

**CERTUS**

domnīca mērķtiecīgai izaugsmei



# Latvia Competitiveness Report

Executive Summary

2015



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# INTRODUCTION

Daunis Auers & Vjačeslavs Dombrovskis

## Is the glass half-full or half-empty?

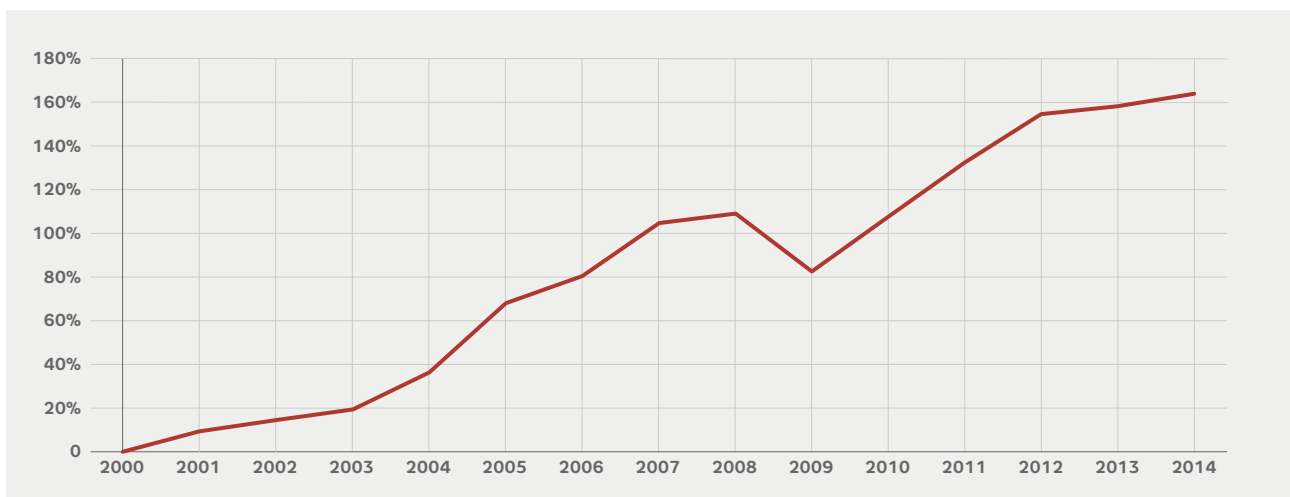
### How is Latvia doing in 2015?

Latvia's economy certainly has the potential for fast, sustainable growth. Macroeconomic indicators are stable. Indeed, between 2010 and 2014, Latvia's GDP increased by 17.4%, making Latvia the fastest growing European Union (EU) member state. Annual GDP growth in the second quarter of 2015 was 2.7%,

inflation was under 1%, and unemployment fell to 9.8%, which is the lowest level since 2008. In the first half of 2015, exports grew by 2.7%, reaching a record level (see Figure 1), and Latvia still has the fourth lowest ratio of national debt to GDP in the EU.<sup>1</sup>

Cumulative growth in Latvian exports from 2000-2014<sup>2</sup>

Figure 1



However, with a GDP per capita of approximately 70% of the EU average, Latvia is still one of the poorest countries in the EU.<sup>3</sup> Moreover, Latvia's continues to

experience severe demographic decline. On 1 January 2015, Latvia's population fell to less than two million for the first time since the 1930s.<sup>4</sup>

<sup>1</sup> Ministry of Finance. 2015.

<sup>2</sup> Eurostat. 2015.

<sup>3</sup> It is worth mentioning that in 2004, upon its accession to the EU, Latvia's GDP per capita was less than 50% of the EU average.

<sup>4</sup> Eurostat. 2015.

This drastic demographic decline is caused by two factors. First, a long-standing low birth rate. Unfortunately, there are few instruments capable of tackling this issue. Countries much wealthier than Latvia have not only made sizable investments in maternity, paternity and child care support and information campaigns, but have even invested in patriotic songs and annual measures to encourage “child birth and family formation” – all to little avail.<sup>5</sup>

The second factor is the high volume of post-2004 emigration to Ireland, the United Kingdom and other EU countries. Open borders to significantly wealthier EU countries mean that, in all probability, this trend will continue into the future. As a result, Latvia must not only tackle the income inequality within its own borders, but also that between Latvia and the much wealthier EU countries that are emigration destinations. If the Latvian economy does not grow faster, then the

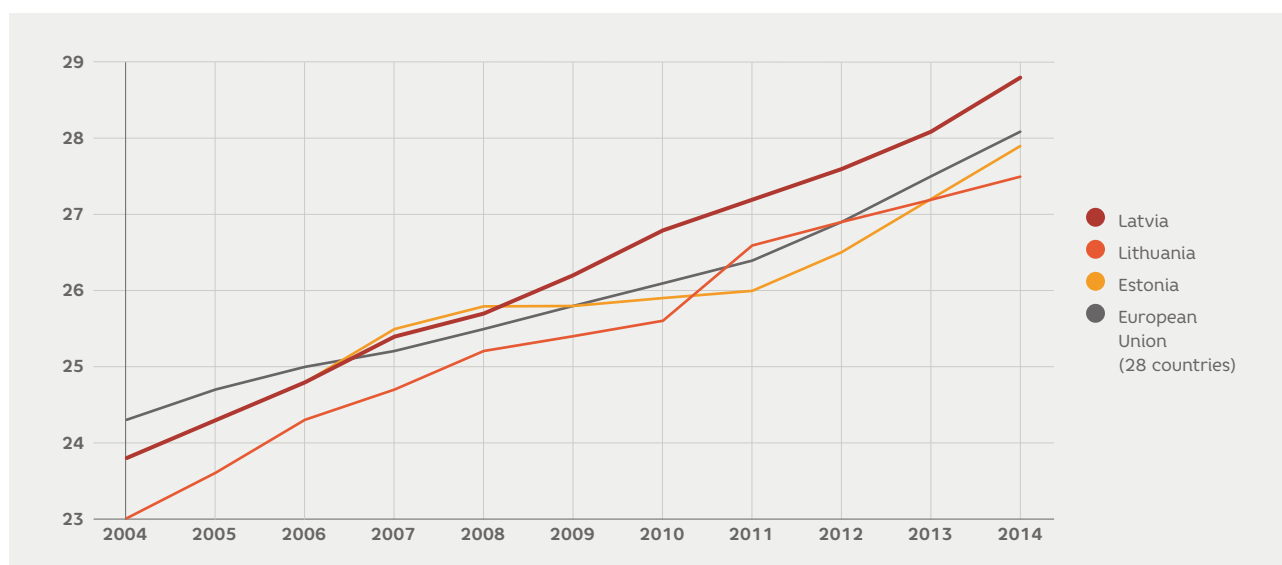
young and ambitious will continue to leave the country.

The falling population will inevitably also have a negative long-term impact on the Latvian economy, as the labour force contracts and pension and healthcare costs rise together with the number of pensioners. Likewise, this means that the share of the labour market comprised of young people, who are not only more productive, but also more innovatively and technologically-minded than senior citizens, will continue to decline.

Moreover, a rapidly contracting population, as well as demographic changes caused by people leaving small villages and towns and moving to the Riga Region, threaten the long-term viability of many Latvian regions and districts. Recent Russian sanctions have hit some of these regions particularly hard, accentuating economic problems and accelerating migration to the Riga Region or overseas.

**Old-age dependency ratio (number of people, aged 65 or over, per 100 people aged 15 to 64 years)<sup>6</sup>**

Figure 2



<sup>5</sup> Adema, W., N.Ali and O. Thevenon. 2014. 'Changes in family policies and outcomes: Is there convergence?' *OECD Social, Employment and Migration Working Papers*, No. 157, OECD Publishing.

<sup>6</sup> Eurostat. 2015.

These two trends impose an additional burden on Latvia's social welfare system. Pensions will continue to stagnate and healthcare services will be cut as the number of economically active taxpayers falls and the number of pensioners rises. As Figure 2 indicates, Latvia has a greater, and growing, old-age dependency ratio than Estonia and Lithuania and well above the European Union average. This growing burden will be particularly

felt by that one third of the population employed in the private sector whose taxes provide for pensioners, children, the unemployed and public sector employees (from teachers to soldiers). They also pay for the upkeep of a broad public infrastructure, including roads, schools and hospitals in underpopulated rural regions.

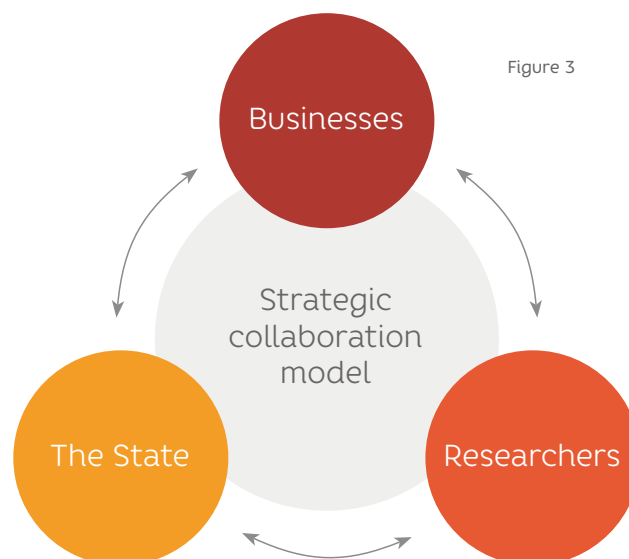
This state of affairs is not sustainable.

## Why Certus?

We believe that economic growth is the only long-term solution to Latvia's severe demographic, labour and welfare challenges.

However, economic growth is not automatic. Latvia must establish a legal basis and physical infrastructure to provide competitive national industries with the opportunity to flourish. The EUR 4.4 billion worth of European funding available to Latvia between 2014-2020 can serve as a powerful economic stimulus. However, there are no one-size-fits-all policies that suit all countries. Not every European Union initiative, no matter how valuable, will benefit Latvia. Different countries have different competitive advantages. Expert debates and discussion of the various policy options available are vital to identifying Latvia's competitive advantages.

However, evidence and research based policy-making is not Latvia's strong suit. There are only a few domestic sources of policy formulation and innovation in Latvia. The Saeima is the only legislature in the Baltic Sea region that does not have a research department to support deputies and political parties in drafting legislation and policies. Ministries lack resources, and studies, if they are conducted at all, are usually financed from European Union structural funds.



Latvia's political parties are small; they lack the personnel and financial resources required to develop and institutionalise research capacity. Latvia's active think tanks and academic research centres are either geared towards participation in national and European Union research funded research projects or otherwise conduct national (Latvian) case studies as a part of large-scale comparative research projects. While this is both valuable and important, it also means that these institutions often lack a uniform and broader perspective of Latvia's development.

*The objective of Certus* – an independent, non-partisan think-tank – is to focus on developing strategies, that can raise the competitiveness

of Latvian industry and the Latvian economy as a whole.

We use a process that Harvard Professor *Dani Rodrik* termed *strategic collaboration* between the state and the private sector (see Figure 3). We bring Latvian economists and researchers together with entrepreneurs, associations, NGOs and policy-makers with the aim of raising economic competitiveness. A deep, structured and ongoing dialogue will create ideas and policy initiatives that will propel Latvia towards faster economic growth.

At the centre of this strategic collaboration process is the annual *Latvia Competitiveness Report*. It provides a study of Latvia's current economic problems and challenges, an analysis of economic sectors, and proposes policy initiatives to increase

competitiveness. In addition to the annual report, *Certus* will publish regular policy briefs that offer a review of current and potential growth drivers in various sectors, as well as analysis of current events.

*This is not the first* overview of Latvia's competitiveness. In addition to the World Economic Forum's annual country report on Latvia, in 2012 the Baltic International Centre for Economic Policy Studies (*BICEPS*) published the *Latvia Competitiveness Report*. This comprehensive and valuable publication offers a vital insight into various dimensions of Latvia's competitiveness, including education, taxation and demography. The *Certus* report has a narrower approach, focusing on only two main 'horizontal' challenges and five industrial sectors. Moreover, we have formulated more precise, policy-oriented and feasible recommendations.

## 2015 Latvia Competitiveness Report

A large number of scholars and researchers from Latvia's leading universities, business schools and research centres have taken part in researching and writing this competitiveness report. They intensively collaborated with industry association, business, government and public sector experts and consultants over the summer months. They interviewed, researched, considered, discussed and developed innovative solutions to grow Latvia's competitiveness.

The report touches on *horizontal* challenges, which encompass all aspects of Latvia's economy including depopulation and regional development, SME access to finance and investment, as well as analysis of five economic sectors with major growth potential. The recommendations are fiscally responsible. The report does not propose additional expenditures without specifying potential sources of funding – whether European Union structural funds or the reallocation of budget funds. In some cases no direct costs are necessary.

This publication is the 2015 Latvia Competitive Report *executive summary*. More detailed chapters of the report can be found at: [www.certusdomnica.lv](http://www.certusdomnica.lv)







# 1. IS LATVIA'S GROWTH MODEL SUSTAINABLE?

Daunis Auers & Vjačeslavs Dombrovskis

What is Latvia's growth model?

Is it found in the National Development plan (NDP)? However, was the National Development Plan hurriedly formulated because the European Commission stressed its existence as a prerequisite for receiving support from EU structural funds during the 2014–2020 planning period? Opinions differ. Nevertheless Latvia's policy making has been driven by three core elements:

1. First, swift integration with western political and economic institutions. While this is a largely political goal it also entailed certain economic reforms. Latvia joined the World Trade Organisation in 1999, NATO and the European Union (in 2004), the Eurozone in 2014, and is preparing to become an OECD member state in 2016/17.
2. Latvia has diligently implemented the principles laid down by the *Washington Consensus* since the 1990s. This oversaw the transition from a planned economy to a market economy, following the *rigid stabilisation, liberalisation and privatisation approach*.

3. Since accession to the European Union in 2004 and integration into Europe's decision-making structures, Latvia's approach to formulating economic policy has been increasingly determined by instructions from Brussels.

Is this broad approach to economic policy-making sustainable? Will it ensure *stable* and *strong* economic growth that rapidly raises the standard of living in Latvia to the EU average and halts economic emigration? In our opinion this is unlikely.

*Accession-based* policy planning is clearly no longer viable. Indeed, it has become a victim of its own success. Implementation of this policy has proved to be so successful that there are no prestigious organisations left to join.

What is the *Washington Consensus*?<sup>1</sup>

In the early 1990s when Western market economies assisted post-communist countries in the transition from centrally planned economies to market economies, the *Washington Consensus* gave its name to a range of principles that defined the framework of economic growth. It was

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<sup>1</sup> This term was first used in: John Williamson. 1990. *Latin American adjustment. How much has happened?* Washington: Institute for International Economics.

initially comprised of ten principles that stipulated fiscal discipline, competitive currencies, economic liberalisation, and privatisation. Since then the list has been significantly expanded, emphasising good governance and the battle against corruption. The *Washington Consensus* has been the most influential mechanism for economic development not only in Latvia, but in all newly-developing countries from the 1990s onwards.

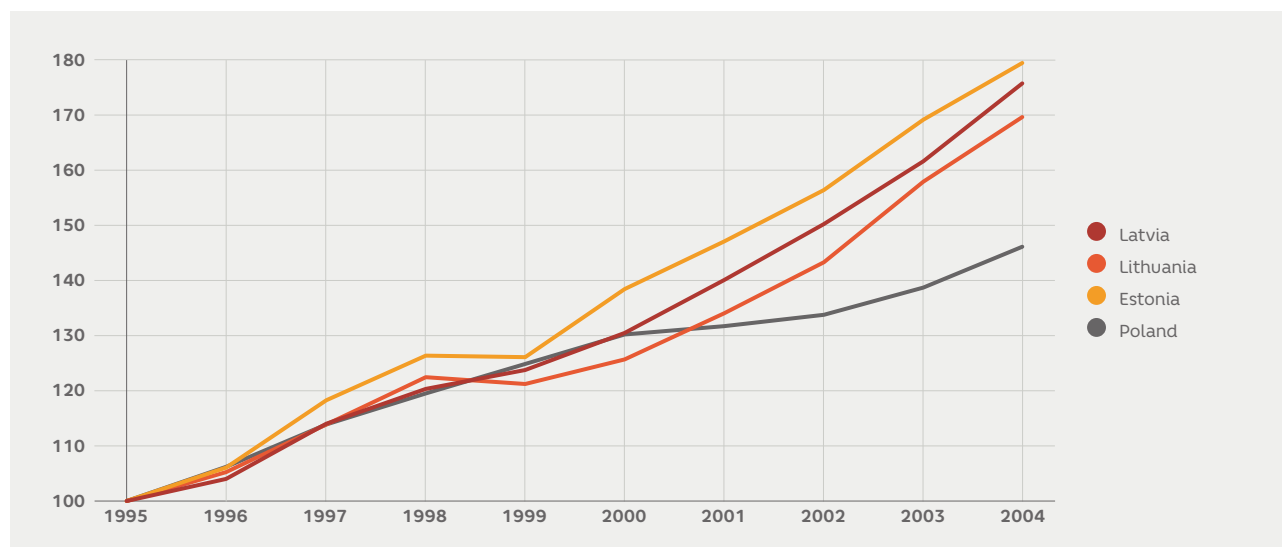
Latvia's accomplishments in implementing the *Washington Consensus* have rightly been praised. Latvia has long implemented a largely responsible fiscal policy, sensibly balanced the national budget, had low national debt, low inflation, as well as an economic system based on private property and competition, in which ownership rights are protected to a relatively high degree. This is a major accomplishment.

Successive Latvian governments have invested a great deal of work in creating a business-friendly environment. Latvia climbed from 34th place in 2006 to 23rd place in 2015 in the World Bank's *Doing Business* report. By way of comparison, during the corresponding period Estonia remained in 17th place, while Lithuania dropped from 15th to 24th place.<sup>2</sup>

Naturally, there is always room for improvement – additional efforts could improve the business climate and the legal system. Fiscal policy could be even more responsible and budgets have an even lower deficit. However, a focus on *Washington Consensus* policies is hardly likely to result in significant economic growth. Although efforts to improve Latvia's ranking in the *Doing Business* table should continue, climbing to 20th or 15th place in the table should not be an overriding political priority.

**Estonia, Latvia, Lithuania and Poland. Total GDP 1995-2004 (1995=100)<sup>3</sup>**

Figure 1.1

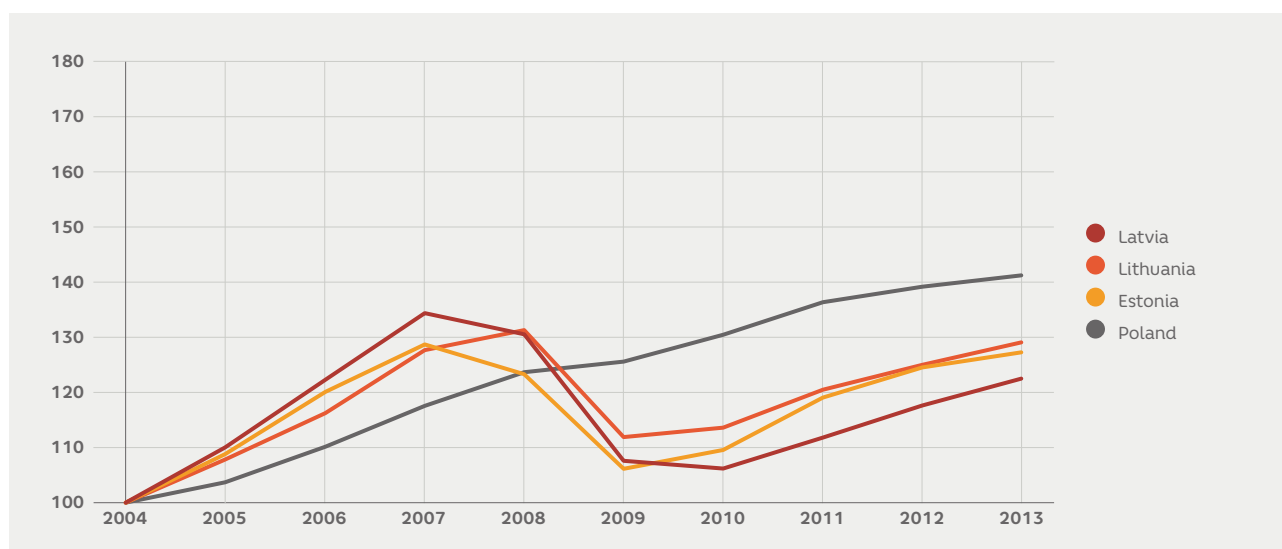


<sup>2</sup> *Doing Business* database: <http://www.doingbusiness.org>

<sup>3</sup> Eurostat. 2015.

Estonia, Latvia, Lithuania and Poland. Total GDP 2004-2013 (2004=100)

Figure 1.2



It is important to reiterate that we are not suggesting that the *Washington Consensus approach* to economic policy-making is wrong. We believe that the progress achieved to date is excellent but that the model itself is no longer relevant. Latvia had reached the *Washington Consensus goals* at the same time it joined the European Union. We can compare Latvia and Poland. In the decade up to EU accession in 2004, Latvia's economic growth was far more rapid than Poland's – between 1995 and 2004 Latvia's GDP, calculated at constant prices, rose by 76% while Poland's GDP increased by just 46%. However, in the decade after EU accession, the situation was reversed. From 2004 to 2013, Poland's GDP increased by another 41%, while Latvia's rose by just 22%.<sup>4</sup>

There are a growing number of influential experts questioning the results of the Washington Consensus as well as its suitability as a model

for the future. Harvard University's Professor of International Political Economy, Dani Rodrik, points out that "Very few people believe that liberalisation, deregulation and privatisation in themselves are the key to the development of economic growth."<sup>5</sup> Rodrik's analysis of economic development shows that, between 1960 and 2004, only a small number of developing countries succeeded in steadily approaching the level of developed countries. The sole exceptions are the countries of East Asia and South-East Asia, which rejected the usual recommendations and significantly deviated from the prevailing policies. For example, South Korea rejected direct foreign investment, while China did not introduce private ownership rights. The governments of South Korea and Taiwan paid no heed to the standard advice that they should not directly intervene in the running of enterprises. Instead, they actively sought to coordinate private investment in certain economic sectors.

<sup>4</sup> Eurostat. 2015.

<sup>5</sup> Rodrik, D. 2007. *One economics, many recipes: Globalization, institutions and economic growth*. Princeton: Princeton University Press. p.55.



„Economic growth is not the natural order of things, and establishing a fair and level playing field may not be enough to spur productive dynamism.”<sup>6</sup>

From 2004 onwards, the third element of Latvia's growth model has been to “do nothing, stand aside and implement everything decreed by Brussels”. At that time, directives and guidance from Brussels became the dominant factor in Latvia's economic policy-making. Membership of the European Union offers Latvia enormous opportunities. It gives Latvia's producers access to the world's biggest and most affluent single market, comprised of 500 million consumers. European Union structural funds have become if not Latvia's only, then certainly its biggest, state investment programme. At the same time, Latvia's approach to the policy-making taking place in Brussels has been, at best, ill considered, and at worst – clearly naïve.

The European Union's policy planning is based on the principle that *one size fits all*. Policy ratification is usually the result of a complicated compromise with the average outcome obtained after the economic interests of all the member states have been weighed up. This approach made sense when the European Union was made up of, at most, 15 member states with a similar level of economic development and therefore, with similar economic challenges. However, it is questionable it is suitable for a union of 28 heterogeneous states. Are the challenges facing Germany, the United Kingdom and France the same as those that concern Latvia, Bulgaria or Greece? Evidently, there is a risk that

this approach is not ideally suited to each specific country, particularly in relation to countries that are far removed from the European average.

“It is always useful to learn from the experience of other countries – it is even necessary. However, if the adoption of policy occurs mechanically, without fully understanding the circumstances that have made it successful, it is a recipe for disaster.”<sup>7</sup>

The energy sector is illustrative of the dangers of implementing policy recommendations without understanding their domestic context and impact. Climate change is clearly a serious challenge and understandably tops the political agenda. This particularly applies to Europe. In the move to increasing renewable energy and energy efficiency the reduction of CO<sub>2</sub> emissions is among the most important policy instruments to tackle climate change. At the same time, it is self-evident that climate change is not as much of a priority issue in the new EU member states as it is with the older, wealthier and more developed members. Latvia is considered to be quite a green country, whose actions have no particular impact on climate change. However, by undertaking to implement the body of climate change policies in full, several Latvian governments have made climate change a real political priority for Latvia; in doing so they have failed to fully appreciate the costs and implications of this policy for the economy.

<sup>6</sup> Rodrik, D. 2007. *One economics, many recipes: Globalization, institutions and economic growth*. Princeton: Princeton University Press. p.45.

<sup>7</sup> pp4-5.

## Example 1

## Striving for renewable energy resources

The transition to the use of renewable energy sources, e.g. wind, solar and water energy, is one of the major approaches to reducing the impact of climate change. The goal is to reduce dependency on burning *fossil energy*, i.e. *fossil fuels* such as coal, oil and natural gas, to generate power. Latvia has undertaken to comply with European Parliament's Directive 2009/28/EC of 23 April 2009 on the promotion of the use of energy from renewable sources. Latvia has been set an individual target, i.e. to ensure that renewable energy forms 40% of gross final consumption of energy by 2020.

This begs the question, to what extent was this *really* a genuine policy priority for Latvia, compared, for example, with reducing unemployment and promoting economic growth? At that time, Latvia did not widely use fossil fuels for energy production. In 2005, the proportion of energy obtained by Latvia from renewable energy resources was 32.5%, which was the second highest indicator in the European Union. In comparison, the corresponding figure was 5.8% in Germany, 1.3% in the United Kingdom and 10.3% in France.<sup>8</sup>

Despite this, Latvia willingly agreed to further increase the proportion of renewable energy resources it consumed. Of course, this required State subsidies. A decision was made to finance the

subsidies, not from the state budget, but rather in the *form of the so-called Mandatory Procurement Component* (MPC). In principle, this meant that the costs of subsidies would have to be met by power consumers for whom energy tariffs would rise. It was also decided that subsidies would have to be financed by all power consumers – both private individuals and enterprises – *proportional* to their energy consumption. Since the majority of total power consumption is used by industrial producers, there was a significant increase in their energy costs. The most energy-intensive manufacturers in relative terms, e.g. *Lauma Fabrics*, *AS KVV Liepājas metalurģs*, *AS Valmieras stikla šķiedra*, *AS Cemex* and *AS Latvia's Finieris* suffered the most from the increase.

The consequences were not long in coming. The rapid increase in the price of power was one of the main reasons why *Liepājas metalurģs* applied for insolvency. One of Europe's biggest fibreglass manufacturers, *Valmieras stikla šķiedra* is implementing a new investment project in the US state of Georgia. One of the principal reasons it cites for its decision to invest there, as opposed to in Latvia, is significantly lower energy resource costs. It is anticipated that over a five year period, the company will invest approximately EUR 14 million and create 150 new jobs, but Latvia will not benefit from these investments.<sup>9</sup>

<sup>8</sup> Annex 1 to Directive 2009/28/EC. <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32009L0028>

<sup>9</sup> Delfi. 2014. "Valmieras stikla šķiedra ražotnē ASV investēs 20 miljonus dolāru". <http://www.delfi.lv/bizness/uznemumi/valmieras-stikla-skiedra-razotne-asv-investes-20-miljonus-dolaru.d?id=44782412>

Example **2**

## The move towards energy efficiency

In October 2012, Latvia undertook another set of policy measures aimed at resolving issues related to climate change: Directive 2012/27/EU on energy efficiency. This directive obliges Latvia to attain a specific quantitative energy efficiency target by 2020.

During the 2014–2020 EU structural fund investment planning period, the Ministry of Economics envisages investments of approximately EUR 333 million in energy efficiency. This is a significant proportion (44%) of the total fund allocated to the ministry. These funds will not be invested in improving access to capital or innovation or other potentially more rewarding ventures. Despite this, in December 2013, the ministry informed the government that even these significant investments would only be sufficient to fulfil 19% of Latvia's obligations undertaken under the Energy Efficiency Directive.<sup>10</sup> The ministry has forecast that the total investment required to attain the objectives set out in the directive could reach EUR 2.1 billion.

In order to obtain the required funds, in December 2013 the government decided to set up the Energy Efficiency Fund to which payments will be made by traders and distributors. In other words, the proposed solution is essentially comparable to paying for renewable energy resources (as mentioned previously), because the costs will actually have to be met by private individuals and businesses that consume power, because their tariffs for power and thermal energy will increase. Higher energy prices will result in an increase in commercial operating costs that will further reduce the competitiveness of the companies affected.

In May 2015, a draft Energy Efficiency Law was submitted to the Saeima which provides for the establishment of the Energy Efficiency Fund.

Latvia clearly needs a new economic growth model that will nurture the development of competitive national industries.

<sup>10</sup> Concept regarding the adoption in regulatory enactments of the requirements of Directive 2012/27/EU of the European Parliament and of the Council of 25 October 2012 on energy efficiency, amending Directives 2009/125/EC and 2010/30/EU and repealing Directives 2004/8/EC and 2006/32/EC.







## 2. A NEW GROWTH MODEL FOR LATVIA

Vjačeslavs Dombrovskis & Daunis Auers

Vigorous economic growth creates jobs, takes people out of poverty and raises the standard of living. It can also prevent the potential disaster that Latvia faces caused by: (i) economic emigration, (ii) an aging population and (iii) the burden of maintain a broad regional infrastructure with a rapidly shrinking population. One thing is clear – emigration from Latvia can only be stopped by reducing the difference in income with other European countries. The calculation is very simple. In order to achieve 90% of the European average GDP per capita over the course of a decade, the actual annual increase in GDP must amount to 5.5%.<sup>1</sup> This must and can be achieved.

However, in order to accomplish this, more is required than merely setting growth as the main priority of the political agenda. We need to extend and broaden our thinking in regard to the existing notion of what is required to attain economic development. We should only emphasise the basic principles of the Washington Agreement (*Washington Consensus*) as a basis for the work to come, as opposed to being wholly dependent on them. We have to understand that more is required to attain rapid growth.

A pragmatic approach is required to negotiations with other European countries, based on a clear understanding of Latvia's national interests. It is necessary to form alliances and achieve mutual understanding with other likeminded European nations. A 28 nation European Union might not hear the voice of one peripheral state. A salient example of this approach is Poland, which has been a much smarter and successful player in the European Union than Latvia. Together with other Central European states, Poland formed the *Visegrad Group*, which has become an influential alliance within the EU policy-making process. In contrast, Latvia has often struggled to even find a consensus with the other two Baltic states.

The Latvian government must undertake a more active role in promoting economic growth. Larger countries can afford minimal state involvement, with the state stepping into the background and allowing market forces to dictate what will be manufactured. Smaller countries with economies in an earlier stage of development cannot afford this luxury. We must understand where our comparative advantages are hidden and where our opportunities lie – to identify the sectors that could pave the way to Latvia's sustainable growth and welfare.

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<sup>1</sup> Assuming that the average real growth of other European countries will be 2% annually.



Latvia also needs to focus its resources. The government has been assigned the task of implementing countless reforms and is expected to adopt every trait and characteristic of a highly developed country, ranging from company investments in research and development to state funding for non-governmental organisations, without delay. However, Latvia remains much poorer than its Western European partners and government institutions lack the capacity to immediately adopt all these ostensibly mandatory structural reforms. Instead, Latvia should concentrate on a few specific fields, in which implementation of prudent and properly financed reforms would ensure the most productive investment in economic growth.

The most significant prerequisite for growth is *strategic collaboration between the private and public sectors*. For many years, there was an unwritten law that politics should be conducted at arm's length from commerce. This was based on concerns that interaction between business and politics would invariably result in corruption.<sup>2</sup> However, a number of newly developing countries experimented with state-managed development policy and several East Asian states did not build a wall between politics and business. It was in these very country countries that so-called *economic miracles occurred*. It is important to understand what Latvia can learn from these success stories as well as the lessons from countries whose economic development efforts were unsuccessful and led to low growth and a high level of corruption.

In many respects, economic development is tantamount to climbing up the *production ladder*, i.e. the production of new and more complex products or taking over the manufacturing of such products from developed countries, which mastered the process this long ago. Harvard University Professor Dani Rodrik calls this process *structural transformation*.<sup>3</sup> However, the creation of new products often differs from the reality of large volume production. Countries which are in the process of economic development can encounter countless problems. For example, businesses that are the first to begin new operations cannot fully enjoy the income from the production of new products, because information about their successes or failures is quickly discovered by other entrepreneurs. Sufficient investments are not made in the new operating direction, resulting in what Rodrik and his colleagues have termed the *self-discovery* problem. A country can then get stuck at its own level of development, because deep structural transformation typically requires a critical mass of labour and industry infrastructure.

A strategic partnership means *regular dialogue* between the state and the private sector, in order to understand the nature of the obstacles to strategic transformation and to encourage the process of self-discovery. This information requires precise knowledge about what is happening at the *industry level*. This information can only be obtained and used as the basis for drafting policy solutions by maintaining close links to different sectors of the economy.

<sup>2</sup> Dombrovskis, V. 2010. Does Latvia need an industrial policy? Riga: The President's Strategic Analysis Commission.

<sup>3</sup> Rodrik, D. 2007. *One economics, many recipes: Globalisation, institutions and economic growth*. Princeton: Princeton University Press.

This continual dialogue will inevitably generate *ideas* on how to facilitate sustainable economic growth.

Economic growth is not spontaneous or inevitable. It is nurtured by good policies and independent thinking. The generous advice that Latvia has received from the European Commission and World Bank experts who occasionally visit the Baltic region has undoubtedly offered a useful perspective on Latvia's problems and challenges. However, this is an inevitably superficial assessment that has been formed from quite some distance.

The hard work needs to be done at home.







# 3. DEPOPULATION AND REGIONAL DEVELOPMENT

Kārlis Krēsliņš, Andris Miglavs & Uldis Spuriņš

Depopulation is undoubtedly Latvia's primary challenge. This most affects Latvia's regions. In just the past decade, (2004-2014), the size of the Latvian population has declined by 12%. Future forecasts do not provide grounds for optimism. By 2025 the population will have declined by another 12%, reaching just 1.75 million. There will also be a significant change in population structure.<sup>1</sup> The number of people of retirement age (>65 years) will increase by 4%, while the number of working age people will fall by 16%. The shrinking number of working-age people will face the rising burden of funding an increasing number of pensioners.

Latvia's regions will be most seriously and directly hit by these changes. For the past 15 years, these regions, and Latgale in particular, have suffered the biggest fall in population (Figure 3.1). If this trend continues, it is forecast that in 2030, the population will decline by almost one third in most Latvian regions (Figure 3.2).<sup>1</sup> The reduction in the number of people of working age will be even greater. How will the remaining inhabitants cover the costs of maintaining the regional infrastructure?

All too often, thinking about regional development has been dominated by a

*suburban mentality*, particularly at the municipality level. Significant investments are made in schools, sports halls, cultural centres and similar infrastructure. However, comparatively little attention is paid to stimulating business and investments. In all likelihood, this attitude can be explained by the structure of incentives for municipalities. The main source of income for municipalities is the income-tax of residents declared according to their *place of residence*. Municipality revenues are not directly dependent on how many people *work* in the municipal territory.

We have analysed the economic side of the regional development equation. Good schools, kindergartens, sports centres and good roads are undeniably important components of life. However, people will not remain in places where they can't hold down well-paid jobs. The viability of rural territories is currently based on three economic foundations: agriculture, forestry and logging, as well as rural tourism. These industries do not require a significant concentration of inhabitants.

The development of rural territories is and will remain closely linked to the developmental trends of these industries. However, this offers no guarantee of jobs for all the inhabitants in the region.

<sup>1</sup> *Jāņa sēta and Grupa 93*. 2014. "Public individual service offering assessment compared to population distribution". 1st interim report. Characterisation and forecasts of demographic changes, Riga: MoEPRD.

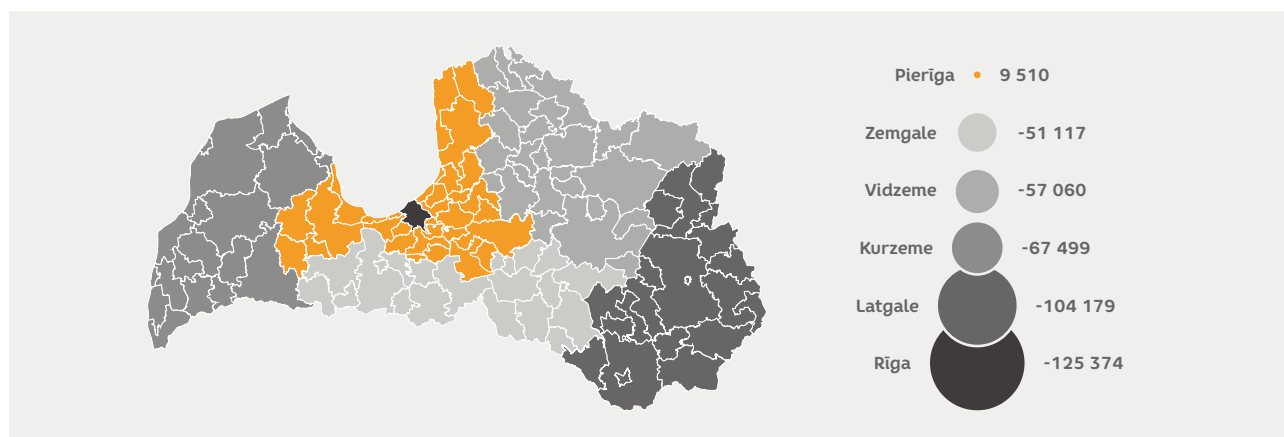


The availability of jobs is one of the main factors in tying inhabitants to regions. One job created in a production plant creates three additional jobs related to the education of the labour force as well as the provision of other services. Thus the future existence and development of regional centres is closely related to the prospects for the development of manufacturing. Attracting foreign

direct investment (FDI) to support manufacturing is key to creating jobs in Latvia's regions. However, increased investment and a much more focused approach is required to attract foreign investors. The strategy of attracting investment for manufacturing must be built on three pillars: regional industrial zones, flexible professional education centres and a rapid response fund.

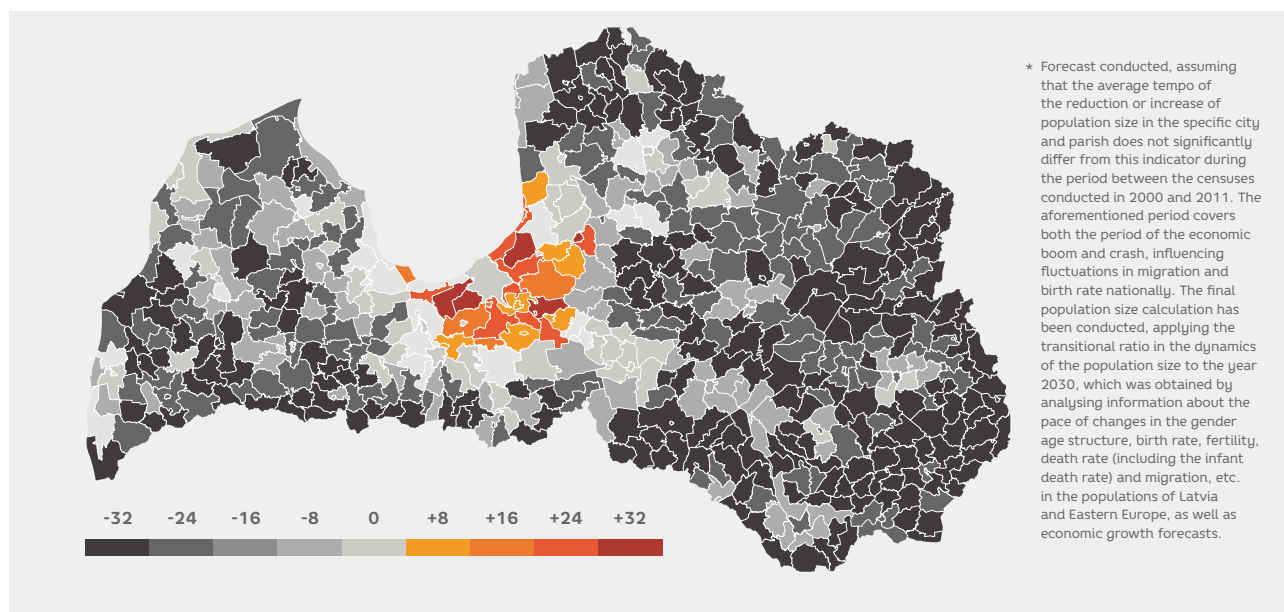
Changes in population size by statistical region from 2000-2015.<sup>2</sup>

Figure 3.1



Forecast changes in population size in Latvia's cities and districts in 2030 (% compared with 2011)\*

Figure 3.2



<sup>2</sup> Central Statistical Bureau. 2015.

## 3.1. Industrial zones

Foreign direct investment is central to Latvia's regional development. Empirical studies show that attracting large factories to specific territories can change territorial developmental trends. For example, if one compares territories which have succeeded in being chosen by a company as locations for manufacturing with territories that have also competed for this privilege but lost out, it is clear there was a significant increase in the value of real estate in the territories that attracted the FDI, which is an indirect indicator of a change in the level of welfare.<sup>3</sup>

The sustainable development of Latvia's regions can be enhanced through the creation of industrial zones. The minimum components required for the establishment of a business/industrial zone are land, transport infrastructure, including access roads, water and sewerage, as well as both quantitative and qualitative labour force potential. The experience of both Latvia and other countries shows that the existence of industrial zones is an absolute prerequisite for attracting the interest of manufacturing investors.

### *Kirde-Eesti* industrial zone

*Kirde-Eesti* is an export-oriented industrial zone in Estonia that successfully incorporates industrial parks. It increased regional exports from EUR 260 million in 2004 to EUR 410 million in 2012.

Even though the formation of the industrial zone began after 2000, significant investments in *Kirde-Eesti* were made during the period from 2010-2012, especially in thermal power plants and shale oil extraction. By way of comparison, investments in

2010 amounted to EUR 220 million, whereas in 2011 they totalled EUR 411 million.<sup>4</sup>

On average, it took 3-4 years to establish the key infrastructure and build a production plant. The industrial parks that are part of *Kirde-Eesti* are very important for regional development. For example, in 2014 *Intec-Nakro* was the base for 42 enterprises with a total turnover of EUR 66 million, employing a total of 1,200 people.

<sup>3</sup> Greenstone, M., & Moretti, E. 2004. Bidding for Industrial Plants: Does Winning a 'Million Dollar Plant' Increase Welfare? *NBER Working Paper No. 9844*.

<sup>4</sup> Zimin, D. 2014. *Kirde-Eesti, Estonia: Patterns of Socio-Economic Development - Case Study Report. GRINCOH Working Paper Series*.

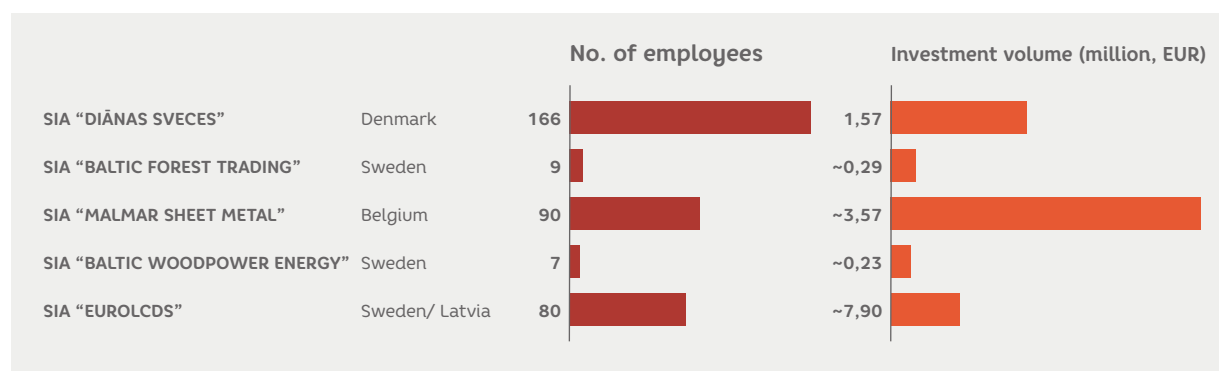
## Industrial zones in Latvia

Latvia has two successful examples of industrial zones: the Jelgava Industrial Zone and the Ventspils Industrial Zone, which has been developed by

the Ventspils Free Port Authority in collaboration with Ventspils City Council (Figure 3.3).

Investment in manufacturing companies in the Ventspils industrial zone (2002-2013)

Figure 3.3



The Ventspils Industrial Zone has attracted 10 manufacturing enterprises with total investment of EUR 35.7 million, creating 700 jobs. Based on interviews with representatives of companies established in the Ventspils Industrial Zone and the Ventspils Free Port Authority, factors stimulating and hindering the attraction of investments are collated

in Infographic 3.1. It should be noted that the Ventspils Industrial Zone is primarily comprised of a concentration of manufacturing companies involved in engineering, including electronics, electrical engineering and metal working. The principal target countries where investors were sought were Germany, Scandinavia and the Benelux countries.

Factors stimulating and hindering the attraction of investments to the Ventspils industrial zone

Infographic 3.1



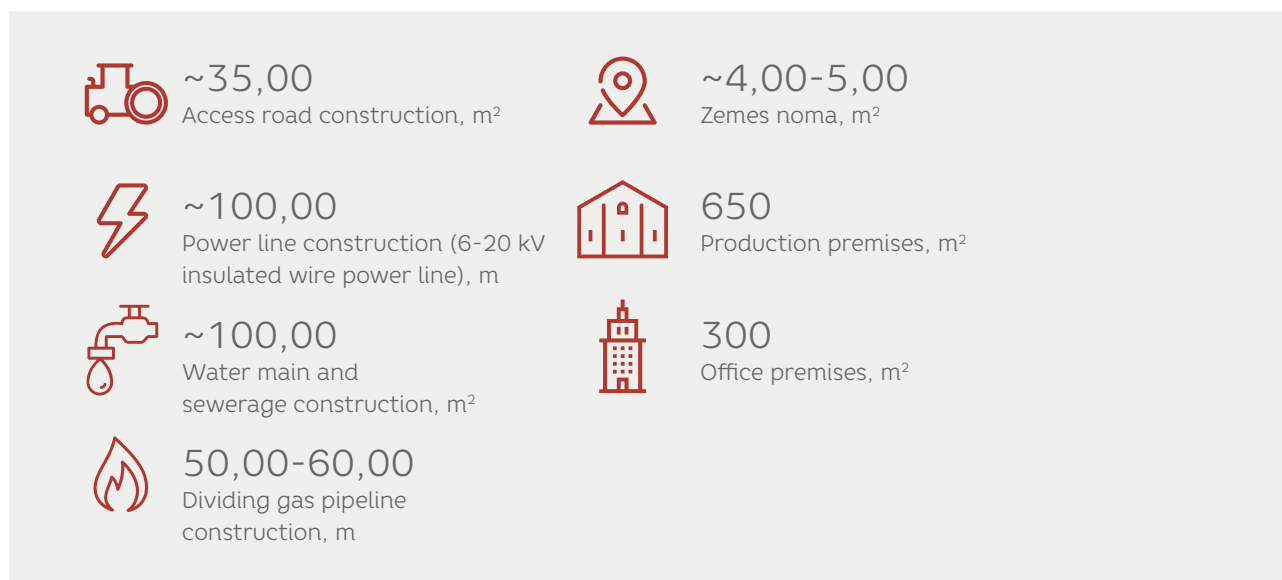
The main factors that persuade foreign investors to invest in an industrial zone include transport and logistics infrastructure, telecommunications and IT infrastructure, the stability and transparency of the political, legal and legislative environment, the potential rise in the productivity of the company concerned, the skill level of the local labour force, labour force costs, and the size and nature of the national and regional market.

Industrial zones require significant investment (Infographic 3.2). Assuming that a new industrial zone were to be established with five production plants, each containing 2,000 m<sup>2</sup> of manufacturing space and 750 m<sup>2</sup> of

office space, it would also be necessary to build a 1 km access road, 500 m power line, 500 m<sup>2</sup> water main and sewerage systems and a 200 m dividing gas pipeline. It would also be necessary to pay a lease fee for the land spanning a total area of 5 ha. Accordingly, the total expenditures would come to approximately EUR 7.5 million. In turn, assuming that the infrastructure required for the industrial zone has been built (as is the case, for example, in Daugavpils and Valmiera), but that it is also necessary to build 4-5 production plants that incorporate 3,000 m<sup>2</sup> of manufacturing space and office premises spanning an area of 1,000 m<sup>2</sup>, the total costs will also amount to approximately EUR 11 million.

#### Industrial zone infrastructure costs (EUR)<sup>5</sup>

Infographic 3.2



Assuming the funding available for industrial zones currently amounts to approximately EUR 311 million, it would be possible to establish 4-5 new industrial zones in Latvia with the necessary infrastructure and 10 production plants with office premises.

Remaining funds, amounting to approximately EUR 80-90 million, could be used for the development of 6-7 smaller business/industrial zones, assuming that these already have the required basic infrastructure.

<sup>5</sup> Calculations made by the authors, based on focus group interviews with representatives of *Bucher Municipality* and *Ventspils Free Port Authority*, as well as on information available from the homepages of *Latvijas Gāze* and *Latvenergo*.



## 3.2. Industrial zone support system: employee training

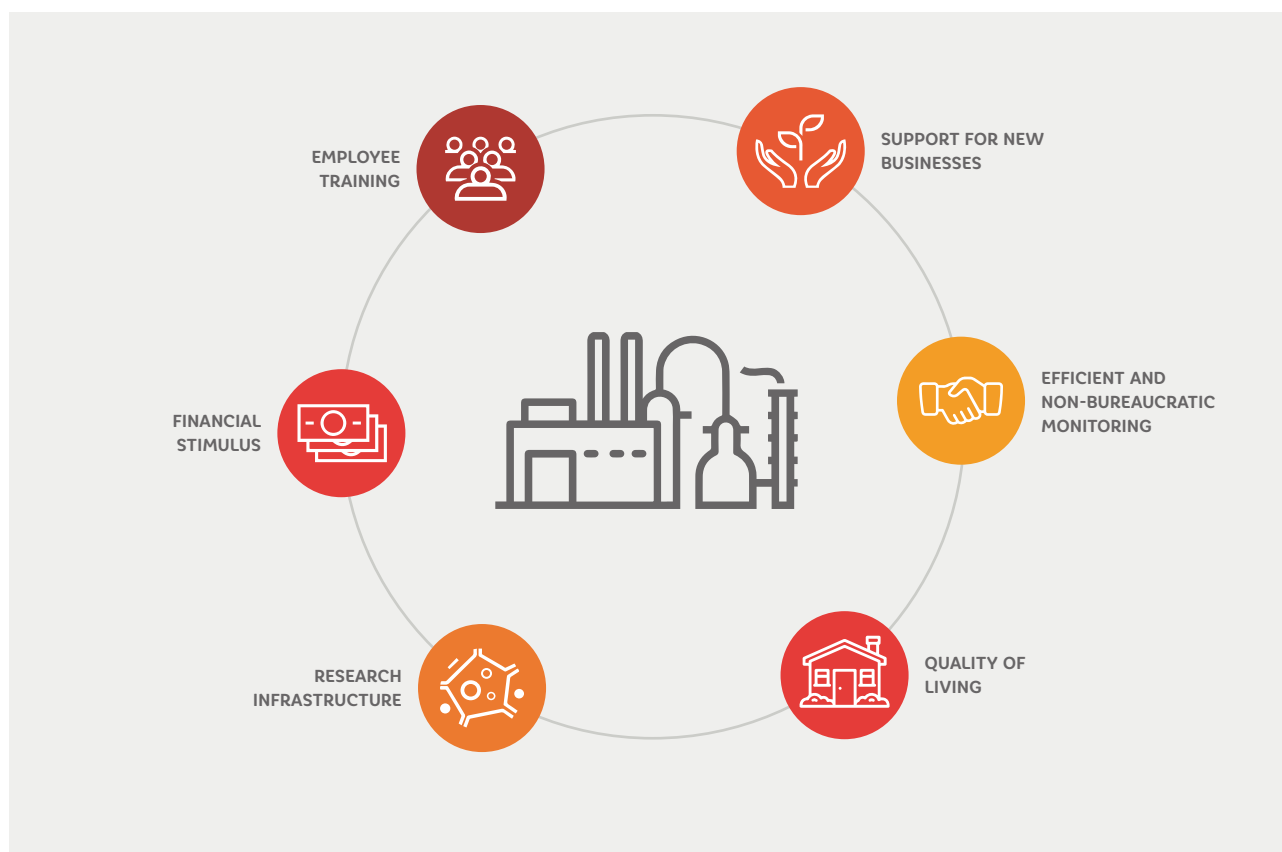
In order to attract manufacturing enterprises, countries and municipalities not only invest in physical infrastructure, but also provide an effective support system, offering various public benefits and forming an open collaboration platform for companies, local residents as well as state and municipal structures.

The various support system elements can be divided into six relative groups (Infographic 3.3). The quality of life

and support for new businesses affect manufacturers indirectly, expanding the possibilities of finding the necessary workers and potential business partners. Other measures are aimed at reducing the manufacturing enterprise's costs or increasing its productivity. Employee training, as well as efficient and non-bureaucratic monitoring are tasks that can also be resolved with limited finances.

Manufacturing enterprise support system

Infographic 3.3



Attracting foreign investors and local producers is one area in which the ability to respond quickly and flexibly to partners' needs is particularly important. In order to ensure this, a rapid response fund should be set up, simultaneously combining the required authority, expertise and funding to resolve problems faced by manufacturers. This fund would, for example, train employees according to a companies specific requirements.

The majority of employees working for manufacturing enterprises need a professional education. This is the responsibility of the Ministry of Education and Science. By 2020 Latvia plans to increase the appeal of professional education and improve and expand collaboration with employers, involving them in the reform of the content of professional education and in the implementation of training, using an approach based on qualification practice and internships. In the spring of 2015, the Latvian parliament approved amendments to the Professional Education Law, which provide for the formation of councils comprised of industry experts. Their operation will be coordinated by the Confederation of Employers and will be comprised of representatives of employers, industry experts, employees, trade unions, the State and municipalities. Industry experts' councils will be responsible for formulating the respective industry's requirements (the required professions, specialisations and number of people to be trained), planning professional education programmes, as well as licensing and accreditation of professional education institutions and programmes.<sup>6</sup> Since 2010 the Ministry

of Education and Science has been optimising of professional education institutions, reducing their number and investing in the remaining bodies more intensively. Fifteen professional education competence centres have been established and are functioning.

Government policy is aimed at increasing the involvement of employers and the formation of a professional education system that allows them to find employees with the required qualifications in the labour market. However, several recent studies indicate that Latvian companies are not sufficiently active when it comes to implementing training in the workplace. Moreover, relatively few companies offer or plan to offer internships.<sup>7</sup> In 2015, only one third of Latvian companies were prepared to offer internships and the proportion of such enterprises is actually declining. Some of the enterprises that offer internships do so in order to obtain cheap labour and do not invest in training.<sup>8</sup> Thus while major reforms of the professional education system have been initiated, the system is not yet functioning effectively enough to provide employers with the employees they require.

Thus it is not certain that companies entering industrial zones will be able to find the employees they require without the involvement of proactive public players. Funding must be provided and a set of procedures should be drawn up to make it possible in a relatively short space of time – from the time of the decision to set up the production plant until the time it enters service – to train the employees a company requires.

<sup>6</sup> Professional Education Law, "Latvian Vēstnesis" [The Official Gazette of the Government of Latvia], 213/215 (1637/1675) (10 June 1999).

<sup>7</sup> AC Konsultācijas. 2015. "On the motivation of employers to engage in the introduction of work environment-based training". Integrated Report", Riga: LR Ministry of Economics.

<sup>8</sup> Employers' Confederation of Latvia (ECL). (2015). *A study of the availability and quality of internships in Latvia. Concluding report*. Riga: ECL.

### 3.3. External financing: EU funds

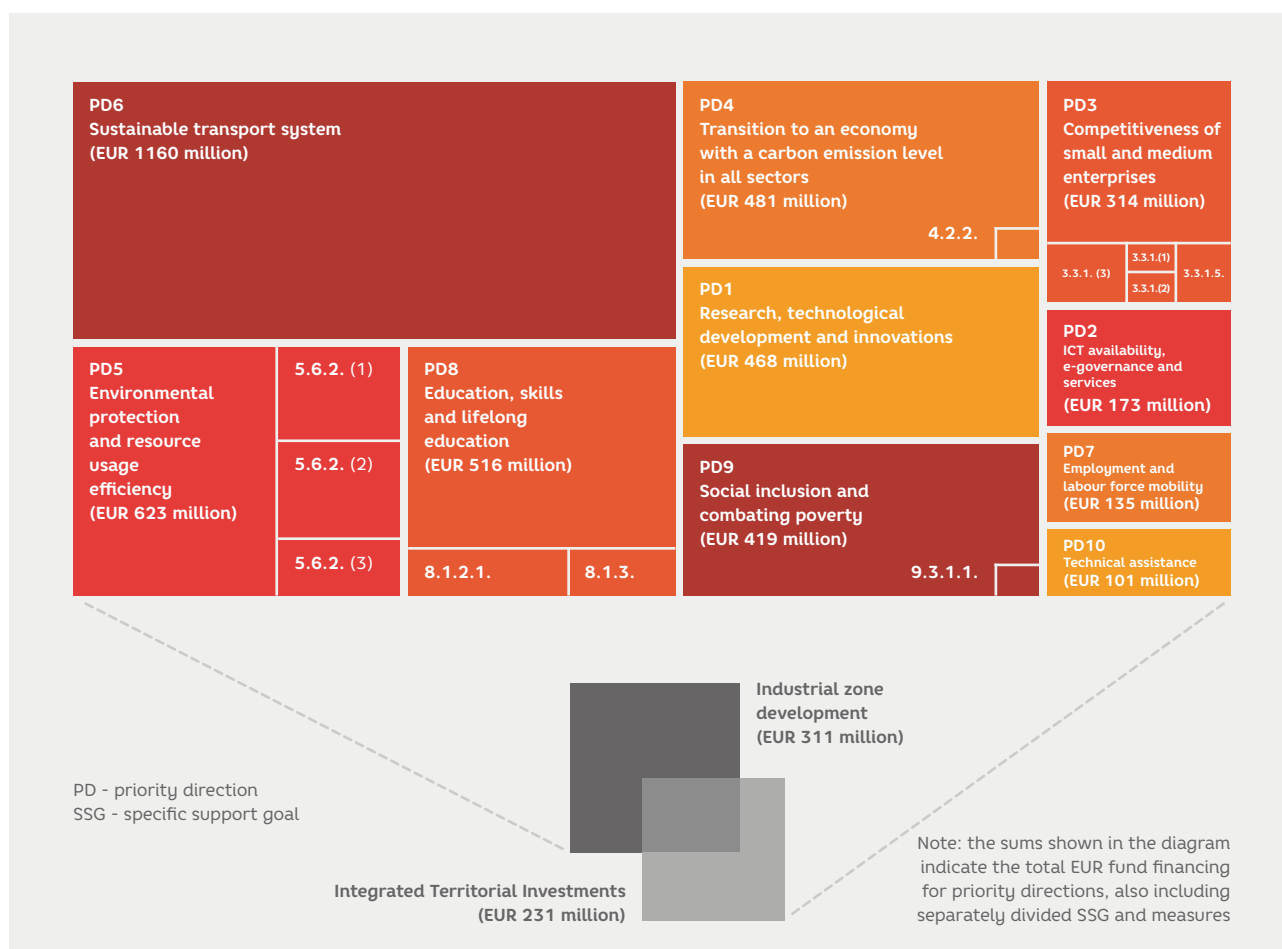
Regional development issues are an important issue at all levels of policy planning. The development of industrial zones conforms to current regional policy and funding availability from EU funds.

The EU fund investment action programme stipulates nine priority directions (PD) for investment, subordinate to each of which are several investment priorities

with corresponding specific support goals (SSG) (Figure 3.4). Regional development and industrial zones are not divided into a separate priority direction for investment, but some investments are provided for certain administrative and functional territories, in addition to which, at the national level measures for individual territories have been highlighted as priorities, using project selection criteria.<sup>9</sup>

EU fund investment breakdown by priority directions for investments<sup>10</sup>

Figure 3.4



<sup>9</sup> LR Ministry of Finance. 2014. *Action programme "Growth and Employment"*. Riga: LR Ministry of Finance and LR Ministry of Finance. 2015. *Supplement to the action programme "Growth and Employment"*. Riga: LR Ministry of Finance.

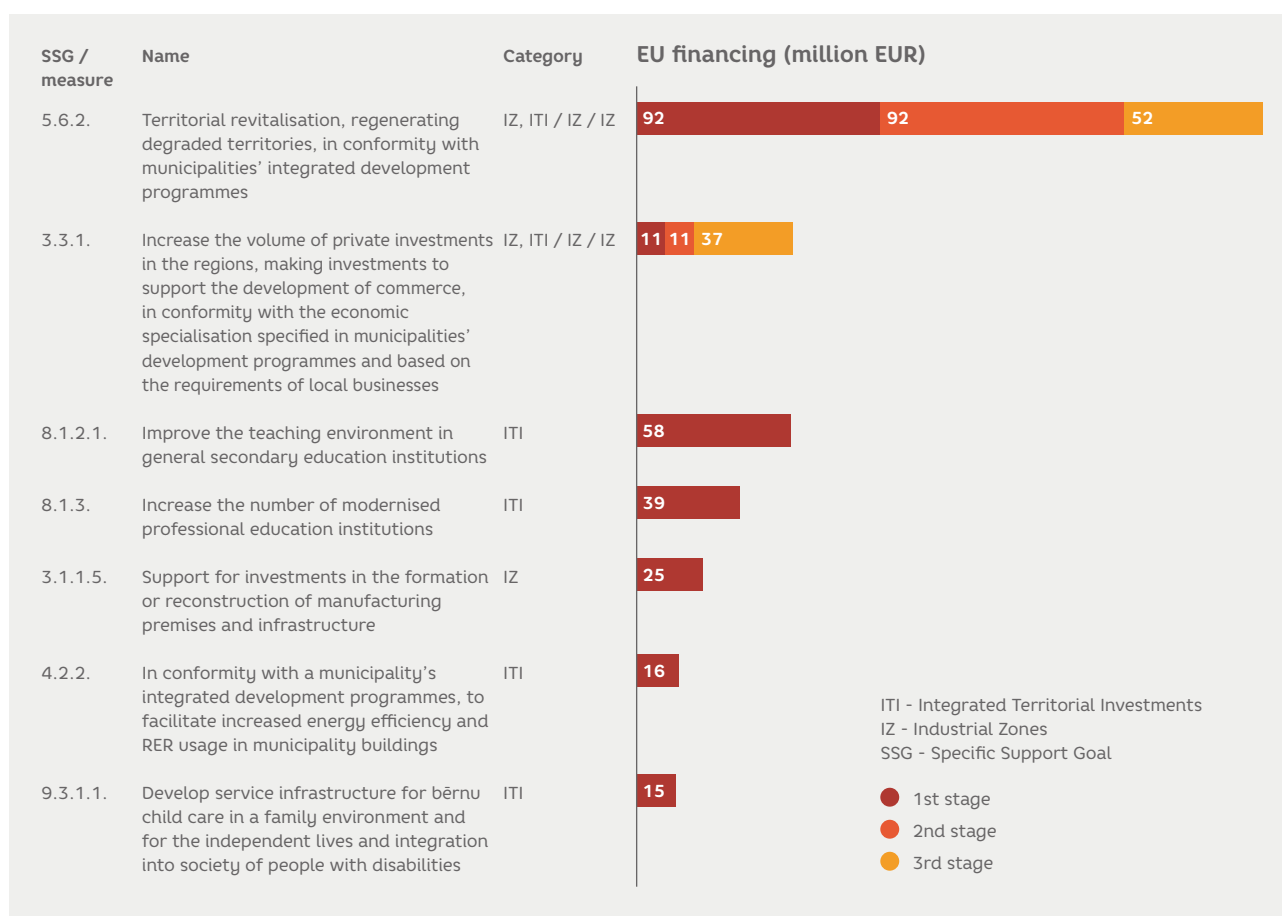
<sup>10</sup> LR Ministry of Finance. 2015.

Accordingly, investments, which could be potentially allocated for the development of industrial zones, will have various preconditions (i.e. the territories, candidates, eligible costs and terms will vary) and will be managed by various government bodies, and, in securing them, recipients will have to consider not only the development of industrial zones, but also various target indicators more or less unrelated to industrial zones. For the development of industrial zones in particular, it will be possible to attract funds from measures that will be organised under three different measures.

The Ministry of Environmental Protection and Regional Development plans to invest funds in the revitalisation of degraded territories and in the development of commerce. The recipients of these investments will be municipalities. The Ministry of Economics plans to facilitate the development of small and medium-sized enterprises (SMEs) by supporting investments in manufacturing premises and infrastructure. The target group is enterprises. Total EU funding of EUR 311 million will be available under these measures (Figure 3.4 and Figure 3.5).

Financing provided for industrial zones and Integrated Territorial Investments<sup>11</sup>

Figure 3.5



<sup>11</sup> LR Ministry of Finance.

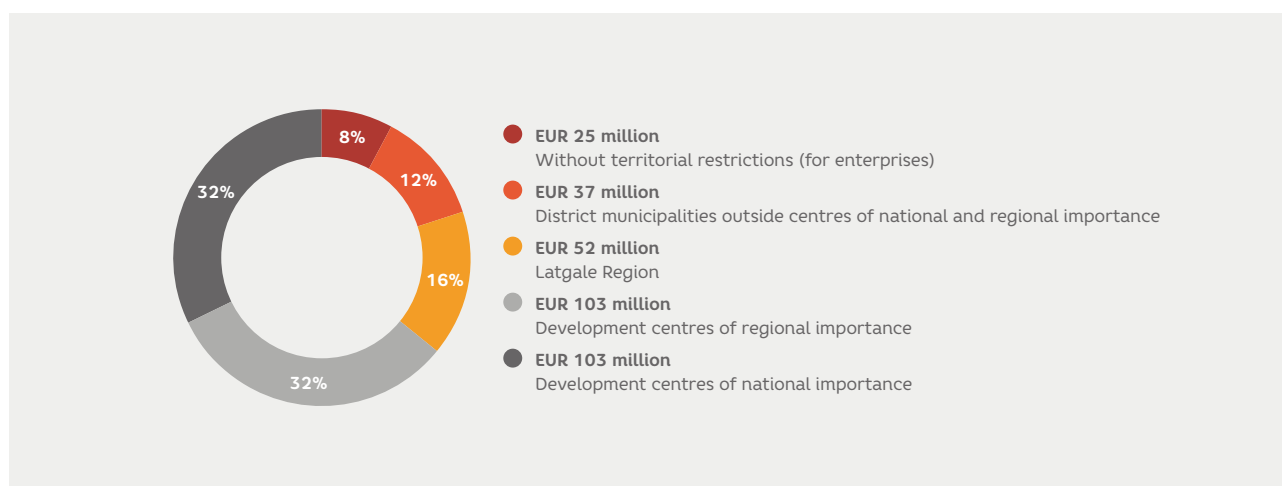


At least one third of the EU funding directly available for the development of industrial zones will be invested in development centres of national and regional significance (EUR 103 million) in each group of municipalities. At least 12% of EUR 37 million (see

Figure 3.6) should be allocated to territories outside development centres of national and regional significance. Moreover, investments in each group of municipalities will most likely be proportionally divided up between the relevant municipalities.

**Regional division of EU funded investments directly secured for industrial zones (million EUR; %)<sup>12</sup>**

Figure 3.6



The action programme envisages investment in developing centres of national significance, using Integrated Territorial Investments (ITI), combining investments from various measures within certain territories. In addition to both measures overseen by the Ministry of Environmental Protection and Regional Development, the financing of which can be allocated to the development of industrial zones, the ITI approach can also be used for investments in secondary education, professional education, increasing energy efficiency and in the deinstitutionalisation of children and people with disabilities – with the help

of ITIs, investing a total of EUR 231 million (see Figure 3.5 and Figure 3.6). ITIs will be made in accordance with the integrated development programmes for development centres of national significance, with the managing institution concluding a delegation agreement with municipalities and municipalities themselves selecting projects. To a certain extent, ITIs point to additional investments that can be most easily attained, which could be used to ensure the efficient operation of industrial zones, but investments can also be combined using financing available under other measures.

<sup>12</sup> LR Ministry of Finance. 2015.

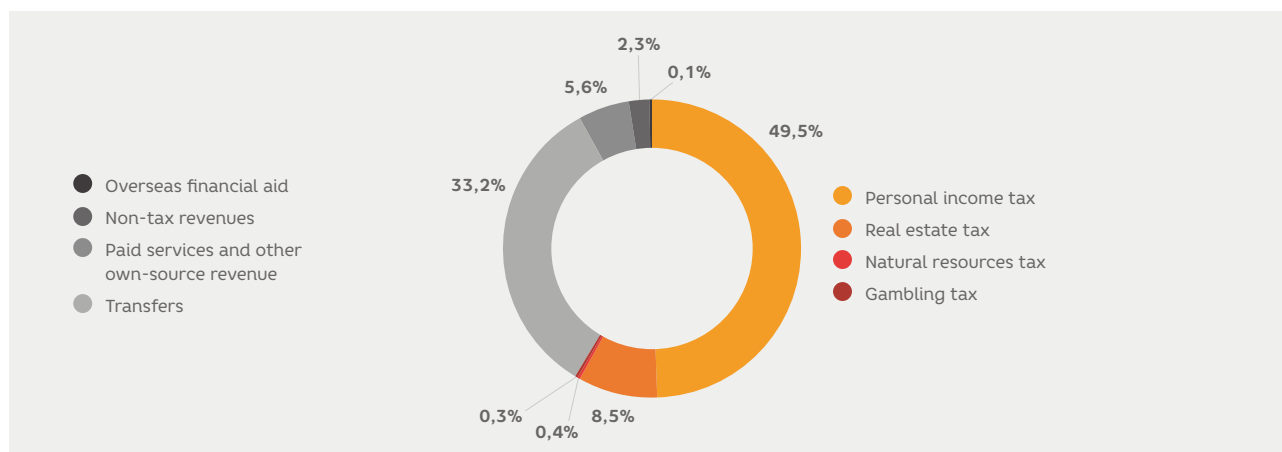
## 3.4. Local sources of financing: personal income tax

The most important source of income for municipalities is personal income tax (Figure 3.7). In compiling the state budget, planned personal income tax payments are divided between municipality and state budgets (for the past four years, the proportion has been 80%:20%), and the share allocated to municipalities is deposited into the budget of the municipality in which the taxpayer has declared his place of residence.<sup>13</sup> Accordingly, municipalities benefit if inhabitants with high incomes declare their place of residence within their territory. In contrast, companies only have an indirect influence on the income of municipalities – via the

employees of the company. However, once again here it is the employee's declared place of residence that counts and not their place of work. The choice in favour of taxpayers' place of residence as the criterion for division would not be so important if the majority of inhabitants lived and worked in the same municipality. Unfortunately, Latvia's territorial structure is extremely fragmented, and data regarding personal income tax payment flows indicates that the majority of development centres of national importance provide jobs for inhabitants from surrounding municipalities.<sup>14</sup>

Breakdown of municipality income in 2014 (%)<sup>15</sup>

Figure 3.7



The autonomous functions of municipalities incorporate the provision of services that are oriented towards both inhabitants and enterprises, including

providing support for commercial operations in general.<sup>16</sup> However, financing available for the performance of these functions is always limited, and

<sup>13</sup> LR Law "On Personal Income Tax", "Latvijas Vēstnesis" [The Official Gazette of the Government of Latvia], 32. 1 June 1993.

<sup>14</sup> Excolo Latvia. 2013. "Determination and analysis of the area of influence of development centres. Description of the development of planning regions, cities of the republic and district municipalities". Concluding report of the study. Riga: SRDA.

<sup>15</sup> The Treasury. 2015.

<sup>16</sup> LR Law "On Local Governments", "Latvijas Vēstnesis" [The Official Gazette of the Government of Latvia], 61 (192). 24 May 1994.

under the current system, in order to provide funds to implement this task, municipalities must firstly consider how to attract residents, meaning that the interests of enterprises are of secondary importance. This situation is not optimal.

As far as municipalities and their residents are concerned, collaboration with enterprises that will increase a territory's economic activity in the long-

term and provide new jobs could take precedence over the short-term interests of individual residents. Therefore, there should be stimuli allowing municipalities to utilise collaboration opportunities without forfeiting available funding. One means of achieving this would be to divide personal income tax payments between municipalities not only on the basis of taxpayers' declared residency, but also on declared workplace.

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## Recommendations

### Recommendation 1

#### INDUSTRIAL ZONES

Industrial zones will ensure sustainable regional development by attracting overseas investments and creating new jobs. The eventual number, location and costs of such industrial zones will depend on the quality of the infrastructure in regional centres. However, in all probability, the number of possible industrial zones will be quite small. For example, based on EU funds totalling EUR 311 million that will eventually be available for the development of industrial zones, it would be possible to establish 5-6 industrial zones that incorporate construction of the required infrastructure, i.e. access roads, water and sewerage systems, energy systems, telecommunications, as well as 10 production facilities including office premises. EU funds would also provide for the development of 6-7 industrial zones, where the basic infrastructure is already in place with the exception of production plants and office premises, which would still need to be built.

### Recommendation 2

#### ESTABLISH A RAPID RESPONSE FUND

A rapid response fund should be established in order to be able to respond quickly and flexibly to the requirements of potential foreign investors and enterprises interested in developing manufacturing facilities. It should possess the required authority, expertise and funding to resolve the problems facing manufacturers. This fund could, for example, be used to train employees. The fund should involve several state, municipal and non-governmental bodies, meaning that they would have to mutually collaborate and, moreover, do so within a limited timeframe. In order to ensure that the process progresses smoothly, one of the parties involved – preferably that which is the direct collaboration partner of the potential manufacturer – should manage the process. The objective of the process would be to provide interested enterprises with employees, while the solutions could vary in specific instances. Firstly, it should be verified whether it is possible to train employees in Latvia's professional education system, i.e. by recruiting those already studying at the given moment or alternatively by attracting new students.

The age of some of these trainees could differ from the average age of the young people acquiring a professional education. Therefore, the recruiting process should not be subject to any formal or informal age restrictions. It is possible that changes to professional education programmes will be required in order to satisfy the needs of investors. The system should be such that these changes can be implemented quite quickly and so that, parallel to this, the training of the next set of employees can begin. Regional high schools, as well as professional education institutions, could also be involved in the training process.

A mechanism enabling collaboration of education institutions at various levels needs to be established. Secondly, mastery of some of the required skills and proficiencies will often only be possible courtesy of job training provided by enterprises offering internships. Thus, if necessary, it must be possible for students to undertake internships with *parent enterprises* outside Latvia. Thirdly, parallel to the training process, consideration must also be given to opportunities to find employees not only in the domestic, but particularly in the EU job market, by focusing on the Latvian diaspora overseas and utilising re-emigration support measures. Finally, one should remember that public players engage in the provision of education services in the interests of society. Therefore, steps should firstly be taken to ensure that skills obtained as a result of state-funded job training can also be used in working for other enterprises in the industry. Secondly, in the event that trained employees choose to leave the Latvian job market in the long-run, a mechanism should be established so that the state can recover its investment.

#### Recommendation **3**

##### **LINK INCOME TAX TO THE WORKPLACE**

In order to increase the incentive of

municipalities to collaborate with business and thus facilitate the development of commerce in their territories, we propose that a portion of personal income tax payments should be allocated to those municipalities in which taxpayers' workplaces are located. The portion of payments to be allocated could initially be small, but could subsequently increase. It is vital to create the system so as to minimise the administrative costs arising from these changes and so that the benefits from collaboration between municipalities and enterprises exceed the resultant costs. Disclosure of the workplaces where employees work could be voluntary. Thus, municipalities would have incentives to provide enterprises already operating in their territory, as well as potential newcomers, with services whose quality could induce these businesses to disclose their employees. However, the choice of whether or not to disclose the relevant information should be left to the enterprises concerned. These enterprises would then be in a position to assess whether the benefits from improvements in the quality of municipal services justify the additional administrative costs involved in disclosing their employees. Workplace declarations would only be possible in places where an enterprise has registered property, a representative office or branch. It would be also prudent to be set a minimum term during which an employee has to work at the specific company (e.g. one month) to preclude the possibility of a declaration being made for short-term employment relationships. Finally, a control mechanism, introduced to dissuade companies from declaring fictional employees, could partially be made accessible to inhabitants who, via a uniform electronic system (e.g. the website *latvija.lv*), would have access to information about where their employer has declared their workplace. In addition, this mechanism would provide the opportunity to dispute or change this information.





## 4. ACCESS TO FINANCE

Andrejs Jakobsons & William Schaub  
Ramona Rupeika-Apoga & Irina Solovjova

Every economy has three potential sources of growth:

- An increase in the size of the labour force and/or more advanced job skills;
- Investment in more advanced manufacturing equipment;
- Innovation, or the creation of new products, using the existing labour force and manufacturing equipment.

For a number of years, 'innovation' has been the European Union's new "mantra".

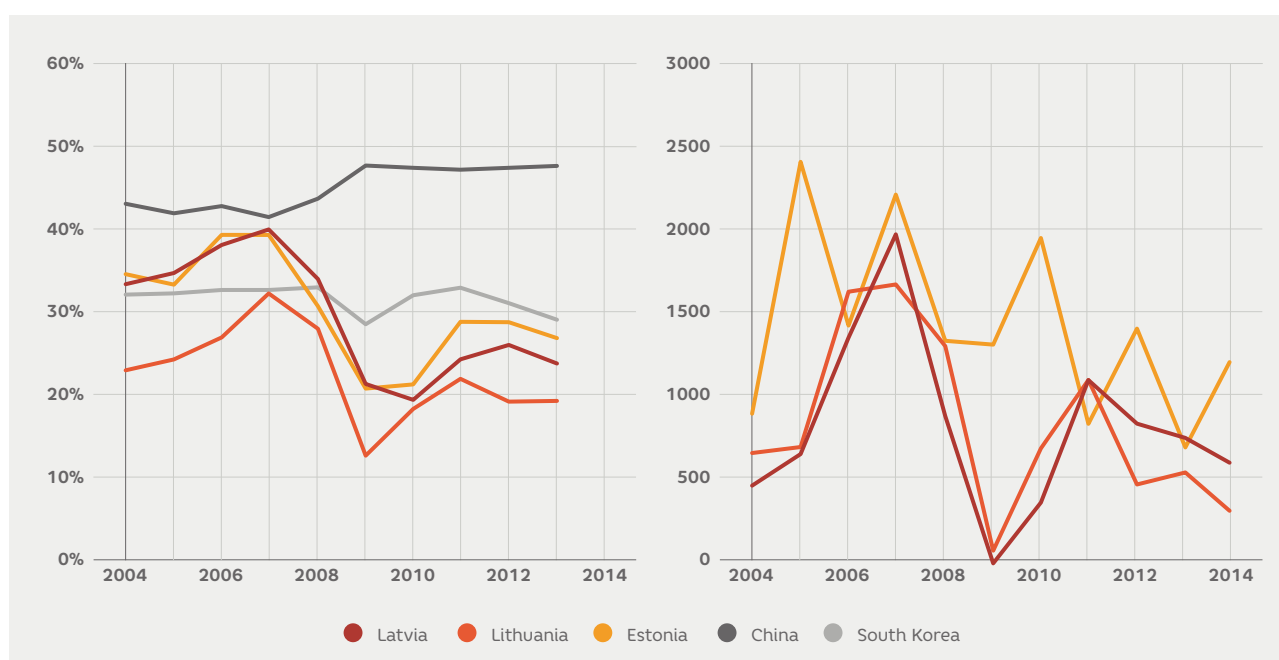
Latvia has fully adopted the idea of setting innovation programmes as the central goal of economic policy, as confirmed by the National Development Plan. As a result, insufficient attention has been paid to other means of encouraging growth, and in particular to one of the conditions most specifically important to Latvia, i.e. capital accumulation.

In the realm of global technology, the majority of Latvia's enterprises are not considered to be direct competitors to American companies or those from other

Gross fixed capital formation (% of GDP) <sup>1</sup>

Direct investments (million EUR)

Figure 4.1



<sup>1</sup> World Bank. 2015. Data bank.



European Union member states. Instead, the challenge facing Latvian industry is to learn to produce products which more developed countries have invented and are already manufacturing, and to move further up the complexity ladder of such products. Investment in physical capital is a significant element of this process.

Investment in Latvia reached a peak in 2007 and then fell sharply to 19% of GDP in 2010, before rising again to 25% of GDP in 2012. However, in 2013 and 2014, there was a significant reduction in the volume of investment. For the last three years, the volume of foreign direct investment has continued to fall.

## 4.1. Lending to enterprises

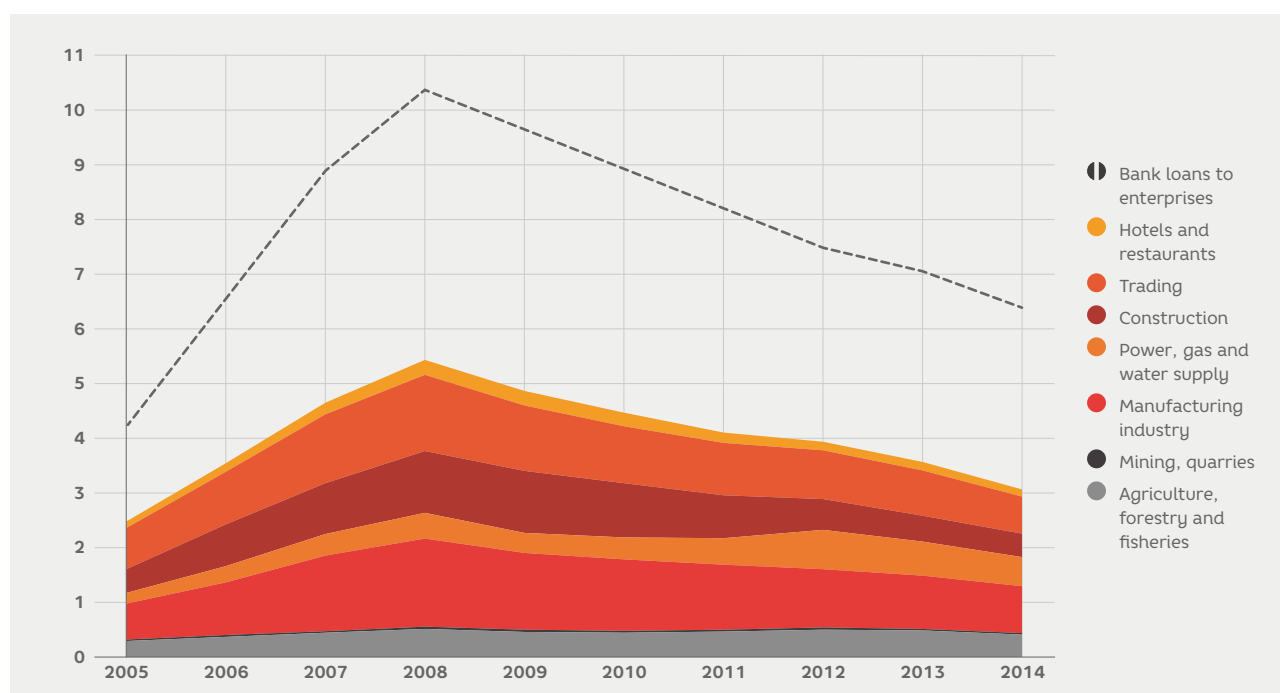
Overall trends, judged from the perspective of the banking system, show that, since 2008, there has been a significant reduction in the volume of loans issued (from EUR 21 billion at the end of 2008 to EUR 12.5 billion in 2015). When it comes to the issue of loans to businesses, the trends are similar. During the past six years, the total volume of loans issued has gradually declined, which

has a knock-on affect on the volume of investments.

In Figure 4.2, information is collated about the total volume of investments in Latvia, as well as the balances of bank loans issued to businesses. In the majority of the sectors reviewed, there has been a reduction in the volume of issued loans. The only exceptions to this trend worth

**Balance of loans issued by banks in individual sectors of the economy 2005-2014 (billion EUR)<sup>2</sup>**

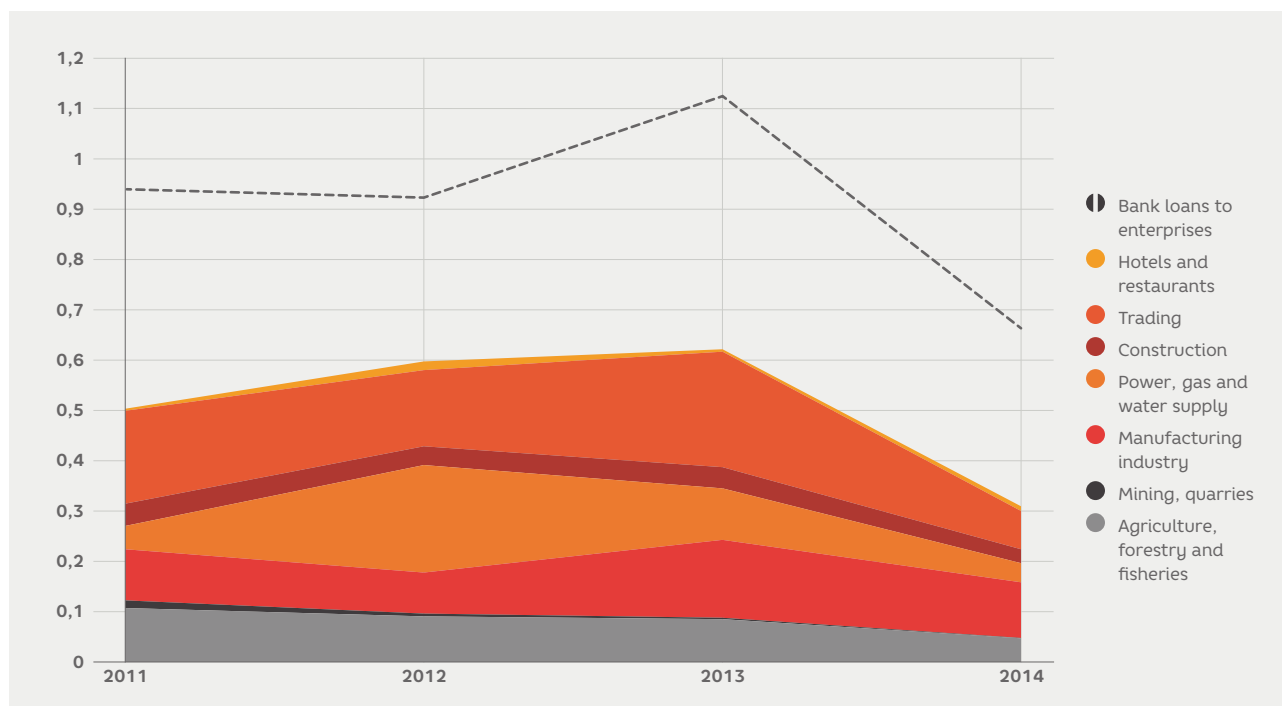
Figure 4.2



<sup>2</sup> CSB 2015, FCMC 2015. No data included about the real estate sector, because the decline in its volumes and trends after end of the lending boom would preclude adequate assessment of lending volumes and trends in other sectors.

**Newly issued loans to enterprises and investments, breakdown by sector 2011-2014 (million EUR)<sup>2</sup>**

Figure 4.3



mentioning are the power, gas and water supply sectors, in which the balance of issued loans has actually increased, compared with the corresponding level in 2007-2008, as well as the agriculture, forestry and fisheries sectors, where the volume of lending has remained quite stable during the past decade. With the exception of these sectors, we are left to

conclude that lending trends are quite unfavourable.

The situation is contradictory. Banks have the financial resources, interest rates are at an all-time low, but banks' loan portfolios are contracting. Do enterprises not want to invest or do banks not want to lend?

## 4.2. Lending in Latvia

This study uses three instruments to study bank lending in Latvia. First, an exclusive data-set developed by Vjačeslavs Dombrovskis and colleagues at the Stockholm School of Economics in Riga's TeliaSonera Institute between 2008-2011. This survey of innovative business in Latvia (SIBiL) tracks the

development of over 1,200 small and medium-sized enterprises in the (SME) manufacturing sector from 2008 to 2015. Secondly, in-depth interviews with board members of Latvia's four biggest banks. Thirdly, case-study analysis of the experience of the timber industry.

<sup>2</sup> CSB 2015, FCMC 2015. No data is included about the real estate sector, because the decline in its volumes and trends after end of the lending boom would preclude adequate assessment of lending volumes and trends in other sectors.

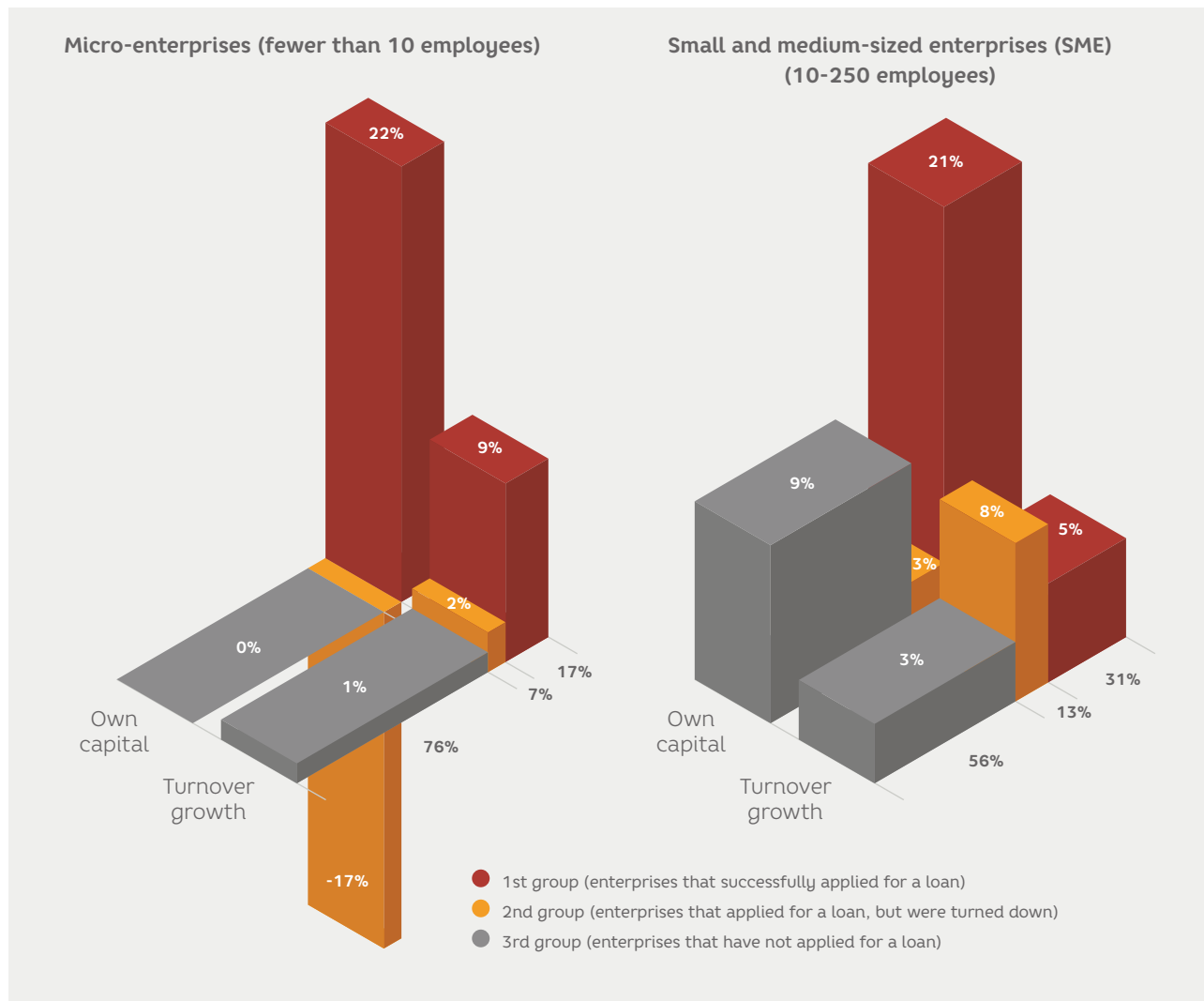
## SIBiL data

In order to understand the trends observed in Latvia since 2008, we studied enterprises grouped according to size and source of financing. The enterprises were

divided into two categories according to the number of employees and into three categories according to their loan application/receipt status.

Own capital dynamics and turnover growth 2009-2014 (annual average)

Figure 4.4





## Conclusions

- Most micro-enterprises (63%) and SMEs (49%) do not apply for loans and are not interested in receiving bank loans<sup>3</sup>;
- The majority of enterprises (65% of micro-enterprises and 70% of SMEs) that applied for loans, did so successfully;
- Enterprises that had available credit rapidly increased their own capital;
- Enterprises that had available credit grew faster than enterprises that did not. From 2009 to 2014, the turnover of micro-enterprises grew by an average of 9% annually, while the turnover of SMEs rose by an average of 5% annually. By way of comparison – enterprises, which showed no interest in bank loans, reported a much smaller increase in turnover: in the case of micro-enterprises, only 1% annually, and in the case of SMEs, 3% annually.

## Interviews with Latvia's banks

During discussions with bank representatives, a range of broader problems which banks and businesses encounter were identified:

- Banks experience low demand for lending, largely because enterprises do not have sufficient capital to qualify for loans. Problems usually arise when an enterprise whose financial indicators have stabilised after the crisis, does not qualify for a loan, because the risk level is still negatively impacted by the drop in indicators during the crisis;
- Decisions regarding corporate loans are highly centralised and the assessment is made based on the financial data submitted and the company's history. At least in relation to SMEs, the situation is rarely assessed *on site*, particularly in the regions. If an enterprise's real situation differs from that depicted in official reports; e.g. if an enterprise avoids paying tax, this is not taken into account;
- At the same time, competition between banks for the business of Latvia's 100 biggest companies is very high, which means that companies in this group enjoy easy and advantageous access to financial resources, compared with SMEs and micro-enterprises. *The example of Latvijas Finieris*, one of Latvia's biggest and most successful enterprises illustrates this situation (see Case 4.1);
- Banks believe that their role in issuing loans to start commercial operations is quite small, because of problems in assessing risk and potential return on investment, therefore other sources of funding will continue to be more important in this segment;
- The large shadow economy that reduces enterprises' legal cash flow, on the basis of which decisions are made about the issue or non-issue of loans;
- Problems related to insolvency proceedings, as well as the slow and complicated review of cases in courts increase lending risks and the real price of credit for enterprises.

<sup>3</sup> Moreover, when companies were asked whether they had recently experienced a situation in which they required credit, but they did not apply for one, because they were concerned that the bank would reject their application, only 12% of SMEs, which did not apply for a loan, replied in the affirmative. The most affirmative answers to this question were made by micro-enterprises (17%). Bearing in mind the aforementioned factors, one can contend that 49% of all SIBIL SME respondents and 63% of the micro-enterprises surveyed were not interested in bank loans.

**LATVIJAS FINIERIS**

Jānis Ozoliņš

Latvia's *Finieris* is Latvia's leading wood manufacturing holding company, which mainly specialises in manufacturing plywood. It employs 2,400 employees or approximately 8% of all those employed in the timber industry. *Latvijas Finieris'* consolidated turnover in 2012 reached EUR 194 million and has increased by approximately 5% since 2013. Its turnover has increased by 40% since 2005, proving that *Latvijas Finieris'* financial indicators are excellent and that it enjoys stable long-term growth. These financial indicators unquestionably make *Latvijas Finieris* an attractive client for banks.

From 2005 to 2014, the value *Latvijas Finieris'* fixed assets on its balance sheet rose 2.3 times, reaching EUR 181 million. The company used its own financial resources to establish its fixed assets.

Between 2006 and 2008, it rapidly increased the balance sheet value of its fixed assets (2.4 times), a process financed with bank loans (the value of its borrowings from credit institutions increased 7.3 times, exceeding EUR 90 million). The main financier of these

long-term investments is *DNB Banka*, but individual loans were also taken out with *Swedbank* and *SEB Banka*. Since 2009, the maximum loan sum received from credit institutions on an annual basis has been reduced to an average 14%, as the company rapidly reduced its debt obligations.

According to the management statement in its 2014 financial report, the company's set priorities are to increase the volume of plywood manufacturing, as well as to increase the value of products and labour efficiency. To attain these objectives, *Latvijas Finieris* plans to invest EUR 280 million by 2020.

In order for *Latvijas Finieris* to implement its plans, it requires bank loans, but even in the case of *Latvijas Finieris*, banks are reluctant to fixed term loans for a period exceeding three years. In turn, the banks say that the main reason for this is the problem of *long money*. Banks' main source of financing is deposits with short repayment terms, which are subsequently used to fund enterprises. A small portion of *long money* is used by banks to finance mortgage loans.

## Norvik Banka

Anna Feldmane

One of the main reasons why banks have become more reluctant to issue loans is undoubtedly related to the impact of bad loans. Insolvency administrators have played a central role in cases involving an inability to repay loans. One of the most salient examples is *Norvik Banka*'s experience of insolvency proceedings, which, in the bank's opinion, allowed *Uzņēmumu Grupa* (SIA WINERGY and its subsidiaries) to execute a swindle that resulted in the bank incurring losses of over EUR 10 million.

The bank issued loans to various corporations for the purchase of wind generators and other purposes. Suspicious activity resulted in the launch of an investigation into the use of the money, as a result of which it was ascertained that the financing was not used for the specified purpose. *Norvik Banka* commenced efforts to recover its money, but encountered a well-planned fraudulent scheme comprised of the following steps:

- *Uzņēmumu Grupa* took out fictitious credit obligations in the amount

of EUR 35 million, before initiating unjustified legal protection and insolvency proceedings, in which decisions regarding *Uzņēmumu Grupa*'s assets were entrusted to its self-appointed insolvency administrator;

- *Uzņēmumu Grupa* provided misleading information, fraudulent bookkeeping entries and signatures;
- The borrower's fixed capital was increased, thus reducing the bank's capital shareholding to 7%;
- New companies were established in the form of SIA *Arsenal* and SIA *Ošmaļi*, to which *Uzņēmumu Grupa*'s most valuable assets and liabilities were transferred, upon the commencement of insolvency proceedings for the newly established enterprises;
- Ignoring the asset freezes imposed on *Uzņēmumu Grupa*, creditors' pledges were registered in relation to the new assets, in order to keep the flow of finances moving.

The problem of the availability of credit mainly exists in relation to financing the investments of small and medium-sized enterprises. The main reasons are: the activities of enterprises related to the shadow economy (which reduces the credibility of financial data), the excessive likelihood of the non-repayment of debt obligations (using insolvency proceedings) and tortuously slow and inefficient recovery of *bad loans* (slow review of cases in court).

There is little likelihood that significant and rapid progress will be made in the area of combating the shadow economy or in the legal realm. Therefore, the focus should be on solutions that can be implemented in practice during the next two years and which will improve the availability of funding for enterprises. We propose three courses of action.

Action **1**

## Use of reinvested profits by SMEs

The use of operating profits for investment can serve to improve the competitiveness of a business, thus enabling it to achieve better long-term results. At present, in Latvia, several corporate income tax incentives are in place that indirectly stimulate an improvement in the enterprise's efficiency, but some of these are primarily geared towards bigger enterprises.

SMEs, and micro-enterprises in particular, have problems with access to financing. Evidently, the most frequently used source of financing is an enterprise's own profits. The state can stimulate investment by not imposing corporate income tax (CIT) on profits reinvested by micro-enterprises and small and medium-sized enterprises.

In Estonia, this system has successfully operated for a decade and a half. The 2000 law is easy to understand and administer. Reinvested profits are subject to a 0% corporate income tax rate. After the introduction of the 0% rate, there has been a rapid increase in the amount of corporate income tax collected – rising from 0.72% of GDP in 2001 to 1.78% of GDP 2004.<sup>4</sup> Waiving CIT on profits reinvested by small and medium-sized enterprises will improve access to bank loans, because enterprises will no longer be motivated to manipulate the

declaration of profits, in order to avoid payment of taxes.

In Latvia, this problem is particularly relevant for small enterprises, due to the CIT advance calculation model. Declaration of profits will improve the quality and credibility of reports and thus improve access to bank loans. In Latvia, there is a belief that the current benefits to those enterprises, which invest in fixed assets, are sufficient to stimulate investments. A speeded-up system of writing off manufacturing equipment, using a ratio of 1.5 (this provision in the existing law is due to be in place until 2020), is already in place. However, this system helps those enterprises, which already have access to investment funding. An accelerated depreciation system does not reduce the motivation not to declare profits to avoid paying taxes.

Not taxing reinvested profits with corporate income tax could resolve the problem of limited access to investment financing faced by SMEs. The solution would be to apply this break to small and medium-sized enterprises, concurrently retaining the available corporate income tax breaks for larger investments. This approach would be *fiscally neutral*, even increasing government revenue in the medium term.

Action **2**

## Financing via the stock market

An enterprise can also attract resources via the stock market, e.g. by issuing shares and bonds. By issuing publicly traded shares, the enterprise concurrently undertakes to publish detailed operating

reports, in accordance with the legislation currently in force. To date, there have only been isolated instances of Latvian businesses attracting financing by issuing shares on the stock market.

<sup>4</sup> Eesti Statistics. 2015.

One example worth mentioning is the emission of shares by *SAF Tehnika* in 2004.

An enterprise can also issue publicly traded bonds. Some Latvian enterprises have implemented this procedure successfully. In recent times, the most prominent example is *Latvenergo*, which has attracted funding worth EUR 180 million in this manner. The biggest volume of bonds, worth over EUR 640 million, has been issued by *ABLV Bank*. Bonds have also been issued by other banks such as *Rietumu Bank*, *Baltic International Bank*, as well as enterprises related to the pay-day loan sector. Bond issues are not common practice, because the related costs are quite high.

Attracting financing via the stock market is common practice in the United States and in other countries with developed stock markets. In recent years, steps have been taken in the European Union to encourage more active use of securities. For example, at the end of 2014, the European Central Bank launched a programme, under the auspices of which asset-backed securities are bought with the objective of diversifying sources of bank funds and stimulating the issue of

new securities.<sup>5</sup> This is an opportunity to stimulate the provision of credit to Latvia's small and medium-sized enterprises.

In order to implement this, the so-called securitisation is used. Securitisation can take place in relation to a set credit portfolio, which the lender sells on to a specially established corporation that in turn, issues securities, which it sells to investors.<sup>6</sup> Ordinarily, loans of a homogenous nature are chosen that make it easier to assess risk more accurately. As a result of securitisation, the issuer (emitter) of the securities attracts capital and gains a greater ability to obtain new loans. The credit risk as a result of this activity is passed to investors.

Combining securitisation with securities guaranteed with assets, makes it possible to securitize loans to small and medium-sized enterprises, concurrently also guaranteeing securities with the assets of these enterprises, reducing the risk posed to investors. This approach would make it possible to reduce the interest rates at which credit is available to small and medium-sized enterprises. In turn, securities could be sold to pension funds and other investors.

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### Action 3

## Savings and loan associations

The availability of loans is also hindered by the lack of trust among lenders who believe that borrowers have opportunities not to repay debts, e.g. by means of insolvency proceedings. Moreover, the review of cases in courts is very slow. In recent years, Latvia's commercial banks have tried to optimise their operations in Latvia's regions, centralising decision-making. However, there is a solution that could

ensure greater trust in borrowers among lenders. This is a regional savings and loan association model.

In many countries, savings and loan associations form an alternative network providing payment and financial services, based on the principles of collaboration and providing services that are important to the members of these companies.

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<sup>5</sup> Asset-backed securities purchase programme (ABSPP).

<sup>6</sup> Special purpose vehicle or SPV.



Usually, these have been formed as an alternative to the banking sector, but, over the course of time, in a number of countries they have secured an important place in the country's financial system. For example, in the USA and Canada up to 40-50% of economically active citizens are members of savings and loan associations.<sup>7</sup>

Savings and loan associations have two potential advantages compared with commercial banks:

- 1) It would be much more difficult for borrowers in the regions to *defraud* savings and loan members, who are often their domestic or foreign neighbours;
- 2) When it comes to making a decision about whether or not to issue a loan, a savings and loan association is not only more likely to have a clearer impression of the borrower's financial situation, but will probably also be knowledgeable vis-à-vis the specifics of commercial activity and development in the region in question.

The regulation of savings and loan associations is usually quite flexible, meaning that it is possible to establish them in cities or towns, or even among certain interest groups. For example, exiled Latvians formed several savings and loan associations in the United States and Canada after the Second World War, stimulating the circulation of money within the community.<sup>8</sup>

According to FCMC data, there were 32 saving and loan companies operating in Latvia at the end of the 1st quarter of 2015.<sup>9</sup> Their total volume of assets and issued loans is negligible compared with other market players. The volume of assets held by savings and loan associations in Latvia at the end of the 2nd quarter of 2015 was EUR 24 million, while the volume of issued loans was only EUR 17.2

million. In comparison, in percentage terms, this is less than 0.1% of the total bank assets, which exceeded EUR 30 billion in 2015.

In Estonia and Lithuania, the development paths of savings and loan associations has varied. In Estonia, although there are over 20 savings and loan associations, their total volume of assets is small. In the middle of 2015, it amounted to slightly more than EUR 45 million. In recent years, the growth in the volume of assets has been quite rapid, but the distribution and significance of these associations in Estonia is small when compared with total bank assets (EUR 22 billion in the middle of 2015).

In Lithuania, savings and loan associations have developed significantly faster than in Estonia and Latvia. At the end of the first quarter of 2015, the total assets of Lithuania's savings and loan associations amounted to about EUR 630 million or 2.8% of total bank assets. The network of savings and loan associations has been used to implement a "Business Development" project (an Investment and Guarantee Programme for certain target groups – young people aged up to 29 years of age, older people aged over 50 years of age, people out of work and people with disabilities). This approach could serve as one way in which to encourage the development of savings and loan associations, using the most important advantages of savings and loan associations – closer collaboration with members with a mutual interest in the attainment of joint goals.

Promoting the operation of savings and loan associations in Latvia would make a contribution to regional development, improving access to small loans that other lenders do not supply. The potential advantage of savings and loan associations could also be better knowledge of a borrower, who is simultaneously also a member of this association.

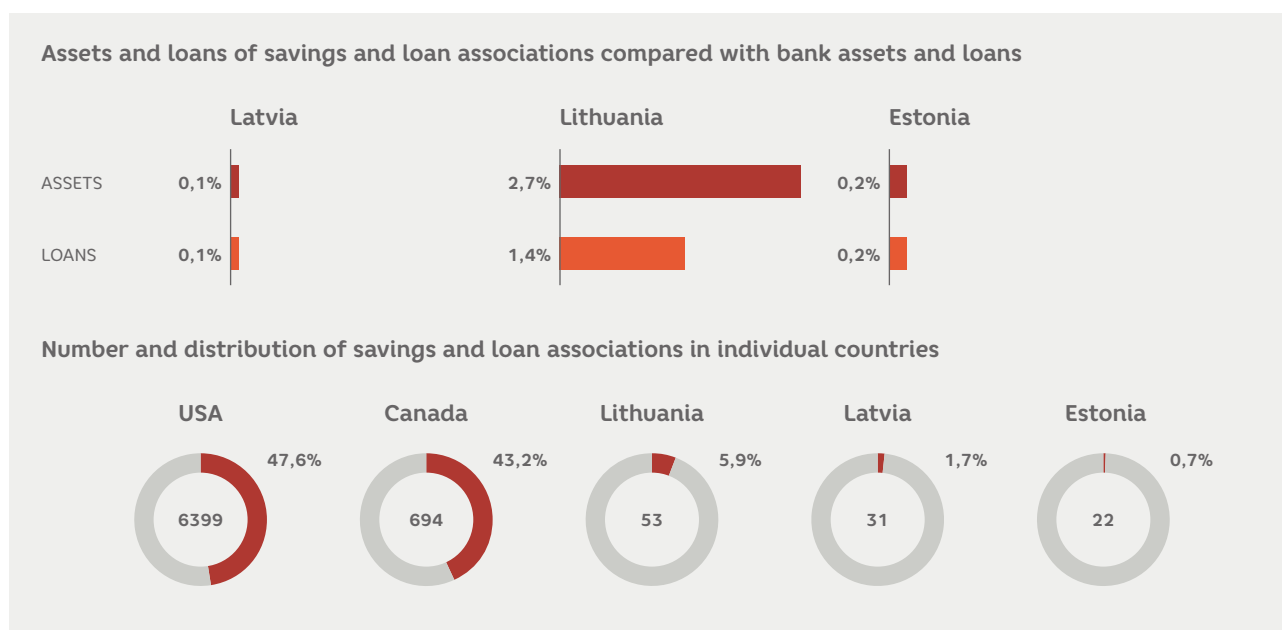
<sup>7</sup> World Council of Credit Unions. 2014. Statistical Report. [www.woccu.org/documents/2014\\_Statistical\\_Report](http://www.woccu.org/documents/2014_Statistical_Report)

<sup>8</sup> E.g. the Latvian Heritage Federal Credit Union (USA). [www.latvianheritage.org/un\\_Latvian\\_Credit\\_Union\\_\(Kanāda\)](http://www.latvianheritage.org/un_Latvian_Credit_Union_(Kanāda)) [www.latviancreditunion.ca](http://www.latviancreditunion.ca)

<sup>9</sup> FKTK. 2015.

About savings and loan associations<sup>10</sup>

Infographic 4.1



## Recommendations

### Recommendation 1

**PROFITS REINVESTED BY SME'S SHOULD NOT BE SUBJECT TO CORPORATE INCOME TAX, RETAINING THE EXISTING ACCELERATED DEPRECIATION MODEL FOR LARGE ENTERPRISES**

### Recommendation 2

**ISSUE OF ASSET-BACKED SECURITIES ON THE BASIS OF SME LOAN PORTFOLIOS:**

- In collaboration with Altum and FCMC, the Ministry of Finance must establish a mechanism for buying loans that meet requirements from credit institutions;
- Using the ECB ABSPP programme, as well as the EIF guarantee programme,

loans must be securitized and sold to the ECB under the auspices of this programme;

- The terms and conditions of financial securities companies must be changed, supporting the securitisation of SME loans so that they can be traded on the stock market or sold to investors.

### Recommendation 3

**FACILITATE THE DEVELOPMENT OF SAVINGS AND LOANS ASSOCIATIONS AND THEIR INVOLVEMENT IN MICRO-LENDING IN LATVIA'S REGIONS, INVOLVING MUNICIPALITIES AND ATTRACTING FINANCING FROM EUROPEAN FUNDS**

<sup>10</sup> Distribution calculated by dividing the number of members of savings and loan associations by the number of economically active citizens aged from 15 to 64 years.



# 5. PHARMACEUTICALS

Uldis Spuriņš

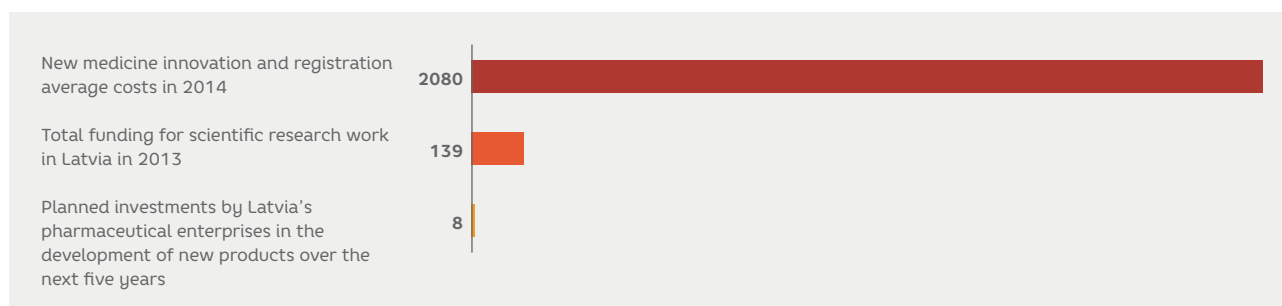
In 2012, the volume of the global pharmaceutical market reached \$965 billion. It is forecast that it could reach \$1200 billion by 2017.<sup>1</sup> However, the pharmaceutical industry is characterised by very high research and development costs. Forecasts by pharmaceutical companies show that the discovery of new medicines and the receipt of registrations needed to authorise manufacturing costs over EUR 2 billion.<sup>2</sup> These expenses make it clear that Latvia is a small player on the global market (Figure 5.1). However, the industry does have the potential to successfully operate in various niche segments of the market.

The direct contribution made by the manufacturing of pharmaceuticals to the added value of the Latvian economy

amounts to approximately 0.5% of GDP or EUR 96 million (2012 data). Similarly to other industries, the pharmaceutical industry also has an indirect impact on added value in related sectors. Calculations show that this is how products and services worth another EUR 60 million are created.<sup>3</sup> In 2013, there were 27 enterprises operating in the industry, which employed just over 2,000 employees. The average industry salary was EUR 1,075, which is 150% of the average salary within the economy. After the 2008-2010 crisis, the sector was characterised by stable growth, although turnover fell in 2013 (Figure 5.2). Provisional data from the State Agency of Medicines (SAM) shows that in 2014 the sales volumes of domestic pharmaceutical manufacturers continued to fall, declining by another 9%.

Cost comparison (million EUR)<sup>4</sup>

Figure 5.1



<sup>1</sup> IMS Institute for Healthcare Informatics. 2013.

*The Global Use of Medicines: Outlook through 2017*. Parsippany, NJ: IMS.

<sup>2</sup> Tufts Center for the Study of Drug Development (CSDD). 2014.

*Cost of developing a new drug*. Boston, Mass.: CSDD.

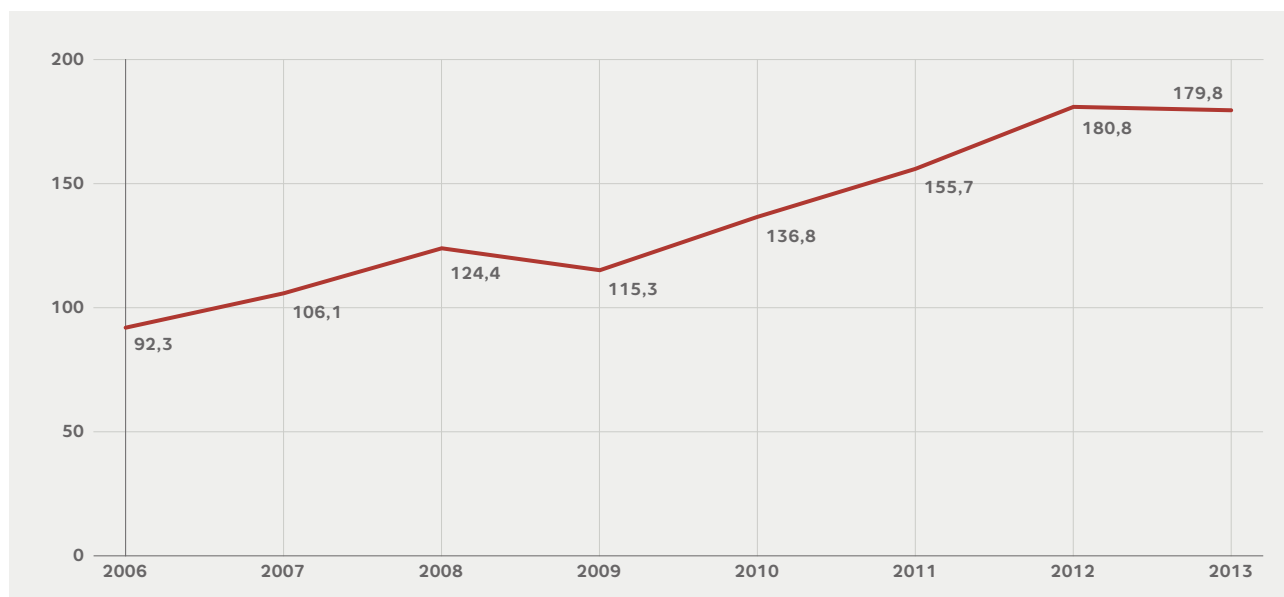
<sup>3</sup> Aprēķiniem izmantoti multiplikatori no PricewaterhouseCoopers (PwC). 2013.

*The pharmaceutical industry's contribution to the Latvian economy*. Riga: PwC.

<sup>4</sup> CSB, CSDD 2014, ALCPI 2015.

Pharmaceutical raw material and medicinal product manufacturers' net turnover (million EUR)<sup>5</sup>

Figure 5.2

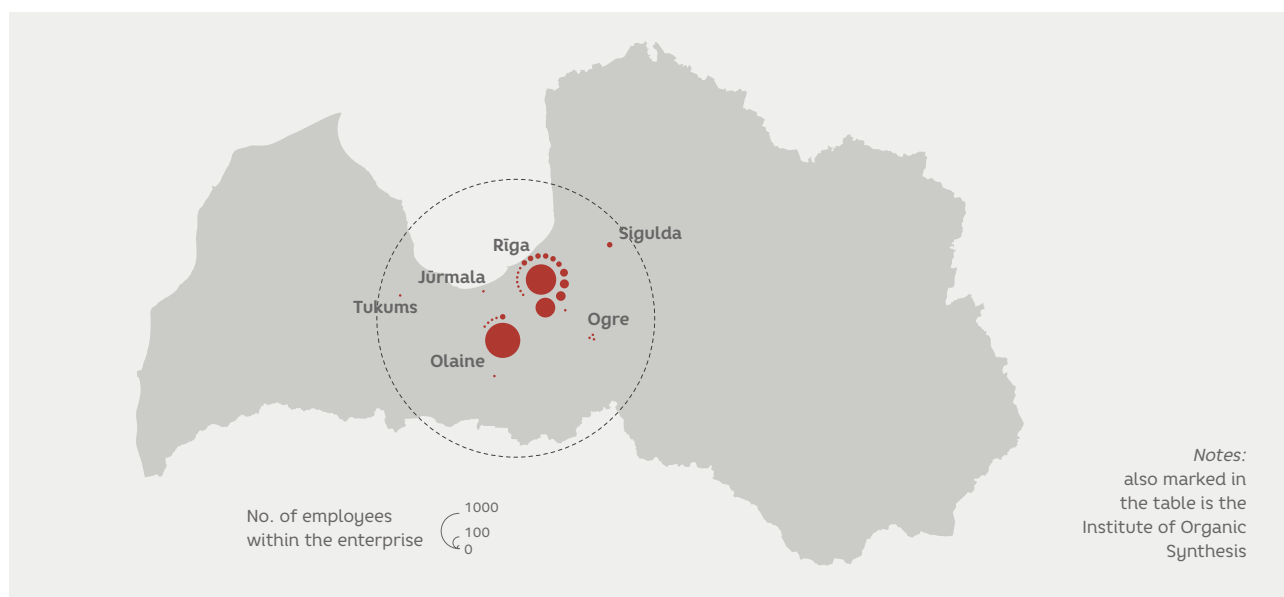


The turnover of the two biggest companies in the industry: *Grindex* and *Olainfarm* make up over 90% of the industry's total turnover. Moreover, *Olainfarm* fully owns the third largest domestic pharmaceutical enterprise

*Silvanols*. The three most important players in the industry are based in Riga (*Grindex* and the Institute of Organic Synthesis (OSI)) and Olaine (*Olainfarm*), and the whole industry is concentrated within the territory of Riga. (Figure 5.3)

Location of Latvia's pharmaceutical enterprises

Figure 5.3



<sup>5</sup> CSP, 2015.



## 5.1. Industry challenges

### Research and new products

The pharmaceutical industry is one of the industries that most heavily invests in research. Research costs have risen sharply over the last half-century. Between 2001 and 2011, the annual research costs of 500 of the world's largest pharmaceutical companies more than doubled, reaching \$131 billion.<sup>6</sup>

Empirical data shows that international collaboration networks are dominated by national clusters. For example, the Danish pharmaceutical company *Novo Nordisk* primarily collaborates with Danish universities and institutes, while the American company *Eli Lilly* mainly works with American researchers. There are individual research institutes, whose operations are genuinely international and which collaborate with most of the major pharmaceutical companies. However, national research

systems are formed around companies, not research institutes.<sup>7</sup>

In recent years, the big pharmaceutical companies have closed many research institutes, reduced investment in the initial phases of research and have ceased clinical field work (recruitment, data collection and so on) instead giving precedence to outsourcing.<sup>8</sup> This trend creates opportunities for Latvia's research institutions (and the internationally renowned OSI in particular). Although, given the significant research costs, it could well be too expensive for these institutions to provide the full process of developing, testing and registering new medicines, they do have the opportunity to become a part of international networks, carrying out specific tasks or using services provided by external service providers.

### Clinical studies

Entrusting the performance of clinical studies to external service providers is another development that has affected the pharmaceutical industry in recent years.<sup>9</sup> Central and Eastern European countries have experienced a boom in the volume of clinical studies. In some countries, (such as the Czech Republic) the volume of studies has almost reached the intensity level of leading countries in the field.<sup>10</sup>

In Latvia, permits to conduct clinical studies are issued by the SAM. Last year, SAM issued permits for 53 clinical studies, while a total

of 267 studies were conducted in Latvia. As Figure 5.4 shows, the number of studies is on the increase. These are mainly financed by foreign pharmaceutical companies and organised by foreign contractual research bodies (Amber CRO, Quintiles, etc.) authorised to conduct the relevant research by the aforementioned companies. The biggest clinical study centres are located at the Stradiņš Clinical University Hospital (where 29 studies were conducted in 2014) and the Riga Eastern Clinical University Hospital (21), while overall clinical studies were conducted by another 75 clinical study centres.

<sup>6</sup> A.T. Kearny. (2013). *Unleashing Pharma from the R&D Value Chain*. Chicago, IL: A.T. Kearny.

<sup>7</sup> Rafols, I., Hopkins, M. M., Hoekman, J., Siepel, J., O'Hare, A., Perianes-Rodriguez, A., & Nightingale, P. (2014). Big Pharma, little science? A bibliometric perspective on Big Pharma's R&D decline. *Technological Forecasting & Social Change*, 81, 22-38.

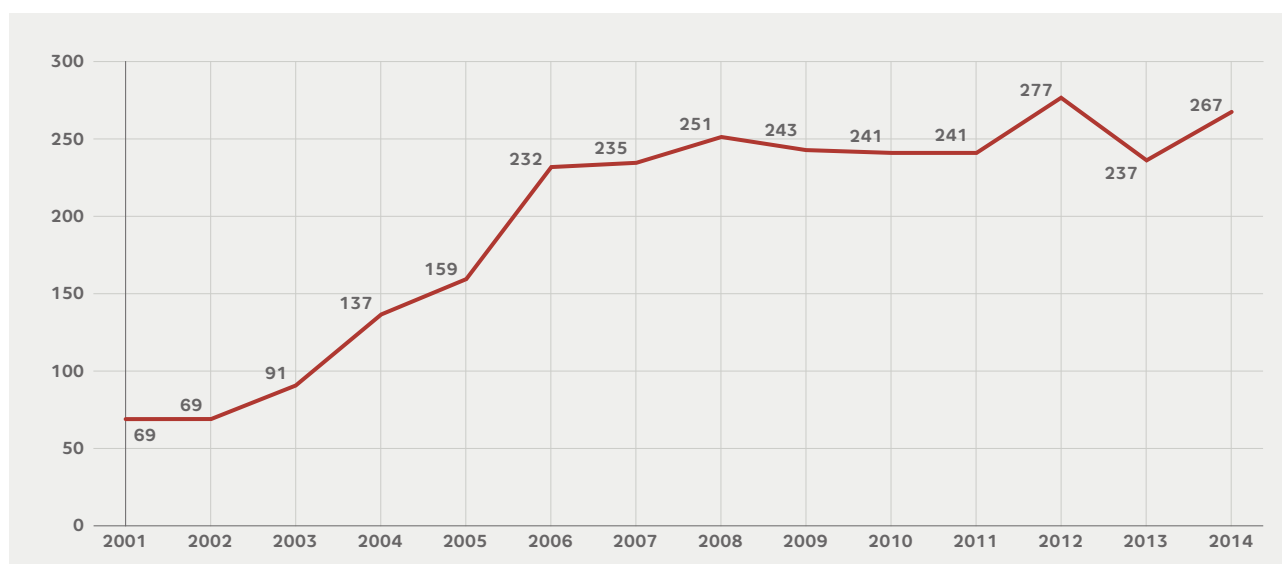
<sup>8</sup> Hirschler, B., & Kelland, K. (2010). *Big Pharma, Small R&D*. London: Reuters.

<sup>9</sup> Petryna, A. (2009). *When Experiments Travel: Clinical Trials and the Global Search for Human Subjects*. Princeton and Oxford: Princeton University Press.

<sup>10</sup> Thiers, F. A., Sinskey, A. J., & Berndt, E. R. (2008). Trends in the globalization of clinical trials. *Nature Reviews. Drug Discovery*, 7(1), 13-14.

Clinical studies in Latvia<sup>11</sup>

Figure 5.4



Overall, the organisation of clinical studies is an important element of the pharmaceutical business. However, it

should be noted that Latvia is involved at the bottom of the industry's supply chain – at the patient and hospital level.

## Manufacturing and generic medicines

The world's leading companies increasingly entrust the production of pharmaceutical products to business partners. External service providers mainly concentrate on the production of active pharmaceutical substances and leasing out certified production plants that meet international standards for the manufacture of other companies' products, but they are also increasingly engaged in activities that increase added value such as manufacturing process development, design creation and the preparation of registration documentation. Manufacturing contractual organisations produce approximately one third of the total volume of products in the pharmaceutical industry.<sup>12</sup>

Entrusting manufacturing to business partners is closely linked to the production of patent-free or generic medicines.

Their manufacturing volumes and total sales grow annually. In 2012, the generic medicine market amounted to 27% of the global market and had a value of \$260 billion. By 2017, it is forecast that the market share of generic medicines will rise to 36% and will already be worth \$432 billion.<sup>13</sup>

The value of the market share of generic medicines will increase, because the patents of a large number of original medicines have already expired or will do so in the next five years. In 2014, the 13 biggest pharmaceutical companies lost their patent rights to pharmaceuticals that generated over one third of these companies' total turnover in 2013. The value of these medicines that can potentially be copied was greater than the whole US generic medicine market in 2013. (Figure 5.5)

<sup>11</sup> State Agency of Medicines.

<sup>12</sup> CEPTON Strategies. 2008. *Strategic outsourcing across the pharmaceuticals value chain*. Munchen: CEPTON.

<sup>13</sup> IMS Institute for Healthcare Informatics. 2013. *The Global Use of Medicines: Outlook through 2017*. Parsippany, NJ: IMS.

Potential of the generic medicine market (billion \$)<sup>14</sup>

Figure 5.5



An important part of the Latvian pharmaceutical business is comprised of the production of generic medicines and active pharmaceutical substances. Changes in the pharmaceutical market open up various opportunities for development. Overall, it appears that specialisation in the development

and manufacturing process increases efficiency. However, specialisation also creates greater or lesser profitability in the overall value generation chain. Latvia's pharmaceutical industry mainly responds to changes as opposed to controlling and choosing which position to occupy on this value generation chain.

## Human resources

One of the most significant obstacles restricting development is the acute shortage of qualified personnel. As a result of the demographic crisis, there are fewer students and it is likely that in future their number will decline even further. In turn, those currently working

in the industry are aging as well as emigrating, in order to benefit from the international circulation of knowledge and to ensure their professional development. Another problem facing the industry is posed by the quality of the education obtained by young professionals.<sup>15</sup>

## Registration of medicines

As an EU member state, registration of medicines takes place under the auspices of the joint system run by the medicinal product agencies of European countries (SAM is the Latvian agency). However, the domestic pharmaceuticals industry is not satisfied with the amount of time that it takes to register medicines which sometimes significantly exceeds the timeframes stipulated in legislation. Another significant problem is the lack of

a good partnership between the industry and the SAM. Manufacturers complain about the lack of support from the SAM and the low quality of its work. SAM, in turn, accuses producers of submitting documentation whose poor quality is such that it sometimes lengthens the registration time. However, everyone within the industry agrees that the SAM can become a serious industry collaboration partner and that raising

<sup>14</sup> Munos, 2015

<sup>15</sup> The Association of the Latvian Chemical and Pharmaceutical Industry (ALCPI). (2015). *The Latvian chemical and pharmaceutical industry's innovative growth strategy*. Rīga: LAKIFA.

the capacity of the SAM could serve to facilitate the development of the whole industry. However, a change in attitudes by SAM is required.

SAM needs to develop a scientific advice service that would incorporate scientific consultations and assistance in the fulfilment of various procedures related to the registration of medicines. SAM could also assist in the development of the design of clinical and bio-equivalence studies for medicines, selections of methods and tests

during the pre-clinical and clinical research process, as well as in the preparation of registration documentation and other matters. However, it is vital to ensure that SAM does not find itself in a conflict of interests, simultaneously drawing up and assessing registration documentation for medicines. It is possible that a scientific advice service could largely be provided as an external facility in collaboration with experts from local higher education institutions.

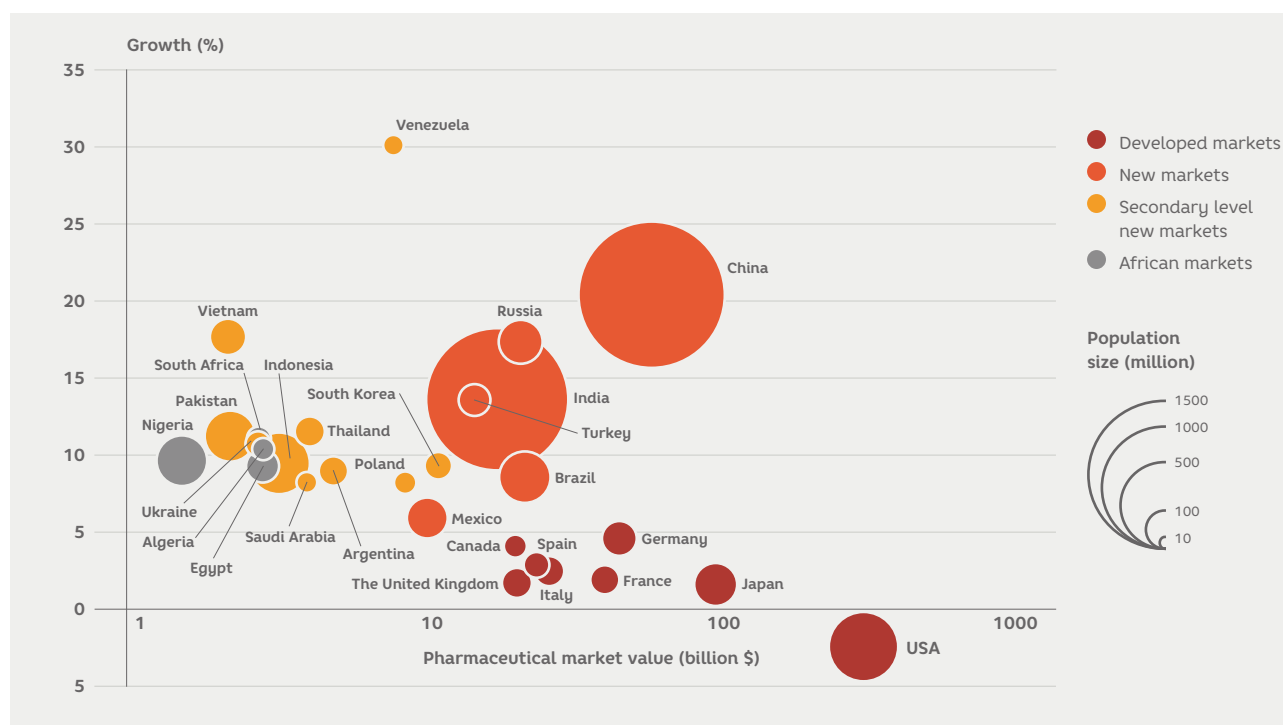
## Market diversification

The biggest consumers of pharmaceutical products are developed countries. However, anticipated future growth is low (represented in Figure 5.6 by the dark red circles). In turn, a number of developing market economies have

the most significant growth potential (represented in Figure 5.6 by orange circles). Secondary level new markets include various countries, which also have the potential to become important medicine markets, based on the size of

Value of national pharmaceutical markets in 2012 (billion \$) and growth from 2011-2012 (%)<sup>16</sup>

Figure 5.6



<sup>16</sup> Booz & Company. 2013.

their populations or the tempo of recent growth (represented in Figure 5.6 by – yellow circles). Finally, African markets, have high population sizes but low consumption of medicines (represented in Figure 5.6 by – grey circles).<sup>17</sup>

Developed markets are well-structured and foreseeable. In contrast, new markets are more complicated and differ, not only at national, but also at regional, urban and rural level.<sup>18</sup> Additional difficulties are posed by the barriers to entry of many new markets, whereby foreign pharmaceutical companies are only allowed to distribute their products if they make direct investments and begin domestic production.<sup>19</sup> Under such conditions, the first strategic choice of small and medium-sized pharmaceutical enterprises is whether or not to attract a business partner or to try to enter the market alone.<sup>20</sup>

Latvia's pharmaceutical sector is largely geared towards exports, therefore, the development of foreign markets is particularly important. The most significant sales markets are Russia and the other CIS countries. In 2014,

*Olainfarm* exported over two thirds of its products to CIS countries, while *Grindex* sold 76% of its ready medicines in CIS countries.<sup>21</sup> Other important export markets for Latvia's pharmaceutical companies are those in the neighbouring Baltic states and other EU members. In contrast, Latvian enterprises make minimal exports not only to the USA, which is the biggest market in terms of the consumption of medicines, but also to the emerging markets of China and India.

The unfavourable geopolitical situation in Russia and Ukraine and the decline in the value of their respective currencies are the main reasons for 2014's slump in financial indicators. It is clear that market diversification is one of the sector's main challenges. The industry's development strategy envisages the implementation of measures aimed at increasing sales volumes in newly emerging markets in Asia and the Middle East, utilising enterprises' knowledge of emerging markets in CIS countries and increasing the proportion of new emerging markets to 50%.<sup>22</sup>

<sup>17</sup> The markets in Russia and Ukraine so important to Latvian companies have declined since 2012.

<sup>18</sup> Yadav, P., & Smith, L. 2014. Pharmaceutical Company Strategies and Distribution Systems in Emerging Markets. In A. J. Culyer, *Encyclopedia of Health Economics* (Vol. 3, pp. 1-8). San Diego: Elsevier.

<sup>19</sup> World Economic Forum (WEF). 2013. *Enabling Trade. Valuing Growth Opportunities*. Geneva: WEF.

<sup>20</sup> Quintiles. 2015. *Emerging markets: Four entry strategies for small and midsized companies*. Durham, NC: Quintiles.

<sup>21</sup> Grindex. 2015. *2014 Book*. Riga: Grindex and Olainfarm. 2015. *AS "Olainfarm" 2014 Consolidated Annual Report and Conglomerate Parent Company Annual Report*. Olaine: Olainfarm.

<sup>22</sup> The Association of the Latvian Chemical and Pharmaceutical Industry (ALCPI). (2015). *The Latvian chemical and pharmaceutical industry's innovative growth strategy*. Riga: ALCPI.



## Recommendations

### Recommendation 1

#### **PHARMAHUB: COLLABORATION, SPECIALISATION AND NICHE PRODUCTS**

Latvia's pharmaceutical enterprises operate at various stages of the product value chain – in the development of original medicines, in clinical studies, in the production of active pharmaceutical substances and pharmaceutical products, and in the development of generic medicines and so on. In all probability, the industry is not currently ready to take control of the whole value generation chain. However, in many specialised directions, it would be worth trying to switch to niches generating higher added value. These opportunities must be taken through networking and utilising the know-how and advantages offered by partners. In order to ensure networking opportunities using the OSI platform, it is necessary to establish a joint usable technology transfer infrastructure in the form of a *Pharma Hub*, including a ready medicinal product form laboratory and pilot production plant. Estimates indicate that by investing EUR 8-12 million in the establishment of a *PharmaHub*, it would be possible to create a system in which both existing players and potential start-ups not only have the opportunity to discover new active pharmaceutical substances, but also to develop new forms of ready medicines.

### Recommendation 2

#### **THE STATE AS A COLLABORATION PARTNER**

The pharmaceutical market is global and characterised by a high level of competition. It is an environment in which private enterprises as well as national institutions and innovation systems often compete. Latvia's pharmaceutical enterprises have set themselves the goal of developing their abilities to create, certify and launch the production of new generic medicines within three years and to increase their sales volumes in new emerging markets in Asia and the Middle East. In order for them to succeed, the capacity of the SAM must be significantly expanded by:

- developing a *scientific* advice function;
- ensuring the competence of SAM within the operating fields of Latvia's pharmaceutical enterprises;
- facilitating the utilisation of SAM as a reference country within the EU's decentralised registration procedure;
- concluding new bilateral agreements regarding the mutual recognition of pharmaceutical registrations outside the EU.

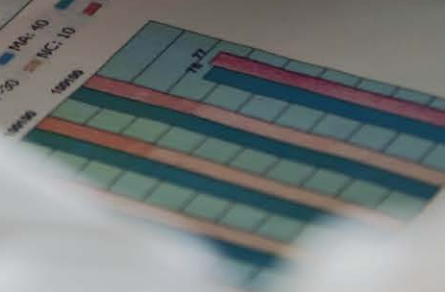
*SAM requires EUR 600,000 of EU funding to establish a functioning scientific advice service and to recruit 12-18 freelance experts. Moreover, in order to ensure the availability of experts and to raise their skills, it is necessary to develop and expand clinical pharmaceutical programmes at Latvia's higher education institutions.*

Recommendation **3****HUMAN RESOURCES**

In order to provide Latvia's pharmaceutical enterprises with the human resources they require, the industry itself must be more proactive in taking responsibility for training young scientists. However, it is difficult to do this without a good basic infrastructure. A higher education industrial pharmaceutical programme should be developed, providing funding for at least 30 study places and supporting the recruitment of international scholar. In turn, in the realm of professional education, the pharmaceutical industry does not have its own professional education competence centre. Therefore, investments must be made in the Olaine College of Mechanics and Technology, establishing it as an industry centre of excellence.

Recommendation **4****MARKET DIVERSIFICATION**

Support must be provided for the industry's efforts to diversify and restructure product sales and distribution to (i) European Union countries, in particular emphasising Western European and Balkan countries (Bosnia and Herzegovina and Turkey, etc.); (ii) the Asia region with an emphasis on South-East Asia (Vietnam, Indonesia and the Philippines, etc.); and (iii) the Middle East (Egypt and Tunisia, etc.).



## 6. TRADE AND FINANCIAL SERVICES

Andrejs Jakobsons & William Schaub

Latvia's strategic geographic location, large ports and region leading banks make it an important trading hub between markets in Europe and the East. In 2013, Latvia's ports handled as much cargo as Estonia and Lithuania's ports together (see Infographic 6.1).<sup>1</sup> At the same time, Latvia's financial services and

banking sector has become a significant segment of Latvia's economy with high added value. In 2014, the banking sector generated 2.44% of GDP (EUR 585.9 million) and employed approximately 9,400 people.<sup>2</sup>

Gross mass of cargoes transported to/from the main ports in the Baltic states in 2013 (thousand t)<sup>3</sup> Infographic 6.1



There already exists a close collaboration between ports and financial institutions. Banks provide financial trading services to traders that operate in Latvia's ports, as well as private financial management services. In addition to competitive ports and banks, Latvia also offers a unique

combination of English and Russian language skills, as well as historical and cultural links, a stable business and political environment, an experienced and well-trained labour force and, crucially, a range of concluded double taxation agreements.

<sup>1</sup> Masane-Ose, J. 2014. Competitive position of the Baltic ports. KPMG. Transbaltica 2014 Conference.

<sup>2</sup> KPMG. 2015. Estimated macroeconomic impact of the banking sector, including the international customers banking segment in Latvia. Riga. KPMG.

<sup>3</sup> Eurostat. 2015.

The strategic and harmonious development of trading infrastructure and banks, with the objective of turning Latvia into a trade hub, could encourage a growing number of small and medium-sized trading enterprises (SMEs) to relocate to Latvia, which in turn, would offer both sectors the prospect of growths. A 2012 report by *KPMG* on international

freight trading companies showed that trading enterprises choose their location, based on developed financial services infrastructures and strategic proximity to the market (Latvia satisfies both of these requirements), as well as investment-friendly government policy and tax rates (this is an area in which Latvia could well improve its competitiveness).<sup>4</sup>

## 6.1. Trade Hubs

Trade hubs offer brokers transport, logistics and a wide range of financial services, using local access ports. Several small countries including the Netherlands and Singapore have established trade hubs as specific instruments within their strategies for economic development.

Rotterdam in the Netherlands is the world's eleventh biggest port and serves as an important entrance and departure point within the continental European market. The Dutch Government has laid down a unique business model – trust services for international enterprises that allow them to optimise their tax burden and preserve their competitiveness. This model induces large importers and exporters to set up special holding companies based in the Netherlands that structure transactions and are run by professional services in close collaboration with legislative, taxation, legal and banking systems.

Despite having a population of just over five million people, Singapore is the world's busiest port in terms of transported tonnage. It enjoys a major

benefit in the form of the day to day use of English and Chinese, which opens up the Indian, Chinese and Western markets. Its trade hub model is based on a labour force policy that stipulates tax-free personal income status for non-resident traders and non-resident intermediaries. At the same time, residents whose movements involve international travel, can further reduce their tax burden below the already low 20% maximum income tax rate.<sup>5</sup>

Latvia has the opportunity to attract trading companies and to induce them to relocate to Latvia by implementing the Dutch trust service model and reforming its basic tax policy for foreign business owners. Latvia already possesses the main components required for the development of these sectors, i.e. large ports, logistics services and developed banks and financial services companies.

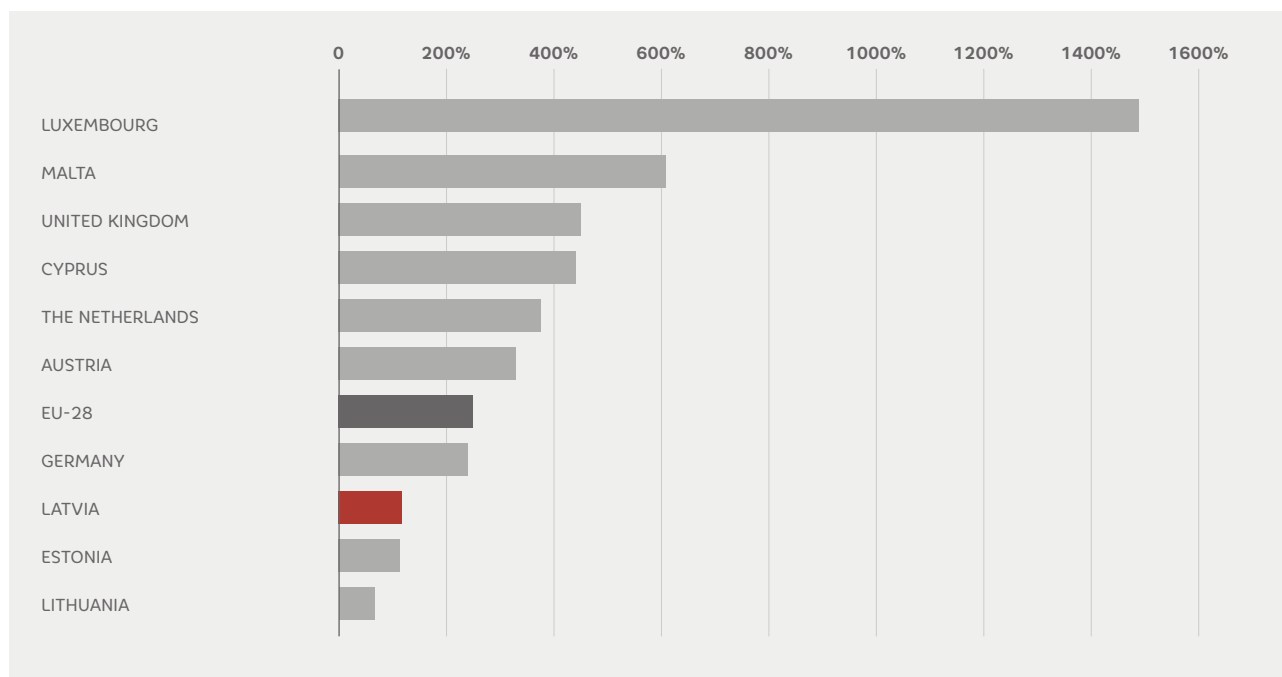
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<sup>4, 5</sup> KPMG. 2012. Commodity Trading Companies. KPMG. Netherlands.



**Assets of individual countries' monetary financial institutions that are not the central bank in 2014 (% of GDP)<sup>6</sup>**

Figure 6.1



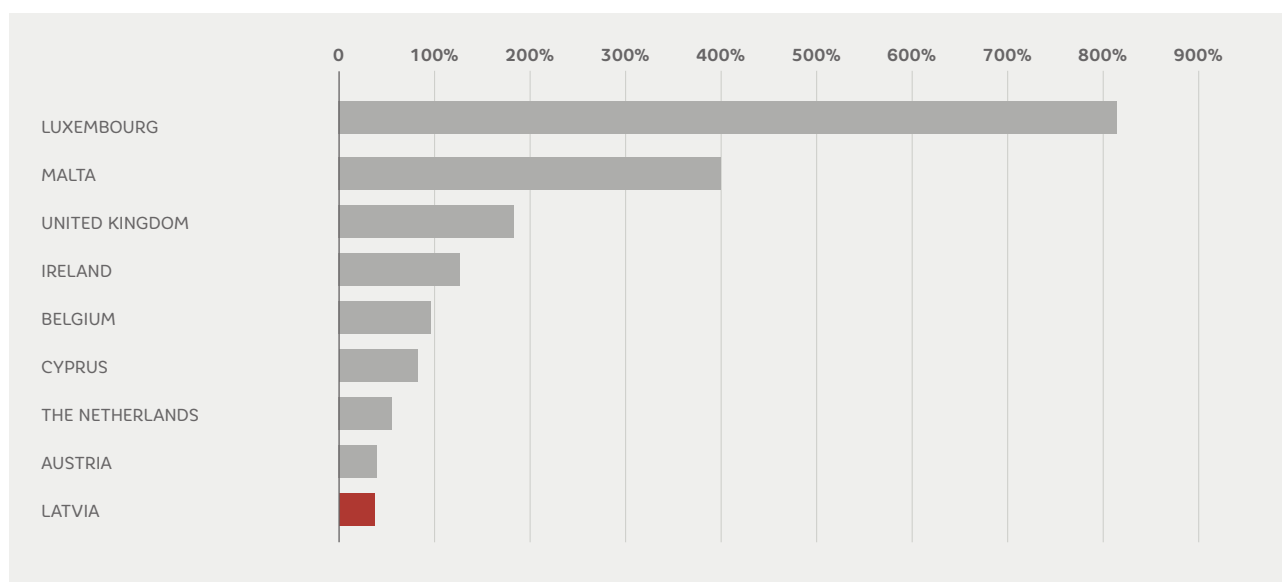
Latvia has marked competitive advantages, compared to its neighbours, in the form of busier ports and growing banks that currently already attract 78% of all international investments that flow through the region. In December 2014, the ratio of the assets of Latvia's banks in relation to GDP was 117%, compared with Estonia (112%) and Lithuania (63%).<sup>7</sup> However, compared with the EU-28 average indicator of 246% of GDP in 2014, it is evident that Latvia is in a position to significantly expand its banking service offering for international clients. Latvian banks are also well-capitalized (considerably above the *Basel III* 8% requirement) and highly liquid.

Latvia's international banks already serve SMEs, whose owners are usually from CIS countries, as well as high net worth individuals that usually manage such businesses. These international banks make up the fastest growing sector of the Latvian banking industry. In addition to deposits, they offer payment and card services, loans, property management, brokerage and trading financing. In 2014, international banks in Latvia generated 1.34% of added value, corresponding to 1.17% of Latvia's GDP and approximately EUR 65 million of tax payments.<sup>8</sup>

<sup>6, 7, 8</sup> KPMG. 2015. Estimated macroeconomic impact of the banking sector, including the international customers banking segment in Latvia. Riga. KPMG.

### Non-resident deposits in EU countries at the end of 2014<sup>9</sup>

Figure 6.2



However, the role of the international banking sector within Latvia's economy is even more significant, if one considers its multiplier effect – additional services purchased by clients in the international banking segment. In 2014, this increased the absolute impact of international banks on Latvia's economy to 2.16%.

As of 30 June 2015, non-resident deposits in Latvia's banks amounted to EUR 11.4 billion, while the deposits of residents came to EUR 10.9 billion.<sup>10</sup> International deposits are usually not used for local loan operations for various reasons including currency and term non-compatibility and difficulties in issuing loans in a foreign jurisdiction. These deposits are used for liquid investments. As a result, the liquidity ratio of international banks is approximately 80%, which is well above the minimum stipulated under legislation (30%).

Accordingly, Latvia's port and banking sectors are suitable for encouraging the future development of a trade hub. In order to persuade enterprises to relocate to Latvia, banks must attract their existing business clients, offering an attractive package of services and incentives. A recently conducted survey of 30 non-resident banking clients, regarding their commercial operations and readiness to relocate to Latvia, produced some interesting results. The average turnover of these clients was \$57 million while 11% of their sales volume was in EU countries. Overall, the respondents conceded that they would consider relocating to Latvia if the corporate income tax rate was 5%, and would also be prepared to relocate about four employees to Latvia.<sup>11</sup>

<sup>10</sup> FKTK. [www.ftkt.lv](http://www.ftkt.lv)

<sup>11</sup> Confidential data provided by an international bank in an interview with the authors of this report.

## 6.2. Challenges and solutions

Latvia already has laws that provide a stable platform on which to further develop the operation of trade hubs. The Law on Joint Stock Companies permits the division of tax-free dividends to enterprises, as well as entitling foreign citizens to hold the office of managing director of a joint stock company.<sup>12</sup>

Other legislation could further strengthen Latvia's status as a trading centre. Various types of financial instruments could be developed, e.g. tax breaks or other types of support, which, of course, must comply with EU State support regulations. Lithuania's INVEST-LT+ programme has successfully developed a corporate *back office* processing operation offering (provided by *Barclays Bank* and *Western Union*), providing large companies that move to Lithuania various forms of financial support and incentives.<sup>13</sup>

Certain tax benefits could be established for enterprises that relocate to Latvia, based on the experience of Singapore. Firstly, companies that relocate to Latvia for at least five years, and whose operations involve significant trade outside the EU, could be permitted to exclude income obtained from trading outside the EU in their Latvian corporate income tax calculation, with a tax threshold of 2% of total taxable income. Latvian citizens employed by such enterprises should be paid salaries that are at least twice the Latvian average wage.<sup>14</sup>

Secondly, enterprises that are currently registered in another country and considering moving to Latvia and whose turnover is less than EUR 50 million, could be offered a two year corporate income tax holiday up to EUR 200,000. In this instance too, the enterprise would have to agree to register in Latvia and operate here for at least five years, as well as to employ Latvian citizens, paying them salaries that are at least twice the Latvian average wage.

Latvia would obtain a new and significant tax income, highly paid new jobs (on average three per enterprise), which are compatible overall with EU state support legislation.

The relocation to Latvia of foreign businesses could also be encouraged by waiving their social security contribution pension shares for a period of up to five years. The State Revenue Service should support international enterprises relocating to Latvia by both conducting official communication and accepting reports in English. The growing number of trading companies would precipitate demand for a larger product and service offering to provide banking functions in the realm of the management of private funds.

<sup>12</sup> This is advantageous in relation to protectionist regulations, e.g. in the Netherlands, where trust service business directors must be citizens.

<sup>13</sup> Invest Lithuania. [www.investlithuania.com](http://www.investlithuania.com)

<sup>14</sup> Deloitte. 2013. Taxation and Investment in Latvia. Riga.

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## Recommendations

### Recommendation 1

#### **TAX BREAKS FOR COMMERCIAL OPERATING ACTIVITIES OUTSIDE THE EU**

Businesses that relocate to Latvia for at least five years, establish a company in Latvia and whose operations involve significant trade outside the EU, should be permitted not to include income obtained from trading outside the EU in their Latvian corporate income tax calculation up to a tax threshold of 2% of total taxable income.

### Recommendation 2

#### **NODOKĻU BRĪVDIENAS**

Small and medium-sized enterprises that are currently registered in another country and are considering relocating to Latvia (by establishing a subsidiary in Latvia) and whose turnover is up to EUR 50 million annually, could be offered a two year corporate income tax holiday up to EUR 200,000. In this case, the enterprise would have to undertake to register in Latvia, be based here for at least five years, and employ at least two local employees for at least five years, offering a remuneration that is at least twice the Latvian average.

### Recommendation 3

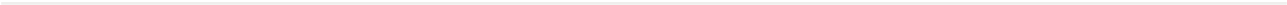
#### **SOCIAL INSURANCE CONTRIBUTION RELIEF**

Foreign businesses starting-up in Latvia should have their social insurance deposit pension shares waived for a period of up to five years.

### Recommendation 4

#### **SUPPORT FROM THE STATE REVENUE SERVICE**

The State Revenue Service should support international enterprises relocating to Latvia by both conducting official communication and accepting reports in English, as well as allowing the preparation of reports to be subject to International Financial Reporting Standards.







# 7. INFORMATION AND COMMUNICATION TECHNOLOGY

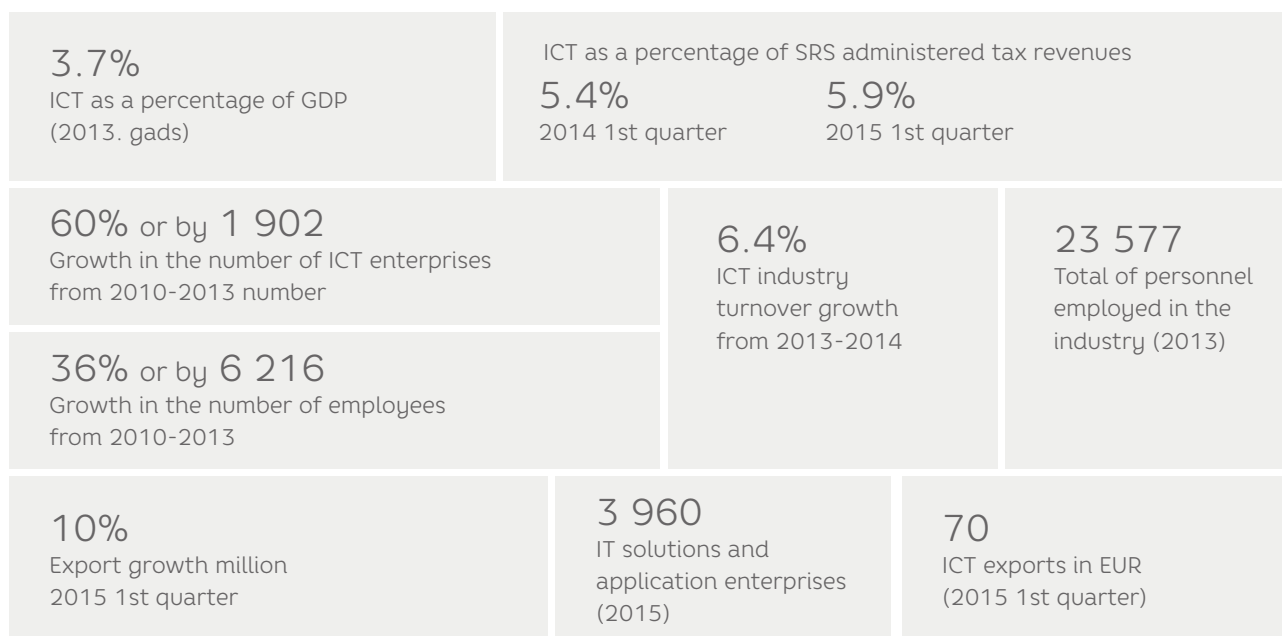
Kārlis Krēsliņš un Sanita Meijere

The development of information and communication technologies (ICT) and

ICT infrastructure are significant drivers of economic growth all over the world.<sup>1</sup>

Latvia's ICT in facts and figures<sup>2</sup>

Figure 7.1



<sup>1</sup> World Economic Forum, INSEAD. 2013. *The Global Information Technology Report 2013*. Geneva: World Economic Forum. Available at: [http://www3.weforum.org/docs/WEF\\_GITR\\_Report\\_2013.pdf](http://www3.weforum.org/docs/WEF_GITR_Report_2013.pdf)

<sup>2</sup> Central Statistical Bureau (CSB). 2013. ICT sector statistics. CSB. Available at: [http://data.csb.gov.lv/pxweb/en/zin/zin\\_datoriz\\_ikt\\_sektors/?tablelist=true&rxid=cdbc978c-22b0-416a-aacc-aa650d3e2ce0](http://data.csb.gov.lv/pxweb/en/zin/zin_datoriz_ikt_sektors/?tablelist=true&rxid=cdbc978c-22b0-416a-aacc-aa650d3e2ce0)

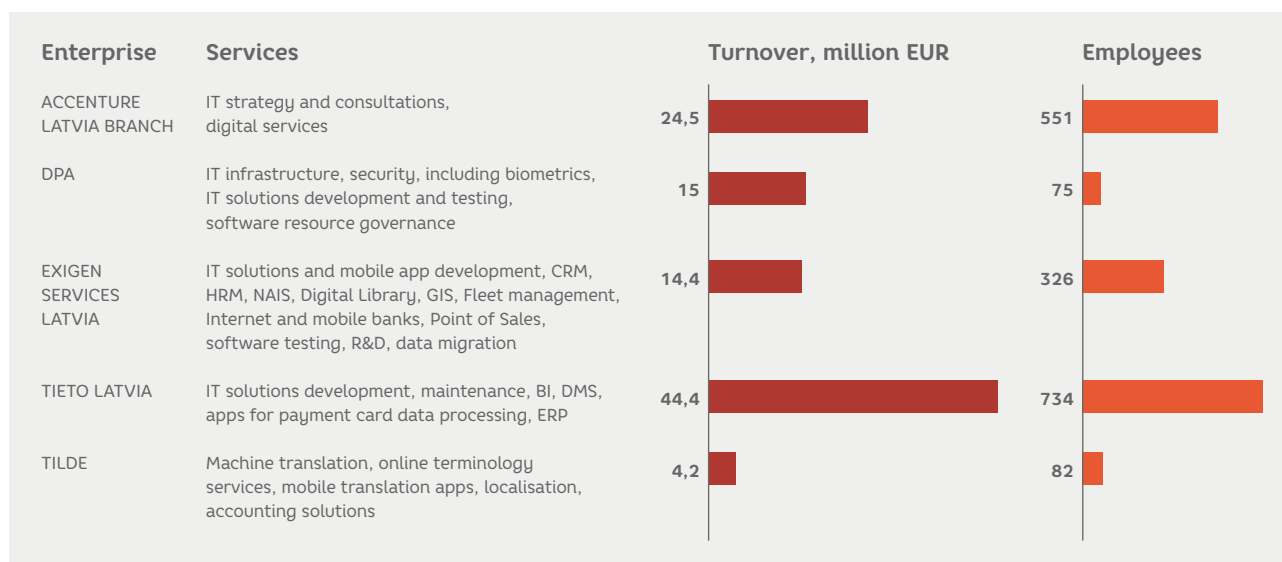
## 7.1. Information technology solutions and app development

Estonia is the IT industry leader in the Baltic States. In collaboration with Silicon Valley, Estonian universities were able to attract *venture capital* funding in the amount of EUR 10–20 million per project (Latvia's start-up enterprises typically attract EUR 1–2 million per project). In 2013, ICT made up 6.8% of Estonia's GDP, whereas in Latvia the corresponding figure was only 3.7%. Estonia's highest state officials are well-informed about developments within the ICT industry and during foreign visits they laud Estonia's IT experience, helping Estonia's IT sector to become globally renowned.

Latvia's ICT market is limited. The biggest clients are the public sector, which requires specific solutions that cannot be replicated. 90% of the app business is comprised of programming services for international enterprises. There is a shortage of IT specialists capable of creating new products. Nevertheless, there are also successful *start-up* projects in Latvia, e.g. the smart address book *Cobook*<sup>5</sup>; infographics (*infogr.am*); the e-commerce platform for digital publishers (*Fastr Books*); and gaming platforms for online games (*Amber Games*).<sup>6</sup>

Biggest ICT industry enterprises in Latvia in 2013<sup>7</sup>

Figure 7.2



<sup>3</sup> Focus group. 2015. Riga. (Focus group including the following ICT associations and enterprises: Latvia's information and Communications Association (LICTA), Latvian IT Cluster, Accenture Latvia Branch, DPA, Exigen Services Latvia, Lattelecom, Latvian State Radio and Television Centre (LSRTC), TechHub Riga and Tilde)

<sup>4</sup> Estonian Association of Information Technology and Telecommunications (EAITT). 2013. Statistics Estonia. EAITT. Available at: <http://www.itl.ee/eng>

<sup>5</sup> <http://www.fold.lv/en/2014/02/springboard-for-technology/>

<sup>6</sup> LIAA. 2013. *Information and Communication Technology Industry in Latvia*. LIAA. 5.lpp.

<sup>7</sup> LIAA. 2013. *Information and Communication Technology Industry in Latvia*. LIAA. 12.-37.lpp.



## 7.2. Challenges for the IT solutions and app development sector

The biggest challenges facing Latvia's ICT sector are a lack of personnel and inadequate qualifications, funding for investments in research and development (R&D) and a low international profile in export markets.

By 2020, demand for IT specialists will exceed supply by 26%; overall, there will be a shortfall of about 100,000 programmers in the Baltic Sea region.<sup>8</sup> Current education programmes do not provide the required quality and flexibility.

Finding IT specialists (programmers) is not the only problem; there is also a shortage of highly qualified support function specialists.<sup>9</sup> The potential workforce possesses theoretical knowledge, but too little inter-disciplinary awareness and too few skills that are not directly related to their specialist profession. Graduates of this kind are suitable for writing code, but not for creating high value-added innovative solutions.

Azerbaijan and Kazakhstan are trying to diversify their economies and encourage innovation – financing sourced from their oil resources has enabled them to establish technology centres, attracting global ICT sector enterprises and highly qualified international IT experts. In order for Latvia's ICT sector to continue to develop, it must be able to access sufficient human resources with the requisite qualifications. Ideally, international students would come to Latvia to study IT and remain after the completion of their studies and become part of Latvia's ICT job market.

By making as effective and efficient use as possible of international funding availability for optimising IT education, an ICT School of Excellence should be established as the next step for students who have just received their Bachelor's degrees. The ICT School of Excellence would provide study courses in modern ICT disciplines, linking these to the disciplines of business management and attracting international academic staff. The cost of such a world-class education programme would be in the region of EUR 1.5–2 million depending on the number of courses and lecturers (5–7 highly qualified ICT industry professors from the USA and teaching staff from Latvia's universities and corporate sector). Collaboration with ICT industry enterprises would be necessary for the sustainable development of the project, offering them an R&D platform, as well as an external service in the form of training of current ICT enterprise employees in those ICT-related skills, mastery of which is the objective of the training currently being organised by these same enterprises for their own employees.

The creation of a human resources base is a precondition for the relocation of the world's major ICT companies to Latvia, which would be an additional stimulus for economic growth. Share options are a widely used remuneration mechanism for promising new start-ups with limited capital. In this case, it would be vital to enact a tax policy that is conducive to awarding and utilising share options, as well as to establish a clear and simple legal mechanism for the emission and holding of shares in the event of the utilisation of options.

<sup>8</sup> Ministry of Economics (MoE). 2014. *Information report on the mid- to long-term prospects of the job market*. MoE. Available at: [https://www.em.gov.lv/files/tautsaimniecibas\\_attistiba/EMZino\\_150814.pdf](https://www.em.gov.lv/files/tautsaimniecibas_attistiba/EMZino_150814.pdf)

<sup>9</sup> Focus group. 2015. Riga

## 7.3. ICT infrastructure

Parallel to traditional infrastructure elements, i.e. railways, roads, ports and airports, as well as energy, in the 21st century, a decisive role in economic development will be played by all-encompassing telecommunications networks that ensure fast flowing data and information, thus increasing economic efficiency as a whole. Telecommunications infrastructure incorporates fixed and mobile networks and corresponding network elements.

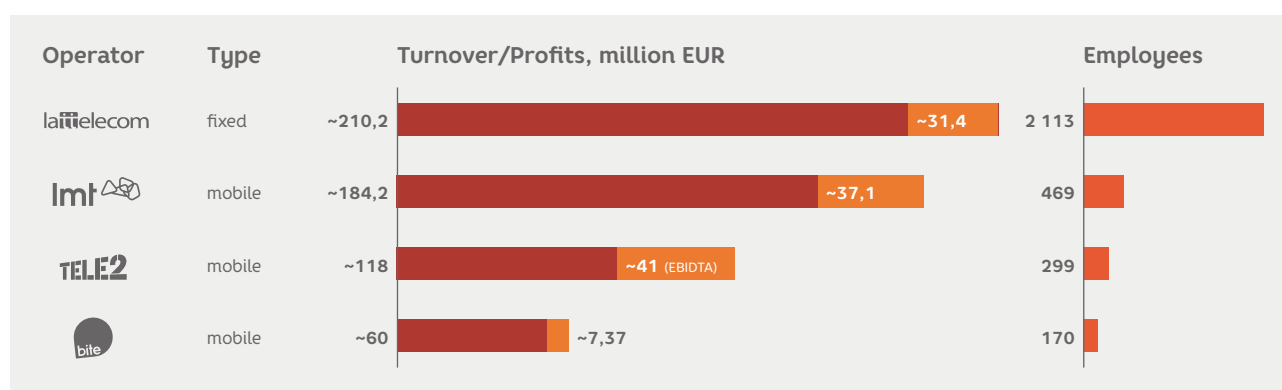
Prior to 1998, each European country had a single fixed telecommunications operator that owned the networks. However, following the liberalisation of the telecommunications market in

many European countries, there has been a rapid increase in the number of fixed service providers that have joined existing fixed network operators in making investments in infrastructure modernisation.<sup>10</sup>

In order to facilitate the development of a fixed network infrastructure in Europe, operators in the Netherlands, Portugal, Spain, Switzerland and several other countries not only made joint investments in the development of optical networks, but also jointly use them. The number of mobile operators in each EU country differs, but, on average, they tend to be 3-4 mobile network operators.

Main operating indicators for Latvia's fixed and mobile operators in 2012

Figure 7.3



The turnover of the telecommunications sector in Latvia in 2013 was EUR 550 million. The fixed telecommunications market leader is *Lattelecom* which has an 80% market share. *Lattelecom* is also the main fibre optic cable provider, offering high-speed Internet of up to 500 Mb/s. The transition from analogue to digital television was completed in 2010, thus freeing up the 800 MHz

frequency band range for mobile services.

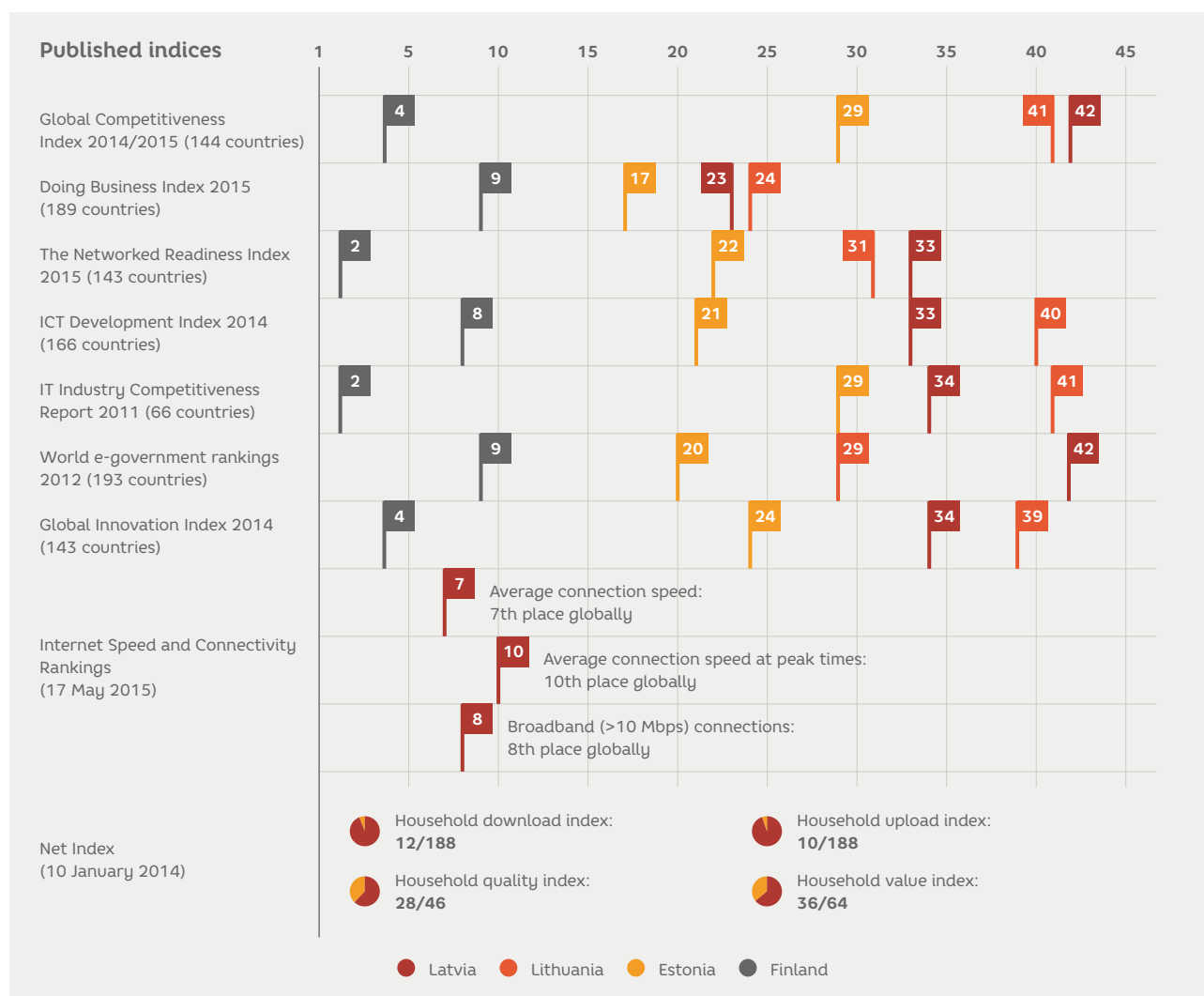
In the mobile telecommunications field, there are three mobile operators: *LMT*, *Tele2* and *Bite Latvia*. *LMT* and *Tele2* each have a market share of approximately 37% of the total subscriber market. At the end of 2013, there were 2.558 million mobile subscribers in Latvia.

<sup>10</sup> Grijpink F. et al. 2012. *A New Deal: Driving investment in Europe's telecoms infrastructure*. McKinsey & Company, 33.lp.



The rankings of Latvia, Lithuania, Estonia and Finland in published international tables related to IT infrastructure

Figure 7.4



Investments to date in the development of telecommunications infrastructure have ensured its global competitiveness. According to data from the World Economic Forum, between 2014-2015, Latvia was ranked 35 (of 144 countries) in terms of the number of mobile telephone subscribers per 100 people, 28 in terms of the number of broadband internet subscribers per 100 people and 38 in terms of the speed (kb/s per user) of international internet data transmission.

However, the existing telecommunications infrastructure will not be sustainable, unless additional investments are made that cover the cost of research and development aimed at the innovation of new products and services and their promotion within the market. The relevant governmental bodies must take firmer action in dealing with those small telecommunications enterprises, which have established their infrastructure (mainly wire and cable networks) without the approval of the responsible institutions, thus forming a shadow economy.<sup>11</sup>

<sup>11</sup> Focus group. 2015. Riga

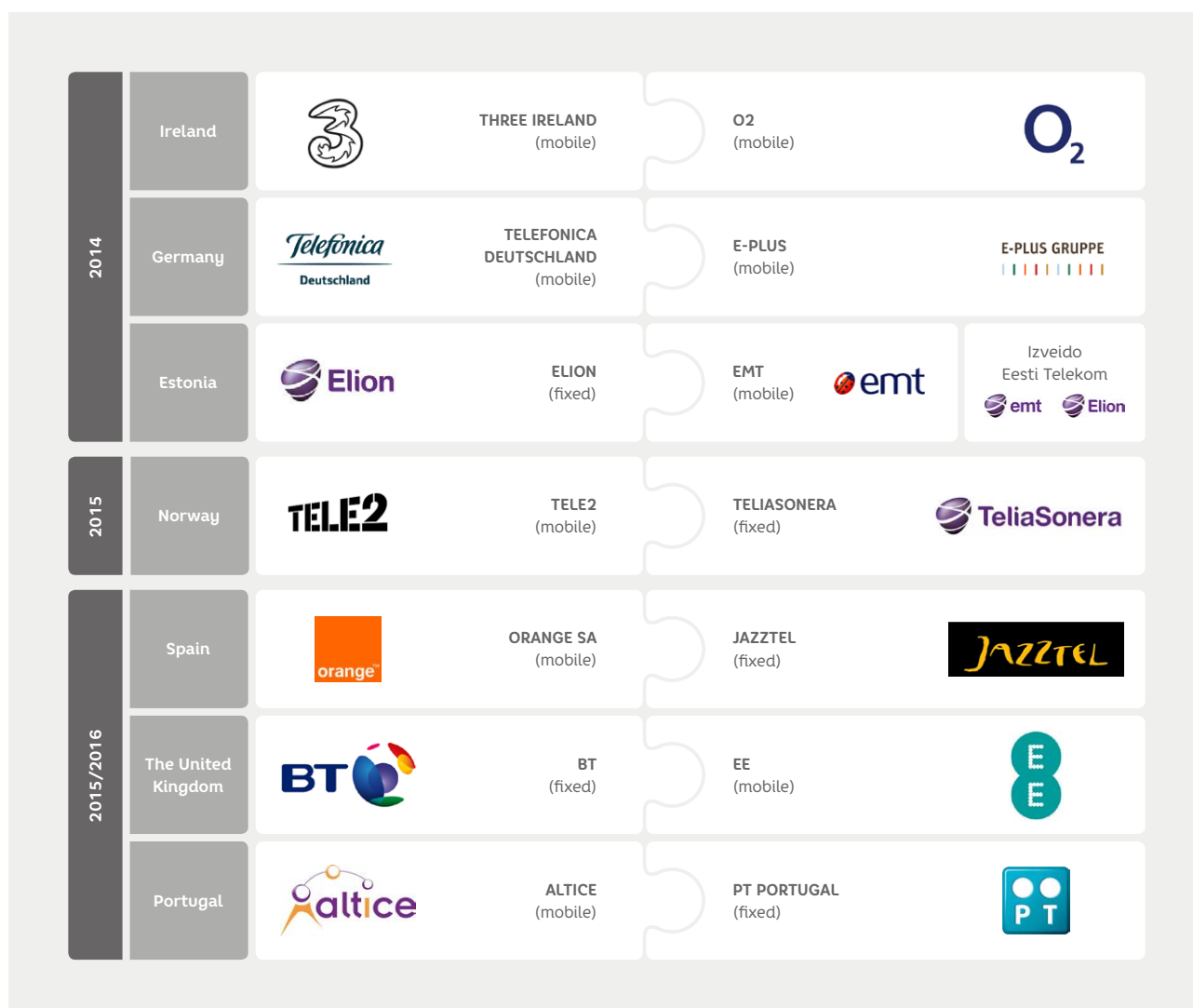
## 7.4. Main challenges facing the telecommunications sector in Europe and Latvia

In order to retain market share, offering the aforementioned new services, as well as packages including TV, broadband Internet, fixed and mobile voice services, telecommunications operators have

started converging in Europe and globally.<sup>12</sup> In recent years, there have been several mergers involving mobile-mobile and fixed-mobile operator in Europe (Figure 7.5).

Mergers of telecommunications operators (actual/planned)

Figure 7.5



<sup>12</sup> Standard and Poor's Rating Services. 2015. *European Telecoms Operators Jockey for Position As M&A Surges Forward*. 3.lpp.

The European Commission has accepted the aforementioned merger processes, albeit often by setting additional terms and conditions. For example, in the case of a merger worth EUR 780 million EUR between 3Ireland and O2, the EC laid down the stipulation that the merged operator would be obliged to help to establish two new mobile operators in Ireland.<sup>13</sup> In turn, in the EUR 8.6 billion merger between *Telefonica Deutschland* and *E-Plus*, the EC stipulated that *Telefonica* must agree to sell 20% of the capacity of the merged network to the virtual mobile network operator *Drillisch*.<sup>14</sup>

A certain challenge to the telecommunications sector is also posed by the agreement between the European Parliament, Council and Commission regarding the repeal of mobile communications roaming changes in the EU from June 2017. There is a possibility that the profits of mobile operators could be reduced as a result of the implementation of the agreement. Furthermore, users could dishonestly use the benefits provided by the regulation, e.g. by using mobile communications services in a country where they are cheaper, while continuing to reside in their country of residence. However, the agreement does make provision for the possibility of such instances, and mobile service providers are entitled to impose a small additional charge on "long-term roamers".<sup>15</sup>

The aforementioned challenges and trends within the telecommunications industry both globally and in Europe are also applicable to Latvia's fixed line and mobile operators. Large volume data transmission, involving vertical sectors, e.g. medicine, finance, M2M and OTT, requires high-speed broadband networks and mobile communications networks. In order for the concept of Europe's common digital market to be implemented successfully, the performance of international online transactions requires networks capable of handling high-volume and high-speed data transmission.

One of the telecommunication sector's current issues in Latvia that has received lengthy media coverage is the future development of the fixed-line service provider *Lattelecom*. *Lattelecom* could consider the possibility of buying one of the mobile communications operators. To implement such a takeover, *Lattelecom* would not require the consent of the European Commission, because the EC investigates mergers between companies, whose annual turnover exceeds EUR 250 million. In this case, the enterprises involved would need to receive the approval of the Latvian Competition Council, which could authorise such a merger if the enterprises involved operate in different markets.

<sup>13</sup> Weckler A. 2015. *3 Ireland finally completes acquisition of O2 for €780m*. Pieejams: <http://www.independent.ie/business/3-ireland-finally-completes-acquisition-of-o2-for-780m-30433999.html>

<sup>14</sup> Filtz M. 2014. *Telefonica Deutschland closes €8.6 bn acquisition of E-Plus*. Pieejams: <http://www.zdnet.com/article/telefonica-deutschland-closes-eur8-6bn-acquisition-of-e-plus/>

<sup>15</sup> European Commission. 2015. *Roaming charges and open internet*. Pieejams: [http://europa.eu/rapid/press-release\\_MEMO-15-5275\\_en.htm](http://europa.eu/rapid/press-release_MEMO-15-5275_en.htm)

## Recommendations

### Recommendation 1

#### PROMOTING IT SKILLS AND EDUCATION

In order to ensure a workforce that is sufficiently large and well-qualified, interest in ICT must be encouraged from primary school onwards. International financing for optimising education must be utilised, establishing an ICT School of Excellence, offering study courses in the very latest ICT disciplines.

### Recommendation 2

#### SECURING ERDF FUNDING

ERDF funding should be utilised to support ICT applications to *Horizon 2020* projects.

### Recommendation 3

#### LEGAL MECHANISMS FOR AWARDED STOCK OPTIONS

The Commercial Law should be amended to allow companies to issue and hold share/stock options. In addition, the tax burden should be eased, encouraging the award of options to employees of *start-up* enterprises, reducing the stock purchase rights holding period, which is currently 36 months to 12 or 18 months.

### Recommendation 4

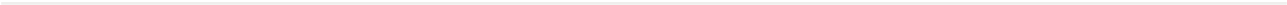
#### MEASURES TO COMBAT THE SHADOW ECONOMY

There are many small and medium-sized telecommunications enterprises that have established networks without the approval of the corresponding bodies. In order to eradicate the shadow economy in the telecommunications sector, the Economic Crime Combating Authority should investigate all telecommunications enterprises and the infrastructure (primarily surface wires and cables) they have established. Moreover this monitoring must be implemented in collaboration with the leading telecommunications enterprises, which could train and advise the authority's employees.

### Recommendation 5

#### ANALYSIS OF THE IMPACT OF MERGERS BETWEEN TELECOMMUNICATIONS OPERATORS

There have long been discussions in Latvia regarding potential mergers between telecommunications operators. The State must formulate its position on this matter. However, additional research is required analysis of all the "pros" and "cons", particularly in relation to the impact of potential mergers on competition and consumer prices.









## 8. WOOD AND TIMBER

Jānis Ozoliņš & Aleksejs Nipers

Forests are one of Latvia's few strategic resources. In terms of forest coverage, Latvia is one of the six richest countries in the EU, because forests cover 50% of the country's territory. Moreover, Latvia's climate and soil are suitable for ensuring a competitive combination of fast growth and high quality timber. In 2013 the volume of growing stock in Latvia's forests amounted to 667 million m<sup>3</sup>, while annual growth exceeds 25 million m<sup>3</sup>. Annual felling volumes amount to approximately 63% of the growth in stock (by way of comparison: in Finland the corresponding figure is 70%, while in Sweden it is 85%) and provide for logging at a level of 11 -12 million m<sup>3</sup> annually. Crucially, 49% of forests in Latvia belong to the State, which, through planned management, stabilises the flow of timber processing raw materials.

Forest resources are closely related to Latvian identity and are critical for the economic development of rural areas. The forest sector is comprised of forestry<sup>1</sup> and the timber industry<sup>2</sup>. It generates almost one third of GDP value added by Latvia's primary and secondary sectors, while it is a source of income for 9% of the country's labour force. The timber industry is the most economically significant part of the two, contributing 70% of the sector's added value, and employing 65% of its total labour force.

One of the central economic effects of the timber industry is its status as a cornerstone of the Latvia's balance of trade. In 2014, exports exceeded imports by EUR 1.43 billion.

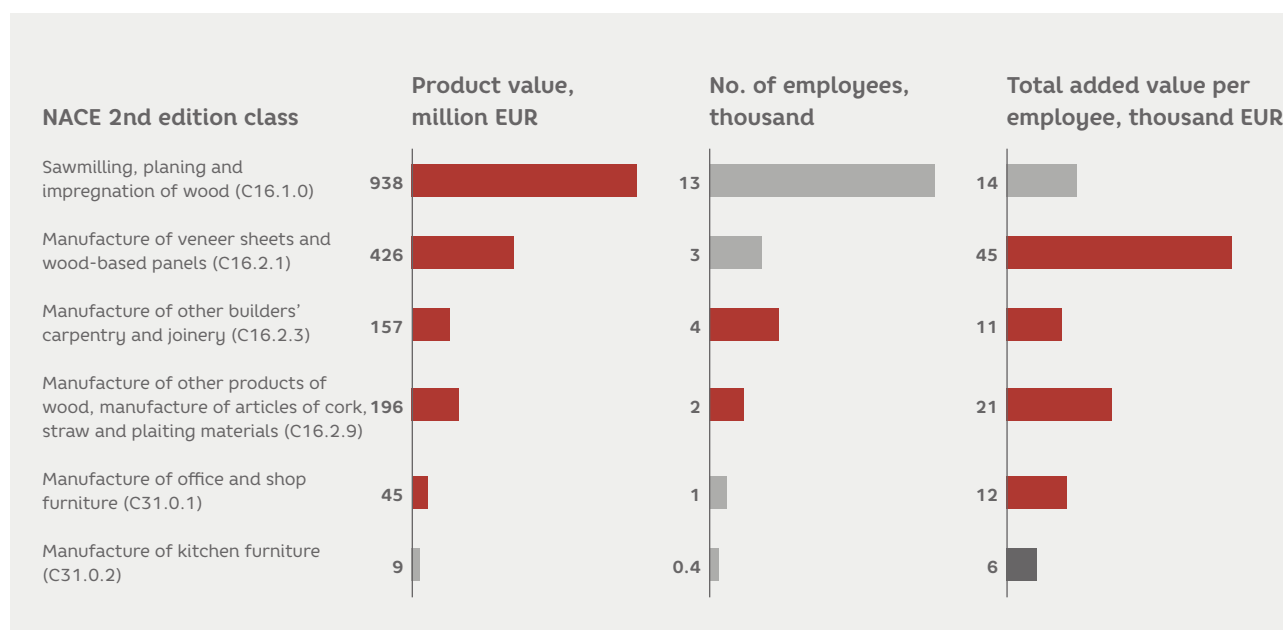
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<sup>1</sup> NACE 2nd edition. A02 (forestry and logging).

<sup>2</sup> NACE 2nd edition. C16 (Manufacture of wood and products of wood and cork, except furniture; manufacture of straw and plaiting materials) and C31 (manufacture of furniture).

Latvia's timber industry in 2013<sup>3</sup>

Figure 8.1

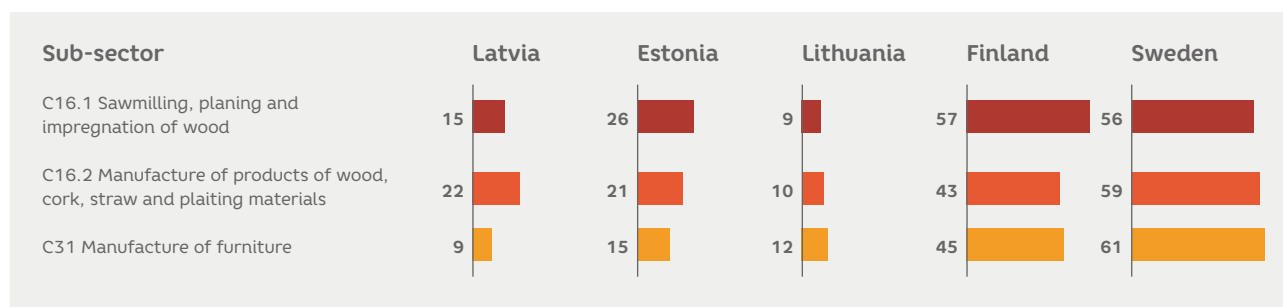


Secondary processing comprised 54% of the added value of Latvia's timber industry and 63% of the total added value, and was responsible for 58% of the total number of employees in the industry. The most notable contribution made by secondary processing came from the veneer sheet and wood panel manufacturing sub-sector, which

alone makes up 28% of added value from timber processing and which has the highest ratio of added value to product value. Also noteworthy is the manufacture of other builders' carpentry and joinery, in which the number of workers is rising, as is added value per employee.

The timber industry's added value indicators compared internationally, 2013<sup>4</sup>

Figure 8.2



<sup>3</sup> LR CSB. Indicator dynamics trends 2008-2013: ● - growing; ● - declining; ● - non-discernible; no data about the manufacture of parquet panels or the manufacture of wooden containers

<sup>4</sup> Eurostat. Added value factor costs per employee, thousand EUR

## 8.1. The timber industry's main challenges and possible solutions

Comparisons with Finland and Sweden, which have even more forest cover than Latvia, and in which the timber industry has long developed under market economy conditions, are useful for determining the sector's problems and future tasks. Added value per employee generated by the timber industry in Nordic countries is up to ten times higher than that generated in the Baltic states (Figure 8.2). For example, 11,800 workers

employed in the primary processing of timber in Sweden manufacture products worth EUR 5.1 billion. In contrast, 12,500 workers employed in the corresponding sector in Latvia manufacture products worth just EUR 875 million. Much has already been achieved, but the results of interviews with company managers in Latvia point to the potential of automated manufacturing in raising productivity.

### More efficient use of timber resources to generate added value in Latvia

Latvia's timber sector has a high proportion of products that can be subjected to more extensive secondary processing, thus creating a greater amount of added value. In 2014, logs and sawn timber comprised 37% of the value of exported products. Subjecting these raw materials to secondary processing in Latvia it was possible to generate an additional EUR 0.28 of added value per unit of products sold.

In 2014, Latvia's timber industry exported approximately 1.9 million m<sup>3</sup> of softwood pulp. If this pulp were to be secondary processed in Latvia, manufacturing panels similar to Kronospan, then the value added by the industry would grow by approximately

EUR 72 million, creating about 400 new jobs and raising productivity within the timber industry by 14%. In order for this economic effect to be achieved in a comparatively short space of time, the Latvian Development Agency, with the support of other State institutions, should attract investors in the form of global or regional secondary processing enterprises with major established sales markets.

From the perspective of timber industry investors, Latvia's advantage is the availability of timber materials suitable for secondary processing and lower labour costs. In contrast, Scandinavian lose added value because of high personnel costs.

## Increasing consumption of the timber industry's products in Latvia

The sub-sectors of Latvia's timber industry would benefit from an increase in the value of local timber and wood product market.

For example, one example of low timber consumption is the low demand for wooden houses in Latvia. In comparison, in Finland wooden houses are very popular. As a result, Finnish manufacturers sell 82% of their products on the local market. Latvia's wooden house manufacturers, mostly comprised of small and medium-sized enterprises, have a limited domestic market and immediately encounter the challenge of selling these quite complicated products in foreign markets.

There little likelihood of an immediate increase in the use of timber and wood products in construction, because this is restricted by shortcomings in Latvia's construction standards required for the utilisation of EU regulations. Architects argue that the fire safety requirements in Latvia's construction standards restrict the use of wood, despite the fact that in several countries, including Norway for example,

multi-storey wooden buildings are built meeting all safety requirements. Latvia's construction standards were adopted in 2015. The Ministry of Economics plans to gradually review them. Faster and more appropriate passage of amendments to construction standards is important for the development of the timber industry.

Despite these circumstances, construction projects, such as the *Amatciems estate*, have been completed in Latvia in which wood is not only an important, but occasionally even the main building material. With public support, public sector organisations and timber manufacturers have collaborated on a notable civil engineering pilot project – a wooden footbridge over a carriageway. Such pilot projects are vital in demonstrating the extensive possibilities offered by the use of wood, as well as its durability, economic viability, safety and environmental aspects. The potential use of public commissions in the development of such pilot projects is significant – public requirements could be met by designing and building wooden structures, thus creating positive examples.

## Capital accumulation in Latvia's timber industry

In the face of rising labour costs, Latvia's timber manufacturers can retain and improve their competitiveness by increasing their productivity and modernising production plants. Productivity in the Finnish and Swedish timber industries is 3-7 times higher than in Latvia. This is the level that Latvia should also aspire to. However, it is important to note that, in terms of the value of their manufactured products, enterprises in the Nordic countries are bigger than in Latvia. In the case of primary processing, they are 3-4 times bigger. Thus, in order to achieve a similar level of productivity, many of Latvia's timber industry enterprises would have to increase their operating volumes several times over, which requires capital investment

in the development of manufacturing, investments in fixed assets, as well as business skills and competence in regard to working on a bigger scale.

In 2013, the value of fixed assets on the balance sheets of Latvia's timber processing companies was similar to the corresponding level in 2008. However, in furniture manufacturing, the value of fixed assets had fallen by 34%. Although the industry's most powerful players such as *Latvijas Finieris* implement considerable investment programmes, the overall speed of capital accumulation within the industry is still slow. The dynamics of the volume of investments offer no indication of rapid growth within the industry.

An analysis was conducted of individual enterprises within the timber industry. This revealed that although economically powerful and upwardly mobile timber industry enterprises can attract the external financial resources they require, credit institutions are reluctant to lend funds for term of over three years without a planned review of the terms involved. For some timber industry enterprises, their chosen operating model and internal factors produce poor results, thus rendering them unattractive candidates for the investment of private or public financial resources. The

slow pace of capital accumulation is due to various restrictions on development: manufacturers whose size makes them non-competitive in regard to particular types of product, the time required to secure a share of the market commensurate with available capacity, difficulties in driving sales in a sector characterised by intensive marketing, as well as the limited availability of funding.

The challenge of capital accumulation is considered more extensively in Chapter Four, which focuses on the availability of funding.

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## Recommendations

### Recommendation 1

#### **MORE EFFICIENT USE OF TIMBER RESOURCES TO GENERATE ADDED VALUE IN LATVIA**

In order to attract strategic investors to a large-scale production plant formation project in the potentially lucrative secondary processing field, e.g. in the panel manufacturing sub-sector a competitive strategic investment project offer must be drawn up and potential investors must be sought proactively, including with the support of senior government officials and members of the diplomatic corps. This is a task for the Latvian Development Agency, the Ministry of Economics and the Ministry of Foreign Affairs.

### Recommendation 2

#### **INCREASED CONSUMPTION OF TIMBER INDUSTRY PRODUCTS IN LATVIA**

The contents of Latvia's construction standards should be reviewed and revised, augmenting and improving their requirements in order to bring them into line with the latest innovations and technological developments in the use of wood carpentry and joinery products

in the EU, in order to eradicate obstacles to the wider use of wood materials in Latvia's construction sector (a task for the Ministry of Economics). Under the auspices of state and municipal orders, pilot wood construction projects should be implemented (in form of buildings and engineering structures), which demonstrate the possibilities and effectiveness of the use of wood in Latvia.

### Recommendation 3

#### **CAPITAL ACCUMULATION WITHIN LATVIA'S TIMBER INDUSTRY**

Continuous provision of public support to help companies break into overseas markets. Support should be provided for participation in trade fairs, trade missions and assessment of the compatibility of production plants and their products (a task for the Ministry of Economics and Ministry of Finance). Political support should also be actively provided for the formation of external economic relations during presidential visits overseas. Public support should also be provided to increase the availability of international level management consultation services to support the capacity of senior management within the timber.







## 9. THE DAIRY SECTOR

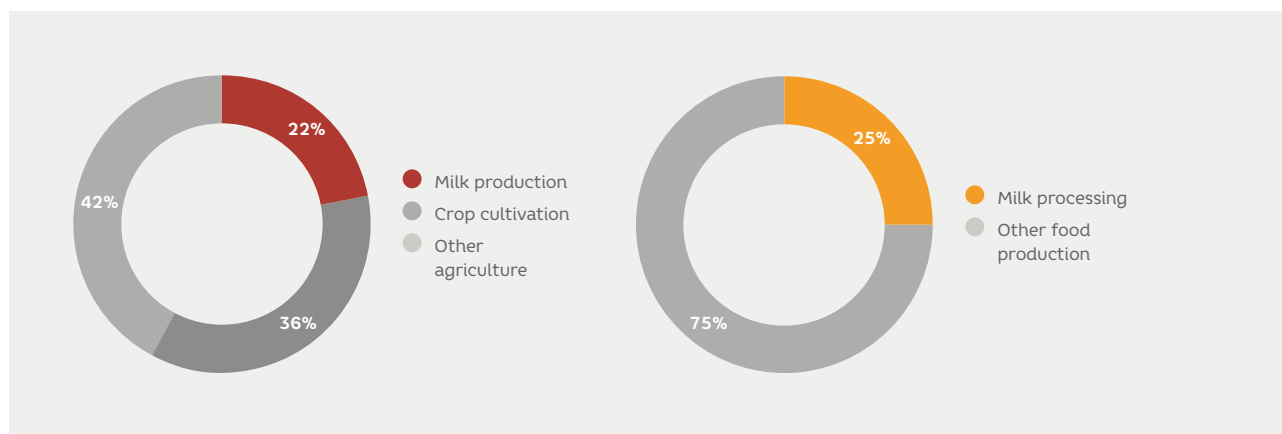
Andris Miglavs

Milk production is one of the most important sectors in Latvia's agribusiness industry. Moreover, it is a sector with significant manufacturing potential.

Comprising almost one quarter of total agricultural product output, it is Latvia's second-biggest agricultural sub-sector.

Importance of the dairy sector to agricultural and food production, % no output in 2013<sup>1</sup>

Figure 9.1



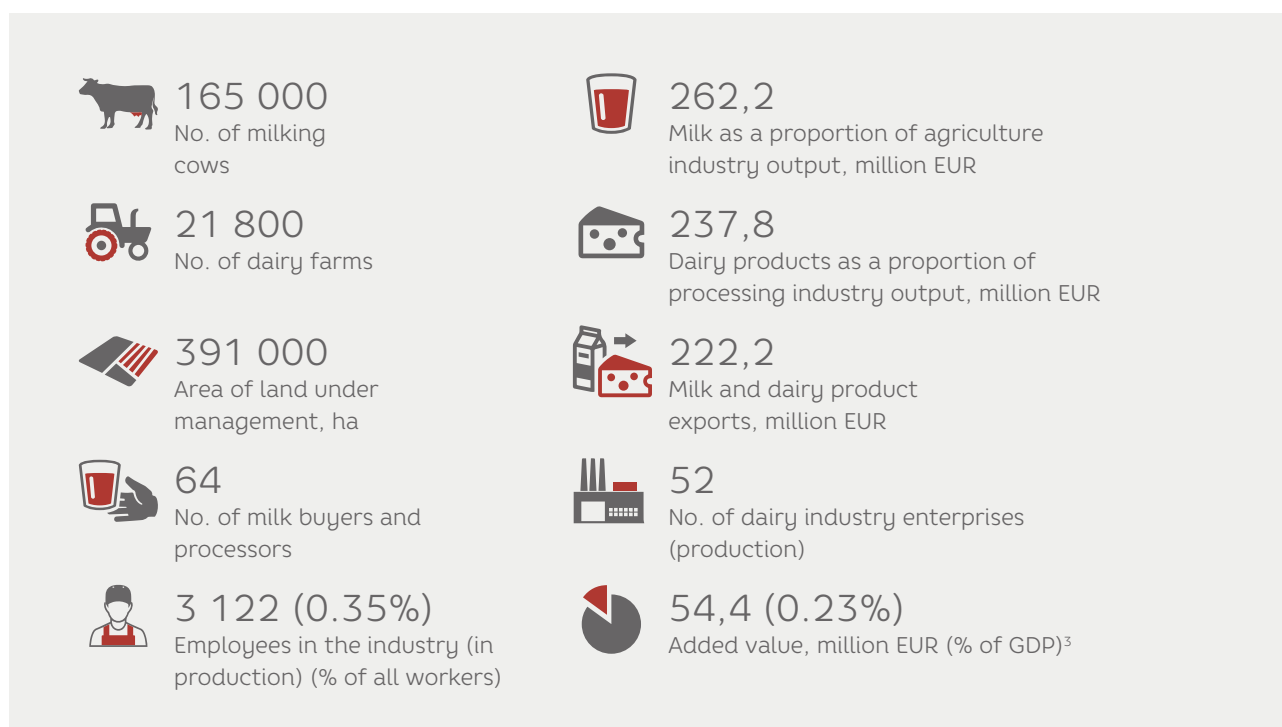
Significant land resources suitable for milk production are still available in Latvia. This could significantly increase agricultural and food production output, as well as the volumes of added value produced within these sectors. In 2013, the structure of the utilisation of agricultural land shows that 59% or 1,154,000 ha of the total agricultural land in use was only occupied by forage crops providing products for use in the feed of herbivorous animals. Even assuming a very extensive level of the

use of land (2 ha of land per 1 unit of beef), this is a resource for the rearing of at least 550,000 cattle. However, at the end of 2014, there were only 422,000 cattle including 166,000 dairy cows. This means that if the current structure of and extent of the use of agricultural land was preserved, using the existing forage base, there is an opportunity to engage at least 130,000 more units of beef in the production of livestock products.

<sup>1</sup> The authors' calculations according to data from the, [https://www.zm.gov.lv/public/files/CMS\\_Static\\_Page\\_Doc/00/00/00/45/84/LAUKSAIMNIECIBASZINOJUMS\\_2014.pdf](https://www.zm.gov.lv/public/files/CMS_Static_Page_Doc/00/00/00/45/84/LAUKSAIMNIECIBASZINOJUMS_2014.pdf)

### Basic operating indicators of Latvia's dairy industry in 2013<sup>2</sup>

Infographic 9.1

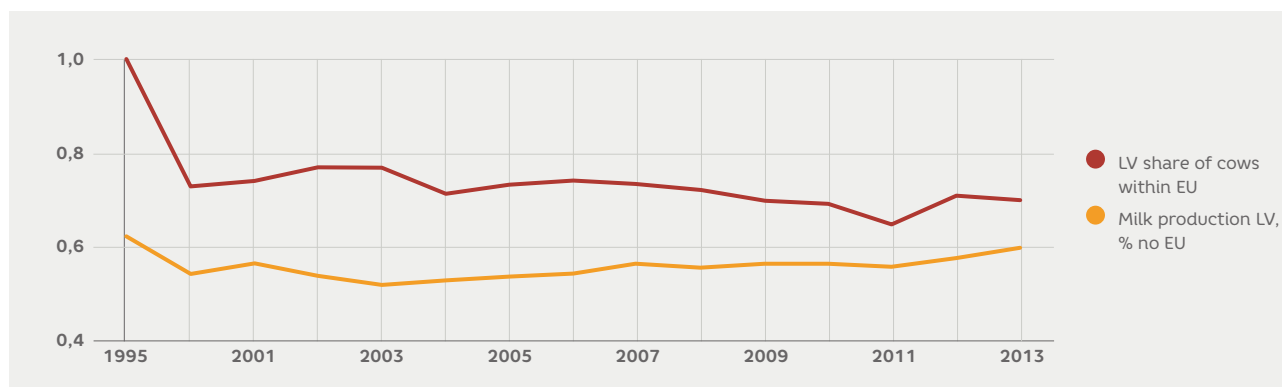


Even though the productivity indicators for milk production in Latvia are significantly below the EU average, progress made in recent years in increasing milk yield from cows has

enabled Latvia to not only maintain, but actually increase its market share of the EU's total volume of milk production, despite the relatively constant number of cows.

### Latvia's share of EU milk production from 1995-2013<sup>4</sup>

Figure 9.2



<sup>2</sup> LR MoA Annual Report on Agriculture. 2014 and EUROSTAT data. 2015.

<sup>3</sup> Factor cost.

<sup>4</sup> The authors' calculations.

Thanks to the comparatively favourable conditions for milk production, Latvia is a net milk exporting country. Assessed according to output per capita, in 2012 Latvia was the seventh biggest EU member state in terms of its milk production volume, which is ~200 kg per capita more than domestic consumption, while the average indicator for the EU-27 was 60 kg per capita.<sup>5</sup>

This determines the comparatively great extent to which the well-being of Latvia's milk production sector (as well as that of the industry in the Baltic states as a whole, because the situation in Estonia and Lithuania is similar) is dependent on its export capacity, bearing in mind that the product exporting structure could be determined either by processed milk products (if the processing industry is competitive) or fresh milk (if this industry loses out to foreign competitors). In Latvia's case, the largest share of the volume

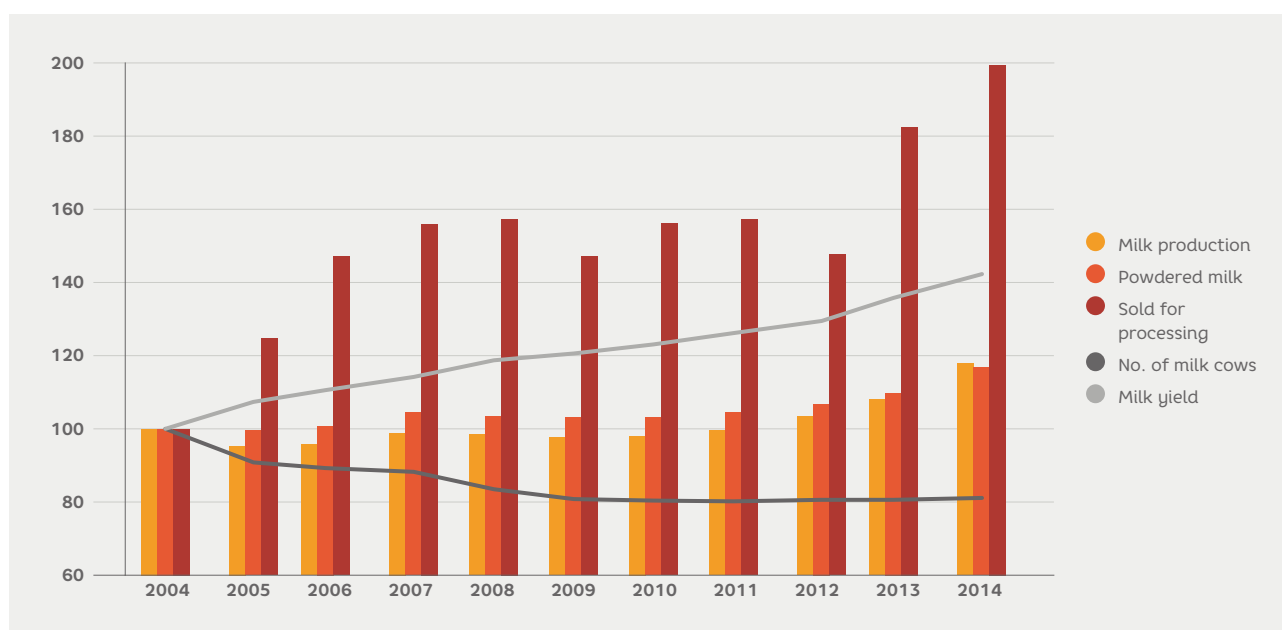
of sold milk (65%) is exported in non-processed or else in slightly processed form of (skimmed milk concentrate or cream).

However, on an EU scale, the total volume of Latvia's dairy sector is very small, making up only 0.6% of the EU's total milk production volume in 2013. In contrast, Germany and France together made up over half of the total EU milk market with 28.6% and 23.4 % market shares respectively, and together with the United Kingdom accounted for 2/3 of the EU's total milk production volume.

This means that the small volume of Latvia's dairy sector gives rise to the hope that it would be possible to not only find an export market outside the borders of the EU, but also within the EU, either through positioning as a relatively cheaper product, or as a special quality niche product for suppliers in the overall EU market or some segment of it.

Development of basic milk production indicators in Latvia 2004-2014<sup>6</sup>

Figure 9.3



<sup>5</sup> EU agriculture, Statistical and economic information, 2013 ([http://ec.europa.eu/agriculture/statistics/agricultural/2013/index\\_en.htm](http://ec.europa.eu/agriculture/statistics/agricultural/2013/index_en.htm)); FAOSTAT <http://faostat.fao.org/site/610/DesktopDefault.aspx?PageID=610#ancor>.

<sup>6</sup> The authors' calculations according to CSB data. 2015.

The 18% growth in the volume of milk production that has occurred during this period was achieved by increasing the productivity of cows, gradually bringing Latvia into line with the average EU indicator – in the past decade in Latvia, the volume of production has increased by 42% and in 2014 amounted to 5,780 kg per cow, compared with the average EU indicator of 6,600 kg in 2012. At the same time, growth in powdered milk (fat and protein) has completely stalled during the past six years at a level of ~7.6 %.<sup>7</sup>

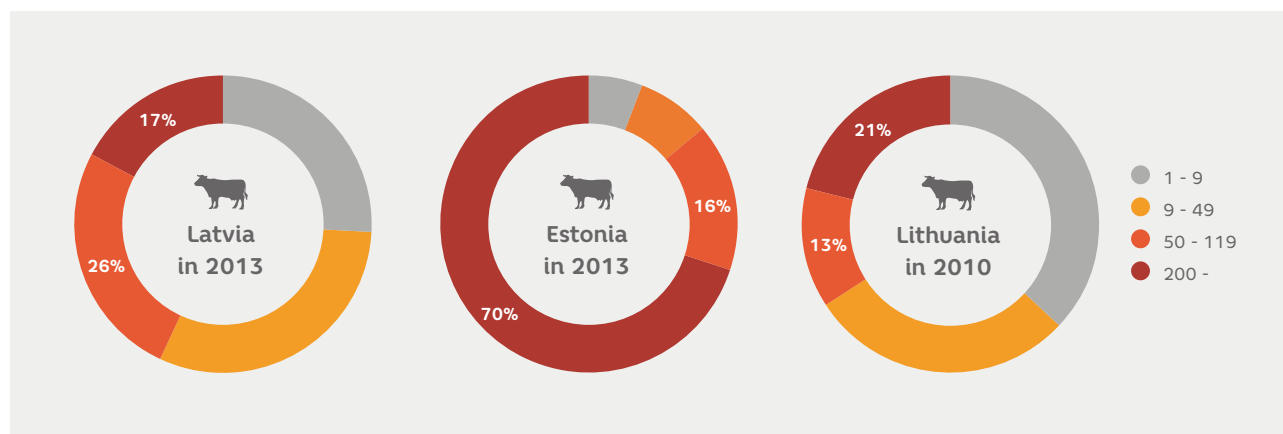
Milk production is very fragmented: at the start of 2015, there were 21,800 dairy farms. Even though the number of dairy farms has been reduced by a thirds from the corresponding figure of 61,200 a decade ago, there are still many hobby farms with up to 10 dairy cows. In 2015, there were 18,700 such farms with 41,000 dairy cows, along with 2,520 farms with 10-50 cows (auxiliary farms) with a total of 50,000 dairy

cows. However, modern technological capabilities point towards a market-oriented dairy farm having no less than 50 dairy cows. There were only about 500 such farms in Latvia in 2015 making up ~43% of all dairy cows, similar to the corresponding figure for Lithuania where dairy cows on such farms comprised 34% of the total dairy cow population. However, in contrast, in 2013 dairy cows on market-oriented farms in Estonia made up 86% of the country's total number of dairy cows.

A further reduction in the number of dairy herds is likely during the next 10 years, parallel to which the size of the average market-oriented dairy farm's grazing herd will exceed 100 dairy cows. The formation and operation of over 1,000 such farms would require a significant influx of new qualified personnel into the industry, posing a challenge to professional education and further education systems.

**Total structure of dairy herds in the Baltic states according to the number of cows per farm in 2013<sup>8</sup>**

Figure 9.4



The fragmented structure of dairy farms is one of the additional factors which determines the relatively low efficiency of

the dairy industry in Latvia, not only at the level of dairy farms, but also at that of the milk processing industry.

<sup>7</sup> The authors' calculations.

<sup>8</sup> The authors' calculations according to EE Statistics and LDC data.  
Note: in Latvia and Estonia in 2013 and in Lithuania in 2010.

A study conducted in 2010 showed that Latvia had the worst performance in terms of added value per employee on dairy farms and in the processing industry in the EU. When it comes to added value obtained from the market, dairy farms produced an average of EUR 4,000 per annual work unit, whereas in the milk processing industry, this indicator came to EUR 15,000. The respective indicators in Estonia were EUR 11,000 and EUR 21,000, while the EU averages were EUR 32,000 and EUR 56,000.<sup>9</sup>

It could well be that the small farming market was one of the factors that has determined that, since accession to the EU, milk procurement prices in both Latvia and Lithuania have been the lowest in the EU Single Market. At the same time, in Ireland, which is a milk exporting country, during the past decade milk procurement prices have been approximately at the average level of the EU-15, as is the case in Germany which is the biggest milk producing country in the EU Single Market.

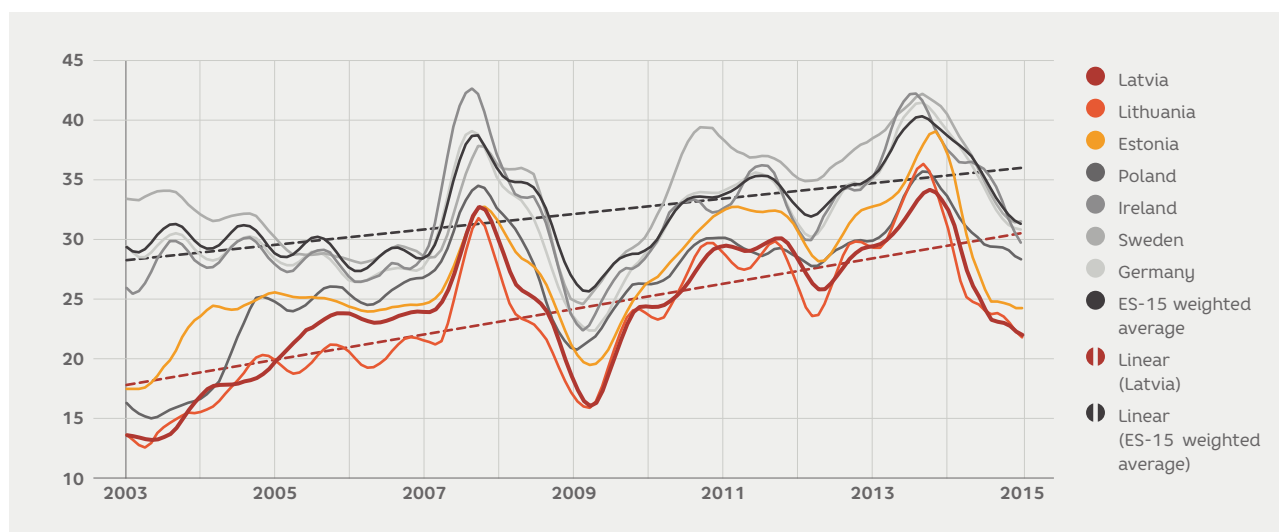
Even though the gap to the average EU-15 purchase price level has narrowed slightly

during this period, the difference before that was only less than EUR 5/t for a few months. Moreover, the slump in all EU milk markets has caused a comparatively deeper decline in the fresh milk market in Latvia. Since the market crisis of 2008-2009, the recovery in Estonia has been faster, and compared with Latvia, prices have stabilised at a higher level.

Latvia's dairy industry is characterised by heightened sensitivity in relation to the unavoidable crises in the global dairy product market, which cause deeper declines in the retail price of milk throughout the EU Single Market, as a result of low competition and market strength. This has a significant bearing on the stimuli for the development of the industry, making this sector an investment risk zone in the eyes of credit institutions, despite general forecasts predicting the stabilisation of the global dairy market, which, given the existence of a competitive farm production structure and organisation, would serve to ensure a sufficient investment repayment level.

Changes in average milk procurement prices from 2003-2014, sliding six month average, EUR/t.<sup>10</sup>

Figure 9.5



<sup>9</sup> Krieviņa, A. 2010. Impact of Capital Investments on Value Added in Dairy Sector. *Proceedings of the International Scientific Conference "Research for Rural Development 2010"*.

<sup>10</sup> The authors' calculations.



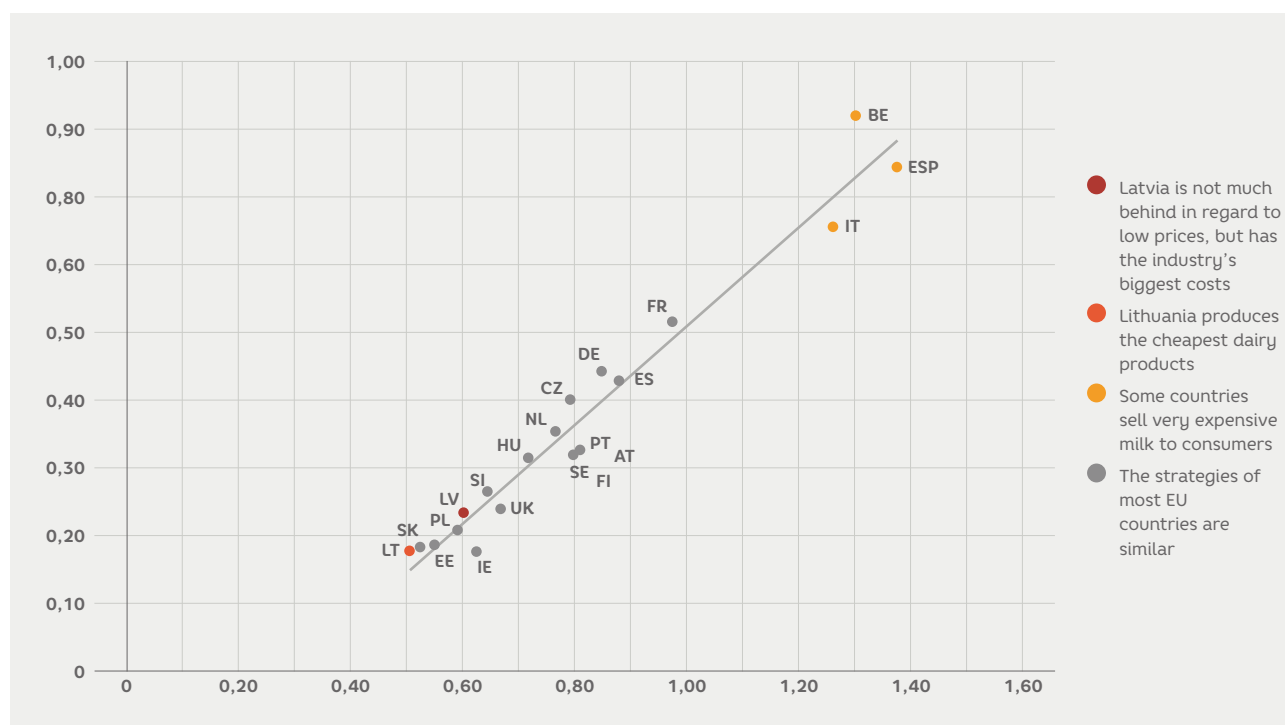
The weakness of Latvia's dairy production sector is also characterised by its dependence on the Lithuanian milk processing industry. Every year over 200,000 tonnes of fresh milk are exported to Lithuanian companies for processing into products that can be sold on the market. The deep integration of both countries' fresh milk market and the relative weakness in the market of Latvian milk producers since 2010 is also indicated by the level of milk procurement prices, which is practically the same in both neighbouring countries but differs from that in Estonia.

The relatively lower milk procurement price is firstly the outcome of milk producers' weakness in the market, which dairy farms have tried to counteract since 2002 by founding joint

dairy sales and processing cooperatives through which they have sold milk, initially even attaining good results. Secondly, it is the consequence of the Baltic milk processing industry's overall lack of competitiveness within the EU Single Market. Similar to the Polish, Slovakian and Irish processing industry, within the EU the Baltic milk processing industry is actually characterised by the smallest amount of value added per processed tonne of raw dairy material. At the same time, compared with the aforementioned countries, Latvia has the biggest inter-consumption costs within processing process itself. This defines the country's milk processing industry as one characterised by production of low priced products with comparatively high processing costs (see Figure 9.7).

**Characterisation of EU state dairy sectors according to the relative retail price of 1 kg of milk in the finished product market, on average from 2006-2008<sup>11</sup>**

Figure 9.6



<sup>11</sup> The authors' calculations.

## Rekomendācijas

### Recommendation 1

#### **BRING LATVIAN DAIRY PROCUREMENT PRICES INTO LINE WITH THE EU AVERAGE**

- Development of cooperation between milk producers to improve the efficiency of logistics and the quality of fresh milk and increase the market strength of milk producers;
- Concentration of investment into export-oriented enterprises. Investment support from the state should only be provided to projects aimed at manufacturing exportable products with significant potential market strength, whose business plans envisage the payment of at least the EU average milk procurement price to suppliers of quality dairy raw materials.

### Recommendation 2

#### **SOFTEN THE IMPACT OF SHORT-TERM SLUMPS IN THE DAIRY MARKET ON THE LATVIAN DAIRY SECTOR, THUS, RETAINING THE INTEREST OF INVESTORS AND FINANCIAL INSTITUTIONS IN FACILITATING THE DEVELOPMENT OF THE SECTOR**

- Establishment of a system to insure revenues against deep short-term market crises. This system should combine the solutions offered by the capabilities of the European Agricultural Fund for Rural Development Fund, with a privately devised system of deposits, which would be formed and run by private insurance companies under the auspices of a specially created product or the industry's own self-help system, adapting legislation accordingly.

### Recommendation 3

#### **INCREASE AND MULTIPLY THE KNOWLEDGE OF PLAYERS RESPONSIBLE FOR THE EFFICIENT DEVELOPMENT OF THE DAIRY SECTOR, I.E. PRODUCT DEVELOPERS, FARM MANAGERS AND WORKERS**

- Establishment of a product development and knowledge transfer centre to drive the innovation of exportable dairy processing industry products and the commencement of their production;
- Strengthening of the system raising professional qualifications to provide new and upwardly mobile market-oriented dairy farms with:
  - manufacturing management specialists,
  - qualified employees;
- Formation of a system that raises professional qualifications to provide upwardly mobile export-oriented enterprises in the milk processing industry with international level technological management specialists.

# Authors

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Dr Dombrovskis has many years of experience in academic work at the Stockholm School of Economics in Riga and an Assistant Professor at the *Baltic International Centre for Economic Policy Studies*. He was a Reform Party Deputy in the 11th Saeima, heading the Economics Committee and Reform Party parliamentary fraction. He was subsequently elected to the 12th Saeima as a Unity Party Deputy. During the course of his political career, he served in government as Minister of Education and Science and as Minister of Economics.

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## Anna Feldmane

Riga Business School

provided valuable research assistance in preparing this report.

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