

## **Republic of Latvia: Selected Issues**

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INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

**Selected Issues**

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Approved by European Department

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## I. POTENTIAL GROWTH AND THE OUTPUT GAP IN LATVIA<sup>1</sup>

*This note presents estimates of potential growth and the output gap in Latvia from different methods. The estimates suggest that output was below potential in the early 2000s but the output gap became positive and large after EU accession. The extent of overheating in the pre-crisis boom is particularly uncertain but staff believes output was about 5–10 percent above potential before the crisis. The output gap became negative and large during the crisis, reaching about -13 percent of potential output in 2009. With unemployment still well above its natural level, the output gap is estimated to be negative at slightly below 2½ percent of potential output in 2012, but is expected to narrow gradually and be closed in the next 3–4 years. Potential growth is nevertheless expected to be substantially lower than in 2002–07 unless structural reforms enable to reduce faster and further the structural level of unemployment and remove bottlenecks that would allow attracting more investment in the coming years.*

### A. Introduction

1. **The concepts of potential output and its associated output gap are central to many macroeconomic policy discussions.** In the near term, the level of potential output indicates the capacity of the economy to expand without leading to inflationary pressures. Over the medium term, it determines the sustainable pace of noninflationary output growth. Moreover, potential output is a crucial input to assess a variety of macroeconomic outcomes, such as the stance of fiscal policy or the sustainability of the external balance. For example, assessing whether Latvia fulfills the commitments under the ‘Fiscal Compact’ will depend on an estimate of the fiscal position net of cyclical effects and hence on the output gap estimate.

2. **However, potential output is an unobservable latent variable and its empirical counterpart needs to be estimated.** Many different methodologies have been used to estimate potential output, each of them encompassing a different precise definition of potential output and entailing advantages and disadvantages. No specific approach can be taken to be “the” correct one and potential output estimates are subject to substantial uncertainty. This uncertainty is probably even larger for countries like Latvia, a transition economy still going through substantial structural changes and coming out of a severe crisis that has likely rendered obsolete a significant part of the economy’s productive capacity. This note presents estimates from various methods, argues in favor of estimates from a variant of the production function approach and uses these estimates to discuss briefly the room for policies to enhance potential growth going forward.

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<sup>1</sup> Prepared by Bertrand Gruss.

3. **Analysts have relied on different methods to estimate potential output.** Most methods can be broadly classified in two groups: univariate statistical procedures and methods based on economic multivariate models.

- *Univariate statistical methods* - The most popular methods within univariate procedures are filters that isolate high from low-frequency components, such as the Hodrick-Prescott filter (HP), the Baxter and King filter (BK) and the Christiano and Fitzgerald filter (CF). The main advantage of filters is their simplicity as they are theory-free methods that only use statistical information from the series itself. The simplicity comes at the cost of some drawbacks though. Filtered trend estimates suffer from significant end-sample bias, that is, they are subject to significant revisions as data for later dates becomes available (even if historical data are not revised). Moreover, these techniques are based only on a statistical decomposition and ignore relevant economic information, which can significantly bias estimates. For example, using an HP filter on a sample characterized by a prolonged period of decreasing inflation—and negative output gap—as a result of tight monetary policy would result in an underestimation of potential output. Also, in the presence of structural changes that render obsolete part of the economy’s production structure, as it is probably the case in the wake of the recent crisis, relying on filtered potential output would most likely overestimate the positive output gap before the structural break.
- *Economic models* - The methods based on economic models entail a multivariate approach based on economic theory, typically exploiting key relationships describing goods and labor markets, the degree of capacity utilization of factors and structural aspects of the economy. Some widely used examples include the aggregate production function approach (PF), several variants of models using the Kalman filter and additional information from the Phillips’ curve or Okun’s law, structural vector autorregression models and multivariate filter models (e.g. Benes *et al.*, 2010). This note focuses on a version of the aggregate PF approach and also reports results from a structural vector autoregression model (as in Blanchard and Quah, 1989; hereafter BQ).<sup>2</sup>

4. **The benchmark model used in this note is a variant of the production function approach.** It implies assuming an aggregate production for the economy and comparing the actual level of input factors with their ‘potential’ or cyclically-adjusted level. The building block is a Solow growth model that relies on two factors that drive growth in the supply side of the

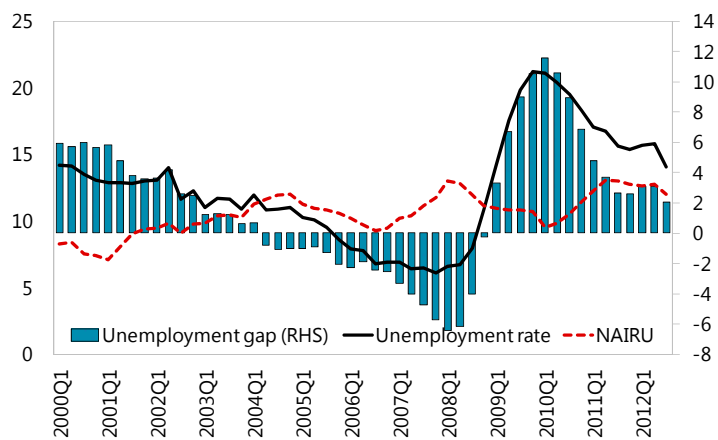
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<sup>2</sup> We estimate a joint model of quarterly real GDP and unemployment and use a Blanchard and Quah (1989)-type decomposition, relying on long-run economic restrictions, to identify supply and demand shocks. The output gap is computed as the accumulation of demand shocks (to anchor the level of the output gap we assume the 2004 gap is equal to the PF method’s gap estimate). We use quarterly data since 1996 and four lags as suggested by lag length selection criteria.

economy: labor and physical capital. The emphasis on a production function approach reflects both staff view that it represents an adequate framework for Latvia (where, for instance, population dynamics and structural unemployment play an important role in potential labor and potential output estimates) and convenience in terms of comparability, since it is the method also used by the Latvian authorities and the European Commission.

- To compute *historical values of potential output*, estimates of potential factor inputs are needed. A simple and widely used approach is to estimate potential factors (labor and total factor productivity) by HP filtering the actual factor series. The problem with this approach is that it shifts the problems of filters highlighted for trend GDP to the trend estimates of the inputs. The benchmark model adopted here relies on estimates of the ‘natural’ rate of unemployment—and the unemployment gap—and, to the extent possible, on a variant of the Okun’s law relationship to decompose trend from cycle in other factor components.<sup>3</sup> The natural unemployment rate used here is a time-varying nonaccelerating inflation rate of unemployment (NAIRU) estimated using a Kalman filter and a Phillips’ curve relationship between prices and unemployment (see Technical Appendix). The degree of capacity utilization is used to infer the potential level of total factor productivity.

**Figure 1.1. Actual and Natural Unemployment Rate**  
(in percent)



Sources: WEO; and IMF staff estimates.

- To compute *potential output in future years*, projections for the cyclically adjusted factor inputs are needed.
- The PF method can provide useful information on the determinants of potential growth. The method relies, however, on an overly simplistic representation of the production technology and on the approach taken to infer the potential level of factor inputs (i.e. the NAIRU estimate and the approach adopted to infer potential productivity).

<sup>3</sup> The PF variant used here bears similarities with the one used by the U.S. Congress and Budget Office as described in CBO (2001)

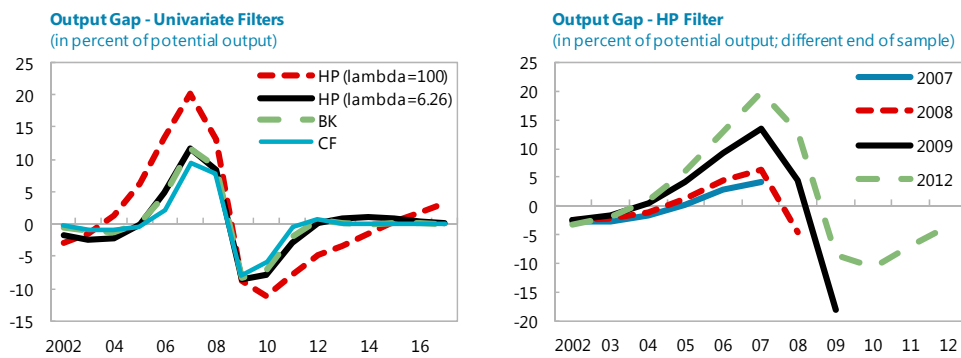
## B. Results

### Pre-crisis period

5. **Estimates suggest that output was below potential in the early 2000s.** Estimates from the PF approach suggest that output was 2½ percent below potential in 2002–03, consistent with high unemployment and a NAIRU estimate implying an unemployment gap of around 1–3 percentage points (Figures 1 and 3). The estimate from the HP filter is about the same, while output gap estimates from the BK and CF filters are negative but much smaller (Figure 2, left chart).

6. **The output gap became positive and large after EU accession in 2004.** Both filters and the PF methods suggest that output increased well above potential from about the time of EU accession (Figures 2 and 3). The estimate from the benchmark PF approach, that incorporates information from the goods and labor markets through the NAIRU estimate, indicate that the widening of the output gap accelerated in 2006, consistent with price and wage inflation developments (Figure 3).

**Figure 1.2. Potential Output, Univariate Statistical Methods**

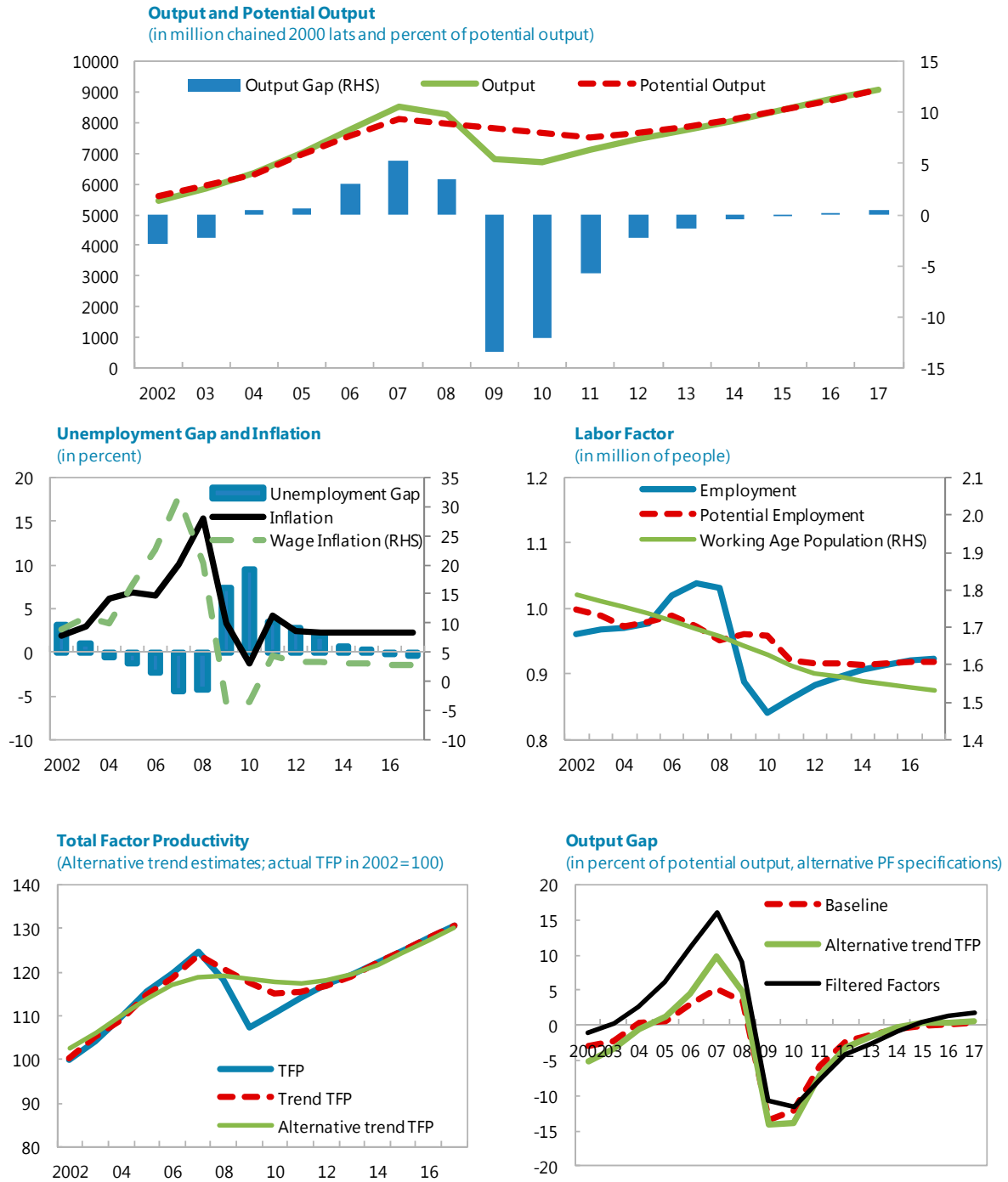


Sources: WEO; Haver; and IMF staff calculations

7. **Output was probably about 5–10 percent above potential before the crisis, although the extent of overheating at the pre-crisis boom is particularly uncertain:**

- On the one hand, filter estimates suggest output might have been as much as 20 percent above potential before the crisis. The HP filter suggests that the output gap surged to about 20 percent in 2007. Also, when the PF model is fed with HP filtered input series, the pre-crisis output gap estimate exceeds 15 percent (using the usual value for annual data of 100 for the smoothing parameter; Figure 3, bottom right chart). But using the HP filter to remove cyclical fluctuations is subject to significant end-sample bias: the 2007 output gap would have been less than 5 percent if estimated with real time information (i.e. with data up to 2007), while extending the sample up to 2009 would lead to a gap estimate for 2007 almost 3 times bigger (Figure 2, right chart).

**Figure 1.3. Potential Output, Production Function Model**



Sources: WEO; Haver; and IMF staff calculations



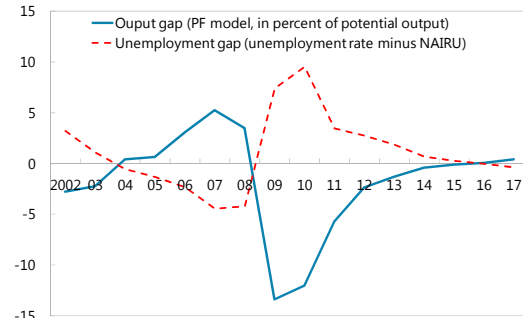
Also, results from the HP filter are very sensitive to the choice of smoothing parameter: when the parameter is set to 6.25, as suggested by Ravn and Uhlig (2002), the pre-crisis estimated output gap is half the size than when the parameter is set at 100. The BK and CF filters also indicate a very steep widening of the output gap before the crisis, though less pronounced. All filter estimates suggest that the absolute size of the pre-crisis (positive) gap was almost twice the size of the (negative) gap during the crisis.

- On the other hand, the benchmark PF model suggests the output gap peaked at around 5 percent of potential output before the crisis, implying that the absolute magnitude of the pre-crisis output gap was less than  $\frac{1}{2}$  the crisis gap. This is consistent with developments in the labor market: while unemployment went below the NAIRU during the boom, the absolute magnitude of the pre-crisis unemployment gap was less than  $\frac{1}{2}$  the size of the crisis gap. The participation rate was also high during the boom, but not extreme. One caveat to this estimate is that the potential TFP series used in the benchmark model might not be completely clean from cyclical factors. Using an alternative potential TFP series (subsequently smoothed with an HP filter; see Technical Appendix) leads to a gap estimate of about 9½ percent. Estimates from the BQ model also point to a positive output gap between 5 and 10 percent just before the crisis.

- While acknowledging the uncertainty of estimates, staff believes output was significantly above potential before the crisis, but probably in the 5–10 percent range rather than in the 15–20 percent range.

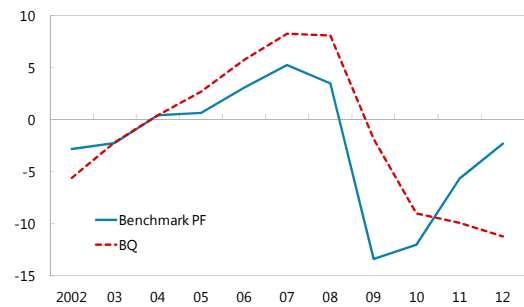
8. **The investment boom financed by capital inflows was the main driver of potential growth before the crisis.** Growth decomposition from the benchmark PF approach shows that in the early 2000s and especially after EU accession, potential output growth was driven mainly by a foreign financed investment boom. Productivity growth also played an important role, although this might partially reflect underestimated rise in factors' utilization.

**Figure 1.4. Output Gap and Unemployment Gap**



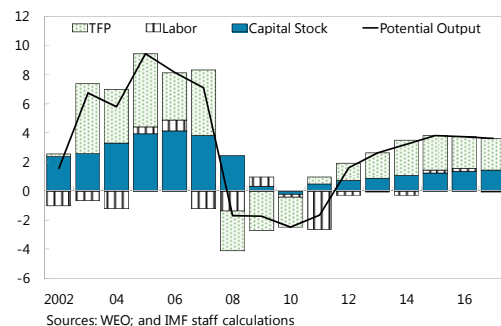
Sources: WEO; Haver; and IMF staff calculations.

**Figure 1.5. Output Gap - PF and BQ Methods**  
(in percent of potential output)



Sources: WEO; Haver; and IMF staff estimates.

**Figure 1.6. Contribution to Growth of Potential Output**  
(in percent)



Sources: WEO; and IMF staff calculations

## Crisis and recovery

9. **All methods suggest that output fell well below potential in 2009–10.** The benchmark PF model suggests the output gap reached -13 percent in 2009. Estimates from filters range from -8 to -10½ percent. All methods have the output gap narrowing from 2010 or 2011, except for the BQ model that shows a larger output gap in 2012 than in 2011 (although quarterly gap estimates from the BQ model are decreasing towards end-2012).

10. **The labor force and productivity were the main factors dragging potential growth during the crisis.** The sharp contraction in potential TFP in 2008–10 contributed significantly to the contraction in potential growth during the crisis. This is consistent with efficiency losses in reallocating factors across sectors—although the drop in TFP might be capturing underestimation of changes in capacity utilization. Emigration flows that intensified at the onset of the crisis affected potential employment and growth in 2007–08. The negative impact of labor to potential growth in 2011–12 responds to an increase in structural unemployment most likely due to “hysteresis”—a transformation of cyclical into structural unemployment as skills of the long-term unemployed depreciate.

11. **The estimates suggest that the effect of the crisis on potential output was large.** While potential output was growing at about 6½ percent per year during 2002–07, estimates suggest it contracted by 7 percent between 2007 and 2011. Potential growth resumed in 2012 but, under current estimates, its 2007 level would not be attained until 2013–14.

## Medium-term projections

12. **The estimated unemployment and output gap is still significantly negative but is projected to close in the next 3 to 4 years.**

- The benchmark PF model indicates that output in 2012 is still about 2.3 percent below potential (above 3 percent using the alternative potential TFP series) but would diminish gradually and be closed by 2015–16. The reason for the still negative output gap in 2012 is the estimated slack in the labor market: the unemployment rate is still about 2¾ percentage points above the 12.3 percent NAIRU estimate. While the NAIRU estimate for 2012 is large, it is consistent with the unemployment rate having been historically high in Latvia: the average unemployment rate between 1996 and 2011 was above 13 percent.<sup>4</sup>
- According to the HP filter the output gap in 2012 is almost 5 percent and would be closed by 2015. The HP filter output gap estimate for 2017 is positive at about 3 percent

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<sup>4</sup> Also, the estimate from using a constant-NAIRU model is almost 12 percent.

(although it is only 0.5 percent if the sample is extended from 2017 to 2020, highlighting the end-of-sample bias of this method).

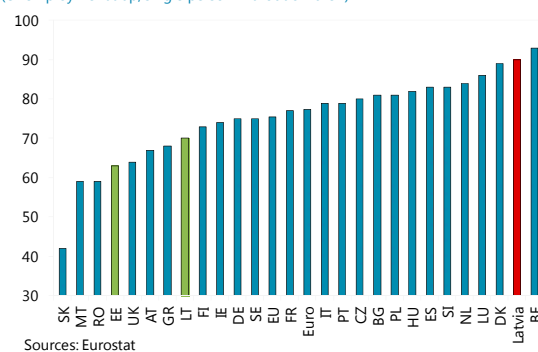
- On the other hand, the BK and CF filters suggest that the output gap is already closed or slightly positive already in 2012—which is at odds with an unemployment rate above 15 percent and a sizeable unemployment gap.

13. **Going forward, staff expects potential growth to be substantially lower than before the crisis.** Staff expects a gradual recovery of investment as FDI inflows pick up, but at a much slower pace than in the pre-crisis years when capital flows to the region were extraordinary. A slower pace of capital accumulation would also be associated with a more modest growth in productivity. Labor is not expected to contribute to potential growth in the coming years. The natural unemployment rate is expected to decrease gradually from its current estimate at 12.3 percent to 10¾ percent by 2015 and to slightly below 10 percent by 2017. But the gradual reduction in the natural unemployment rate barely offsets the expected negative trend in working age population. Altogether, staff projects potential growth to increase to about 3¾ percent in 2014–17.

### C. Policies to Increase Potential Growth

14. **Staff projections suggest that policies increasing potential employment could help attaining higher potential growth in the coming years.** Given current projections for population and structural unemployment, the contribution of the labor factor to potential growth would be almost nil in 2014–17. Two sets of policies could increase the contribution from labor to growth. First, policies aimed at reducing the natural unemployment rate by addressing structural bottlenecks that are keeping long-term unemployment at high levels could provide a boost to potential output. In this sense, findings from the forthcoming World Bank study could be used to: i) design ALMPs that aimed at alleviating skill mismatches in the labor market; and ii) address current disincentives from tax and benefit systems that act as an unemployment trap, reducing the attractiveness of moving from unemployment to employment. In addition, in an effort to reduce net emigration, the authorities are developing plans aimed at assisting emigrants who wish to return. Other demographic policy efforts could help in the longer term (Staff Report, Appendix II).

**Figure 1.7. Tax System Does not Encourage Employment**  
(Unemployment trap, single person without children)



15. **Attaining higher potential growth will depend on fostering productivity and attracting more foreign investment over the medium term.** The growth rate of investment observed during the boom years is not likely to return. Still, stronger investment than currently projected and faster productivity gains could be achieved if structural reforms to address bottlenecks were adopted (see next chapter).

## TECHNICAL APPENDIX

### Assumptions underlying the Production Function Model:

- **Output**- A Cobb-Douglas specification is assumed for output:  
 $GDP_t = TFP_t K_t^{(1-\alpha)} L_t^{(\alpha)}$ , where  $K$  is the capital factor, computed as explained below;  $L$  is the labor factor and  $TFP$  is total factor productivity computed as the Solow residual; the labor share in production ( $\alpha$ ) is assumed to be 2/3.
- **Labor factor** – The actual level of the labor factor is total *employment* in the economy.<sup>1</sup> To estimate *potential employment*, total employment is decomposed in two components: the labor force and un/employment.

The *potential level of un/employment* is proxied by a time-varying estimate of the natural rate of unemployment called the nonaccelerating inflation rate of unemployment (NAIRU). The NAIRU is inferred from a Phillips curve-type regression similar to Gordon (1997) and Boone *et al.* (2001) using quarterly data from 1996Q1 to 2012Q3:

$$\pi_t = \pi_t^e + B(L)(u_t - \text{NAIRU}_t) + d(u_t) + C(L)z_t + e_t$$

where  $\pi_t$  and  $\pi_t^e$  denote realized and expected core inflation<sup>2</sup>;  $u_t$  denotes the unemployment rate;  $z_t$  is a set of variables capturing supply side shocks and normalized to zero (in this paper, changes in consumer taxes and variations in import prices);  $B(L)$  and  $C(L)$  are polynomials in the lag operator; the disturbance  $e_t$  is assumed to be i.i.d. normal with zero mean and variance  $\sigma_e^2$ . Expected inflation is proxied by past inflation ( $\pi_t^e = \sum_{i=1}^T \alpha_i \pi_{t-i}$ ). We impose the sum of the weights on lagged inflation terms to be equal to one to ensure dynamic homogeneity—i.e. no relationship between inflation and real variables in the long-run—which is necessary for the NAIRU to be an economically meaningful concept. The preferred specification uses one lag for inflation.  $\text{NAIRU}_t$  is the natural unemployment rate at period  $t$  and is modeled as an unobserved stochastic process assumed to follow a random walk and estimated using the Kalman filter:

$$\text{NAIRU}_t = \text{NAIRU}_{t-1} + \epsilon_t$$

The disturbance term  $\epsilon_t$  is assumed to be i.i.d. normal with zero mean and variance  $\sigma_\epsilon^2$ . As it is common in the literature,  $\sigma_\epsilon^2$  is constrained to be a fraction of  $\sigma_e^2$  (see Gordon 1997). After comparing the model likelihood from using alternative values, this ratio is set at 0.2.

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<sup>1</sup> Hours worked was not used in this specifications due to data concerns.

<sup>2</sup> An alternative specification using headline inflation and other supply shock control variables (e.g. changes in energy and food prices) was also used and the results were not significantly different.

The *potential labor force* is given by the working age population and the potential participation rate.<sup>3</sup> To estimate the potential participation rate, we use a cyclical-adjustment equation that relies on the gap between the unemployment rate and the NAIRU as an indicator of when actual participation equals potential and that allows for potential participation to grow at a constant rate over one or more historical periods.<sup>4</sup> The cyclical-adjustment equation results from combining the following equations:

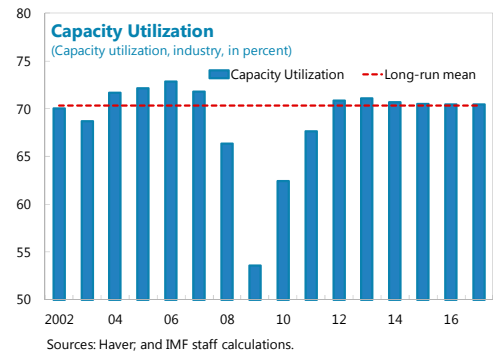
$$p_t = p_t^* + \theta(u_t - \text{NAIRU}_t) + \epsilon_t$$

$$p_t^* = \gamma'(T_1, T_2, \dots, T_N)$$

where  $p_t$  and  $p_t^*$  are actual and potential participation levels;  $\theta$  is an estimated coefficient on the sensitivity of participation to the unemployment gap;  $\gamma$  is a vector of  $N$  coefficients and  $T_i$  is a trend variable that takes zero values up to the break point in period  $i$ .

Historical values for the potential participation rate are calculated as the fitted values from the regression with the unemployment rate constrained to equal the NAIRU at each period. Only one trend break, in 2000, is assumed for the final model specification.

- Capital factor and TFP** – While in principle the capital input does not need to be cyclically adjusted—as the unadjusted level already represents its potential contribution to growth—cyclical variations in the rate at which it is used get reflected in the TFP series if capital is not adjusted. Variations in utilization rates were particularly large in Latvia around the recent crisis. Some studies use data on capacity utilization to infer the potential level of TFP.<sup>5</sup> In this study, a simpler approach is taken. The capital factor is assumed equal to the capital stock in the economy, computed according to the perpetual inventory approach (with depreciation assumed to be 8 percent per year), multiplied by the ratio of capacity utilization.<sup>6</sup> Potential capital is obtained by



<sup>3</sup> For the purpose of this analysis, labor statistics up to 2011 have been estimated by staff by extrapolating the correction introduced in 2011 due to Census data for the period in between census years (2000–11).

<sup>4</sup> This approach is similar to the one used by the Congress and Budget Office to estimate potential output in the U.S.; see CBO (2001).

<sup>5</sup> For example, a new method being used by the European Commission to estimate trend TFP relies on the Kalman filter and data on capacity utilization to disentangle cyclical and structural variations in TFP; see D’Auria *et al.* (2010).

<sup>6</sup> The level of capacity utilization is proxied by the capacity utilization in manufacturing from managers’ answers to business and consumer surveys published by the National Statistical Office.

imposing capacity utilization at its long-run average. The Solow residual after correcting the capital stock by the degree of capacity utilization is assumed to represent the structural level of efficiency in the economy and is taken as the *benchmark* potential TFP. Arguably, the resulting TPF series might still include cyclical elements such as variable utilization not captured by the capacity utilization rate used (e.g. as we are not correcting the labor factor by variations in the intensive margin). As a robustness exercise we construct an *alternative* potential TFP series by HP filtering the benchmark series (with a low smoothing parameter of 6.25). Estimates from both approaches differ mainly in magnitude of the pre-crisis output gap estimate (Figure 3). As the process to obtain the alternative potential TFP series embeds no economic information and might be smoothing out non-cyclical variations, the unfiltered series is used for the benchmark model specification.

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## II. MICROECONOMIC REFORM CHALLENGES<sup>1</sup>

### A. Introduction

1. **Latvia's reform challenge is ongoing.** Latvia has seen two decades of sweeping political, economic, and social changes since regaining its independence in 1991, beginning with the reintroduction of a market economy, and with additional impetus from preparations for EU and NATO accession in 2004. More recently, Latvia needed further reforms to restore competitiveness and the public finances as boom turned to bust in 2008–09. Much has been done. Even so, a significant reform agenda remains ahead.

2. **Latvia is recovering well from its 2008–09 crisis.** Latvia implemented a very strong macroeconomic adjustment program—with international financial support—in response to the 2008 financial and balance-of-payments crisis. Central to the adjustment was a massive fiscal consolidation, and unwinding of previously rapid price and wage increases, to close the gap between incomes and productivity. A firm recovery has taken hold, with real GDP expanding rapidly in 2011 and 2012—and, in contrast to the 2004–07 boom, the external imbalances are under control. Yet Latvia continues to face major long-term challenges: unemployment and poverty rates are still high, the working-age population is falling, and income levels are still low by EU standards. Thus, an overarching challenge for policymakers is to promote economic growth that can raise living standards sustainably, while avoiding a repeat of past imbalances.

3. **Future growth will come in a context of constraints on macroeconomic—fiscal and monetary—policies.** While the most difficult fiscal measures are now in place, and the general government deficit has been sufficiently reduced for Latvia to meet the Maastricht deficit criterion, fiscal space is still limited. And monetary policy is centered on the peg to the euro, with a view to euro adoption in 2014. To be sure, the stability associated with disciplined macroeconomic policies is a necessary condition for sustained economic growth—and Latvia is by no means alone in facing policy constraints. But to promote growth more actively, Latvian policymakers need to look beyond fiscal and monetary policies.

4. **This paper discusses the microeconomic reforms that are most needed to support growth.** The next section provides an overview of recent evidence on strengths and weaknesses in Latvia's business environment. The following sections focus in more detail on three areas in which reform efforts in progress could bear most fruit: the efficiency of the legal framework, including the insolvency framework; governance of state-owned enterprises (SOEs); and higher and vocational education. Though some of these areas, including SOEs and education, clearly have fiscal implications, the paper emphasizes non-fiscal aspects, i.e. supply-oriented reforms aiming primarily at removing impediments to growth.

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<sup>1</sup> Prepared by Agnese Bukovska and David Moore.



## B. Overview of Latvia's Competitive Strengths and Weaknesses

### 5. Fostering growth is an EU-wide challenge, but the challenges differ from country to country.

- Barkbu et al. (2012) discuss policies to promote growth in Europe as a whole, with an emphasis on labor and product market reforms, but recognizing regional differences. They recommend “granular” reforms: in southern Europe, these reforms should address insider-outsider gaps in the labor market and relative price misalignments that hold back the competitiveness of the tradable sector. In northern Europe, reforms should target higher labor participation and a more vibrant services sector.
- Turning to the case of Latvia, three different sources of information help identify the country-specific challenges: international survey evidence, progress on the structural reform agenda during the 2008–11 program, and more recent Latvia-specific analysis of strengths and weaknesses.

#### International survey evidence

### 6. Survey evidence is mixed on the competitiveness of Latvia's business environment, but on balance suggests it lags the other Baltic and EU-27 countries.

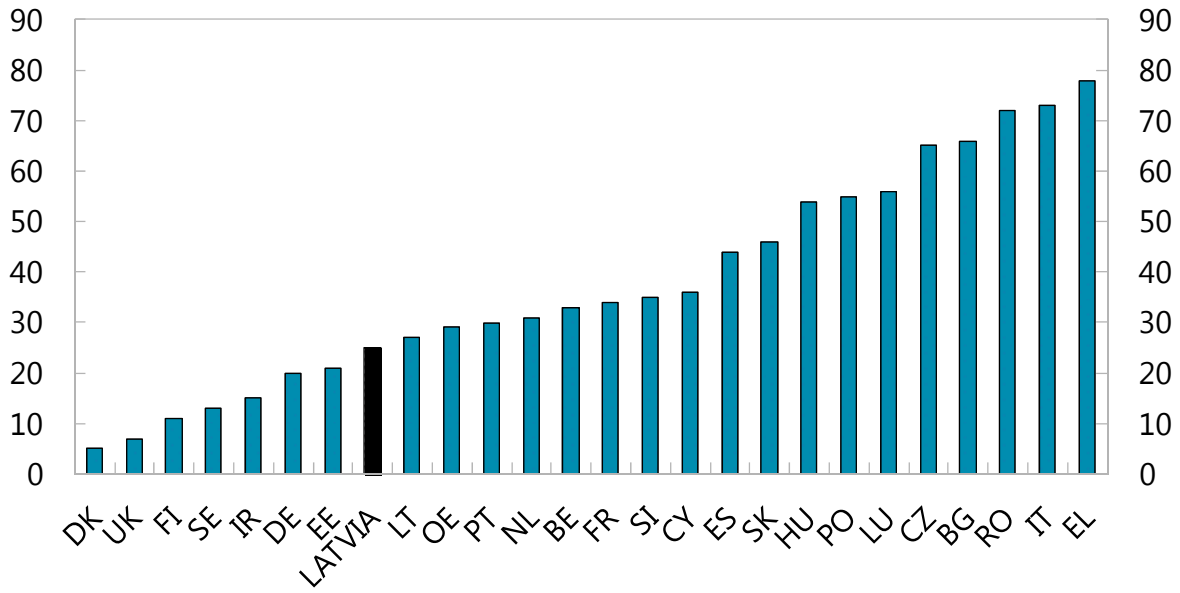
- Latvia does relatively well in the World Bank's *Doing Business* ratings, in 2013 ranked overall at 25 out of 185 economies (Figure 1). Even so, despite its rise in the rankings through the past few years, Latvia fell back four places in the most recent survey as other countries made improvements of their own. Latvia's ranking is in line with those of Estonia and Lithuania (21<sup>st</sup> and 27<sup>th</sup> respectively).  
In the subindicators,<sup>2</sup> Latvia ranks well in “starting a business”, reflecting changes in 2011 to simplify procedures. Latvia ranks less favorably on “protecting investors” (70<sup>th</sup> out of 185).
- The *2012–13 Global Competitiveness Report* of the World Economic Forum (WEF) ranks Latvia 55 out of 144 countries (Figure 2). This is well behind Estonia (34<sup>th</sup>) and Lithuania (45<sup>th</sup>), but represents a notable improvement from two years ago, when Latvia ranked 70<sup>th</sup> out of 139. Latvia's WEF subindicators are most favorable for labor market efficiency, and least favorable on business sophistication, innovation, and market size. In addition, Latvia ranks 106<sup>th</sup> in “efficiency of legal framework in settling disputes”, corroborating a *Doing Business* finding.

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<sup>2</sup> Some of the *Doing Business* subindicators seem more reliable than others. Latvia's ranking for “getting credit” (4<sup>th</sup> out of 185) seems too favorable given the extent of deleveraging. And a caveat to Latvia's unfavorable ranking on “protecting investors” is that Finland has the same ranking (70<sup>th</sup> out of 185) on this subindicator—which is hard to square with other indicators for Finland showing a particularly strong business environment.

**Figure 2.1. Doing Business, EU Countries**

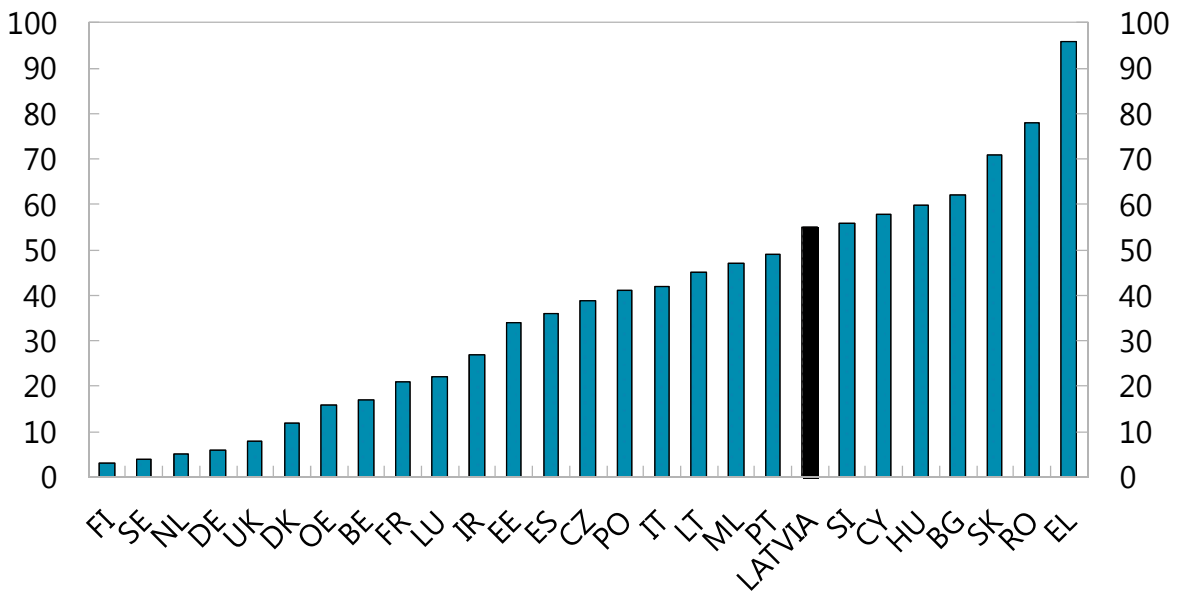
(2013 rankings, of 186 countries)



Source: World Bank.

**Figure 2.2. Global Competitiveness Index, EU Countries**

(2012-2013 rankings, of 144 countries)



Source: World Economic Forum.

## Latvia-specific analysis

7. **The *Latvian Competitiveness Report 2011 (LCR)* provides a careful diagnostic of Latvia's competitiveness.** The report, commissioned by the authorities and prepared by independent academics, assesses Latvia's relative strengths and weaknesses. It finds Latvia's strengths include:

- its strong growth and diversification in exports coming out of the crisis; and
- its physical infrastructure for transport and logistics.

But weaknesses include:

- high inequality (Figure 3);
- limited innovation (Figure 4);
- low manufacturing productivity;
- the quality of education, especially in the higher and vocational sectors;
- underdeveloped financial markets;
- and a large informal economy, estimated at some 40 percent of GDP.

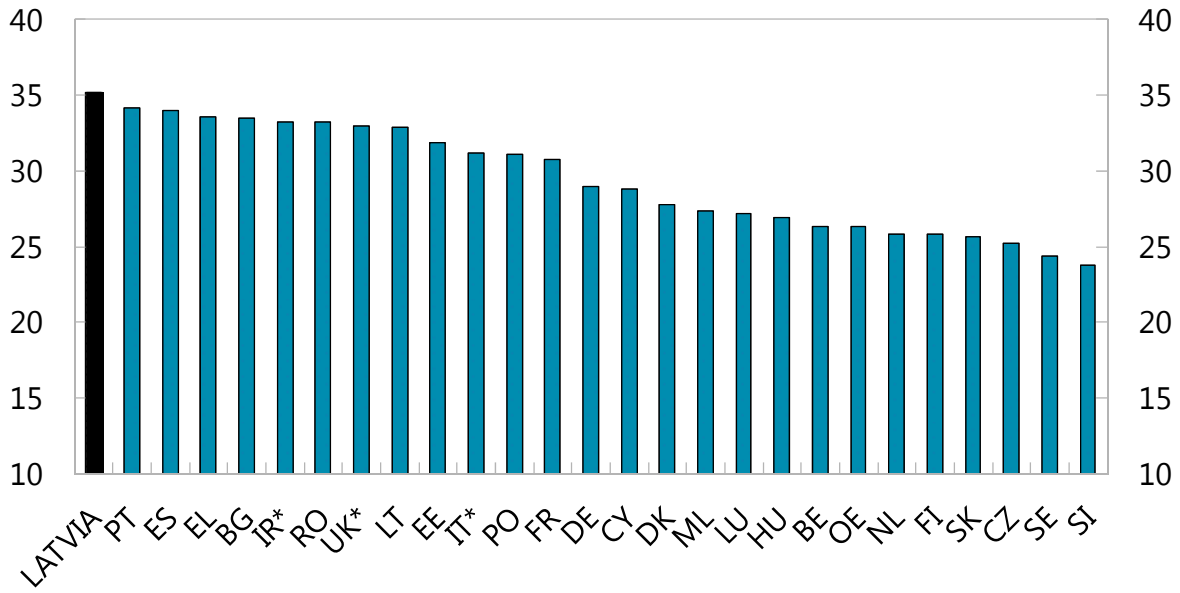
For the most part, the LCR limits itself to a diagnostic approach. While it tries to avoid prescribing detailed policy responses, putting the onus on policymakers to draw their own conclusions, it does recommend actions prioritizing actions to curb the informal economy (including an overhaul of tax administration), to improve the quality of education, and to build on Latvia's strengths in transport and logistical infrastructure.

8. **The LCR notes the costs to competitiveness where flouting of the rules is widespread.** Most obviously, the informal economy distorts competition, biasing activity towards short-term gains and against longer-term productive investments. The LCR also finds that, while the Latvian labor market has been flexible in practice, much of this flexibility reflects circumvention of formal employment rules: this is costly in terms of resources diverted to circumvention and to the credibility of labor market institutions. And, while not attempting a detailed analysis of Latvia's legal efficiency, the LCR does find that perceived inefficiencies in both legislation and implementation are discouraging investment, and that a high number of business disputes is contributing to resource misallocation and lower competitiveness.

9. **The LCR distinguishes between the relatively good quality of primary and secondary education, and deeper problems in higher and vocational education.** In terms of enrolments of preschool children in education, a low share of 15-year-olds with insufficient knowledge of reading, mathematics and science, and the share of early school leavers, Latvia performs better than the EU average, even if short of the Europe 2020 targets. But only a low share of adults take part in lifelong learning. In the secondary education sector, the introduction of the "money follows the student" principle in 2009 represented a major reform. Latvia's scores in the Program for International Student Assessment (PISA) are below the OECD average, indicating room to improve quality, but are not an obvious outlier. Problems are deeper in higher and vocational education (sections E and F).

**Figure 2.3. Gini Coefficient, EU Countries**

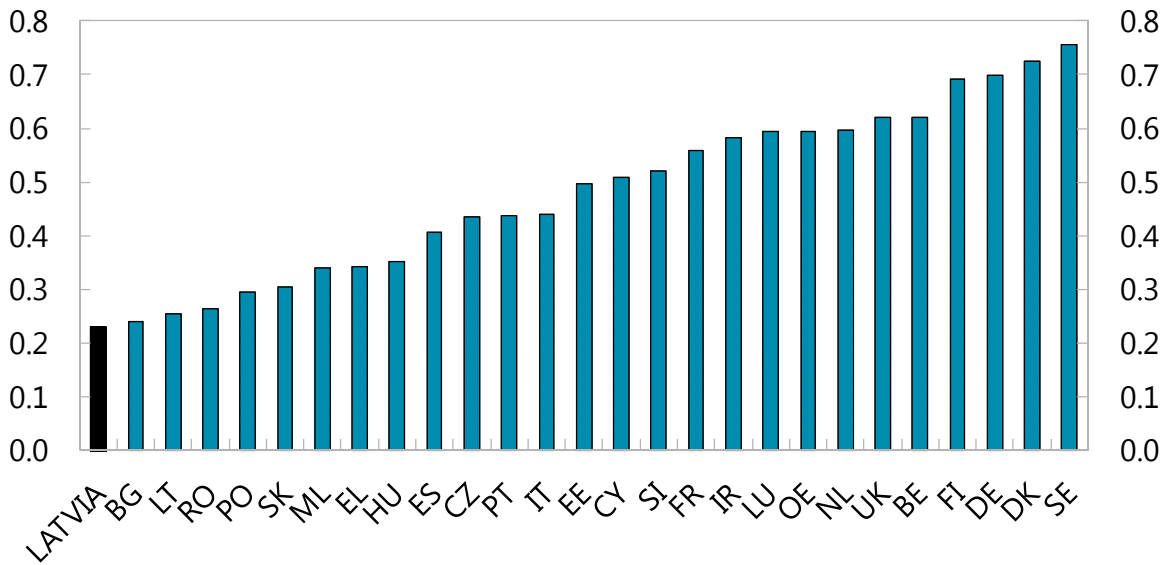
(Data for 2011, except \* 2010)



Source: Eurostat.

**Figure 2.4. Innovation Index, EU Countries**

(Data for 2011)



Source: Innovation Union Scoreboard 2011, Maastricht Economic and Social Research Institute on Innovation and Technology.

**10. The authorities are incorporating the LCR findings into their own policy planning document, the draft *National Development Plan 2014–20* (NAP).**

- The NAP is intended to ensure the consistency of sectoral policies through the next EU budget period, and to promote reforms while fostering recognition of sectoral budget constraints. It is premised on the main findings on the LCR, in particular acknowledging high inequality, the large grey economy, and weak innovation.
- In response, the NAP sets three priorities: economic growth; “securitability”, i.e. to empower individuals, with a view to mitigating inequality and mitigating Latvia’s demographic decline; and development of Latvia’s regions. The NAP largely defers to line ministries to elaborate the details of intended sectoral measures to meet these goals.<sup>3</sup>
- The authorities envisage parliamentary approval of the NAP in December 2012.

**11. The regular half-yearly report of the Ministry of Economics (MoE) sets out the ongoing policy agenda for the business environment and other structural areas of economic policy.** The most recent report (MoE, 2012) reviews Latvia’s progress in implementing its National Reform Programme for 2011–14, introduces the government’s ideas for a new industrial policy, and discusses developments in energy, construction, tourism, competition, and other structural policies.

**12. Other stakeholders regularly contribute to the structural policy debate.** One forum is the National Economy Council (NEC), an advisory institution of stakeholders including the MoE, business groups, trade unions, local governments, and academics (MoE, 2012). In addition, the government holds an annual consultation with the Foreign Investors’ Council in Latvia (FICIL); the June 2012 Government of Latvia-FICIL communiqué<sup>4</sup> discussed structural challenges including the need to address weaknesses in the Latvian court system, the gap between insolvency law and procedures, and the need for good corporate governance for state-owned enterprises.

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<sup>3</sup> However, the NAP proposals on regional development—while consistent with earlier long-range planning documents—are now proving controversial. The NAP envisages focusing resources on 9 larger cities and 21 development centers: the trade-off is that smaller municipalities would miss out, but resources would no longer be spread too thinly to be effective.

<sup>4</sup> See <http://www.ficil.lv/index.php/documents/communique/>

## Structural issues and the EU-IMF program<sup>5</sup>

13. **Latvia’s balance-of-payments assistance from the European Union included significant conditionality on non-fiscal structural areas.** While the IMF part of the program focused on restoring macroeconomic and financial stability, the EU institutions followed a somewhat broader mandate. As well as supporting policies to promote competitiveness under a fixed exchange rate, the EU’s part of the program explicitly took into account the goals of the “Europe 2020” growth strategy. In its first post-program surveillance (PPS) report on Latvia, the European Commission (2012) summarized the remaining structural agenda as follows:

“The main challenges for the government, as presented in the latest National Reform Plan (NRP) and Convergence Programme (CP), are to continue reducing budget deficit and debt levels, refocus and adequately finance active labour market policies, reform and better target the social safety net, improve the judiciary system and the economy’s energy efficiency, strengthen the capacity to monitor and enforce competition, and continue reforms in higher and vocational education.

While progress is remarkable in many areas, the PPS mission revealed less progress than expected as regards several conditions included in the latest Memorandum of Understanding, notably on management of state owned enterprises (SOEs), public administration and the unified public sector wage grid reforms, strengthening of the competition framework, and setting up of the Development Bank.”

Drawing on PPS findings, and as part of the Europe 2020 process, the European Council made “country-specific recommendations” in these areas in July 2012 (Box 1).

14. **IMF structural conditionality during the 2008–11 program focused relatively narrowly on fiscal and financial sector reforms.** The Stand-By Arrangement (SBA) included a fairly high number of benchmarks on areas that could deliver permanent deficit reduction, or were aimed at resolving financial sector weaknesses. Benchmarks on SOEs had a fiscal as well as a structural rationale. Even so, given the need for Latvia to restore competitiveness under its fixed exchange rate, discussions<sup>6</sup> through the program period pointed to the need for structural reforms outside these core macroeconomic and financial areas. In addition, following up on its technical assistance in 2009–10 on debt restructuring issues, the IMF’s Legal Department provided technical advice to the justice ministry during the development of a new insolvency law that was introduced in 2010.

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<sup>5</sup> For a more complete overview of program issues from the IMF perspective, please see the upcoming *Ex-Post Evaluation of Exceptional Access Under the 2008 Stand-By Arrangement*. For the European Commission’s perspective, see Giudice et al (2012).

<sup>6</sup> See for example, IMF Country Report No. 12/171, the staff report for the 2010 Article IV Consultation.

### **Box 1. Europe 2020: Country-Specific Recommendations for Latvia**

The European Council made the following recommendations to Latvia in July 2012:

1. *Ensure planned progress towards the timely correction of the excessive deficit. To this end, implement the budget for the year 2012 as envisaged and achieve the fiscal effort specified in the Council recommendation under the Excessive Deficit Procedure. Thereafter, implement a budgetary strategy, supported by sufficiently specified structural measures, for the year 2013 and beyond, to make sufficient progress towards the medium-term budgetary objective (MTO), and to respect the expenditure benchmark. Use better than expected cyclical revenue to reduce government debt.*
2. *Implement measures to shift taxation away from labour to consumption, property, and use of natural and other resources while improving the structural balance; ensure adoption of the Fiscal Discipline Law and develop a medium term budgetary framework law to support the long-term sustainability of public finances; restore contributions to the mandatory funded private pension scheme at 6 percent of gross wages from 2013.*
3. *Take measures to reduce long-term and youth unemployment by fighting early school leaving, promoting more efficient apprenticeships and VET [vocational education and training], enhancing the quality, coverage and effectiveness of active labour market policy and its training component and through an effective wage subsidy scheme.*
4. *Tackle high rates of poverty and social exclusion by reforming the social assistance system to make it more efficient, while better protecting the poor. Ensure better targeting and increase incentives to work.*
5. *Further encourage energy efficiency by providing incentives for reducing energy costs and shifting consumption towards energy-efficient products, including vehicles, buildings and heating systems. Promote competition in major energy networks (electricity, natural gas, heating) and improve connectivity with EU energy networks.*
6. *Take measures to improve management and efficiency of the judiciary, in particular to reduce the backlog and length of procedures. Take steps to improve the insolvency regime and the mediation laws.*
7. *Continue reforms in higher education, inter alia, by implementing a new financing model that rewards quality, strengthens links with market needs and research institutions, and avoids fragmentation of budget resources. Design and implement an effective research and innovation policy encouraging companies to innovate, including via tax incentives, upgrading infrastructure and rationalising research institutions.*

Source: Council of the European Union (2012)

[http://ec.europa.eu/europe2020/europe-2020-in-your-country/latvija/index\\_en.htm](http://ec.europa.eu/europe2020/europe-2020-in-your-country/latvija/index_en.htm)

## Reform priorities

15. **While the different information sources point to several areas for reform, they consistently identify the need to upgrade judicial efficiency and the insolvency framework, SOE governance, and higher and vocational education.** Encouragingly, the authorities have reform plans for each of these areas; but implementation is largely still to come. The following sections consider in turn the challenges in these sectors, the authorities' proposed responses; and the prospects for their proposals to deliver lasting improvements.

16. **Reforms in these and other areas would help address high structural unemployment.** The previous chapter on potential output finds that the natural unemployment rate (NAIRU) remains high, at around 12–13 percent. Further reform efforts could contribute to a lower NAIRU in several ways. First, a more efficient legal system and better business environment would be conducive to higher rates of investment and economic growth, increasing overall employment. Second, an education sector better aligned with the needs of employers would contribute to higher productivity and to reducing skills mismatches. Third, as discussed in the accompanying Staff Report, tax-benefit reforms could promote incentives to work; a forthcoming World Bank study due in spring 2013 is expected to include important recommendations on this issue.

### C. Judicial Efficiency and the Insolvency Framework

#### Background

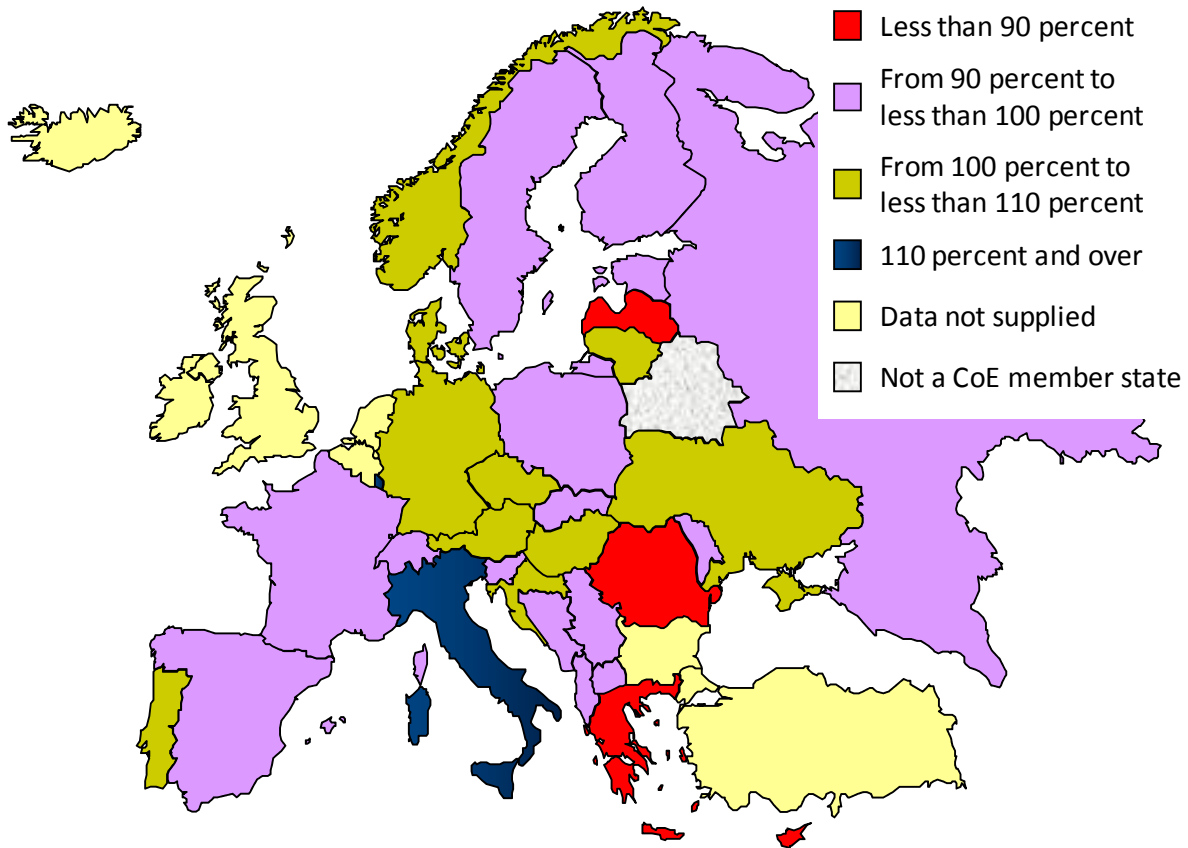
17. **Multiple sources point to costly inefficiencies in the judicial system.**

- In the WEF *Global Competitiveness Index 2012–13*, Latvia ranks 106<sup>th</sup> out of 144 countries for the subindicator “efficiency of legal framework in settling disputes.” Latvia’s weakest *Doing Business* rating is in the area of investor protection.
- Discussions with stakeholders corroborate the survey evidence, with representatives of foreign investors describing the legal system as a “bottleneck.”
- The Council of the European Union (2012) notes a “large backlog of proceedings in the first and second instance courts in civil and commercial cases, especially as regards contractual obligations and insolvencies.”

18. **While efficiency indicators are favorable for administrative and criminal courts, indicators for civil courts are low by EU standards.** CEPEJ (2012) reports core efficiency indicators for European courts using 2010 data. On the positive side, Latvia’s clearance rate—the ratio of resolved to incoming cases—was 99.6 percent for criminal cases and 95.8 percent for administrative law cases in first-instance courts. This is in line with EU peer countries. However, for litigious civil and commercial cases in first-instance courts—most relevant for contract enforcement—the clearance rate was only 85.8 percent (Figure 5), compared with between



**Figure 2.5. Europe: Clearance Rates of Litigious Civil and Commercial Cases in First Instance Courts, 2010**



Source: CEPEJ (2012).

90 and 110 percent in most EU peer countries. According to Ministry of Justice (MoJ) officials, the backlog peaked in 2011 and remains significant, but they expect the number of resolutions in 2012 to exceed the number of new incoming cases.

19. **Multiple sources indicate that low access fees, and excessive discretion for judges to adjourn cases, have contributed to delays.** In principle, low fees have been intended as promoting universal access to justice. In practice, according to discussions with stakeholders, they have provided incentives for routine appeals against unfavorable first-instance rulings—adding considerably to the burden on Latvia’s three-instance legal system. FICIL (2012a) recommends higher fees for larger claims, noting that the state fee for claims of LVL 1,000,000 is almost ten times higher in Estonia and about three times higher in Lithuania. In addition, according to the LCR and FICIL (2012a), parties to legal proceedings have considerable scope for delaying tactics, for example by simply not turning up in court. FICIL (2012a) recommends modifying the Law on Civil Procedures to reduce judges’ room for discretion and instead provide for automatic sanctions against such tactics.

20. **Stakeholder perceptions of the arbitration system limit its effectiveness as an alternative to civil courts.** Latvia has around 120 arbitration institutions, compared with 2 in Estonia and 3 in Lithuania.<sup>7</sup> To the extent that private parties lack confidence in the neutrality of arbitration institutions, their incentives are stronger for dispute resolution instead through the civil court system—adding to the backlog. The LCR interprets the high number of arbitration institutions in Latvia as a sign of a potential quality problem, since Latvia is too small to have sufficient qualified experts to staff them. FICIL (2012a) recommends stricter qualifications for establishing arbitration institutions and for individuals to serve on them.

21. **The legal framework for insolvency has been significantly upgraded since the crisis.**<sup>8</sup> The corporate insolvency law was amended in two steps. In July 2009, amendments strengthened incentives to restructure corporate debt, including through procedures for expedited court approval of restructuring plans under Legal Protection Proceedings (LPPs). In 2010, parliament approved a new insolvency law that streamlined liquidation procedures to speed up the exit of nonviable firms and further refine LPP procedures. In line with international best practice, the new law replaced two tests for insolvency, the “balance-sheet” test and the “cash-flow” test, with a single cash-flow test. In addition, a new personal insolvency law also became effective in 2010. Under this framework, an individual debtor will be fully discharged from his/her remaining debt liabilities after successfully implementing a repayment plan closely monitored by the court.

22. **Nevertheless, the insolvency framework remains prone to abuse.** In 2011, a number of reports emerged of apparently financially sound companies nevertheless being subjected to insolvency proceedings.<sup>9</sup> In a high-profile case in early 2012, a large retail foreign investor was put into insolvency on the basis of a claim it disputed,<sup>10</sup> prompting the acting prosecutor general to file a protest with the Supreme Court Senate; only several months later were the insolvency proceedings dismissed. FICIL (2012b) argues that insolvency administrators are not accountable

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<sup>7</sup> See the LCR, and Lawin (2009).

<sup>8</sup> For further information see Erbenova et al. (2011). The IMF’s Legal Department provided technical assistance to the MoJ in the design of amendments to the insolvency framework.

<sup>9</sup> See, for example, *Ir* magazine, May 19, 2011.

<sup>10</sup> Under section 57(2) of the Law on Insolvency, a legal person is liable to insolvency proceedings if its unpaid debt exceeds LVL 3,000, and if three weeks after a warning from its creditor, “has not paid its debt *or raised justified objections to the claim.*”

Under section 67 of the Law, an administrator has rights including to sell the property of the debtor (67–1), and to liquidate branches or representation offices of the debtor (67–2).

The Law does not provide for an appeal against a court decision to launch insolvency proceedings and appoint an administrator. UNCITRAL (2005) recommends allowing the debtor a right to appeal, though without an appeal granting suspensive effect (so as to deter frivolous appeals).

for their actions under current law; it proposes specifying them in the law as part of the judicial system, effectively increasing disclosure requirements and other controls.

### **Authorities' response**

23. **Evaluation of judges' performance begins in 2013.** Amendments to the Law on Judicial Power were approved in June 2011, providing for every judge to be evaluated during the three years from January 2013. Although the Ministry of Justice may express opinions, the evaluations will be carried out by other judges—crucial for maintaining judicial independence. Judges will also be provided training in newer areas of the law, such as insolvency, anti-money laundering, and cybercrime.

24. **Logistical improvements are under way.** With assistance from a Swiss-supported judicial modernization project, sound recording and videoconferencing equipment is being installed in all courtrooms. This enables witnesses to appear in court remotely, reducing costs of travel and delays. In addition, all records of court decisions will be anonymized and made available electronically; under amendments to the Law on Judicial Power, only decisions entered into the new electronic system would be considered authentic.

25. **The MoJ envisages further changes to the legal framework intended to promote judicial efficiency:**

- The introduction of a “pure instance” system, requiring that all cases be submitted in the first instance in district courts, to reduce fragmentation of court competencies. The necessary legislation is in effect for criminal cases (with a transitional period to 2015) but remains pending for civil cases (transitional period envisaged to 2019).
- Parliament is in the final stage (third reading) of reviewing amendments to the civil procedure law that would restrict presentation of new evidence in appeal courts, with a view to ensuring full introduction of evidence at the first instance.
- Amendments to the law on the commercial register, to prevent illegal takeovers of enterprises, are in parliament at the second reading stage. The amendments would create a special court outside Riga (in Jurmala or Jelgava) to rule on disputes between shareholders.
- The government approved a draft law on mediation in November 2012, which would transpose the EC directive 2008/52/EC to facilitate mediation as an alternative dispute resolution mechanism in civil and commercial cases. Parliamentary approval is pending.
- The MoJ is working on a proposal, for presentation in January 2013, to significantly tighten the requirements for accrediting arbitration institutions.

26. **Next steps on the insolvency framework are still under discussion.**

- The MoJ is working on amendments to the insolvency and civil procedure laws, to make clearer that disputed claims cannot be used to trigger insolvency. Possible amendments to the civil procedure law could give the courts clearer jurisdiction to turn away cases brought under the insolvency law, but in which the alleged debtor objects to ostensible creditor claims (see footnote 12).
- On a separate track, parliamentarians have reopened the law on insolvency for discussion. Proposals include the reintroduction of the “balance-sheet” test and easing conditions for personal insolvency. Banking groups object to these proposals.

**Assessment**

27. **The judicial system is inherently difficult to reform quickly.** Judicial independence constrains the degree to which executive government or parliament can force reform. Yet, judicial independence correspondingly requires judicial accountability. The introduction of an evaluation system for judges, by judges, appears to be a major step in this direction, though the results are yet to be seen.

28. **Pending legislative and procedural changes augur well for accelerating judicial processes.** Measures to introduce the “pure instance” system and require full presentation of evidence in first-instance courts appear promising, as do the logistical improvements to court infrastructure, though there may be room to accelerate the transition to the “pure instance” system in civil cases somewhat earlier than end-2019. Measures to streamline the system of arbitration institutions could be politically contentious, but are warranted both to restore confidence in arbitration options and to reduce the load on civil courts. Further consideration could be given to the system of court fees, to strike the right balance between access to justice and reducing incentives for delaying tactics.

29. **On the insolvency framework, the focus should be on better implementation.** Some minor legal changes could be helpful, for example by introducing a right of appeal (but without suspensive effect) in cases of involuntary insolvency. But it should be clear that current law already excludes disputed claims as grounds for insolvency; a judicial decision to the contrary does not reflect a failing of the insolvency law itself. To reduce risks of such cases, a rigorous judicial evaluation process may be a better medium-term corrective. Best international practices that were introduced with the new insolvency law in 2010, including the single “cash-flow” test for insolvency, should remain in place.

## D. State-Owned Enterprises

### Background

30. **Oversight of state-owned enterprises remains a challenge, from both fiscal and governance perspectives.** Latvia has a large number of SOEs—more than 140 as at end-2009—whose ownership and control is dispersed among many agencies. Some SOEs are predominantly commercial; others perform governmental functions. While there are exceptions, relatively little information has been publicly available about SOE performance and operations—an environment conducive to risks that loss-making SOEs require state support. Similar issues arise for at the local level for municipally owned companies. In addition, and somewhat unusually, most Latvian SOEs lack supervisory boards, which were abolished in 2009 to curb political influence; but this leaves the burden on capacity-constrained ministries to supervise the management.

31. **Some Latvian SOEs perform well.** The Baltic Institute of Corporate Governance finds that Latvia has “both the best and the worst” SOEs in the Baltic region (BICG, 2012). On the positive side, it finds SOEs with the strongest corporate governance include Citadele Bank, which had been carved out of the failed Parex Bank in 2010; and 51 percent state-owned Lattelecom, which imported strong governance practices from its foreign parent company.

32. **But fiscal and governance risks have materialized in some other SOEs:**

- **Energy: Latvenergo** senior officials, including the CEO, were arrested and replaced in 2010 following a bribery investigation by the anti-corruption bureau.<sup>11</sup> BICG (2012) finds that the new management board was very cautious in the aftermath of the scandal, referring decision-making responsibility to the state—which may conflict with the state’s role of monitoring the enterprise.
- **Air transport: airBaltic** incurred heavy losses in 2010 and 2011, requiring a state bailout to keep the airline from collapse. In contrast to Lattelecom, the partly private ownership of airBaltic had not translated into stronger governance: despite owning 53 percent prior to the bailout, the state was unable to access airBaltic’s accounts even as losses increased. The government incurred bailout costs of 0.4 percent of GDP in 2011. The European Commission is currently assessing the consistency of this support with state aid rules: the former private partner had agreed to participate in the bailout, but could not provide the financing, leading the state to take full control of the airline. A new

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<sup>11</sup> See KNAB (2012).

management team is now pursuing airBaltic's restructuring, and the government is seeking a new private investor.<sup>12</sup>

- **Rail transport: Pasazieru vilciens (PV)** signed a large tender in early 2012 to purchase railway passenger cars, whose provisions were contrary to EU procurement rules, and despite guidance from the government not to go ahead. The government subsequently replaced PV management and cancelled the contract; at time of writing it is unclear whether the Latvian state is still liable to the supplier under the cancelled contract.

33. **Both the IMF and EU programs had included structural benchmarks on SOEs; progress was uneven.** The two-part approach was straightforward: first, take stock of the state's shareholdings (end-September 2010); second, assess the best way to manage them (end-2010). The first benchmark was met. The second benchmark was eventually met in late 2011, though with implementation issues left for later.

34. **The first consolidated annual review of SOEs was completed in 2010.** The *Annual Review of Latvian State-Owned Assets 2009 (ARLSOA)* was the first exhaustive list of Latvia's state-owned enterprises, including basic information on their finances and employment, prepared by a combination of local financial experts, the BICG, and the prime minister's office. The report included 142 SOEs with total assets of EUR 10.2 billion, combined turnover of EUR 3.2 billion, and over 52,000 employees. The ARLSOA estimated the potential for SOEs to pay additional dividends of over LVL 70 million annually if their corporate governance could be raised to the level of EU peers.

35. **Nongovernmental organizations have recommended a number of reforms:**

- BICG (2010) has called for clearer ownership policies and information on the government's portfolio of enterprises; stronger oversight and control; effective regulatory regimes in regulated industries; and a public and enforceable dividend policy.<sup>13</sup>
- BICG (2012) also recommends the reintroduction of supervisory boards for SOEs, on the grounds that Latvian SOE boards—with exceptions such as Citadele and Lattelecom—are management boards “staffed fully by insiders”, and do not hold the enterprise and its managers to account. BICG argues that the capacity of line ministries to exercise the necessary professional oversight is “generally severely constrained”.

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<sup>12</sup> See the Staff Report for the Fifth Review Under the Stand-By Arrangement (IMF Country Report No. 12/31), Box 1.

<sup>13</sup> Baltic Institute of Corporate Governance, *Baltic Guidance on the Governance of Government-owned Enterprises*, June 2010. Available at: <http://www.corporategovernance.lt/en/news/17>

- FICIL, while generally supportive of the above (FICIL, 2012c), has also suggested privatizations of SOEs by initial public offering to support capital market development (FICIL, 2011).

### **Authorities' response**

36. **Development of a strategy for SOEs has moved ahead, albeit more slowly than the EU-IMF program envisaged.** An end-2010 benchmark envisaging a reform strategy for the sector proved ambitious. But in May 2012, the government approved two concept papers, *Concept for Commercial Activities of Public Persons* and *Concept for Management of State Capital Shares*. Although the concept papers envisaged the necessary legislation to be in place by January 2013, political agreement on the draft legislation is still pending at time of writing.

37. **The government-approved proposal envisages a new institution to oversee SOEs, and enhanced reporting of financial information:**

- The new institution, a “partially centralized” ownership agency or “centralized governance institution” (CGI) reporting to the prime minister, would begin operations in 2013 and take shareholdings in selected SOEs as of January 2014. The CGI would establish corporate governance guidelines, supervise their implementation, monitor the SOEs’ financial objectives, and introduce a new system for SOE financial reporting.
- Decisions would be taken later on which SOEs would remain under line ministries and which would be transferred to the new CGI.
- All SOEs—whether under the CGI or under a line ministry—would be required to provide financial information to the CGI. Initial proposals envisaged quarterly reporting from the first quarter of 2013; current proposals envisage semi-annual reporting. Reporting to the CGI would be mandatory for SOEs in which the state shareholding exceeds 50 percent, and recommended for other companies with state participation.

38. **The economics minister has been candid about the need for reform.** From MoE (2012):

“Management of state companies is one of the fields reasonably criticised by the international organizations and local business organizations. Management of state companies should serve as a good practice. Unfortunately, we are currently lagging behind our closest neighbours who already make the best out of the better management of state capital shares. Therefore, the decision of the Cabinet of Ministers is somewhat historical, because we have made a step closer to good, efficient and professional management of state capital shares.”

39. **A working group is currently reviewing each SOE to consider its future status.** A working group including staff of the MoE and the cross-sectoral coordination unit (under the

prime minister) is assessing each enterprise under two criteria: whether the enterprise responds to a particular market failure; and/or whether the enterprise serves a clear strategic interest of Latvia. SOEs that do not meet these criteria will be considered for privatization.

## Assessment

40. **The introduction of an effective CGI would be a welcome measure.** Neighboring countries, including successful examples in Sweden and Finland, offer good role models of how the CGI model can work in practice. For example, the introduction of centralized ownership steering in Finland in 2007 separated the state's ownership and regulatory functions, improving governance and transparency.<sup>14</sup> In Latvia, it remains to be seen what share of enterprises will be transferred to the new CGI, and which will remain directly under line ministries. Political agreement and parliamentary approval of the legislation necessary to establish a strong CGI, with clear and transparent operational objectives, should be a priority.

41. **Enhanced SOE financial reporting is critical for curbing fiscal and governance risks.** The introduction of semi-annual or (better) quarterly financial reporting would represent a major improvement in transparency. It would reduce risks of a repeat of the case of airBaltic in 2011 when neither the public nor the authorities had access to the accounts. It would allow less threatening losses and inefficiencies to be detected and addressed at an earlier stage and enhance incentives for efficiency gains.

42. **Any privatizations of SOEs should be orderly and transparent.** While a number of privatization methods work well in principle, it will be important that future privatizations avoid the intransparent approaches of the early 1990s. Sales should be timed to avoid fire sales and defend taxpayer interests. Appropriate regulatory frameworks should be in place prior to privatizations. The use of public offerings—in increasing use in other countries as a privatization method<sup>15</sup>—has pros and cons. On the positive side, it could contribute to capital market development, and listing disclosure requirements could contribute to transparency. But enhanced disclosure should be part of SOE reporting anyway; and diffuse private shareholders may find it difficult to exert influence if the state maintains concentrated ownership stakes.

43. **Supervisory boards are good in principle, but require a critical mass of expertise to be a workable improvement.** Concerns about the burden on ministries alone to supervise SOEs are valid. But, to avoid any return to past politicized boards, Latvia needs a sufficiently large pool of qualified professionals who are ready to act as board members. BICG provides executive education training in an effort to develop such a pool, but this is a work in progress. To the

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<sup>14</sup> See OECD (2011).

<sup>15</sup> See OECD (2009).



extent that capacity constraints in practice weaken the case in principle for reintroducing supervisory boards, they also reinforce the case for establishing a strong, well-resourced CGI.

## E. Higher Education

### Background

44. **Latvia has a very high number of higher education institutions (HEIs).** For a population of 2 million, Latvia has 58 accredited HEIs that provide either academic or professional<sup>16</sup> higher education (AIKNC, 2012), of which 36 are public, 20 are private, and 2 are branches of foreign universities. The public HEIs are a mix of universities and public colleges for professional education. According to the Ministry of Education and Science (MoES), about 50 percent of students enrolled in public academic education study in the two largest state universities (MoES, 2011a). Other Baltic countries have far fewer HEIs: Lithuania (population 3.4 million) has 27 HEIs (14 universities, 13 colleges), while Estonia (population 1.4 million) has 16 HEIs (6 universities, 10 colleges) in Estonia.<sup>17</sup>

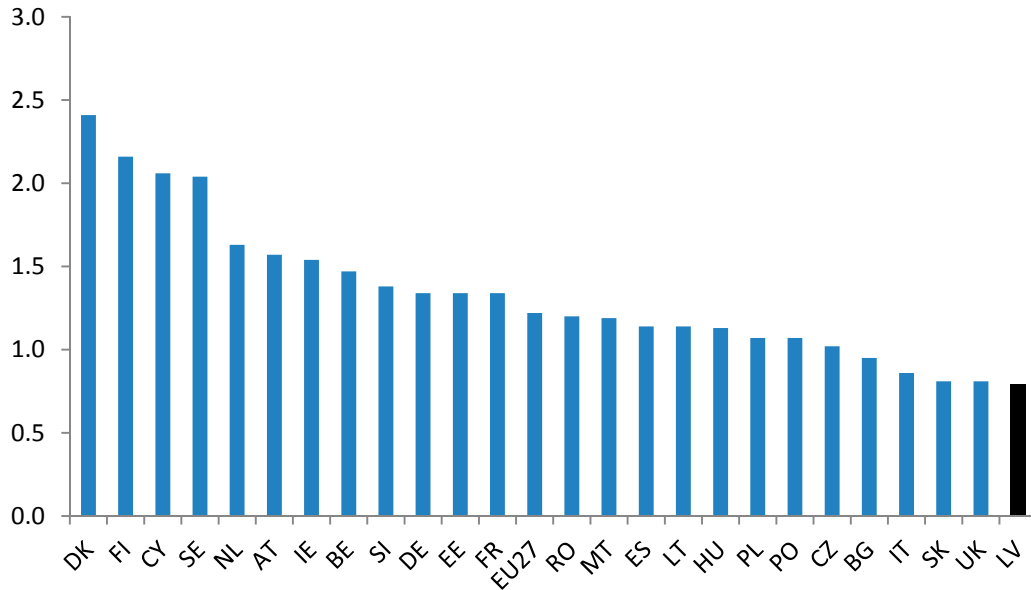
45. **Public expenditure on tertiary education is very low by EU standards—and thinly spread over many institutions.** Eurostat data for 2009 on public expenditure on tertiary education show Latvia as spending the least in the EU (0.79 percent of GDP), compared with an EU average of 1.22 percent of GDP (Figure 6). A caveat is that 2009 was the worst crisis year for Latvia. However, MoES (2010a, 2011a) reports state budget financing for the HEIs (private and public) of 0.64 percent of GDP in 2009 and falling to just 0.54 percent in 2010. A government-approved action plan of the MoES (2010b) envisages a gradual increase in state budget financing for higher education to 1.2 percent of GDP in 2013. This still implies very limited resources for a high number of institutions. In addition to providing resources directly to HEIs for research, the state covers tuition fees for some study places (“budget places”). The HEIs themselves determine tuition fees for the remaining study places. Students are entitled to state-guaranteed student loans.

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<sup>16</sup> HEIs that provide higher professional education are colleges. These institutions also provide vocational secondary education.

<sup>17</sup> Sources: AIKOS (2012), and Estonian Ministry of Education and Research (2009).

**Figure 2.6. EU Countries: Total Public Expenditure on Tertiary Education, 2009**  
(in percent of GDP)

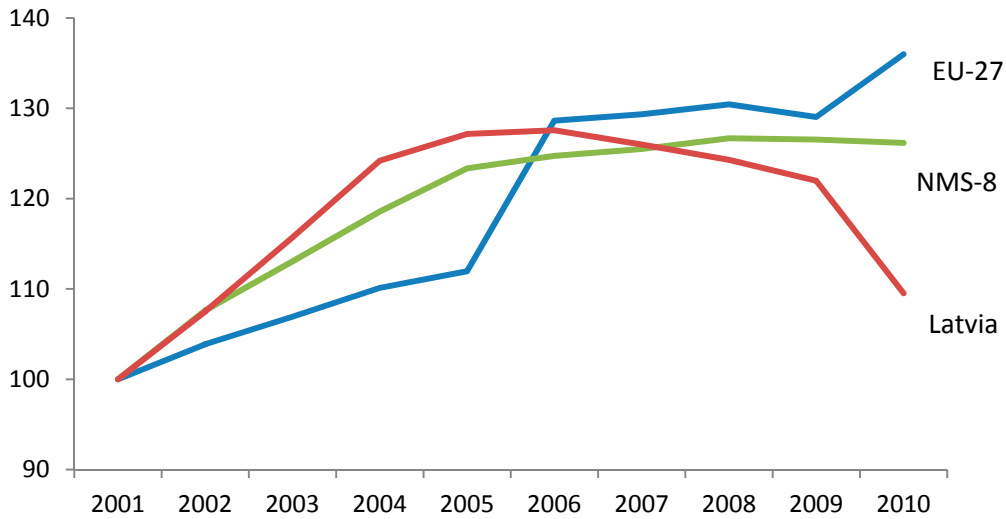


Source: Eurostat.

46. **Enrolments in HEIs are falling.** In contrast to rising enrolments in the EU as a whole, and a milder upward trend in countries that joined the EU in 2004, enrolments in Latvian HEIs have been falling steadily since the mid-2000s (Figure 7). This reflects the decline in Latvia's birth rate over the past two decades (Figure 8) and the emigration wave since 2004. MoES data show the number of new students admitted to HEIs falling from 44,000 in 2005 to around 32,000 in 2011, a decrease of 27 percent.

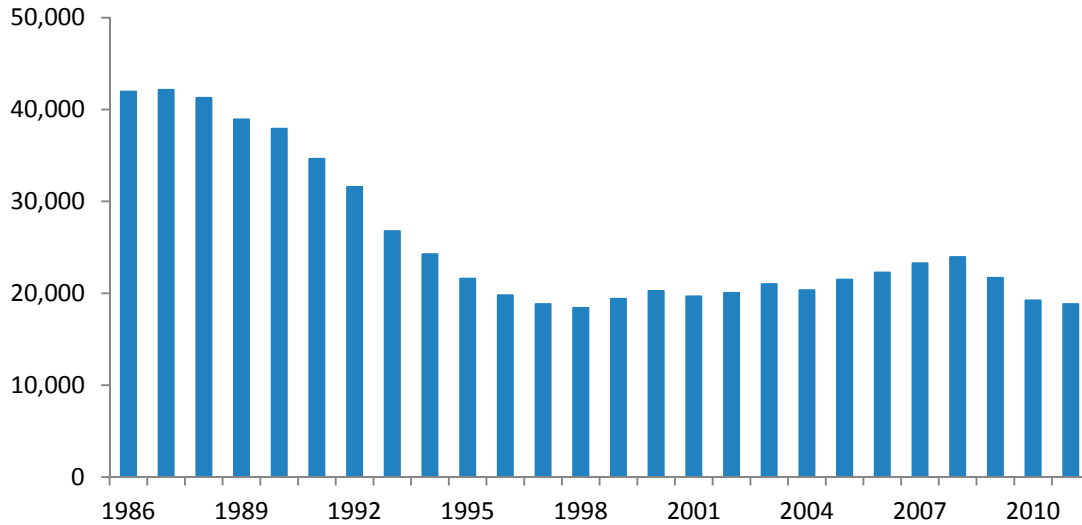
47. **The combination of a disproportionately high number of institutions, limited financing, and falling student numbers generates serious—potentially even unsustainable—strains on the higher education system.**

**Figure 2.7. Europe: Trends in Tertiary Enrolments, 2001–10**  
(Index 2001 = 100)



Source: Eurostat.

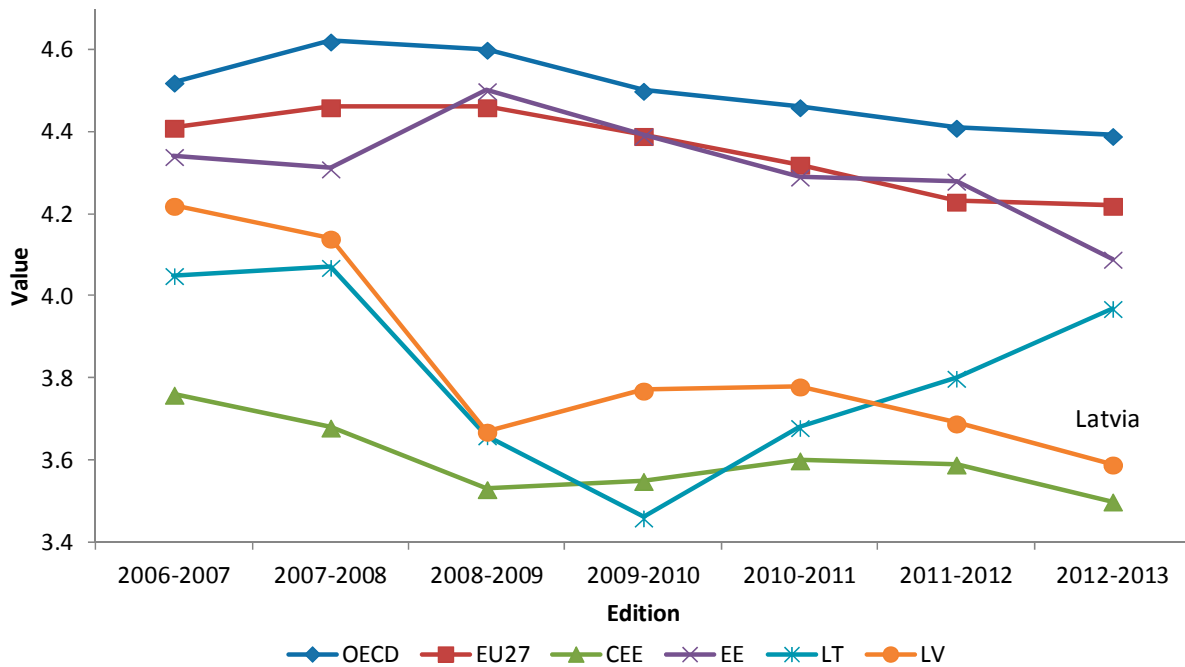
**Figure 2.8. Latvia: Birth Rates, 1986–2011**



Source: Statistics Latvia.

48. **Survey evidence suggests Latvia lags behind with respect to the quality of education.** According to the WEF *Global Competitiveness Index 2012–13*, Latvia's educational system considerably lags its neighboring countries (Figure 9). Although the WEF does not deeply analyze these results, they are corroborated by the LCR findings, which emphasize the quality problem in higher education.

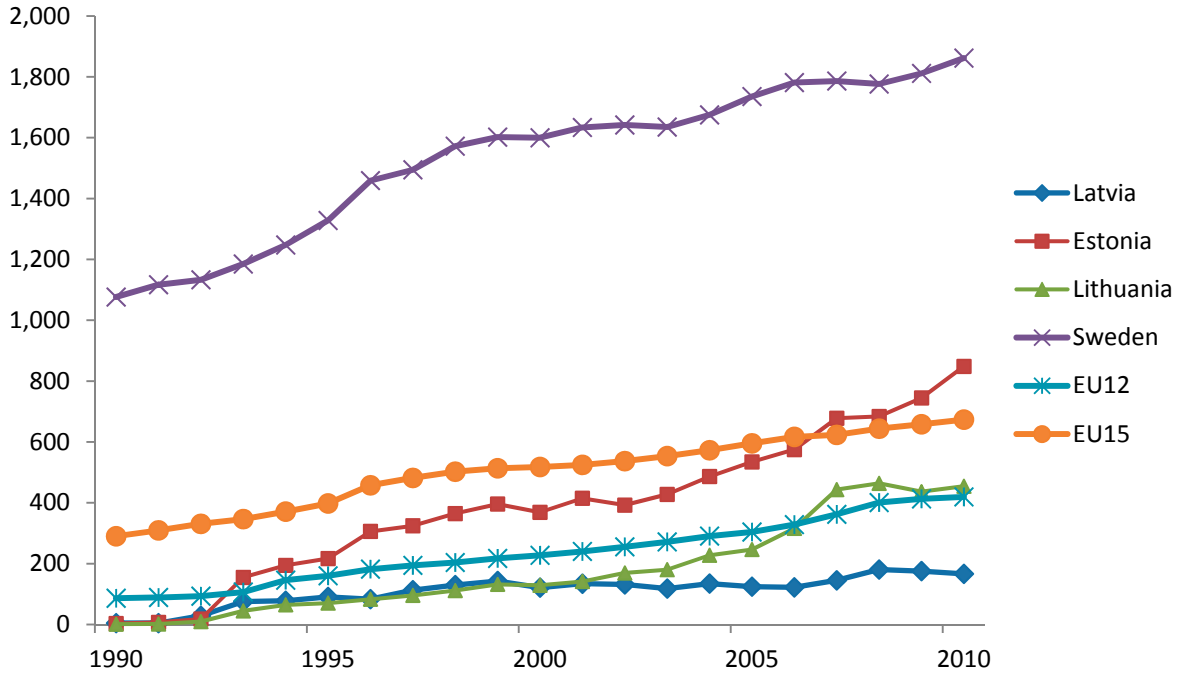
**Figure 2.9. Selected Countries: Quality of the Educational System, 1-7(best), 2006-07 to 2012-13**



Source: World Economic Forum (2012).

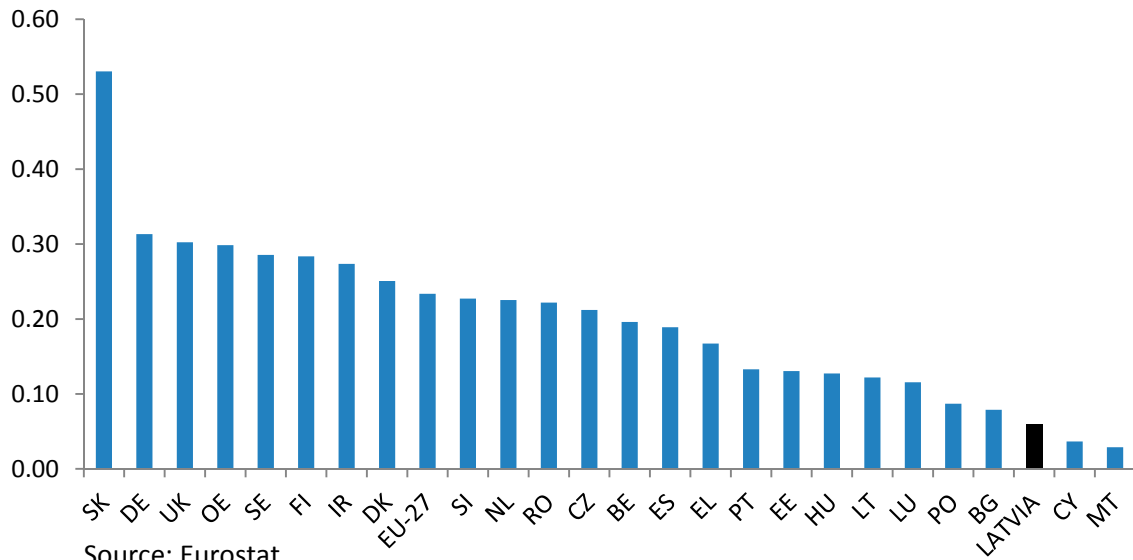
49. **Latvia's HEIs have low rates of international publication and doctoral graduations.** Based on the number of international publications, the LCR finds that Latvian researchers are falling behind their colleagues in Estonia and Lithuania (Figure 10). Dombrovsky (2010) notes that the number of PhD graduates per 1000 people is one of the lowest in the EU (Figure 11). The LCR emphasizes that “the small number of people pursuing studies at the highest level threatens the future development of the higher education system, since the academic workforce in Latvia is ageing and there is no source of replacement.” It also finds that the higher education has lost effectiveness in promoting innovation.

**Figure 2.10. Selected Countries: Number of Publications in Science Citation Index Articles in English per Million Population, 1990–2010**



Source: *Latvian Competitiveness Report 2011*.

**Figure 2.11. Number of PhD Graduates per 1000 Population, 2010**



Source: Eurostat.

50. **Latvian HEIs are subject to Latvian language requirements.** The Law on Higher Education Institutions stipulates Latvian as the language of instruction in the public HEIs, with the possibility to implement at most 20 percent of the study program in an official EU language. This does not apply to the final exams and thesis. International students can pursue their studies

in an official EU language, but their study programs are separate from the programs for local students. The language requirements also make it difficult for HEIs to hire foreign academics who lack fluency in Latvian.

51. **Multiple sources point to skill mismatches between HEI graduates and employer needs.** According to the State Employment Agency (2008), about 52 percent of employees in 2008 were working in fields other than those for which they had qualified. This suggests that the HEIs and other educational institutions are not providing adequate skills and knowledge to future employees, and/or that the study programs and student enrollment in those programs are not linked to labor market needs. According to MoES (2011a), in 2011 around 40 percent of all students were enrolled in social sciences, business and law fields, while only 24 percent pursued their studies in engineering, manufacturing, construction, natural sciences, mathematics and IT. This does not correspond to labor market demands: the WEF *2012–13 Global Competitiveness Report* ranks Latvia 110<sup>th</sup> out of 144 countries for availability of scientists and engineers. Given the large number of HEIs, and falling student numbers, the resulting large supply and duplication of study programs generates perverse incentives for HEIs to relax enrollment conditions and course requirements. This is convenient for students, at least in the short run: it is common for students to combine studies with work at the expense of class attendance and time for independent studies (see LCR, and Auers et. al, 2007). FICIL (2010) argues for reducing the number of HEIs to address fragmentation and quality issues.

52. **HEIs have a tradition of autonomy.** According to the Law on Higher Education, HEIs independently determine the content of the study programs, their organizational and governance structure, and the remuneration their staff. Each HEI elects its own constitutional assembly and senate, each comprising faculty and student representatives; the assembly elects the rector. The government regulates procedures for the accreditation of HEIs and their study programs with the MoES. An HEI may be reorganized or closed by its founder; in the case of state HEIs, this requires a government decision on the basis of the recommendation of the minister of education and an advisory opinion from the Council of Higher Education.<sup>18</sup>

53. **An assessment of HEI study programs, commissioned last year by the Council of Higher Education (CHE), has become highly contentious.** The assessment reviewed around 850 accredited HEI study programs, finding that 55 were of poor quality and should be closed, and 210 require serious improvements (AIP, 2012). The education minister argues that these findings understate the quality problems—the MoES identified 182 poor-quality programs—and

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<sup>18</sup> According to the Law on Higher Education, the 12-member Council of Higher Education (CHE) includes representatives from 9 educational organizations: the Latvian Academy of Science, the Association of Art Higher Education Institutions, the Latvian Association of Education Managers, the Colleges Association of Latvia, the Council of Rectors, the Latvian Association of University and College Professors, the Education and Science Workers Trade Union, the Latvian Students Association, and a representative of non-state HEIs. The CHE also includes 2 business group representatives and the education minister ex officio.

has accused the CHE of tampering with the results. The MoES will commission an independent audit of the project.

### **Authorities' response**

#### **54. The education minister proposes deep reforms to higher education:**

- Concentrating funding for HEIs according to course quality;
- Creating incentives for discontinuing poor-quality courses and reducing the number of HEIs;
- Reforming student financing to better link tuition costs to future income;
- Easing language restrictions to promote openness of HEIs; and
- Reforming governance structures for HEIs.

Although detailed policy proposals are not yet available in written form, the minister has released a video to explain his intentions.<sup>19</sup>

**55. As an initial measure, the government has approved new accreditation regulations that exclude poor-quality study programs from state budget financing.** On the basis of the September 2012 regulations, the MoES will commission an independent international institution (included in the European Quality Assurance Register) to assess the HEIs. Accreditation of institutions will be decided by the CHE, which will accredit an institution if half or more of its study programs are accredited. The accreditation committee will involve representatives of both public and private stakeholders accepted by the education minister, in an effort to avoid previous practice whereby accreditation decisions were by insiders (Ir, 2012a). The education minister also proposes to make it mandatory for lecturers to conduct research (Ir, 2012b).

**56. MoES is developing a proposal to reform the financing model of the higher education system.** Currently, the tuition fees of around 35 percent of students are covered by state funding—the so-called “budget places”—while the remaining 65 percent have to ensure their own financing. Though full details of the reform are not yet available, the intention is to introduce a universal student deferred-fee system, repaid contingent on income after graduation (Dombrovsky, 2011). According to MoES, this would be similar in nature to a progressive income tax, on the grounds that people with higher education earn by about 40 percent more than others (MoES, 2011b). At this stage this is not the government’s position; opposition to the

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<sup>19</sup> See <http://www.youtube.com/watch?v=Lh6ySXwiaS0> (in Latvian).

reform is significant within the coalition, with some arguing that the proposal would aggravate emigration (Diena, 2012a).<sup>20</sup>

57. **The MoES has prepared legislative amendments that would enable greater usage of foreign languages in HEIs.** The education minister proposes that Latvia follow the practice of Estonia and Lithuania where the lecturers are appointed based on the results of international competition. Under the envisaged amendments, Latvian HEIs would have more flexibility to teach purely in English, raising their attractiveness to foreign students and making HEIs more competitive. The amendments would enter into force starting from the next study year. Coalition agreement is pending; the amendments would then need parliamentary approval.

58. **The education minister has also suggested reforming HEIs' governance structures.** The intention is to address the “self-isolation” of HEIs—the flip side of their independence. The minister points to a closed academic club in Latvia, especially in the social sciences. He cites Denmark as a good example of how to address the problem: more than half the members of a Danish academic senate come from outside the university, for example from the business sector. This fosters cooperation between HEIs and wider society, and in particular narrows the distance between the education system and the labor market, all without government interference in the design of academic studies. The ministry is developing a proposal for new governance structures for HEIs—entailing new councils for HEIs with two thirds of their members representing non-HEI stakeholders—with a view to their introduction by the beginning of the next study year (September 2013). The new council would decide on strategy and budget issues, as well as elect the rector. The HEI would retain its autonomy with respect to decisions on academic issues.

## Assessment

59. **The authorities' proposals to reform higher education would seek to address the sector's pressing sustainability and quality challenges.** The very high number of HEIs relative to population, falling student numbers, and the case for concentrating the limited available financing, taken together would make selective HEI closures seem inevitable. The MoES, in allocating funding (including EU funds), can create powerful incentives for the retention or closure of individual institutions; targeting funding to course quality is a logical approach. Greater openness of HEIs to international students and foreign academics would foster quality; more flexible language rules would break down an important barrier to openness. Since fiscal space will remain constrained and HEIs continue to face limited financial means, efforts to restructure the financing model of the higher education, with a view to improving both quality and accessibility, are timely.

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<sup>20</sup> Chapman and Tulip (2008) provide a concise overview of international experience with income-contingent student loans (ICL) and other forms of financing tuition. They caution that the effectiveness of ICL depends on the effectiveness of a country's income tax system to track graduate incomes and collect debts.



60. **Details remain to be elaborated in a number of key areas.** The authorities have explained the intended direction of reforms; the ideas appear to correspond to the underlying problem. But a policy paper with details is not yet available. And seemingly small technical issues have the potential to cause bigger problems. For example, the international experience with income-contingent loans to finance student tuition is generally favorable, but is based on efficient collection of repayments by tax authorities. For Latvia, the proposal now being developed by the authorities would need to take into account capacity constraints in tax administration evident from the shadow economy.<sup>21</sup> More generally, the eventual outcomes will hinge on implementation.

61. **Political economy obstacles are formidable.** The independence of HEIs limits the extent to which even a determined minister with a coherent plan can impose reform unilaterally. Under current law, closures of individual state HEIs need to be ratified by the Cabinet, based on guidance from the Council for Higher Education—a majority of whose members are drawn from HEIs. And the assessment of course quality is proving contentious in practice. This points to the desirability of cooperation, where it can be found, from stakeholders—some of whom will lose out from reforms from which the wider public will benefit—and to the need to build wider political support to implement necessary changes to the system. The political sensitivity of language issues in Latvia is an additional complication for a sector in need of greater access to expertise from outside.

## F. Vocational Education

### Background

62. **Under the Law on Vocational Education, the Ministry of Education and Science finances vocational education institutions (VEIs) and in co-operation with employers designs the study programs.** The VEIs under the MoES are financed from the state budget, with money per student for teachers' wages and school maintenance. The MoES also approves the by-laws of the schools, which among other things determine the number of students to be admitted and the content of the study programs. The MoES develops standards for vocational education in cooperation with professional associations.

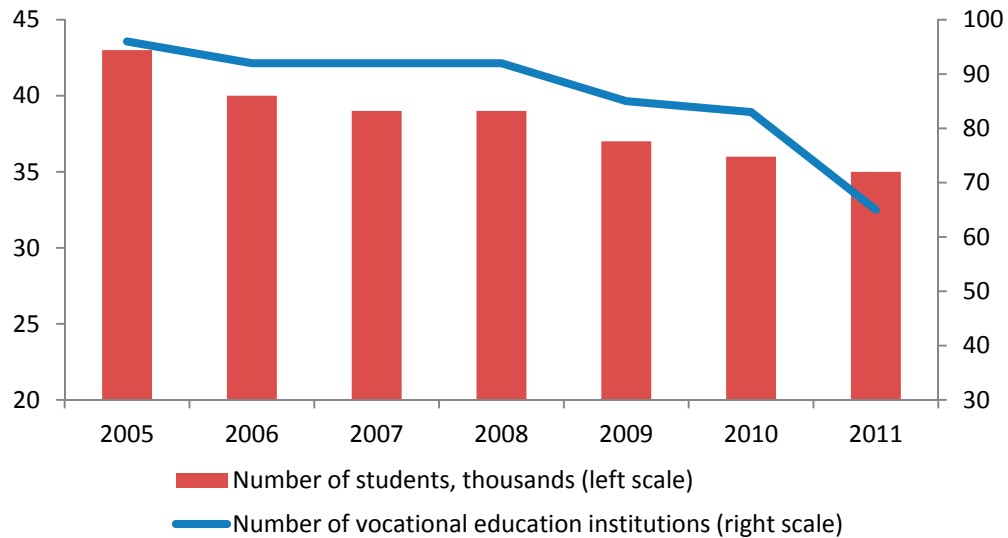
63. **Student numbers are falling** (Figure 12). In 2011 around 12,000 students started vocational education programs compared to 14,000 in 2008 and 15,000 in 2005. As with falling tertiary enrolments, this reflects the sharp fall in birth rates in the 1990s (see above). In 2010 the Ministry of Education and Science initiated a reform of the network of vocational education institutions (VEIs) aiming to reduce the number of state schools, to promote efficient use of

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<sup>21</sup> This is a main finding of the *Latvian Competitiveness Report 2011*.

resources, and to modernize the remaining schools. The number of state vocational schools<sup>22</sup> fell from 59 in 2009 to 38 in 2012, and could further fall to 30 in 2015. The intention is that 14 of these schools would have the status of a competence center (criteria: sufficiently large number of students, students on average have good results in the qualification exams, the institution actively cooperates with employers, etc.). Currently there are 6 competence centers. Financing of vocational education is low compared with financing of general secondary education (Figure 13).

**Figure 2.12. Latvia: Vocational Education: Numbers of Students and Institutions, 2005–11**  
(At beginning of each study year)

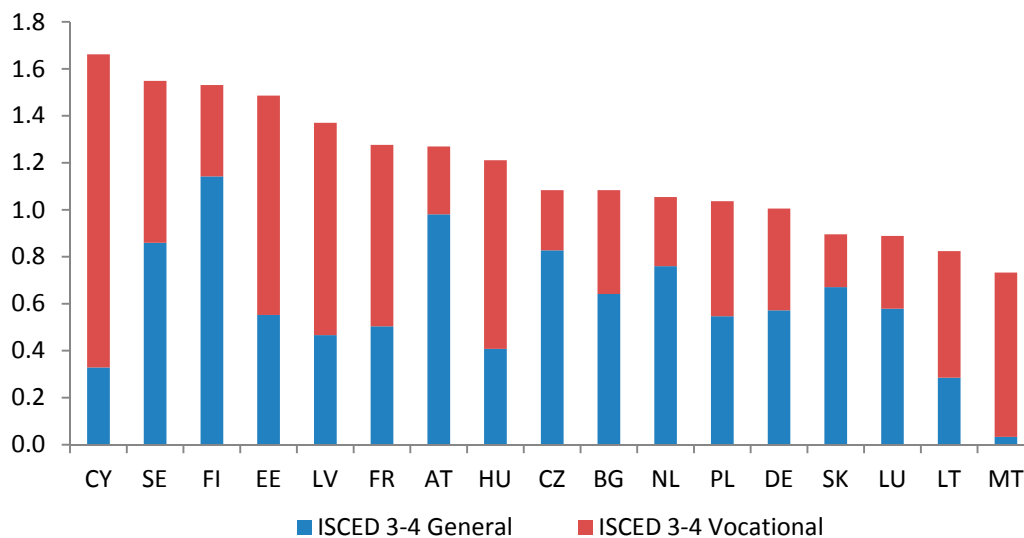


Source: Statistics Latvia.

<sup>22</sup> Apart from state vocational schools, VEIs are local government-owned or private. Including non-state VEIs, the total number of VEIs was down from 85 in 2009 to 65 in 2011. In 2011, around 88 percent of vocational education students were enrolled in state vocational schools.

Colleges—educational institutions which provide 1st level higher vocational education programs, as well as vocational education and secondary vocational education programs—are considered as HEIs rather than VEIs in the national statistics.

**Figure 2.13. Selected EU Countries: Total Public Expenditure on Secondary Education, 2008**  
(Secondary vocational and secondary general education, in percent of GDP)



Source: CEDEFOP (2012a).

64. **A widespread view in Latvian society has been that the vocational education is inferior to general education.** The study “Prestige of the Vocational Education in Latvia” (Analītisko pētījumu un stratēģiju laboratorija, 2007) found that, in students’ view, vocational education was less valuable than general education, with vocational education chosen by students who misbehaved and did not want to study. The education minister has acknowledged that the vocational education has been disadvantaged for many years and has lacked investments. In addition, limited options for teachers to raise their qualification and professional skills, and low teachers’ salaries that deter industry specialists from teaching, negatively affect the quality of vocational education and training (VET) and consequently the prestige of VEIs.

65. **Different financing models of general and vocational education are resulting in an unhealthy competition for basic education graduates.** In both cases the money is distributed based on the money-follows-student principle. But general education is financed by the local governments (receiving transfers from the state budget), while vocational education is financed directly by the central government. The authorities confirm reports that competition for students is a problem: some local governments try to discourage basic education graduates from entering vocational education by impugning the reputation of vocational schools and by offering different benefits including financial support if students continue their studies in general education (Diena, 2012b).

66. **The Latvian Competitiveness Report 2011 indicates that the vocational education system does not meet labor market needs.** The LCR cites survey evidence that employers see VEIs failing to supply students with sufficient practical skills in their chosen profession. Latvia

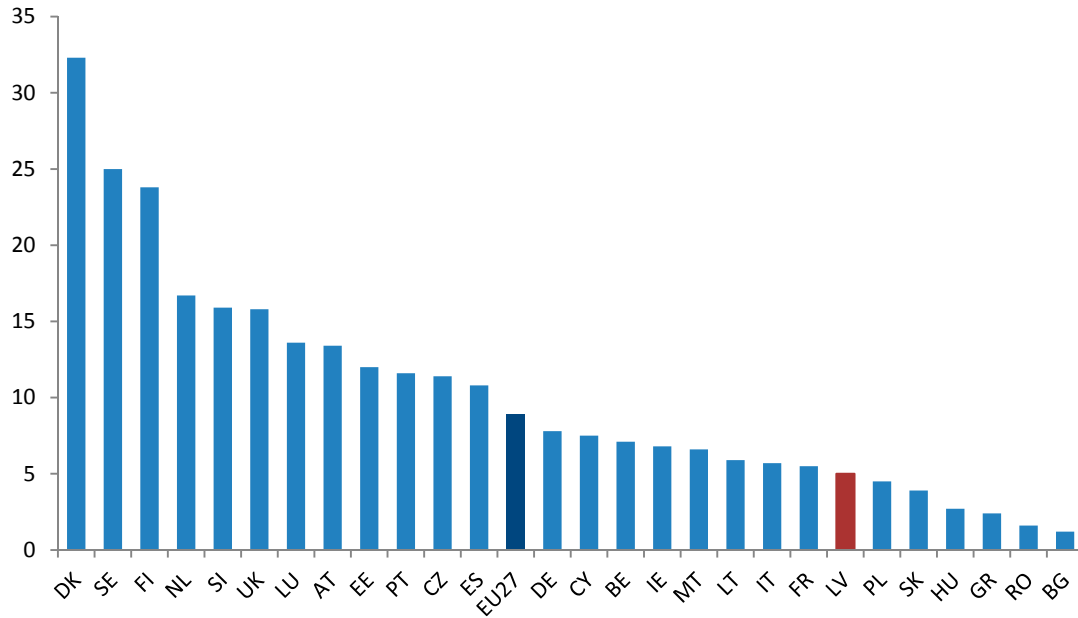
does not have a meaningful apprenticeship system. Employers are involved in vocational training mainly through their role in defining the curriculum of vocational schools.

67. **Employers may lack motivation to participate in vocational training.** According to the MoES (2009), all VEI graduates have undergone vocational training and received a positive evaluation by their supervisors. In addition, all graduates have to pass a qualification exam and the exam committees comprise employees of commercial companies. Theoretically, employers are involved not only in defining the curriculum, but they can also take part in running and assessing the practical training. However, they are not obliged to offer apprenticeships. The VEIs cannot always ensure that their students undergo an apprenticeship in a real company and sometimes end up providing the training at the school premises, which hardly resemble the field experience. According to the Employers' Confederation, employers would like to see more incentives for providing apprenticeships, such as compensation or tax incentives, ensuring work clothing, better cooperation with the VEIs, and greater involvement in the long-term planning of the vocational education content.

68. **The labor market has changed more quickly than the supply of VET programs** (CEDEFOP, 2012b). The real work environment, technologies, working methods are in a constant transformation, while it takes time and requires substantial financial investment to adjust the study programs and the equipment to the actual situation in the labor market. The MoES (2009) found that, given changing labor market needs, demand increased for VET programs with a relatively short duration. This also shows the importance of close cooperation between the VEIs and the business sector in ensuring practical training for the students in a company.

69. **The LCR points to insufficient adult involvement in lifelong learning.** According to the Europe 2020 targets, Latvia is falling behind with respect to adult participation in education and training, which was only 5 percent compared with the EU27 average of 8.9 percent in 2011, and the EU-wide target of 15 percent in 2020 (see Figure 14). The MoES (2009) acknowledges that the supply of VET programs does not correspond to adult education needs, for two reasons. First, the time-consuming design of the study and training programs makes them outdated by the time they are actually implemented. Moreover, given the changing skills required in the labor market, the demand for shorter VET programs is on the rise. Second, limited flexibility in these programs precludes the employees from combining work with education and training.

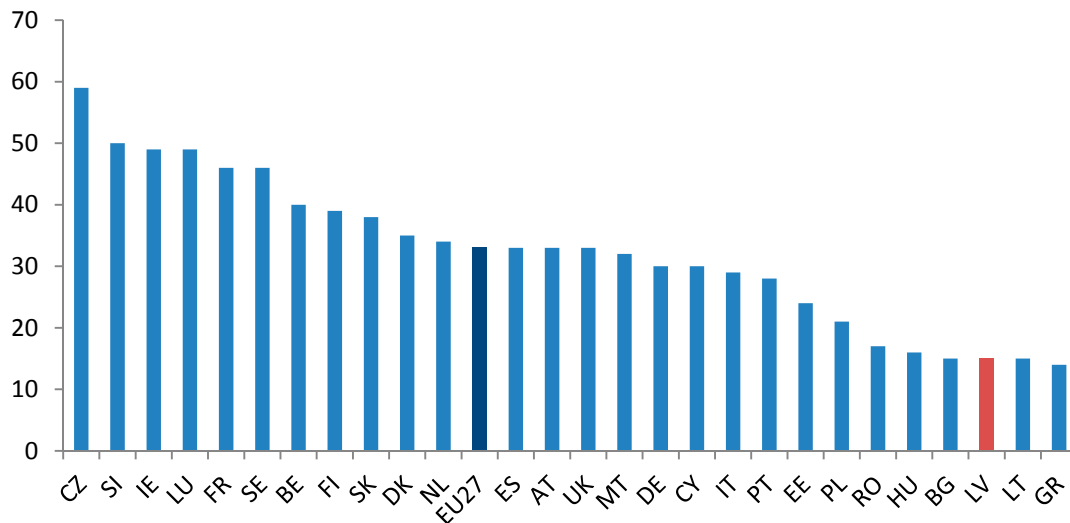
**Figure 2.14. EU Countries: Participation in Lifelong Learning, 2011**  
(Percentage of population aged 25-64)



Source: Eurostat.

70. **Employees themselves appear reluctant to invest in training.** In 2005 the share of employees participating in the continuing vocational training was only about 15 percent – one of the lowest in the EU (Figure 15).

**Figure 2.15. EU Countries: Participation in Continuing Vocational Education, 2005**  
(Percentage of employees)



Source: CEDEFOP, European Centre for the Development of Vocational Training.

## Authorities' response

71. **The government's action plan calls on the MoES to prepare for transferring the ownership of the VEIs to local governments or sectoral associations by 2015.** On the one hand, this could stop the unhealthy fight for students between secondary general and secondary vocational schools. Elimination of the differences in the allocation procedure of state transfers would make the local governments neutral whether the student attended the vocational or general school. On the other hand, the authorities are aware that the majority of local governments are not willing to take over vocational schools until the unclear financing issues are resolved.

72. **The MoES is exploring other governance models as well.** It is considering a proposal of the Latvian Chamber of Industry and Trade to establish a governing council for each VEI, similar to the situation for higher education institutions. Another idea involves creating integrated schools to provide both general and vocational education.

73. **Work on the restructuring of the content of vocational education programs is underway with expected completion at the end of 2013 (MoES, 2012).** The project is co-financed from the ESF with total financing amounting to LVL 2.5 million. The business sector is involved in redesigning the vocational education programs, which should narrow the skills mismatch gap in the labor market in coming future. This aims to solve the problem of program consolidation and reduce the number of programs. The intention is also to structure the VET programs in modules, to make the programs more flexible to the changing labor market needs. The authorities also hope to increase the employers' willingness to support apprenticeship programs, which has been an issue previously, as this is the only way how students could learn to work with the latest technologies.

74. **The MoES plans to make vocational education more attractive by promoting career guidance and counseling, increasing financial support to students and improving VEI teacher qualifications.** To satisfy the increasing labor market demand for qualified specialists the government intends to increase the proportion between the students studying in general secondary education institutions and in VEIs after completion of basic education from 60-40 to 50-50. An important instrument for achieving this would be to create a position of career counselor in VEIs. However, the availability of sufficient funding is unclear. Apart from that, there are also intentions to provide additional financial support, for example by increasing the ESF stipend to an average of 70 lats.<sup>23</sup> As a part of another ESF project, the MoES will invest in raising the qualification of the vocational education teachers (MoES, 2012).

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<sup>23</sup> Currently each vocational education student receives a state stipend of 7 lats per month and can apply for an additional ESF stipend of 10 to 50 lats per month. This would be in force until the end of 2015.

75. **Given limited fiscal space, EU funds remain the only source of funding modernization of VEIs.** The ERDF program has been reserved for modernizing the schools, after their number is reduced (MoES, 2012). LVL 113 million will be available for modernizing the schools during 2014–20. This will help to fully equip and modernize 11 VEIs. 15 schools will be able to implement some development projects. The funding for the renovation of the remaining schools and for the development of new programs in 11 modernized schools would come from the EU funds available during the next financial perspective (2014–20).

### Assessment

76. **The process of concentrating resources in fewer VET institutions is appropriate, especially given the falling number of students.** This helps to reduce the fragmentation and facilitate specialization of VEIs, which facilitates closer cooperation with employers. Given a smaller number of students, VEIs have spare capacity and infrastructure that can be used to provide adult education as well.

77. **However, the proposed decentralization of VETs to local governments is risky.** The authorities fairly argue that local governments have perverse incentives to try to draw students away from VET schools towards general education schools raises concerns. But the decentralization runs some risk of reversing the recent efforts to concentrate resources into fewer but more viable institutions. At the same time, financing issues remain unclear and local governments do not seem willing to take over these schools without additional financial transfers from the central government to cover maintenance costs. A school-by-school approach could work better: the largest VEIs could remain under the ministry's supervision, while the ownership of smaller schools in rural areas could be transferred to local governments that agree to cover the maintenance costs. In the small municipalities, integrated school programs—that is, combining vocational and general education—could make better use of the available resources.

78. **The VEIs' role in retraining should be strengthened.** The low adult participation in the lifelong learning and the high structural unemployment signals the need for well designed adult training programs. The VEIs, especially those that are modernized, are the best placed institutions to provide such training, even within the tight available resource constraints.

79. **Employers should be more closely involved in VET on a permanent basis.** Employers also benefit from a functioning VET system because the supply of skilled labor increases. But the current share of the workplace content in the VET programs is only about 20 percent, which is insufficient to ensure rapid transition of the students to the labor market. The ESF project offers a way forward: it has involved formation of 12 sector expert councils that will help to redesign the VET programs. If this contributes to employers' willingness to provide practical training, the study programs could better accommodate labor market needs. However, the changing labor market implies a need for more long-term forms of cooperation, for example by making greater use of the sector expert councils.

80. **The introduction of career counselors could help raise the VEIs' attractiveness.** It is important to provide full information to students before they decide whether to continue their studies in general upper secondary education or pursue VET. This and other measures could help to raise the prestige of VEIs and foster more widespread recognition that general and vocational education each serve different needs and career paths. Career counselors could also intermediate between students and companies, further strengthening each VEI's cooperation with employers. However, the introduction of counselors has yet to take place, and will to a large extent depend on the available funding. This project should be a priority in allocating the EU funding for education.

## G. Other Structural Issues

### Competition policy

81. **While the crisis led to improvements in competitiveness via price and wage falls vis-à-vis other countries, competitive pressures appear to have eased within Latvia.** IMF (2012) suggests that widespread bankruptcies of small firms during the crisis have dampened product market competition. EC (2012b) shares these concerns, pointing to limited competition in “construction, healthcare and pharmacy, public services, and food supply (dominated by two big chains)”.

82. **Limited capacity at the Competition Council remains a challenge.** The authorities recognize the importance of increasing product market competition, but have previously noted difficulty in attracting qualified personnel to work in the Competition Council given low public sector pay (IMF, 2012). A new Competition Council head, appointed in June 2012, is seeking to build the agency's capacity for econometric analysis, to supplement information from external complaints.<sup>24</sup>

83. **More work is needed to fill information gaps on product market developments and regulations.** Numerous studies at the European level draw on the OECD index of product market regulation. The OECD has previously extended its database to non-OECD countries, including those on track for accession such as Estonia; see Wöfl et al. (2010). A similar exercise for Latvia could yield useful results, if capacity constraints allow for this, and could be made a priority in the context of Latvia's current efforts to join the OECD.

### Public procurement

84. **Large procurements are being made subject to more stringent checks.** In response to the PV passenger car tender, new rules apply for public procurements above LVL 1,000,000 or connected with EU funds: draft contracts now need to be cleared with the Ministry of Finance,

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<sup>24</sup> Interview with Skaidrite Abrama, *The Baltic Course*, July 6, 2012.



Ministry of Justice, and the State Chancellery, followed by review by the Cabinet of Ministers. The new rules do not affect the role or independence of the Procurement Monitoring Bureau.

85. **Parliament is considering legislation to expand the centralized public procurement system to local governments, and to introduce administrative penalties for violations of procurement procedures.** The draft legislation is in line with EC program recommendations. Administrative penalties would range from warnings for minor infractions; fines on members of procurement committees (natural persons, rather than their institutions) between LVL 50 and LVL 500; and disqualification from future contracts (combined with fines) for serious violations.

### **Industrial policy**

86. **The MoE is developing a new industrial policy, which the World Bank is peer reviewing.** The MoE and the World Bank organized a practitioners' workshop and public discussion in December 2012 to discuss work in progress, and provide advice on good international practice for resolving coordination failures. At this event, the economics minister outlined principles for an industrial policy that would avoid a "picking winners" approach and minimize risks of rent-seeking, and instead emphasize the need to identify and address market and government failures, and for dialogue with stakeholders.

## **H. Conclusions**

87. **The authorities have developed, in varying degrees of detail, reform plans in several areas where these are particularly needed.** In general, and with some caveats, this paper finds that planned reforms to the judiciary, SOE governance, and higher and vocational education would address the underlying problems in these sectors. In specific areas:

- *Judicial efficiency:* welcome measures are in train to address court system delays, both directly and by making alternative dispute resolution methods more reliable. Scope may remain to accelerate the introduction of the "pure instance" system in civil courts.
- *Insolvency:* the priority should be to improve implementation of the insolvency law adopted in 2010. Best international practices that were introduced with the new law, including the single "cash-flow" test for insolvency, should remain in place.
- *State-owned enterprises:* conceptually approved reforms would do much to promote transparency and address long-standing fiscal and governance risks, but political agreement is still needed on the necessary legislation.
- *Higher education:* the minister has outlined controversial proposals consistent with a diagnostic of the sector. But details remain to be fleshed out; support from coalition partners is uncertain; and stakeholder resistance is evident.

- *Vocational education*: efforts to concentrate resources in fewer institutions, supported by investments in modernization, are welcome, as is greater involvement of employers in course design. But the proposed decentralization of vocational schools is questionable.

88. **A common challenge across these sectors is political economy: how to build support for moving from plan to implementation.** The above areas are difficult to reform, and in some cases the interests of established stakeholders and the broader public will differ. In addition to the usual political economy issues, the judicial and academic sectors have important traditions of independence. This means policymakers need to navigate between two valid and legitimate considerations: institutional independence and institutional accountability. The current dispute over the assessment of course quality in higher education is an example of the difficulty. But the launch in 2013 of an evaluation process for judges, by judges—though yet to be tested in practice—could become a good example of independence and accountability being reconciled.

89. **Progress on the microeconomic reform agenda would bolster Latvia's already strong recovery.** Latvia has already implemented a very strong macroeconomic adjustment, underpinned by numerous structural reforms, which has been critical to restore external and fiscal sustainability. And Latvia's growth performance over the past two years has been impressive. Post-crisis, Latvia's competitive strengths and weaknesses are increasingly well understood. This means that the opportunities are there—though implementation will be key—for structural policies to contribute to sustainably higher rates of investment, employment, and living standards.

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