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Foreign Investors on the Investment Climate in Latvia

This brief summarizes the results of an annual study on the development of the investment climate in Latvia from the viewpoint of key foreign investors - companies that have made the decision to invest in the country and have been operating here for a considerable time period. The study was initiated in 2015 and aims to assess investors' evaluation of the government policy initiatives to improve the investment climate in Latvia. It also aims to provide an in-depth exploration of the main challenges for and concerns of the foreign investors, both by identifying problems and offering solutions. The study draws on a survey/ mini case studies of the key foreign investors in Latvia. Our findings suggest that in recent years, some progress has been achieved on a number of dimensions that are crucial for the competitiveness of the investment climate in Latvia, such as the political efforts by the government of Latvia to improve the investment climate, the overall attitude to foreign investors, and labour efficiency. At the same time, foreign investors see little, if any, improvement with regards to other key areas, such as the availability of labour, the quality of education, the court system, corruption and the shadow economy.



Introduction

The study on the development of the investment climate in Latvia from the viewpoint of key foreign investors in Latvia was first launched in 2015 by the Foreign Investors' Council in Latvia (FICIL) in cooperation with the Stockholm School of Economics in Riga (SSE Riga). This study aims to foster evidence-based policy decisions and promote a favourable investment climate in Latvia by (i) Assessing how foreign investors evaluate the government's efforts and current policy initiatives aimed towards improving the investment climate in Latvia, and (ii) Providing an in-depth exploration of the main challenges and concerns for the foreign investors, both by identifying problems and offering solutions.

The study draws on a survey/mini case studies of the key foreign investors in Latvia. The first 2015 wave of the survey covered 28 key foreign investors in Latvia. Our panel has gradually expanded over time, reaching 47 participating companies in 2019. From September to early November 2019, we interviewed 47 senior executives representing companies that are key investors in Latvia. Altogether, these companies (including their subsidiaries) contribute to 23% of Latvia's total tax revenue from foreign investors, 9% of the total profit and employ 11% of the total workforce employed by foreign investors in Latvia, where by foreign investors we mean companies with above a 145 000 EUR turnover and 50% foreign capital (data from Lursoft, 2018).

All interviews were conducted by FICIL board members. The guidelines for the interviews consist of the following key parts: (i) Assessment of whether, according to foreign investors, the

investment attractiveness of Latvia has improved during the past 12 months; (ii) Assessment of the work of Latvian policy-makers in improving the investment climate during 2019; (iii) Evaluation of progress in the major areas of concern identified by foreign investors in Latvia in 2015, including demography, access to labour, level of education and science, quality of business legislation, quality of the tax system, support from the government and communication with policy-makers, unethical or illegal behaviour on the part of entrepreneurs, unfair competition, uncertainty, the court system and the healthcare system in Latvia. Furthermore, in the 2019 study we included questions related to some of the key issues discussed between foreign investors and policymakers during 2019, including the tax system, the stability of the financial sector and the quality of higher education and science in Latvia.

Investment Attractiveness of Latvia: Key Concerns of Foreign Investors in Latvia

The results of the 2019 study suggest that, even though the assessment of foreign investors with regards to the investment attractiveness of Latvia and the work of policy-makers to improve the investment climate in Latvia is still at the average level, it shows some positive tendencies. Namely, on a scale from 1 to 5, where '1' means that there are no improvements at all, '3' some positive improvements and '5' significant improvements, the development of the investment climate in 2019 was evaluated as '2.6' ('2.5' in 2018 and 2017). Furthermore, when asked to score the policy-makers' efforts to improve the investment climate in Latvia, using a scale of 1-5, where '1' and '2' were



fail and '5' was excellent, investors responded with an average of '2.9' in both the 2017 and 2018 studies, whereas in 2019, the score improved to '3.1'.

Foreign investors were also asked to evaluate whether there has been any progress within the key areas of concern as identified in 2015. The results of the most recent study suggest that the demographic situation, which in the long term reflects both the availability of labour and market size, is still among the key challenges for the foreign investors. Namely, on the scale from 1-5 (where an indicator value of 1 means that Latvia is not competitive and 5 means that Latvia is very competitive in this dimension), investors assessed the demographic situation of Latvia with only '1.5' in 2019. Furthermore, as many as 35 (out of 47) foreign investors stated that they had not seen any progress in this area over the past 12 months. This lack of progress is, perhaps, not very surprising as demographic changes may take substantial time.

Another two key areas where investors would like to see more progress are the quality of education and science and the availability of labour. On a 5-point scale, the quality of education and science was evaluated with '2.7' in 2019 ('3.0' in 2018, '3.1' in 2017) and 30 out of the 47 investors interviewed have seen no progress in the development of education and science in Latvia over the past 12 months. The availability of labour was evaluated with '2.8' in 2019 ('2.7' in 2018 and 2017); investors scored the availability of blue-collar labour with '2.4' in 2019 ('2.3' in 2018, '2.5' in 2017) and the availability of labour at management level with '3.1' ('3.0' in 2018, '2.9' in 2017). The majority, i.e. 39 of 47 investors have also seen no progress with regards to the access to labour during the past 12

months. In this context, however, it should be emphasised that the efficiency of labour is increasing in Latvia, according to foreign investors: in 2018, it was assessed with '2.9', yet, in 2019, investors evaluated the efficiency of labour in Latvia with '3.4' out of '5'.

The quality of health and social security as well as the quality of business legislation are yet another two indicators of the competitiveness of the investment climate in Latvia that have been evaluated around the average level of '3'. Further, 33 of 47 investors have seen no progress with regards to improvement of the healthcare system in Latvia over the past 12 months.

While the overall standard of living is evaluated rather positively at '3.8' in 2019, there is still not much improvement in this indicator as compared to the previous three years. One encouraging result of the 2019 study is that according to foreign investors, the attitude towards foreign investors is gradually improving in Latvia: from '3.2' and '3.1' in 2016 and 2017 to '3.6' in 2018 and reaching '3.7' in 2019.

The foreign investors in Latvia who took part in the 2019 study also expressed an expert opinion with regards to whether there has been any progress during the previous 12 months in the other areas of concern. In this light, the perception of uncertainty should be highlighted. As many as 25 (out of 47 investors) have seen no progress in this area, 16 have seen partial progress and 6 stated that there has been progress in reducing uncertainty. The court system of Latvia is another area where many foreign investors have seen no progress, i.e. 22 said 'no progress', 23: 'partial progress' and only 1 that there has been progress in the development of the court system in Latvia.



Specific Issues: Tax System, Stability of the Financial System and Quality of Higher Education and Science

In the 2019 study, we also initiated an in-depth exploration related to three key issues of concern extensively discussed between foreign investors and Latvia's government during the FICIL High Council 2019 spring meeting, and throughout the year 2019 in general. These are: (i) the tax system, (ii) the stability of the financial system, and (iii) the quality of higher education and science. Foreign investors were asked to comment on the current situation and progress over the past years, as well as to provide suggestions to the policymakers in order to improve the situation in the particular area.

(i) Tax system:

The most recent tax reform was implemented in 2018, and the newly elected government has announced that the next reform will take place in 2021. Therefore, this year we asked investors to evaluate the results of the previous tax reform in Latvia. We also asked investors to comment on whether the recent tax reform has brought any benefits to their company and the overall economy of Latvia. On average, foreign investors scored the results of the previous tax reform in Latvia with '3.1', i.e. slightly above the average.

Overall, at least one part of the foreign investors who took part in the 2019 studies highlighted that the previous tax reform was a step 'in the right direction'. In particular, the zero-rate on reinvested profit was highlighted by a large number of investors as a very positive improvement. In some

cases, investors also praised the progressivity of labour tax rates. However, a number of foreign investors highlighted that the tax system has actually become more complex after the reform. Investors also expressed suggestions for further steps to improve the tax system in Latvia, and these are as follows:

Avoid uncertainty. Stability and predictability of the tax system is what the majority of the foreign investors wish to see. In essence, this means fewer changes to the tax system.

Simplify and explain. Investors highlight that paying taxes should be a "simple task" and easy to understand. According to the viewpoints of foreign investors, there is also the potential for improvement with regards to how the responsible organisations, such as the State Revenue Service, communicate changes in the tax system to the private sector.

(Continue) the shift from taxing labour to consumption. Some of the investors that took part in the 2019 studies see that the process has been initiated by the previous tax reform and recommend continuing in this direction.

(ii) Stability of the financial sector in Latvia.

On average, foreign investors evaluated the progress with regards to the effectiveness of combating economic and financial crime with 3.2, i.e. above average. We then asked foreign investors whether they have felt any negative effects on their companies with regards to the situations in the financial sector over the past 2 years. We received some positive opinions, yet the negative ones prevailed. Namely, foreign investors highlighted the reputation risks of Latvia that often



impact upon the operation of their companies and create challenges when working with foreign banks.

(iii) Quality of university education and science in Latvia.

Here, foreign investors were asked to reflect upon whether they were aware of any activities that policymakers carried out during the past year to improve the situation. On a positive note, a number of investors mentioned the recent development of the University of Latvia and Riga Technical University's campuses. Some investors also highlighted that the reform to change the governance model of higher education institutions, initiated by the Ministry of Education and Science, was a good step towards improving the quality of higher education and science in Latvia. However, we also received a number of negative opinions, such as "Nothing has been accomplished, just talking".

When asked "What changes would you suggest to improve the quality of education and science in Latvia and why? How would this help the business environment, e.g. companies such as yours?", foreign investors emphasised the following:

Higher education (and science) is too local, fragmented and outdated. In essence, investors pointed out that there are simply too many higher education institutions in Latvia, that they work with outdated methods and are afraid (with no good reason) to open up internationally - also by attracting top quality foreign staff.

Change the governance of higher education institutions in Latvia is another strong request from foreign investors in Latvia. Many investors believe

that changes in the financing model should also follow.

Improved connection between education and science and the world of business was yet another important aspect which was highlighted during the 2019 interviews, and also strongly emphasised in the previous studies.

Further Investment Plans and Message to the Prime Minister

When asked whether they plan to increase their investments in Latvia, as many as 64% of the investors interviewed answered with 'yes' (in the 2018 study, 55% interviewed answered with 'yes'), 25% said 'no' (35% in the 2018 study) and 11% answered that 'it depends on the circumstances' (10% in the 2018 study) or that they have not yet decided.

Finally, we invited foreign investors to send a message to the Prime Minister of Latvia: one paragraph on what should be done to improve the business climate in Latvia, from the viewpoint of a foreign investor. These messages closely parallel the other findings of the 2019 study, stressing a number of key concerns that foreign investors are still facing in Latvia: the situation with regards to demography, quality of education and science, availability of labour, challenges with corruption and the shadow economy as well as needs for improvements in the health care sector amongst others.

Conclusions

The findings of the 2019 study on the view of the key foreign investors of the investment climate in Latvia suggest that in recent years, some progress has been achieved on a number of dimensions,



such as political effort to improve the investment climate, attitude towards foreign investors, and labour efficiency. At the same time, foreign investors see little, if any, improvement with regards to other key areas, such as the availability of labour, the quality of education, the court system, corruption and the shadow economy.

Our findings highlight the need to continue policymakers' efforts to improve the investment climate in Latvia and provide policymakers with better grounds for making informed policy decisions with respect to the entrepreneurship climate in Latvia. We also hope that our study will further facilitate constructive communication between foreign investors and the government of Latvia.

References

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