on responses to the question: “In your country, who holds senior management positions in companies? [1 = usually relatives or friends without regard to merit; 7 = mostly professional managers chosen for merit and qualifications]”.
Source: Eurostat; World Economic Forum (2019), The Global Competitiveness Report 2019.

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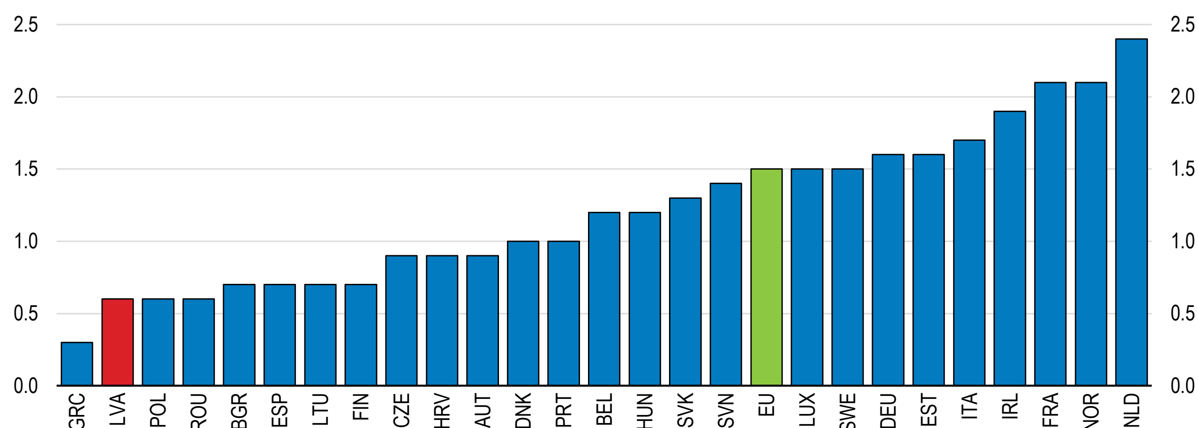
While the various public programmes to strengthen digital skills are welcome, it is also important to further improve incentives for firms to expand training of their workforce. Training investments of firms as a share of total labour costs are among the lowest in the EU (Figure 2.41). This is related to the large number of small firms, who lack management skills to implement effective human resource practices or do not have sufficient resources to provide training. Moreover, severe skilled labour shortages exacerbate the problem of poaching of skilled employees by other firms, which reduces incentives to invest in training of employees (Acemoglu, 1997[93]). This is particularly problematic as coordination across firms is weak, as only about half of firms are members of an employer organisation, which is far less than the EU average (OECD, 2022[94]). Better cooperation among firms of the same economic sector is necessary to coordinate initial and continued vocational education and training (VET) including with training providers and public VET institutes, which could be facilitated by establishing a training fund as recommended by the previous OECD Economic Survey of Latvia (OECD, 2023[95]). This is particularly important for sectors with many smaller firms, as coordination is more complicated. Training funds are planned to be piloted in three sectors starting in 2027 but given severe skilled labour shortages and weak training investment of firms the piloting should be accelerated. The recent decision to expand payroll tax exemptions for training provision of firms to also

include support for higher education is welcome but should be accompanied with further measures to improve coordination in training provision among the government, firms and workers.

Figure 2.41. Firms need to step up training

Spending for continuing vocational training (CVT) courses, % of total labour cost of all enterprises, 2020



Source: Eurostat, Continuing vocational training survey (CVTS) 2020.

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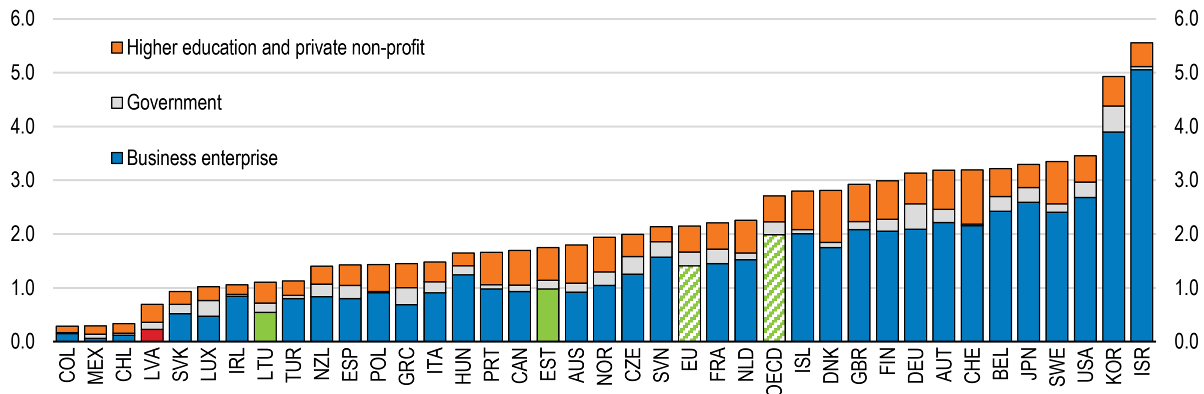
Low spending on research and development (R&D), in particular by businesses, hampers innovation and productivity growth (Figure 2.42). There are no specific corporate tax incentives for R&D, which are used by many countries to stimulate private sector innovation (OECD, 2022[1]). Instead, the government focuses on grants and financial instruments to support innovation and the digital transformation of enterprises. However, the governance of innovation policy can be improved, as responsibilities are shared by several ministries and agencies. Many different small-scale programmes exist with different application procedures and requirements and a lack of comprehensive and centralised impact evaluation. In this respect, the transfer of some research management functions from the State Education and Development Agency to the Latvian Council of Science in 2022 is a welcome step. Further centralisation of innovation support in a single agency would help to reduce the administrative burden on applicants and conduct a comprehensive evaluation and consolidation of existing programmes. Effective programmes should then be scaled up and expanded.

Moreover, a better cooperation and coordination between universities, research institutes and the private sector is needed to foster innovation. Plans to consolidate universities and create specialised research clusters are welcome, as the low number of researchers is dispersed across a relatively large number of universities, hampering knowledge spill-overs and effective coordination with the private sector (OECD, 2022[1]). Making funding for universities more performance based, in particular, regarding innovation outcomes and successful cooperation with the private sector, would help to foster knowledge transfer and innovation. Increasing the representation of private sector representatives in university councils would help to strengthen links with the private sector and better update study content according to skill needs of firms. As the previous Economic Survey of Latvia has argued, increasing the share of royalties of patents that researchers receive could help increase the incentives to innovate, invest and commercialise innovative ideas. Better using synergies between specialised research institutions and creating research clusters, as for example done by the Technical University of Riga, can help to improve cooperation with research institutions in other EU countries and increase visibility to attract funding and cooperate with innovative start-ups.

Figure 2.42. Low spending on Research and Development holds back innovation

Expenditure on Research and Development (R&D) % of GDP, 2021 or latest available year

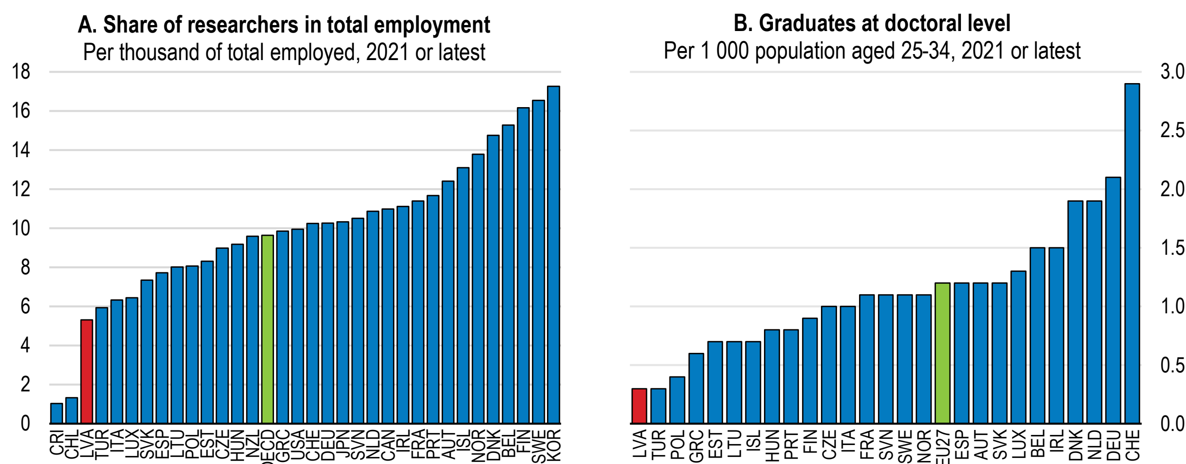


Source: OECD Main Science and Technology Indicators database.

A relatively low number of researchers and STEM graduates holds back innovation and digital adoption (OECD, 2022[1]). Latvia has one of the lowest numbers of researchers per employed person in the OECD (Figure 2.43). This is linked to the low share of tertiary and doctoral graduates among the 15-29 year old due to high dropout rates, particularly in STEM and ICT fields (OECD, 2023[96]). The government has raised the share of tuition fee waivers in STEM and ICT studies to above 80% of study places, which increased incentives for secondary graduates to choose these subjects in university. However, severe skilled labour shortages in the booming ICT sector and low funding for living costs lead many successful students to take job offers and dropout before graduation. Other students struggle due to weak quantitative and language skills, which calls for improving the quality of STEM and language education in schools (see Chapter 1). Moreover, the allocation of university funding should encourage higher graduation rates, while controlling for quality standards, to incentivise universities to provide sufficient support for struggling students. Data on labour market outcomes of graduates and alumni surveys should be used to evaluate the quality and regularly update the content of study programmes. To improve the financial situation of students, the existing means-tested financial support to cover living costs for students should be further increased.

To increase the number of researchers and doctoral graduates, funding for doctoral students and working conditions for researchers as well as links between teaching and research need to improve (OECD, 2022[1]). Plans to introduce professor positions with reduced teaching requirements can help to attract researchers to university teaching, improve working conditions and increase the exposure of students to frontier research topics. Providing sufficient funding for living costs for PhD students is crucial to reduce dropouts and should be combined with better cooperation with the private sector to allow for joint research projects, which could provide additional income for PhD students and foster knowledge spillovers. Moreover, attracting foreign and diaspora researchers through specific funding programmes, more flexible language requirements and better working conditions would help to raise knowledge transfers, facilitate international research cooperations and raise the quality of research.

Figure 2.43. The research workforce is small



Source: OECD Main Science and Technology Indicators database; Eurostat.

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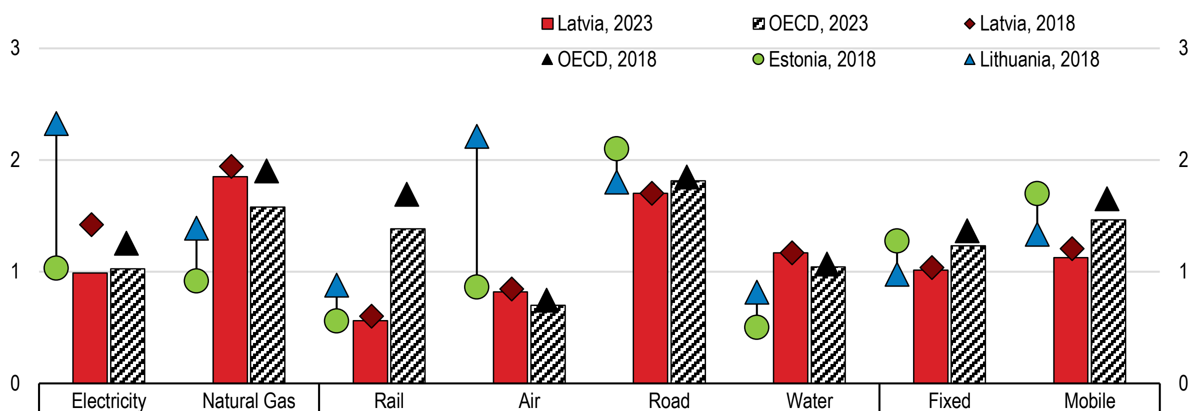
Improving competition enforcement

Competition enforcement is key for ensuring competitive markets, which are the basis for firm innovation and productivity growth. Safeguarding a level playing field ensures that innovative market entrants can challenge incumbents, which need to innovate and improve their products and services or free resources to allow more innovative and productive firms to grow. The independence and capacity of the Competition Council of Latvia to enforce competitive markets have been strengthened since 2020. The Competition Council retains the exclusive right to enforce competition laws and its decisions can only be challenged in court. Its budget has been separated from the Ministry of Economy and is submitted directly to the parliament's Budget and Finance (Taxation) Committee, in line with the previous recommendations of the OECD Economic Surveys of Latvia and the implementation of the EU's ECN+ Directive as of 2020. Resources have increased by about 22% in inflation-adjusted terms over the last two years, mainly for employee remuneration, resulting in an increase in the number of staff from 47 in 2020 to 59 in 2023 and a decrease in the staff turnover rate from 32% in 2019 to 12% in 2022. An IT laboratory was established to improve data analysis, including the pilot of an automated cartel screening and a merger report submission tool. Amendments to the Competition Law in June 2022 further strengthened the capacity of the Competition Council by increasing the number of representatives in its decision-making body from three to five and establishing a new unit to enforce the 2022 law on the prohibition of unfair trading practices. A separate unit of six economists has also been created within the Council to improve analysis to support damage claims and evaluate the benefits of the council's interventions. In 2022, the conclusion of legal proceedings on previously imposed fines has led to the collection of fines amounting to more than EUR 9 million, which is more than four times the allocated budget of the Competition Council.

However, significant challenges remain, particularly in services sectors where competition remains weak (see Chapter 1) (Figure 2.44). High entry barriers and a strong presence of national and local SOE's pose challenges to new entrants in some network sectors, such as road and air traffic as well as energy and heat production and distribution. This weighs on business dynamism and innovation and may reduce the quality and raise prices of services for consumers and firms that use these services as production inputs. Mark-ups have also been relatively high in other services sectors with a strong presence of SOEs, such as in arts, entertainment and recreation, real estate activities, and health and social work, pointing to weak competition (OECD, 2019[3]; Statistical Institute Latvia, 2023[97]). Moreover, according to the 2023 OECD PMR Indicators market entry barriers remain high in many professional services, such as lawyers, architects and civil engineers, as well as in retail sale of medicine, contributing to high prices.

Figure 2.44. Barriers to competition remain high in some network services

OECD Indicators of Product Market Regulation (PMR), index scale of 0-6 from least to most restrictive, 2023 (higher values indicate worse performance)



Note: OECD average includes all OECD countries, apart from Belgium, Hungary, Mexico, the Netherlands, and the United States for which data collection is still ongoing. PMR values for Estonia and Lithuania for 2023 will only be released in Summer 2024.
Source: OECD (2023), Product Market Regulation Database (forthcoming).

https://stat.link/53tycv

In 2020, the principle of competitive neutrality was introduced following the implementation of the EU's ECN+ directive to prevent market distortions caused by SOEs or regulations, but its enforcement should be improved (OECD, 2022[1]). A pre-condition for competitive neutrality is to clearly separate the management of SOE's from other functions of the public administration such as regulating markets, conducting public procurement or designing laws and regulations (see Chapter 1). Moreover, to strengthen the enforcement of competitive neutrality, the Competition Council should receive the power to initiate market investigations and challenge decisions of public bodies, in case certain administrative decisions, regulations, institutional arrangements or SOE practices hamper competition (Motta and Peitz, 2021[98]) (OECD, 2021[99]). So far, the council only has an advisory role and can only start evaluations when asked by market participants or the public body (see Chapter 1). In this respect, Latvia can learn from the example of the UK, where the Competition and Markets Authority (CMA) can even impose remedies following market investigations, which conclude that competition is being restricted (Whish, 2020[100]). The remedies sought by the CMA are binding orders for future conduct, such as to supply goods or services or to divest or not to acquire a business, among others, which are not sanctions to punish any past wrongdoing. Legislation in Greece, Iceland, Romania and Mexico also provides competition authorities with market investigation powers similar to those of the CMA (OECD, 2016[101]).

The large number of SOEs and relatively weak data transparency at the municipal level poses a challenge for monitoring abuse of dominance in markets where SOEs and private companies compete. In line with the OECD Ministerial Council Recommendation on competitive neutrality, requiring all SOEs to apply high standards of transparency, accounting separation and disclosure for activities that pursue public policy objectives, including those of statutory natural monopolies, and their commercial activities, which compete with private market players, is key to facilitate investigations on unfair practices of cross-subsidisation (OECD, 2021[102]). The Competition Council should receive sufficient resources to regularly monitor this accounting separation and assess whether SOEs are cross-subsidising their commercial activities. For example, the Australian Competition and Consumer Commission provides comprehensive guidance for SOEs to assess cross-subsidisation and monitors its implementation (ACCC, 2014[103]). Listing of SOEs can also help improve transparency and accounting separation (see Chapter 1).

There is also scope for strengthening the enforcement of the competition law. Time for merger control investigations is too short. They must be completed within 4 months and the Competition Council does not

have stop-the-clock powers during an ongoing review, which creates incentives for investigated firms to withhold information and reduces the quality of assessments. The Competition Law should be aligned with the EU Merger Regulation to allow the Competition Council to suspend reviews until essential missing information requested from the merging parties is provided (European Commission, 2004[104]). The Competition Council also does not have legal tools to assess the acquisition of minority shareholdings, which may harm competition due to common ownership. In Germany, for example, acquisitions of minority shares of 25% or more have to be notified and can be subject to merger control under certain conditions (OECD, 2017[105]). The investigative capacity of the Competition Council should be expanded to enable tracking concerted practices involving the exchange of sensitive commercial data that could be used to prove concurrence of wills in tacit collusion cases (OECD, 2017[106]; OECD, 2020[17]). For example, investigations by the Portuguese competition council of email exchanges between bank employees allowed to prove collusion in a case against major banks coordinating in setting mortgage rates (see above) (OECD, 2020[17]). Finally, further raising resources for staff training and IT equipment and software to improve the IT laboratory and the capacity to carry out regular ex-post evaluations is key to guide future investigations and decisions based on past experiences and rulings.

MAIN FINDINGS	RECOMMENDATIONS (Key recommendations in bold)
Improving credit provision	
Banks have not passed on lower funding costs to lending rates due to a market practice of setting a zero lower bound for the base rate for lending. Common ownership among banks, and between banks and other financial market institutions, is weakening competition in the financial system.	**Strengthen the legal and investigative powers and tools of the Competition Council to monitor anti-competitive behaviour in financial markets.** Introduce a mandatory notification of minority shareholdings for financial market participants.
Low customer mobility related to high fees and information asymmetries is reducing competitive pressures on banks. The household saving ratio is low and few households save in time deposits, partly due to low deposit rates.	**Extend the platform on payment account commissions to include information on bank deposit rates as well as other fees, such as minimum fees charged for refinancing loans, and provide standard switching packages and contract templates for loans.**
Regional disparities in access to banking services remain high. Information on borrowing activity and access to banking services is only available at the nationwide level.	Collect information at the municipal level on the availability of banking access points and services. Incentivise online banking by reducing information asymmetries on fees and contract conditions and improving cyber security.
High AML risk aversion by banks increases barriers to market entry and costs for FinTech firms.	Grant FinTech firms direct access to the national payments system, while maintaining security and consumer protection in line with the EU Payment Services Directive 2.
High AML risk aversion by banks has increased the administrative costs of loans and led to unwarranted de-risking.	Better define low-AML risk cases in line with the EBA guidelines and assess the degree of de-risking. Provide regular training to the relevant staff and require AML/CFT compliance officers in the financial sector to undergo additional training where necessary.
Regulatory and supervisory functions are centralised in the central bank, which could lead to prioritising financial stability over the effective functioning of financial markets.	Maintain current separate reporting, budget lines and staffing arrangements for different functions and monitor risks to the governance of financial sector policies.
Deepening capital markets to foster alternative sources of credit	
Stock market capitalisation is very small and none of the large SOEs are listed in the stock market, in contrast to other Baltic countries.	**Accelerate current plans to list large SOEs.**
For smaller companies, the administrative burden and costs of listing are high, preventing them from entering stock markets.	Simplify listing procedures and provide direct or indirect financial support for advisory fees associated with listing. Design mechanisms for companies listed in the Secondary List to transfer to the Main List.
Corporate bond issuance remains very limited, which is related to the high costs of obtaining creditworthiness information as well as low financial literacy, particularly among smaller firms.	Consider using data from the credit registry and the State Revenue Service to provide low-cost creditworthiness information on smaller firms and continue to improve the financial literacy of smaller firms.
Investments of pension funds, mostly in foreign assets, have yielded low returns, while many domestic firms have difficulties in accessing financing through domestic capital markets.	**Raise investment and concentration limits of second-pillar pension funds for single issuer assets, real estate and private investment funds, while ensuring appropriate risk management and governance processes.**
Common ownership between pension funds and banks is weakening competition and reducing asset returns for clients. Pension fund operating expenses are high.	Further improve the design of key information documents and provide a single point of access to aggregated information on investment performance and fees across all existing pension funds.
Application and reporting requirements for Venture Capital (VC) support programmes for start-ups are very stringent, resulting in a heavy administrative burden.	Simplify registration and reporting requirements for venture capital funds in line with EU regulation to reduce the administrative burden.
Exit strategies for start-ups are scarce due to shallow capital markets, which reduces access to VC finance.	Implement plans to introduce the public IPO fund.
Improving contract enforcement and insolvency procedures	
Insolvency proceedings remain long on average. The establishment of the Economic Court in 2021 has improved the efficiency of judicial proceedings concerning complex commercial disputes and large economic-crime, money laundering and corruption cases.	**Expand the remit of the Economic Court, while raising its resources.**
Insolvency procedures are costly and burdensome, discouraging low-income small business owners from filing for insolvency and hampering the reallocation of resources to more productive firms.	Increase the income threshold for the eligibility for legal aid of natural persons. Reduce the cost of filing insolvency to eliminate upfront barriers faced by debtors, while compensating insolvency administrators.
Property registries do not exist for machinery, creating uncertainty for leasing companies. Leasing of machinery is scarce.	Introduce a deed register for all leased assets to facilitate leasing as an alternative source of credit.

Strengthening innovation and digital adoption	
A lack of digital and management skills holds back digital adoption and innovation. Firm-provided training is weak due to poaching concerns and a lack of cooperation with VET institutes and training providers.	**Establish a tri-partite training fund and improve cooperation in training design and implementation among firms and training providers.**
Governance of innovation support programmes is weak and the administrative burden is high. Many small-scale programmes exist without a comprehensive impact evaluation.	Further centralise innovation support in a single agency, evaluate existing programmes and scale up the most effective ones.
The low number of researchers and PhD graduates weighs on innovation performance.	Continue to improve funding for PhD students and working conditions for researchers, while strengthening the links between research and university teaching.
Dropout rates in tertiary education are high, particularly in STEM fields. Funding for students to cover living costs is low.	Incentivise increased graduation rates through university funding allocation while controlling for quality standards. Increase the means-tested financial support scheme to cover living costs for students.
Improving competition enforcement	
Monitoring abuse of dominance in markets where SOEs and private companies compete is hampered by weak data transparency at the municipal level.	Require and dedicate the necessary resources to monitor the implementation of accounting separation between activities pursuing public policy objectives and commercial activities by all SOEs.
Time limits for merger control investigations are too short and the absence of stop-the-clock powers creates incentives for investigated firms to withhold information reducing the quality of assessments.	Align the Competition Law with the EU Merger Regulation to allow the Competition Council to suspend reviews until essential missing information requested from the merging parties is provided.
Although IT capacity of the Competition Council has improved, resources are not sufficient to regularly conduct ex-post evaluations of interventions to guide future investigations and decisions.	Further raise resources of the Competition Council for staff training, IT equipment and software to improve ex-post evaluations and expand its IT laboratory.

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Russia's war of aggression against Ukraine has led to higher energy prices and disruptions in trade and supply chains, weighing on economic growth. Economic convergence had already slowed down before the pandemic, calling for accelerating structural reforms. Rising spending pressures related to defence, internal security, health and old age poverty need to be addressed by raising spending efficiency and tax revenue, while the tax burden should be shifted from labour towards other income, property, and environmental taxes. Continuing to improve the capacity of the public sector, fostering investment and innovation and addressing skilled labour shortages are key for raising potential growth. Low credit supply is a main factor for weak investment and should be tackled by fostering competition and deepening capital markets. High informality, which hinders access to finance and distorts the level playing field, should be addressed by reducing labour taxes for low-wage earners, improving tax enforcement and continuing to fight corruption. Strengthening the power of the Competition Council to enforce competitive neutrality of state-owned enterprises and challenge regulation that restricts competition would help to foster business dynamism and innovation. Addressing skilled labour shortages will require facilitating skilled migration and investing more in human capital.

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