Review of the Latvian Competitiveness Report

Maya Jollès

In February 2011, the Latvian State Chancellery ordered a report on the country’s competitiveness. The Latvian Competitiveness Report (LCR), delivered in April 2012, aims to “provide an overall assessment of competitiveness” in Latvia and “to develop a methodological framework”. One obvious outcome is its direct use for policy making decisions. It was a timely initiative to request the report in order to reflect on longer term sources of growth. After recent internal devaluation adjustments, a broad look at GDP growth sources offers a range of long term policy options.

Policymakers, economists or anyone interested in the recent but also structural economic changes in Latvia will find reading it worthwhile. Although commissioned by the Latvian government, its potential readership is in reality quite large. Not only can it be used in Latvia, but also outside, in neighbouring countries, in transition economies or in the context of international organisations. The LCR synthesises in one report in Latvian or English a perspective on the country’s competitiveness performance. It also offers an analytical framework that can serve as a reference for other countries.

The framework developed by the authors allows for a comprehensive overview of Latvia’s competitiveness, supported by a selection of in-depth studies. The LCR is a balanced mix of new analysis, of references to recent academic research and to recent international reports. The authors offer a deep knowledge of the region, but not only. The Baltic International Centre for Economic Policy Studies (BICEPS), the Stockholm School of Economics in Riga and other economic experts collaborated with Dr Ketels from the Institute for Strategy and Competitiveness at Harvard.

This review examines first the original angle of the LCR. Second, it highlights the report’s most striking features and findings. Third, it reflects on how to make use of the current LCR for policymaking and what could be expected from a potential future edition.

1. Scope of the LCR

A consensus exists on the importance of ‘competitiveness’ but no general understanding of the term. Since the LCR is not only a “country report” but a competitiveness report, what exactly is meant by competitiveness? What does it entail? The authors recognize the polysemy of the term “competitiveness”. They intentionally choose the productivity-based approach to competitiveness. This is in fact a perspective taken by many other reports on competitiveness,
such as the European Competitiveness reports (European Commission 2011)\(^1\). If productivity, measured broadly as GDP per capita, is considered the main source of competitiveness, the implication is that improved competitiveness, i.e. increase in GDP per capita, is synonymous with amelioration in standards of living. Since growth theory points to convergence in productivity levels from countries with the lowest GDP per capita, it is all the more relevant to look at how this convergence can be facilitated in Latvia. And as there is no one-size-fits-all answer to how a country can grow, the exhaustiveness of the report is very welcome.

But an increase in GDP per capita does not necessarily translate into social progress. Therefore the authors purposely complement the economic angle by social indicators. This broad vision of development reflects a general awareness that was propelled by Amartya Sen (Sen 1999)\(^2\) and translated into human development indicators\(^3\) by the UN. This approach has gained ground. Indeed, the Europe 2020 headline targets include socio-economic and environmental targets (European Commission)\(^4\). At EU level again, “Beyond GDP” (European Commission)\(^5\) offers not only economic indicators, but also social, environmental and well-being ones. The authors take as a reference the Stiglitz-Sen-Fitoussi report (Stiglitz, Sen and Fitoussi 2009)\(^6\), a French initiative used internationally.

2. Original findings and features of the LCR

Once the objectives and definitions of the key concepts of the report are set, the report is structured with an analytical part, a competitiveness diagnostics, an assessment and a prioritisation.

The analysis

The analytical second part of the LCR is based on three pillars - prosperity outcomes, intermediate indicators and competitiveness fundamentals - that can feed into each other. This rather simple structure makes the report clear and exhaustive. The report “scans” the Latvian economy from all levels: micro-, meso- (intermediate indicators on sectoral composition) and macroeconomic. The scope and variety of experts provides insight into all topics ranging from the labour market to fiscal policy and many more areas.

A considerable amount of data is processed. More than 100 indicators are selected. All data are from secondary sources. But this is not a shortcoming. On the contrary, it offers the reader a synthesis. Since this considerable collecting effort has been done once, it would be highly appropriate to capitalise on it and pursue it. The idea of renewing the report is discussed later in the review.

\(^3\) http://hdr.undp.org
\(^4\) http://ec.europa.eu/europe2020/targets/eu-targets/index_en.htm
\(^5\) http://www.beyond-gdp.eu
The LCR is the strongest in its country-specific perspective. While many facts and data are often available in other publications, the background explanations are unique. The mix of international academic knowledge and Latvian knowledge offers insightful comparisons, especially with other countries. The most insightful parts for the reader not knowledgeable about the Latvian economy are certainly the precise analysis of the institutional specificities. This reader will learn about the Latvian wage bargaining system and about the system of “envelope wages”. The part on the under-development of the Latvian financial markets is also very substantial and insightful for a better understanding of its impact on the macro-economic situation. The explanations about legal aspects of innovation in Latvia clarify why the legal framework limits incentives for commercialisation of innovation.

Interestingly, the macro-economic imbalances section of the so-called “intermediate indicators” is very much in line with recently enacted monitoring mechanisms at EU level that intend to prevent the build-up of imbalances at an early stage. The Alert Mechanism Report in 2012 did not identify that Latvia needed an in-depth review as part of the Macroeconomic Imbalance Procedure. A repetition of the LCR, as discussed later in this review, would offer an additional useful source to determine the signals of potential future crises.

**The diagnostics**

Diagnostics is performed by isolating the areas that constrain growth most. What is meant by “diagnostics” is taken from the literature (Hausmann Rodrik and Velasco 2005). A methodology, such as a decision tree, can be used to identify issues more cumbersome than others. The areas selected have the largest knock-on effect on the rest of the economy. Three issues are selected to perform diagnostics: the large size of the shadow economy in Latvia, the low share of manufacturing, and the high level of income inequality.

The main problem with the informal economy is that its negative effects are pervasive and affect all sectors, not only areas traditionally dominated by informality in Latvia. What is more, informality tends to inhibit productivity growth and discourage foreign direct investment (FDI). The second issue, the low share of manufacturing in Latvia, is partly explained by low FDI. In comparison to Estonia, Latvia has not attracted as much FDI geared towards export sectors. The National Reform Programme of 2011 also mentions this shortcoming of a limited manufacturing sector. But this phenomenon is rather recent historically. The paradox is that Latvia had a large manufacturing sector in the Soviet era. The authors regret that Latvia has not been able to transform itself into a competitive economy and has therefore shrunk. The monopolistic character of certain sectors can sometimes explain lack of incentives for modernisation and innovation. The choice of inequality as the third area has to do with the economic structure of Latvia. Latvia has the highest gini coefficient of all EU member states, signalling a worrying inequality in distribution of incomes. The report reflects on why and

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7 http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm
how inequality affects competitiveness. The distribution of skill levels across the population, the heterogeneity in capital and technological intensity across sectors and industrial composition itself (very low versus very high productivity sectors) contribute to fuelling inequalities. Indeed, the LCR identifies access to education across regions, migration and informality as key explaining factors of inequalities.

The prioritisation

As the authors note, the same structural problems persist over time. Latvian institutional specificities are largely responsible for the inertia. The authors call for urgent institutional changes to break the harmful effect of short-termism. The recent fiscal discipline law as well as electoral reform or use of a more diversified pool of talent in public administration are among the suggestions.

In the prioritization effort, the LCR is in line with the EU approach which favours focus on a few outstanding issues rather than on a laundry list of measures. Six problematic areas and two areas of strength are identified as standing out. Priority weaknesses include inequality, innovation, the low share of manufacturing, education, under-development of financial markets and informality. Priority strength areas are export diversification and transport and logistics infrastructure. Among those, three are singled out as the most crucial priorities: informality, education, and transport infrastructure.

Even if it is subject to discussion, the prioritisation exercise is highly valuable. It helps focus attention on only a few high impact areas. Nonetheless, the technique for prioritizing could be explained further, especially if the report is to be reproduced in the future for Latvia or for another country. This would ensure consistency across time and regions. It would also make the final choices even more credible. Some might debate selection of informality and education as priorities. Informality is very difficult to estimate and education could be seen from a wider angle, i.e. skills. Workforce training together with education would have been a relevant proposal. The third priority, transport infrastructure, has a strong EU component. This is also why the report should be read outside Latvia. Large scale infrastructure and transport projects are a typical area of cross-border industrial policy.

3. The report’s input for policymaking

Are the recommendations of the LCR detailed enough?

Since policymakers in Latvia receive recommendations from different sources, what is the specificity of the LCR with regard to other reports? Comparing with country-specific recommendations at EU level helps understand the specificity of the LCR recommendations. Among the three priorities identified in the LCR, education is the only one that coincides with one of the European Semester Country-specific Recommendations 2012-201311. The

objectives of the LCR and the European Semester overlap, but are intrinsically different. The European Semester is developed with a three-pronged objective in mind while the LCR is centred on competitiveness. The three objectives of the European Semester are 1/ monitoring budgetary discipline in the EU 2/ monitoring Europe 2020 progress 3/ preventing emerging macro-economic imbalances. In practice, the European Semester leads to identification of country-specific recommendations on a yearly basis in line with priorities laid out in the annual growth survey. The LCR mentions immediate possible changes but focuses its prioritisation on a longer term approach. Changes in the areas selected (e.g. education or transport infrastructure) are to be tackled immediately but will not bring immediate results. Therefore, monitoring them on a one year cycle is more difficult.

Since the report builds on the academic field of applied economics, should the authors go at length into practical implementation of the recommendations? In fact, the level of detail of the recommendations of this edition is optimal, as they can be used as a starting point. The added value of the report stems from its thorough analysis and prioritisation, not from highly detailed prescriptions. In practice, policy decisions stem from a careful interdisciplinary approach, in consultation with stakeholders. The economist alone may not be able to find the cure. Depending on the issue, an economist would need for instance to collaborate with a public-private partnership specialist or an education specialist to offer very specific advice. Concrete policymaking solutions are based on experiments over time. The risk also arises, if the LCR is repeated over time, of the authors becoming both the judges and the judged.

Is the scope of the report broad enough?

The Stiglitz-Sen-Fitoussi report (2009) recommends setting aside issues related to sustainable development and environment as those deserve their own indicators and perspectives. The authors follow this approach so that sustainability/environment issues are almost absent (and analyses of these issues scarce) in the LCR.

An additional report would therefore be desirable. Especially so as the energy sector has been pinpointed as a recommendation in the European Semester exercise. If social indicators are included, why not also take into account sustainability indicators? GDP measures and welfare measures do not indicate whether the environment or natural resources are preserved in the long term. As environmental issues are as important as social issues for both intra-temporal and inter-temporal equity, it would be worth having at least one additional in-depth report.

Is the LCR the first report of a long series?

In the long run, the report offers a basis for independent and long term thinking about the Latvian economy. The report should be repeated in order to take stock of what has been achieved and what reform measures are still pending. Incidentally, the framework is broad enough to open later editions to newly emerging topics.

Every year, various organizations and stakeholders also analyse the Latvian economy from a ‘competitiveness angle’. One can mention the national reform programme, a yearly exercise by the national authorities and coordinated by the European Commission that touches upon competitiveness issues. The “Member States competitiveness performance and policies 2011” report\(^\text{13}\) is a case in point as it is a yearly monitoring exercise from the European Commission. The World Bank’s ‘Doing Business’ (World Bank 2012)\(^\text{14}\) or the ‘IMD World Competitiveness Yearbook’ (IMD 2012)\(^\text{15}\) are also reports that look at member state economies from a competitiveness stance. All shed some light on the underlying strengths and shortcomings of the Latvian economy. While the national reform programme provides an exhaustive overview, it is not an independent exercise. The international rankings, on the other hand, provide some comparability across countries but only help identify some outstanding issues, not their source or how to resolve them. The added value of ranking is mainly to raise awareness. The ‘Member States competitiveness performance and policies 2011’ mixes in-depth thematic analyses and country-specific knowledge. But it is centred on benchmarking and does not aim to reach the same level of detail as the LCR. The LCR therefore has no equivalent.

Considering that the positioning of the LCR is unique, clearly the exercise should be repeated. But at what frequency and with what content? The framework offers a base that could be followed yearly or biennially. The OECD typically conducts country reports with a thematic approach on a biennial basis (OECD)\(^\text{16}\). But Latvia is currently not part of the OECD. Moreover, OECD topics change according to a set of chosen policy priorities. They are not called ‘competitiveness reports’ even though the content is very much related to competitiveness issues. The optimal option could be a mixed approach, with a skeleton structure that does not change and a few in-depth issues that vary. This formula would benefit from comparability across time and from thorough insights into specific areas.

Maya Jollès, European Commission

*Views expressed in this review represent the position of the author and do not necessarily reflect those of the European Commission.*

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\(^\text{14}\) [www.doingbusiness.org](http://www.doingbusiness.org)

\(^\text{15}\) [http://www.imd.org/research/publications/wcy/index.cfm](http://www.imd.org/research/publications/wcy/index.cfm)

\(^\text{16}\) [http://www.oecd.org/document/15/0,3746,en_2649_34111_34627763_1_1_1_1,00.html](http://www.oecd.org/document/15/0,3746,en_2649_34111_34627763_1_1_1_1,00.html)
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