



COUNTRY BRIEFING LATVIA

Vienna Institute for International Economic Studies

Industrial Policy for a New Growth Model

Country Briefing Latvia

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FES programme »European Economies of the East«

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Please find all the publications of the programme under its webpage:

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CENTRAL AND EASTERN EUROPE NEEDS INDUSTRIAL POLICY TO ESCAPE THE MIDDLE INCOME TRAP

Since the early 2000s, the EU member states of Central and Eastern Europe (EU-CEE) have achieved an impressive economic catch-up process. However, the previously successful model of taking over labour-intensive production steps as an 'extended workbench' of Western corporations has reached its limits. Combined with major global challenges such as decarbonisation and digitalisation, this makes it essential for EU-CEE to develop a new, innovation-based economic model. Only then will these states be able to complete the catch up with Western Europe in terms of productivity and living standards. The situation is exacerbated by the economic consequences of the war in Ukraine, such as permanently higher energy prices and higher inflation, which pose grave challenges for the region's external competitiveness.

The problem is that the central technological competences and those parts of production with the highest added value are located in the 'headquarter economies' of Western Europe. Meanwhile, the EU-CEE countries – Poland, Czechia, Slovakia, Hungary, Slovenia, Croatia, Romania, Bulgaria and the three Baltic states – are still extremely specialised in labour-intensive production. They depend heavily on lower labour costs, and this restricts their prospects of catching up economically with Western Europe. A good example of this is the car industry, which is so important for the region as indicated by its high share of value added, jobs and exports, especially in the Visegrád states, Romania and Slovenia.

The study shows that the EU-CEE countries have so far lacked a constructive approach to industrial policy in their development trajectories. They have had a very broad ranging FDI promotion policy, weak investment environments for start-ups, and the activities of state-owned enterprises have not been aligned with the greater development goals. In general, there is a lack of state entrepreneurship in these countries that could nurture promising industries. This is particularly challenging for regions that are lagging behind within countries, as they lack the technical capacities for industrial policy. Due to these factors, the study argues that the EU-CEE countries are struggling to get out of their middle income trap.

Their EU membership offers unique opportunities for industrial policy, but also challenges. On the plus side are access to funds, participation in research networks and the opportunity to shape industrial policy on the EU level. Important-

ly, industrial policy in the EU has taken a much more prominent role in recent years as shown by initiatives such as the European Chips Act or the Important Projects of Common European Interest (IPCEI). This provides some momentum for the development of industrial policy in the EU-CEE countries. Strict state aid rules and an EU competition policy that gives preference to free market principles, on the other hand, are challenges for an effective industrial policy.

As discussed above, the growth model of the EU-CEE countries must be made fit for the future. Decarbonisation, digitalisation and a shrinking labour force require massive efforts to be made. For countries like Poland, the green transition is a major challenge. This transition can only be managed through huge public investments in green technologies and digitalisation, combined with the right conditions for private enterprise to thrive, to create a fully joined-up approach combining the best of the public and private sectors and academia. This means more money for education, research and development, as well as active labour market policies to manage the transition.

Above all, however, the countries of the region need a strategically oriented industrial policy to support the emergence of more globally competitive companies and to emphasise their own economic strengths. While a true "entrepreneurial state" may be too ambitious for many EU-CEE countries in the coming years, steps in this direction are the way to go. We propose eight steps, that should be taken:

1. Create a national innovation system in each country, bringing together the private sector, universities, key ministries, and business agencies. Within this biotope, new ideas can be developed, tested, and financed. Each country should define which sectors and specialisations are promoted, rather than relying solely on external market forces.
2. Make full use of EU funds and maximise participation in EU research initiatives to advance industrial policy goals. Governments should also get more involved in industrial policy debates at the EU level. Greater participation in the EU's Horizon Europe research funding programme or in the EU's Important Project of Common European Interest (IPCEI) initiative would also be particularly important for the region's technologically less advanced countries.

3. Learn from each other's successes stories to emerge as frontrunners in the digital economy. Estonia is generally well prepared in this area and often raised as an example. However, there are also other positive cases in the region. Romania and Croatia have a particularly high proportion of graduates in ICT, relevant for digitalisation. Czechia shines with its digital start-ups, the Baltic states with the quality of their digital public services. The Visegrád countries and Slovenia have highly digitalised and automated industries.
4. Harmonise investment schemes to attract foreign companies with national industrial policy. Instead of providing blanket support for all investments by foreign companies, national governments should strategically consider which sectors and parts of the value chain they want to attract, and create incentives that maximise the potential for spillovers from foreign giants to domestic firms.
5. Identify and exploit promising niches. Given the lack of technological experience, the establishment of the semiconductor industry in the EU-CEE countries, for example, would not be very promising. However, each country has traditional strengths that should be built upon.
6. Institutional reforms. In some states of the region, the quality of public institutions has declined significantly in recent years. This is worrying. Countries in East Asia have a lot of experience in building adequate institutions for an active industrial policy, even if the framework conditions there partly do not meet Northwest European standards. This experience should be used.
7. Structural change must be cushioned socially in order not to lose the support of the population. EU-CEE countries should aim for a flexible labour market to ease the transition from old to new jobs, but underpin this with extensive retraining programmes and a social safety net that means that workers themselves do not bear the costs of the transition.
8. Each country needs a tailor-made industrial strategy adapted to its specific needs. While the Baltics, for example, are well positioned for the digital transformation, they are struggling above all with distribution problems and a shrinking population. Czechia, Poland or Slovenia are industrially the most advanced, but must make the transition from 'extended workbench' to innovative economy. For the less developed parts of EU-CEE such as Bulgaria and Romania, the priority should be on maximising the transfer and knowledge and innovation from big foreign investors.

COUNTRY BRIEFING LATVIA

COUNTRY OVERVIEW

Latvia is the least industrialised country in the EU-CEE, and also one of the least developed. This is reflected by the various indicators of industrial competitiveness. The country has got one of the highest shares of low-tech industry within manufacturing value added in the EU. This is also an outcome of very low FDI in the manufacturing sector (while most inward FDI went to the service industries).

Building upon the natural resources of the country, one core activity in the economy is the processing of wood (together with forestry upstream and furniture production downstream), which accounts for 20.9 per cent of total employment in manufacturing. In general, companies are small to medium in size; Lavijas Finieris and Kronospan Riga are the largest two, producing wood-based panels. Given the advanced tertiarisation of the economy, the fabrication of metal-based products declined in importance in the past (to 10.1 per cent of employment in manufacturing) and only one enterprise in this sector (Severstal distribution) as well as one in the electronics industry (Mikrotils) are of medium to large size. Thus, food production amounting to 17.3 per cent of total employment, became the second largest manufacturing subsector. Two of the three largest Latvian employers in manufacturing however are pharmaceutical enterprises (Olainfarm and Grindeks) since larger facilities are required for efficient production in this sector.

The human capital situation can be described as middle-rate in comparison to the EU-CEE. In terms of tertiary educated workforce, the country is a front runner in the EU-CEE region, and while in terms of digital skills Latvia ranks below the EU average, the share of ICT graduates surpasses EU levels.

The economy is on a good track concerning environmental transition, however in the case of material use and energy efficiency Latvia lags behind. In addition, in the past two decades greenhouse emissions were, contrary to the EU average and the national reduction target, on the rise. Upon lately dependence on Russian energy imports had been high. The reorientation towards Northern and Western Europe took place or is ongoing but results in higher energy prices. Thus, the issue of energy security and costs represents a challenge for industrial competitiveness going forward.

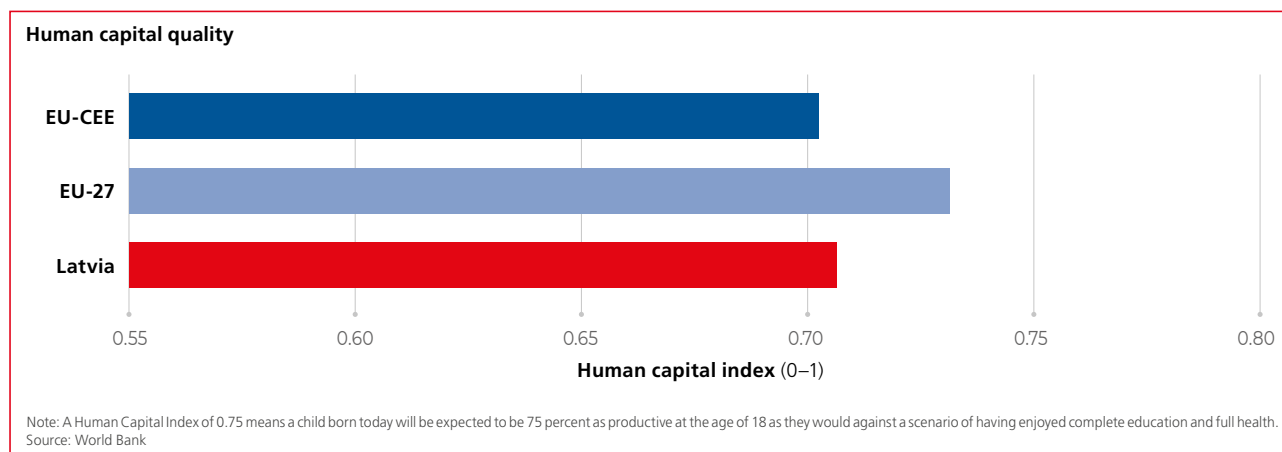
INDUSTRIAL COMPETITIVENESS – SWOT

Strengths

- Latvia has a high share of population with tertiary education and one of the highest shares of ICT graduates among students in comparison to other EU-CEE countries, which allows to use the opportunities of digitalisation in all industries

Industrial development – I			
	Competitive industrial performance index	Manufacturing value added (MVA) (% of GDP)	Medium- and high-tech MVA (% of total MVA)
Latvia	0.05	12	21
EU-27	0.14	15	41
EU-CEE	0.10	17	38

Note: 2020 values. The CIP index assesses the strength and complexity of an economy's industry, with Germany claiming the maximum score in 2020 at 0.42.
Source: UNIDO



- Institutional quality is among the highest in the EU-CEE, behind the leader Estonia but in line with Czechia, Slovenia and Lithuania, offering solid pre-conditions for state entrepreneurship

Weaknesses

- Latvia has a low innovative capacity and progress in this field is lower than for the EU average. Government support and finance for R&D business expenditure is lacking. Thus, also patent applications are among the lowest in the EU.
- Environmental expenditure is relatively low and the R&D investment rates is one of the lowest in the EU

Opportunities

- Latvia has one of the highest broad-band penetration rates in the EU, which points to a relatively well-developed digital infrastructure in the country. Moreover, in the area of digital public services, Latvia (along with the other Baltic countries) outperforms the EU average.
- The ongoing experience with skill shortages incentivises productivity-enhancing automation

Threats

- Integration of digital technology in enterprises, particularly in SME's is developing slowly, although the RRF foresees public investments in this area.
- The lowest share of new doctorate graduates within the EU impedes the development and application of innovation in Latvia and hinders the potential of a more high-technology based economy.
- The working age population is about to shrink strongly in Latvia. Skill shortage is already for a longer time a serious issue for the manufacturing sector.

INDUSTRIAL POLICIES AND STRUCTURAL REFORM DEVELOPMENTS

FDI promotion and value chain upgrading

- FDI policies have been rather passive in Latvia. Not recently, but in the past the country has established five free trade areas, which offer companies apart from other benefits a substantial reduction in corporate income taxes and real estate taxes.

New technologies, digitalisation, innovation

- The National Industrial Policy Guidelines 2021–2027 approved in 2021, focus on the development of human capital, i.e. particularly ICT and vocational skills of the incoming as well as the existing workforce. In addition, innovation and export capacities of firms should be fostered. The government identified five Smart Specialisation areas in their RIS3 strategy: Knowledge-intensive bioeconomy; biomedicine, medical technologies and biotechnology; smart materials, technology and engineering; as well as advanced ICT and smart energy as horizontal enablers of structural transformation across all economic sectors.
- About 21 per cent of the Recovery and Resilience Facility (RRF) is allocated to the digital transformation, supporting particularly digitalisation of businesses, a digital upskilling of the workforce and a fast development of the 5G infrastructure in Latvia.

Green transformation of industry

- Only a small share of the funds foreseen in the RRF for green transition is directed towards industry, while most towards public transport and energy saving measures. Nevertheless, the investment in the green and digital transformation of electricity grids as well as the renovation initiative to increase the energy efficiency of building are horizontal measures that also raise the resource productivity of Latvia's industry.

COUNTRY-SPECIFIC RECOMMENDATIONS

As for the other Baltic countries, the core focus for policymakers in Latvia should be to maximise advantages in the digital sphere, address the distributional implications of this type of growth, take steps to maximise the growth potential of the green transition, and address the extremely challenging issue of labour supply.

- **Take advantage of strong human capital and address demographic decline with a stronger push towards automation and active labour market policy.** Latvia has a reasonable level of human capital by EU-CEE standards, but has been experiencing, and will continue to experience, very negative demographic

trends. These are visible in skills and general labour shortages in the economy, and present a major break on future growth potential. Policymakers must prioritise making the most of the available human capital with targeted policy interventions, focused on education, training, the retention and attraction of human capital, and improving labour productivity. The government should invest more in the upskilling of the existing workforce and increase spending on active labour market policies including training and foster the development of digital and vocational skills in education. By targeting a higher minimum wage, the government can incentivise the automation of more routine tasks, and combined with the formulation of retraining policies, a stronger social safety net, and minimal entry and exit restrictions for employment, ease and speed-up the transition of workers towards higher value added tasks (see policy recommendation 5.7 in the main report). Moreover, immigration policy could be adapted in order to attract much-needed skilled workers in particular sectors.

- **Take a more proactive approach to foster innovation capacity of the economy by taking steps towards the establishment of an entrepreneurial state with a national innovation strategy.** The low performance in research and innovation in Latvia highlights the need for a substantial increase in direct public support to R&D and more incentives for business to invest in R&D. A greater proportion of research funding should be devoted to ICT-related projects, which are currently underfunded. Although we do not identify Latvia as one of the EU-CEE countries fully at the state of being able to build an entrepreneurial state, steps should be taken in this direction. The state should seek to build up more networks of exchange between key ministries, academia and the private sector in order to exchange information with the aim of building a feed-

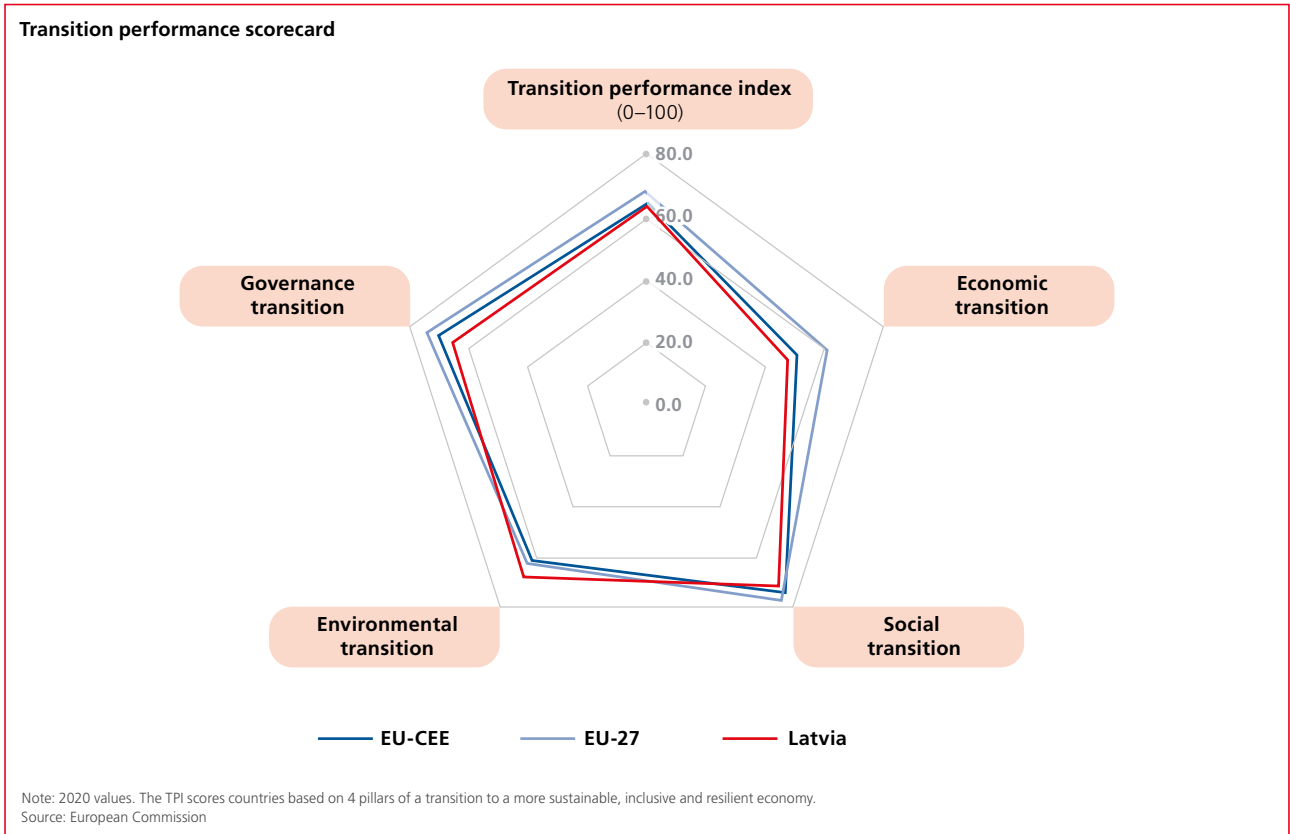
back loop to develop ideas (see policy recommendation 5.1 in the main report).

- **Implement incentives to attract proactively FDI in industrial sectors relevant for the digital and green transformation of the economy, and consistent with a national innovation strategy.** Following on from the previous point, foreign investment will remain a central channel by which the Latvia economy receives and implements innovation, and in this sense FDI policy should be increasingly steered towards attracting investment that will bring innovation in line with the economy's needs. The government should seek to build on existing niches, aiming to attract FDI to these niches, and incentivizing foreign investors to operate in a way that will generate spillovers for the domestic economy (see policy recommendation 5.4 in the main report). A more active approach in FDI attraction could foster the development of the areas targeted at in the RIS3 strategy mentioned above as well as other relevant business services. In addition, FDI could facilitate a swift restructuring in energy and transport towards smart and green technologies, which Latvia anyway needs due to the breakdown of the economic ties with Russia and Belarus.
- **Make green transition a key element of the economic development strategy.** Latvia was until recently heavily dependent on Russian gas and oil. It has to invest in further energy interconnection capacities with neighboring countries. It should further promote renewable energy generation in particular by removing administrative barriers to the development of (on- and off-shore) wind energy projects. Green transition (raising material use rate, resource productivity, etc.) should also be fostered by improving access to finance for small and medium-sized enterprises through public lending and guarantee schemes.

Industrial development – II

Sector	% of manufacturing employment
Wood and products of wood, cork, straw, etc. except furniture	20.9
Food products	17.3
Fabricated metal products, excl. machinery and equipment	10.1
Wearing apparel	6.2
Furniture	6.1
Other non-metallic mineral products	5.1

Note: 2021 values.
Source: Eurostat Structural Business Statistics.



Latvia



COUNTRY OVERVIEW

Latvia is the least industrialised country in the EU-CEE with high share of low-tech industry

Core manufacturing activities are the processing of wood and food.

Best share of tertiary educated workforce in the EU-CEE region; ICT graduates surpass average EU levels.

Energy security and costs represent a challenge for industrial competitiveness.

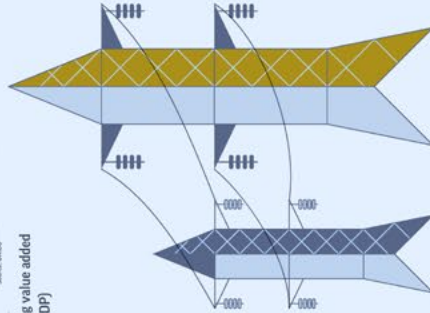
INDUSTRIAL DEVELOPMENT

	0.05	12%
LATVIA	0.05	12%
EU-27	0.14	15%
EU-CEE	0.10	17%

Competitive industrial performance index

Manufacturing value added (MVA) (% of GDP)

Source: OECD, Eurostat, The EU-CEE Competitiveness Index, Strength and Resilience of the European Economy, Germany's Innovation Strategy, Science & Innovation, Science & MBO



INDUSTRIAL COMPETITIVENESS - SWOT



STRENGTHS

- High share of population with tertiary education and one of the highest shares of ICT graduates among EU-CEE countries
- Institutional quality is among the highest in the EU-CEE



WEAKNESSES

- Low innovative capacity and slow progress in this field. Little government support and finance for R&D business expenditure
- Environmental expenditure is relatively low and the R&D investment rates is one of the lowest in the EU-CEE



OPPORTUNITIES

- One of the highest broadband penetration rates in the EU relatively well-developed digital public services above the EU average.
- Skill shortages: incentives productivity-enhancing automation.



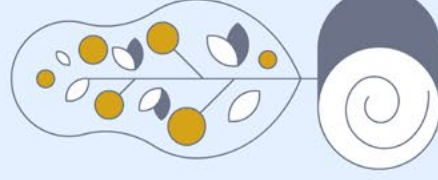
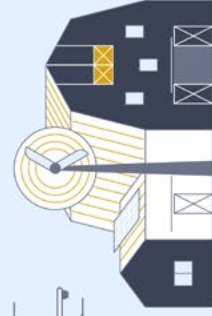
THREATS

- Integration of digital technology in enterprises, particularly in SMEs is developing slowly.
- The lowest share of new doctorate graduates within the EU impedes the development and application of innovation.
- Skill shortage and shrinking working age population is a serious issue for the manufacturing sector.

WHAT SHOULD BE DONE?

COUNTRY-SPECIFIC RECOMMENDATIONS

- Take advantage of strong human capital and address demographic decline with a stronger push towards automation and active labour market policies including efforts in upskilling and training and a higher minimum wage.
- Take a more proactive approach to foster innovation capacity of the economy by taking steps towards the establishment of an entrepreneurial state with a national innovation strategy.
- Implement incentives to attract FDI in industrial sectors relevant for the digital and green transformation and consistent with a national innovation strategy.
- Make green transition a key element of the economic development strategy by promoting renewable energy and particular the development of wind energy.



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Industrial Policy for a New Growth Model: A Toolbox for EU-CEE Countries

This country briefing is a short summary of a much broader study that deals with the perspectives of industrial policies in Central Eastern and Southern Eastern Europe and the question how these countries can avoid to get stuck in a middle-income trap. The study has been authored by a team of experts from the Vienna Institute for International Economic Studies on behalf of Friedrich-Ebert-Stiftung.

The study argues that the EU-CEE countries have so far lacked a systematic approach to industrial policy in their development trajectories. They have had a very broad ranging FDI promotion policy and weak investment environments for start-ups, while the activities of state-owned enterprises have not been aligned with the greater development goals.

Hence, the growth model of the EU-CEE countries must be made fit for the future. Decarbonisation, digitalisation and a shrinking labour force require massive efforts to be made. This transition can only be managed through public investments in green technologies and digitalisation, education and infrastructure, combined with the right conditions for private enterprise to thrive.

The study includes eleven country profiles that analyse the economic and industrial structures for their strengths and weaknesses and identify possible courses of action for an active industrial policy.

The full study can be found here:
<http://library.fes.de/pdf-files/bueros/budapest/20260.pdf>



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