

Executive Summary

The economy is recovering from the global COVID-19 shock

The pandemic has hit the economy hard, but catch-up in per capita incomes has continued. Initial containment measures and restrictions were lifted in mid-2021, but a subsequent surge in case numbers following slow vaccination led to a three-month-long state of emergency and a short shutdown, weakening the pace of recent growth. Targeted fiscal support is being prudently maintained while pandemic restrictions are still in place. Increasing vaccination rates should lessen the need for such restrictions.

The recovery is set to accelerate (Table 1). By the spring of 2021 the economy had regained its output level from the end of 2019. The pickup in growth is broadly based, led by pent-up consumer demand, EU-financed public investment and exports. Inflation has also picked up considerably because of surging energy prices, other global supply shocks and domestic wage increases.

Table 1. The recovery is well underway

	2020	2021	2022	2023
Real GDP growth	-3.8	4.8	3.6	4.8
Unemployment rate (%)	8.1	7.5	6.6	6.2
Harmonised consumer prices (%)	0.1	3.2	4.9	2.7
Fiscal balance (% of GDP)	-4.5	-8.7	-5.4	-3.9
Public debt (Maastricht, % of GDP)	43.3	49.0	52.6	54.6

Source: OECD Economic Outlook 110 (December 2021) and updated historical data.

However, downside risks to growth dominate, the most important of which relate to the pandemic, as well as to global geopolitical and trade tensions. Also, possible further negative supply shocks could keep inflation higher beyond the short term.

The government appropriately intends to ease the burden of the pandemic on vulnerable households and firms. However, with continued expansionary monetary policy in the euro area and large EU funding inflows, it is

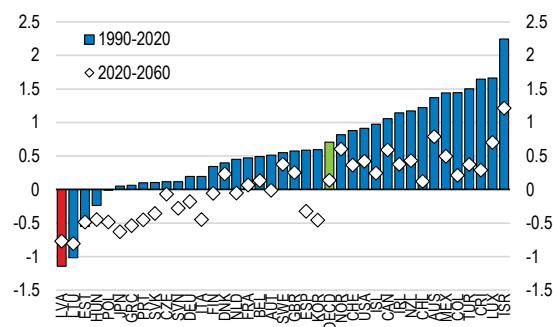
crucial that short-term fiscal settings not increase the risks of overheating. Furthermore, given the many demands on the budget, a credible fiscal strategy is needed to prepare for ageing- and climate-related challenges and stabilise the public debt at a sustainable level.

Addressing medium-term labour market and inclusion challenges would support growth and equity

The main factor influencing medium-term growth prospects is demographics. The population has been shrinking for three decades (Figure 1), driven by net migration, low fertility and short (albeit rising) life expectancy. Going forward, continued population shrinkage will lead to further losses in agglomeration benefits and accentuate fiscal challenges in a context of worsening old-age dependency and an already fairly uneven distribution of income and wealth. It also puts the labour market under pressure from the decline and ageing of the labour force.

Figure 1. The population is shrinking

Population changes, annual % change



Source: United Nations (2019), World Population Prospects: The 2019 Revision, Online Edition.

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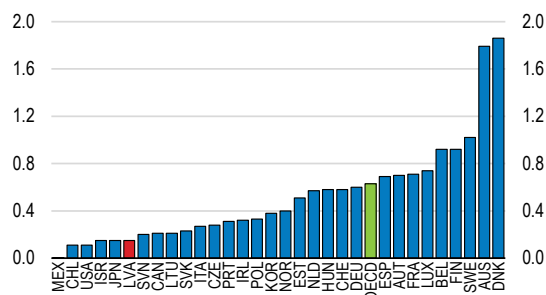
Although participation and employment rates have enjoyed trend improvement, labour-market performance could still be enhanced. Pervasive business informality and underreported wages result in lost training opportunities, pension rights and tax revenues. The government is preparing an action plan to combat informality, including welcome steps to step up enforcement; tax wedges should also be reduced. The long-term unemployment share in

total unemployment is larger than in the average OECD country. This problem should be tackled by boosting active labour market spending, notably on job training of reasonable duration (Figure 2). Addressing gender stereotypes and enforcing anti-discrimination legislation need to continue in order to reduce the growing gender wage gap, which is among the EU's highest.

The tax and transfer system could do more to alleviate income and wealth inequality. Recent efforts to confront poverty, especially severe among the elderly, should be strengthened. Similarly, the social safety net remains minimal, pointing to the need to further raise the Guaranteed Minimum Income.

Figure 2. Active Labour Market Policies should be strengthened

Active Labour Market Policy spending, % of GDP, 2019



Source: OECD Labour Market Statistics database.

StatLink  <https://stat.link/tqwp2>

Pensions, health-care and housing policies are all in need of attention

Living conditions could be significantly improved by changes to the pension, health care and housing sectors. Poverty, and population ageing and shrinkage make these policy areas especially challenging.

Old-age pension replacement rates are modest and, under current rules, will fall in the future. More must be done to improve pension adequacy by encouraging longer working lives, including through future increases in the pension age as life expectancy rises.

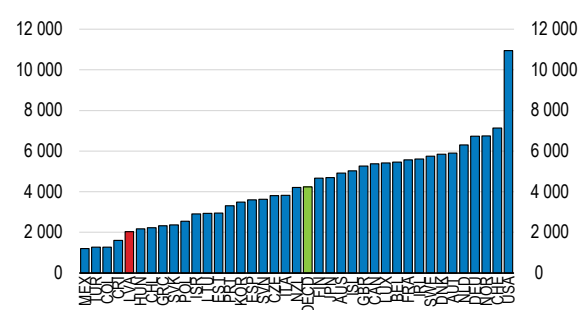
Low life expectancy underscores the need for more health-care spending (Figure 3). Latvia

spends about half the OECD average per capita on health care. As a result people rely heavily on out-of-pocket outlays to meet their medical needs. Widening public insurance coverage and lowering spending caps would be helpful. The tight supply of practitioners should be alleviated by continuing pay rises and making medical careers more attractive.

The efficiency of the hospital network should be re-examined, and more resources provided to preventive measures, primary and home care, mental health treatment and long-term care, all of which are underfunded. Making greater use of digitalisation and training nurses to perform more functions would help to improve treatment quality.

Figure 3. Health-care spending is very low

Current health expenditure per capita, USD PPP, 2020



Source: OECD Health Statistics database.

StatLink  <https://stat.link/9v4tly>

Excessive alcohol consumption, smoking and poor diets lead to adverse health outcomes. Raising applicable excise taxes and better informing citizens of the benefits of dietary change and more exercise are crucial steps towards healthier lifestyles. Warning labels for unhealthy foods would also be helpful.

The disadvantaged suffer from poor housing conditions, notably overcrowding. Housing investment as a share of GDP, especially in new construction, has been the OECD's lowest for many years. Housing benefits are modest and poorly allocated. Rental markets are thin, with little social housing, reducing labour mobility and Latvia's attractiveness to potential foreign investors. Meeting the National Development

Plan's housing objectives, notably by raising the supply of affordable and social housing and improving home-heating systems is crucial.

Dealing with environmental challenges is urgent

Despite some progress, more should be done to achieve green and sustainable economic growth. GHG emissions per capita are still rising, and air pollution from fine particles weighs heavily on health outcomes.

Latvia is committed to reducing GHG emissions by 65% from 1990 levels by 2030. Yet, this does not go much beyond reversing post-2000 increases. Lowering and ultimately removing the favourable treatment of natural gas and diesel for vehicle use (while protecting the poor) would help. Policies will also need to seek to raise the share of renewables and to integrate regional power and gas markets.

Air pollution is caused mainly by low-quality heating systems and industrial boilers. The relevant regulations need to be toughened. Agricultural activities are the major cause of diffuse-source water pollution, with nutrients causing negative impacts on water quality. Remaining untreated wastewater should be tackled by consolidating regional water companies. Finally, population shrinkage provides an opportunity to boost the share of protected land.

Investment, skills and innovation need support for export-led growth

Demographic pressures and slowing income convergence underscore the need to rely more on investment, innovation and skills in the search for faster productivity growth.

Progress has been made in the fight against corruption, bribery and money laundering, which should encourage more investment. Yet, trust in government is low, and bribes are still seen as common. Meanwhile, the responsible agency has been given considerable additional resources, and Latvia has been deemed as largely or fully compliant in all dimensions of the MONEYVAL anti-money laundering process.

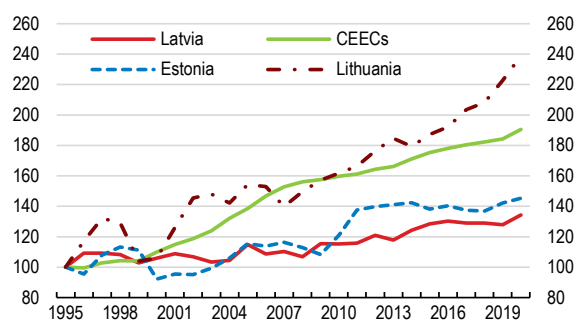
The imminent government action plan to shrink the shadow economy must also be implemented effectively.

Investment is being held back by a lack of credit. While the large banks are in good shape, lending conditions are tight. Many households are credit constrained, and access to finance – along with its cost and collateral demanded – is a serious barrier to business investment. The authorities need to deepen capital markets, create a culture of investment, starting with improving financial literacy, and fully transpose the EU restructuring directive, including simplifying corporate debt restructuring through out-of-court and hybrid procedures. A larger role for nonbanks, notably fintechs, would be helpful.


Focusing on exports is the best growth strategy for Latvia, given its demographic outlook. However, Latvia's exports have underperformed in recent decades (Figure 4). This may be attributable to the country's industrial structure, which is still dominated by low- and medium-low tech firms, along with the persistent rise in real labour costs. The government should aim to support the development of Latvia's exports of more complex products by fostering innovation, increasing worker skills and improving the business environment.

Figure 4. Exports have underperformed

Export performance, 1995 = 100



Source: OECD Economic Outlook database.

StatLink  <https://stat.link/5ut4wi>

Poor basic digital skills and high tertiary dropout rates point to an insufficiency of workforce skills. So does a scarcity of employer-provided training and adult education more generally. Too few youth study STEM subjects. One way forward is to hire high-quality teachers by giving schools more flexibility in setting their wages, provide tertiary students with greater financial support and implement training funds through tripartite social dialogue.

Improving the innovation system is equally important. The framework conditions for innovation are weak, with limited private-sector adoption of digital technologies, low-quality higher education institutions with few doctoral graduates, and low R&D spending in relation to GDP, especially by businesses. The 2018 corporate tax reform resulted in treating R&D like any other investment; this should be re-examined in light of persistently weak outcomes. It should also allow its academic researchers to share in the returns to their inventions.

MAIN FINDINGS	KEY RECOMMENDATIONS
Supporting the recovery and setting appropriate policies for sustainability and equity	
The vaccination rate has accelerated since the summer, reaching nearly 70%, close to the EU average	Continue efforts to accelerate vaccinations.
The national and EU budget rules have been suspended again for 2022. Budget balances are still feeling the effects of the COVID-19-related recession in 2020-21. Public debt is projected to exceed 50% of GDP in 2022. Annual spending reviews have been underway since 2016.	Maintain targeted short-term fiscal support to vulnerable households and the sectors hardest hit by COVID-19-related restrictions. Devise a credible fiscal strategy including effective associated fiscal rules, to prepare for ageing and climate challenges. Continue the process of annual spending reviews. Ensure effective implementation of projects financed by RRF funds, and coordinate the process with other national planning documents.
Latvia's tax and transfer policies provide little in the way of redistribution of income and wealth, whose inequality is severe. Old-age poverty is high. The Guaranteed Minimum Income was recently raised but is still insufficient to live off. Geographic disparities are pronounced.	Review minimum income thresholds on a regular basis, and raise the benefits for vulnerable groups, notably the elderly.
Long-term unemployment is high as a share of the total, especially in certain regions. Active labour-market measures are insufficient. Only about half of the unemployed receive unemployment benefits.	Raise active labour market spending. Expand eligibility for unemployment benefits.
The gender wage gap of 22% is among the highest in the European Union. The government has just adopted a Plan for gender equality and equal opportunities.	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.
Revising pension, health care, housing and environmental policies to enhance social welfare and sustainability	
Latvia's demographics have long been unfavourable and look set to continue to worsen. The ageing burden is set to fall mainly on retirees as pension replacement rates will fall, exacerbating old-age poverty.	Continue to raise the retirement age beyond 2025 by automatically linking it with life expectancy.
Public health-care spending is low relative to GDP, even allowing for Latvia's low per capita income level. Out-of-pocket spending is unusually high, and indicators of treatment quality (such as preventable and treatable mortality) and patient satisfaction (including unmet needs) are poor. Long-term care is a small share of total spending. Risky behaviours are widespread, especially in the form of heavy alcohol consumption, and obesity is prevalent.	Boost government health-care spending, and reduce the cap on individual contributions and improve access to state-funded health services and medicines to cut out-of-pocket expenses. Increase health-care spending on preventive measures, primary and home care, mental health treatment and long-term care. Consolidate the hospital network, and make greater use of digitalisation in the health-care sector.
Much of Latvia's housing is old, of poor quality and overcrowded. A lack of affordability is a widespread problem, as many households who cannot afford a mortgage are ineligible for housing benefit.	Ensure effective implementation of the National Development Plan's housing objectives, notably by raising the supply of affordable and social housing and improving home-heating systems.
Latvia has a number of sub-standard environmental outcomes. Carbon emissions have risen since 2000, and effective carbon tax rates are well below the estimated global cost of such emissions. Air quality is especially poor because of severe fine particle pollution.	Gradually raise effective carbon tax rates in sectors not covered by the EU-ETS, phasing out gas subsidies and redistributing revenues towards poorer households. Encourage greater use of renewables, and increase system inter-connection in both electricity and natural gas. Fight fine particle pollution through more stringent regulations and tighter enforcement of heating-system standards.
Strengthening investment, skills and innovation to boost exports and productivity	
Labour market informality, tax evasion, bribery and official corruption are seen as longstanding problems. Perceptions suggest that conditions have improved.	Continue to fight corruption, increase transparency in public procurement processes, and enforce the heavy penalties for tax evasion and bribery that existing legislation allows.
Export production is concentrated in low-complexity products, and few exports go outside the EU.	Strengthen business networks to support SMEs throughout their internationalisation process.
Despite recent progress, the quality of road infrastructure is well below the EU average, causing high road mortality. The government plans to upgrade most main roads by 2040.	Improve cost-benefit analysis and the selection process for new infrastructure projects, prioritising road safety.
Skills development is still lacking as seen by high dropout rates from tertiary education and below-average PISA outcomes in reading and sciences. The share of students in STEM subjects is low, while STEM graduates enjoy a high wage premium. A low level of basic digital skills is limiting the uptake of advanced digital technologies, which could overcome labour shortages in key sectors.	Boost student financial aid, and provide appropriate financial incentives for tertiary institutions to increase graduation rates. Provide schools with more flexibility in setting teacher wages to address recruitment difficulties for some subjects. Accelerate government collaboration with training providers to support the skills needed for the adoption of digital technologies.
The provision of employer-provided training is insufficient.	Establish training funds based on tripartite social dialogue.
Many aspects of Latvia's innovation performance are weak, including limited private-sector adoption of digital technologies, low-quality higher education institutions with few doctoral graduates and very low R&D spending in relation to GDP, especially by the business sector.	Improve the financial incentives for business R&D after evaluating the impact of the 2018 corporate tax reform. Allow academic researchers a share in royalties earned from their research.



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