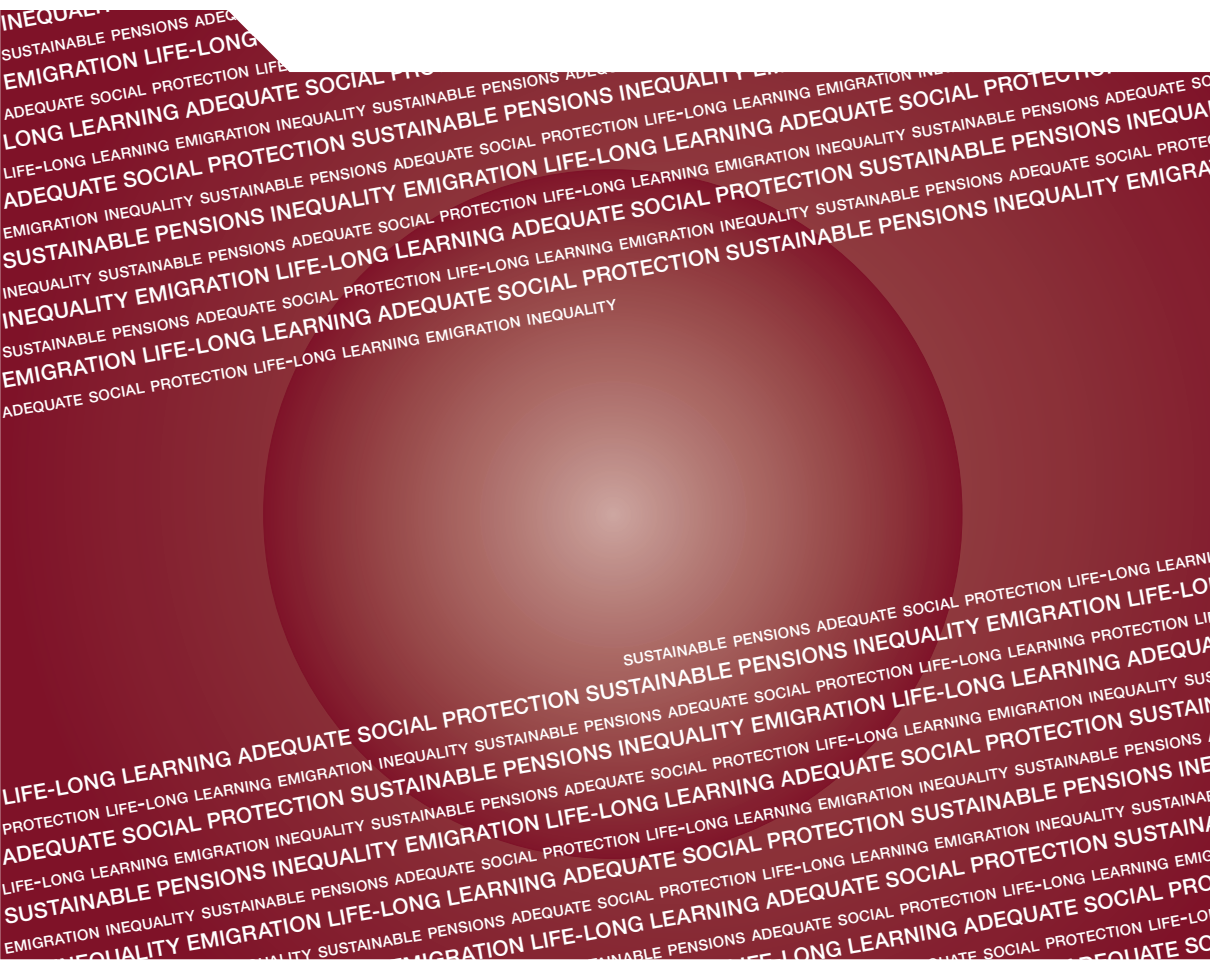




OECD Reviews of Labour Market and Social Policies

LATVIA



OECD Reviews of Labour Market and Social Policies: Latvia 2016

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Foreword

This volume consists of a background report prepared by the OECD Secretariat to support the Labour Market and Social Policy Review of Latvia which is currently being undertaken by the OECD Employment, Labour and Social Affairs Committee as part of the process for Latvia's accession to the OECD [see the Roadmap for the Accession of Latvia to the OECD Convention: C(2013)122/FINAL]. In accordance with paragraph 14 of Latvia's Accession Roadmap, the Employment, Labour and Social Affairs Committee agreed to declassify the report in its current version and publish it under the authority of the Secretary General, in order to allow a wider audience to become acquainted with the issues raised in the report. Publication of this document and the analysis and recommendations contained therein, does not prejudice in any way the results of the review of Latvia by the Employment, Labour and Social Affairs Committee as part of its process of accession to the OECD.

The review was prepared by Jonathan Chaloff (Chapters 1 and 2), Paolo Falco (Chapters 1 and 3) and Herwig Immervoll (Chapters 1 and 4, Assessment and Recommendations), with statistical support from Véronique Gindrey, Maxime Ladaique and Sébastien Martin. Herwig Immervoll (herwig.immervoll@oecd.org) co-ordinated and edited the report. Jean-Christophe Dumont, Mark Pearson, Monika Queisser, Stefano Scarpetta and several other colleagues at the OECD provided valuable comments. The report also accounts for comments received from the Latvian Ministry of Welfare.

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Acronyms and abbreviations

ALMP	Active labour market policy
CEF	Common European Framework
CSB	Central Statistical Bureau
EC	European Commission
ESF	European Social Fund
GMI	Guaranteed minimum income
ISCED	International Standard Classification of Education
LBAS	Free Trade Union Confederation
LDDK	Employers' Confederation
LFS	Labour force survey
LMP	Labour market policy
MOE	Ministry of Economics
MOES	Ministry of Education and Science
MOF	Ministry of Finance
MOW	Ministry of Welfare
MOIN	Ministry of Interior
MW	Minimum wage
NDC	Notional defined contribution
NEET	Not in employment, education or training
PAYG	Pay-as-you-go

PES	Public employment service
PIAAC	Programme for the International Assessment of Adult Competencies
SEA	State Employment Agency
SEC	Sectoral Expert Council
SME	Small and medium enterprise
VET	Vocational education and training

Executive summary

Like other economies in Eastern Europe and the former Soviet Union, Latvia underwent major economic and social change since the early 1990s. The transformation from planned to market economy was accompanied by fundamental reforms of political institutions and integration into the European Union and, in 2014, into the euro area.

Over the past two decades, economic growth has been impressive, narrowing the income and productivity gaps relative to wealthier EU and other OECD countries. But the global financial crisis resulted in a deep recession and one of the worst output losses in the world. Dramatic fiscal consolidation measures, soaring unemployment and unprecedented nominal wage adjustments caused wages and family incomes to plummet. Since 2011, output recovery in Latvia has been among the fastest in the European Union but GDP remains below the pre-crisis peak.

Despite the remarkable narrowing of national-income gaps relative to comparator countries, deep structural problems remain. Latvians reported very low degrees of life satisfaction in the boom years prior to the Great Recession, and measured subjective wellbeing is still among the lowest in the European Union and lower than in some OECD countries with lower or broadly similar GDP per capita. Income inequalities rose steeply and continuously prior to the recent crisis, from very low levels in the early 1990s (a Gini coefficient below 0.25) to one of the highest in the OECD (a Gini of around 0.35 since 2005).

Latvia's labour force participation is higher than the OECD average, but the labour market is very heterogeneous, with sizeable regional disparities, a very large share of low-paid jobs, and large minority groups who can face specific labour market problems. Highly volatile economic growth and one of the biggest income disparities in the European Union create a pressing need for effective social and labour market policies. Without sustained policy effort and adequate resources, there is a risk that inequality remains very high or, as during earlier recoveries, increases further.

A rapidly declining population – with a drop of 25% over 25 years – and the large shadow economy create substantial additional challenges for

maintaining growth and boosting inclusiveness. With an unfavourable demographic outlook, Latvia's future growth prospects rest on its ability to raise labour productivity by making the most of its available human resources.

A principal objective of this report is to support the Latvian Government in its stated aims and ongoing efforts to promote inclusive growth. It highlights the need to improve workforce skills, attract and retain talent, strengthen social protection and employment support, and tackle informality and labour market inequality. Concrete recommendations include:

- Sustaining efforts in key areas where significant policy progress has already been made, such as promoting work-based learning and enforcing applicable labour and tax law.
- Redoubling efforts in areas where they currently do not appear sufficient, such as connecting with Latvians abroad and promoting labour migration to ease current or future skills shortages in Latvia.
- A careful review of existing regulations, such as the minimum wage or formal language requirements for a wide range of occupations, to promote equal access to good-quality jobs.
- A more systematic evaluation of support measures, notably active labour market programmes, to identify best practice and help channel resources to the most cost-effective programmes.
- Making adequate social protection and employment support measures more accessible for those who need them, notably by improving coverage for jobseekers and addressing projected gaps in income security during old age.

Some recommendations imply a rise in public social spending that would require higher tax revenues or a shift in the composition of spending towards labour market and social policies.

Assessment and recommendations

Towards a less volatile economy, and a more inclusive society

Latvia is a small open economy with a population of around 2 million. Like other economies in Eastern Europe and the former Soviet Union, Latvia underwent major economic and social change since the early 1990s. After regaining independence in 1991, the transformation from planned to market economy was accompanied by fundamental reforms of political institutions and integration into the European Union and, in 2014, into the euro area.

Latvia has enjoyed strong economic growth

Over the past two decades, economic growth has been impressive, narrowing the income and productivity gaps relative to wealthier EU and other OECD countries. During the pre-2008 boom years, per-capita GDP growth was among the highest in the European Union, averaging some 8.5% per year between 2000 and 2007. Despite strongly growing income inequality, even families towards the bottom of the income distribution saw rising living standards.

But economic progress has been volatile and gains were unequally distributed

The global financial crisis resulted in a deep recession in Latvia with one of the worst output losses in the world. This led to dramatic fiscal consolidation measures, linked also to Latvia's need to accept an IMF/EU programme and its determination to adopt the euro. Soaring unemployment and unprecedented nominal wage adjustments caused aggregate wages in the economy to plummet by more than a third in two years. Since 2011, output recovery in Latvia has again been among the fastest in the European Union but in 2015 (second quarter) GDP remains some 6% below its pre-crisis peak. Workers' incomes started to climb only later and recovered less quickly than GDP. Significant wage cuts followed the recent crisis, but labour productivity below levels in comparator countries nonetheless creates challenges for competitiveness.

Latvia experienced rapidly rising income inequalities prior to the recent crisis: the traditional Gini coefficient rose steeply and continuously from below 0.25 in the early 1990s to around 0.35 since 2005. Persistently high poverty and structural unemployment were among the most visible symptoms of uneven growth patterns, even as overall inequality stabilised at very high levels during the recent crisis. As disadvantaged households struggle to hedge against economic uncertainty and the consequences of economic downturns, those facing prolonged or repeated hardship may find it difficult to take full advantage of economic opportunities during an upswing. Without counteracting policies, there is a risk that inequality remains at a very high level or, as during earlier recoveries, increases further.

Highly volatile economic growth and one of the biggest income disparities in the European union create a pressing need for effective social policies. They also highlight the importance of well-functioning labour market institutions that support the necessary economic transformation, while encouraging the creation of employment opportunities for groups that remain underrepresented in the labour market.

Life satisfaction is low

Despite the remarkable narrowing of national income gaps relative to comparator countries, Latvians reported very low degrees of life satisfaction in the boom years prior to the Great Recession, and measured subjective wellbeing is still among the lowest in the European Union and lower than in some OECD countries with lower or broadly similar GDP per capita (e.g., Poland, Chile, Mexico). It is likely that high and increasing inequality, combined with the economic uncertainty resulting from the experienced boom-and-bust cycles are among the reasons why strong economic growth failed to translate into bigger and more widespread improvements in life satisfaction.

A large linguistic minority population, not all of whom are citizens

Latvia has historically had an ethnic Latvian majority speaking Latvian, but also large minority populations (especially in urban centres) speaking different languages. The composition of these minorities has varied, with today's national minorities composed mostly of ethnic Russians (26% of the population). 37% of the population are native Russian speakers. Many ethnic Russians and Russian speakers immigrated to Latvia during the Soviet epoch. These immigrants and their descendants were not eligible for Latvian nationality in 1990, but were granted indefinite residence as "non-citizens".

The number of non-citizens has been declining, due to emigration, mortality and naturalisation. Non-citizens comprise 12% of the population in 2015, concentrated in the older population groups: 32% of the population over 65, and less than 3% of the population under 24. Even though a significant number of non-citizens have acquired Latvian citizenship in the past, the rapid ageing of this group means that naturalisation looks unlikely to be a main reason for the decline of the non-citizen population in the future.

Although Latvian is the official language, the Russian language remains widely spoken. Minimum Latvian language proficiency requirements apply to a large number of occupations. There are still many Russian speakers who do not have a sufficient knowledge of the Latvian language to participate fully in the labour market: according to a recent language survey, almost one-third of native Russian speakers do not have a conversational level of Latvian, although only 6% have no knowledge at all of Latvian (European Commission, 2012, “Special Eurobarometer 386: Europeans and their Languages”, http://ec.europa.eu/public_opinion/archives/ebs/ebs_386_en.pdf). Opportunities to learn and improve Latvian language proficiency are provided by the state, principally to unemployed people by the public employment service (State Employment Agency, SEA) but also through other programmes. Nonetheless, bilingualism is not unusual, and not only among native Russian speakers. About 30% of native Latvian speakers use Russian on a nearly daily basis.

Managing emigration and a shrinking population

The population has contracted by 25% in 25 years

The population is declining at a rapid pace due to ageing and very high emigration, with an overall loss of 25% over a 25-years span. Emigration has slowed after peaking during the recent economic crisis, but continues to exceed natural population decrease (i.e., mortality minus births) by a factor of 1.6 according to the population register in 2011-14, and by more according to estimates based on destination country data.

All economies of Central and Eastern Europe and the former Soviet Union saw declining birth rates from 1990, and Latvia was no exception. As in other OECD countries, Latvia’s population is also getting older. However, the demographic challenges are more severe than in much of the OECD area or in other parts of Eastern Europe. Uncertain economic conditions at the family level are likely contributing factors to low birth rates and high emigration in Latvia.

The working age population is shrinking faster than in any OECD country

Latvia's population decline has been driven by low birthrates and by a net emigration rate higher than that of any OECD country. The population decline is fastest among the working age population, creating challenges for maintaining growth and boosting inclusiveness.

The working age population in Latvia is also shrinking faster than in any OECD country – and fell by 25% since 2000. Even with the most optimistic estimates of slower emigration, the working age population is projected to be almost 10% smaller in 2020 than in 2010. Low birthrates are part of this – the age cohort 0-4 in 2000 was half the size of the same cohort just ten years earlier – and fertility is likely to remain low in the years to come, as in many other OECD countries. The old-age dependency ratio is expected to increase by 20% in the next decade, to as much as six persons over 65 years of age per ten working age residents.

Steady net emigration, which spiked during the recent crisis and remains high, has affected all age groups. But its effects on the number of youth are especially notable, as emigration further exacerbates the effect of shrinking youth cohorts. Latvia's residents age 25-29 in 2015 numbered 144 000, at least 60 000 fewer than there would have been in the absence of emigration. Younger cohorts are much smaller and new entries to the working age population will be declining for the foreseeable future.

Even in the presence of a shrinking youth cohort and emigration, the size of the tertiary educated population in Latvia had been increasing due to higher educational attainment among youth. But since 2013, it has been falling. In addition, of those who graduated in Latvia between 2002 and 2009, about one-third was no longer in the country in 2014.

Latvia now has a substantial diaspora abroad

As a result of large and constant emigration, Latvia now has a substantial diaspora abroad. In 2010, about 12% of the Latvian-born population over the age of 15 was living abroad. The number has since increased and the factors pushing emigration are not likely to vanish in the short term.

Expectations of large-scale return do not appear realistic, as fewer than 20% of emigrants surveyed in 2014 planned to return within the next five years. After five years abroad, return becomes even less likely. About one in six recent emigrants has a foreign partner, and this is often a main obstacle to return. Little effort has been made so far to focus on Latvian graduates abroad, to establish a matching service between candidates abroad and Latvian employers, or to focus on strategic sectors for business co-operation.

Latvia is only starting to develop a comprehensive policy to maintain a relationship with this diaspora. Many of the elements are in place albeit with limited resources, building on the legacy of the political diaspora which developed during the Soviet epoch. The focus in the past has been on cultural and civic outreach, although it has recently started to shift towards economic co-operation and to return migration. Latvians abroad have the right to vote, and in most major emigration countries there are weekend language schools for their children.

Even without return, Latvia can benefit from its large diaspora. At least one in eight emigrants has a clear potential to develop business in Latvia – either because of concrete co-operation plans, or an existing business in Latvia. These contacts can be important. Maintaining ties with the diaspora can ensure positive ties in the future, including the potential to maintain remittance flows – which currently provide an average of 20% of income for the 10% of families which receive them.

As remittances to families in Latvia decline, alternative means of attracting financial transfers will become more important. Similarly, as the number of educated Latvians abroad increases, scientific and technical collaboration should become a priority to foster positive contributions to Latvia's economy of these talents abroad.

Labour migration is a crucial channel for meeting Latvia's labour needs

Too little attention has been given so far to the possibility of meeting labour needs through labour migration. Labour migration will not compensate for the population loss through emigration but can be better used to meet unmet demand and to support economic growth.

Progress in this area is challenging as the same factors which are driving emigration are holding back immigrants. Yet international migrants do come to study, work or invest in Latvia. These growing channels for migration could be better harnessed to support retention. Currently, international students do not have a favourable framework for post-study stay. Labour migrants are not actively targeted (e.g., through outreach activities to third-country nationals by employment services) nor given incentives to remain. Latvia has issued about 4 000 residence permits to investors (as well as about 8 000 to their family members) since 2010. Although the government has to date not carried out detailed evaluations of the motivation for obtaining residence permits via this route, there are strong reasons to believe that a large majority of these permit holders comprise absentee property-owners for whom the residence status is primarily used for access to the Schengen area.

Making the most of Latvia's human capital in the context of a declining population

Sustained economic growth requires tackling productivity challenges in the labour market

With a challenging demographic outlook, Latvia's future growth prospects rest on its ability to raise labour productivity and make the most of its available human resources. As in other transition economies, labour productivity in Latvia has increased, doubling between 2000 and 2013. But productivity gains slowed down significantly after a rapid increase prior to the crisis. Output per hour worked remains below OECD comparator countries in Eastern Europe, and some 50% below the OECD average.

Factors holding back productivity gains include a very sizable shadow economy, long-term joblessness, as well as a significant skills shortage and mismatch. Productivity is typically much lower in the informal sector, which is estimated to represent around a quarter of GDP. At 44.2% of the unemployed (Q4 2014), the share of long-term unemployment has remained stubbornly high after a temporary decline after 2012. At the same time, a significant share of youth (15.2% against an OECD average of 14%) are not in employment, education or training (NEET), and the lack of labour market opportunities for youth becomes more dramatic when considering that inactivity rates could be much higher without the unprecedented out-migration of the past decade.

In addition, the large cyclical swings in Latvia's labour market have stretched and probably overwhelmed the capacity of formal labour market institutions to facilitate smooth transitions into employment and promote the necessary reallocation of jobs towards higher-productivity sectors. A quick succession of labour shortages and high unemployment also makes workforce planning difficult for employers, and may reduce incentives to invest in productivity-enhancing training and workforce development.

Helping jobseekers find productive employment opportunities

Active labour market policies are a policy focus, but they remain under-resourced and participation is low

Participation in active labour market programmes (ALMPs) is low by international standards and Latvia spends only around 0.22% of GDP on employment services and related ALMPs. A very large part of ALMP funding (more than three quarters in 2014) has relied on external sources, notably the European Social Fund (ESF). Despite a significant increase

since 2007, programme participation among the unemployed is often much lower than in other European countries.

A new profiling system supports the State Employment Agency's (SEA) crucial task of assigning jobseekers to the most suitable programmes. But fiscal consolidation during the crisis resulted in substantial cuts of ALMP resources, especially in the area of employment services. As a result, caseloads/staff ratios have surged, reducing the SEA's capacity to devise and monitor effective activation strategies. Capacity constraints have also affected municipalities as the primary providers of social services, including for jobseekers.

Participation of youth in active programmes, such as short-term training programmes, has increased significantly since the introduction of the Youth Guarantee in 2014 as part of an EU-wide initiative. These trends are encouraging, but close monitoring is important to inform subsequent programme adjustments. As the Youth Guarantee is expensive, effective targeting and clear priorities are needed to maximise its positive impact.

Optimising service quality by fostering co-operation between institutions and levels of government

ALMPs and unemployment benefits are administered by the SEA and the Social Insurance State Agency, while social assistance and a large part of social services are the responsibility of municipalities. Cross-institutional co-ordination of employment-related support strategies is crucial for maximising administrative efficiency and achieving good outcomes for jobseekers.

The SEA's profiling system, accessible by both SEA and municipal welfare offices, contributes to effective information sharing. In addition, a national pilot project to improve inter-agency co-ordination was launched in 2013 with a specific focus on the long-term unemployed. But as in other countries, ensuring consistency across institutions with different objectives, political responsibility and budgeting procedures is not straightforward and remains a challenge. Co-ordination is currently not systematic and responsibilities appear not fully aligned with resources, especially in some financially weaker municipalities.

For youth, timely career consultations require better information exchange between labour market and educational institutions.

Towards a systematic link between programme results and funding decisions

Resources should be concentrated on programmes that are known to work well for the intended target groups, while spending on other ALMPs should be periodically reviewed, possibly by linking funding more closely to the results of proper evaluation exercises. While data collection and analysis have accompanied selected policy reforms and pilot projects, particularly when co-financed by the ESF, translating the results of these monitoring efforts into policy actions is frequently hampered by an absence of clear counterfactuals that are needed for a policy-relevant interpretation of measured programme effects.

Latvia has recently made considerable technical and legislative efforts to provide policymakers with high-quality and up-to-date information on programme participants, and to create the organisational and legal pre-requisites for combining information recorded by different institutions and levels of government. The resulting rich administrative data provide an excellent basis for continued policy learning based on systematic evaluations of both past and ongoing policy reforms. To realise its analytical potential, the government should match its commendable investments into data infrastructure with equivalent efforts to promote systematic use of available data sources for policy evaluations.

Aligning budget allocations with policy priorities and evidence

Direct job creation still accounts for nearly one-third of overall ALMP spending. The public works programmes under this heading served as crucial income safety nets during the crisis, as out-of-work benefit programmes were overwhelmed by the large inflow of unemployed: by 2012, jobseekers outnumbered benefit recipients by a factor of five. During the economic recovery phase, this objective is better met by improving the accessibility of unemployment benefits, for which coverage remains very low. However, organisational structures for public works programmes should be maintained to facilitate quick and temporary expansions if the need arises during future downturns.

Available evidence shows good results for occupational training programmes, providing a solid argument for extending these programmes by making them more accessible. A voucher system introduced in 2011 has already provided jobseekers with greater freedom of choice across programmes. But funding responsibilities for some marginal programmes – such as substantial state subsidies for summer jobs of 13- to 18-year-old students – which have a loose or unclear connection with concrete labour-market objectives should be shifted away from the ALMP budget to avoid diverting resources from more essential programmes.

Developing workers' skills at all stages of their career

Achieving upper secondary education for all students must remain a priority

The number of students has fallen dramatically over the past decade as a consequence of migration and low fertility rates. Ensuring that all young people obtain upper-secondary education is therefore crucial and additional efforts should be devoted to further reducing the incidence of early dropouts, especially among boys and in rural areas. Key challenges include better information sharing between schools, municipalities and employment services, more systematic follow-up with school leavers to help raise school completion rates and facilitate students' access to the labour market, and more options for "second-chance" education.

Participation in lifelong learning is low

Participation in formal training and re-training programmes among adult workers – lifelong learning – is below 5%, among the lowest in Europe, especially among older workers. Encouraging workers' participation in lifelong learning, and a constructive and facilitating role of employers, requires a shift in perceptions based on raising both the quality and the accessibility of training programmes. OECD work has identified a number of key components of such a strategy, including carefully tailoring available training programmes to employer needs and employee circumstances, and favouring real work activity and participatory learning methods over traditional classroom training.

Vocational education is undergoing reforms, but employer involvement is a key challenge

Vocational education and training (VET) is an essential part of a broader education strategy. A strategy of fundamental consolidation of the VET system was followed for a number of years, with a substantial reduction of the large number of different professions and specialisations that partly originated during the Soviet period. But the Latvian VET system has suffered from poor reputation and a weak connection with the labour market, and the share of students enrolling in VET programmes after basic education (approximately 35%) has remained fairly constant in recent years, despite the government's plans to increase it.

More recently, larger VET institutions have acquired the status of Vocational Education Competence Centres, serving a role as regional "hubs" with upgraded and modernised facilities. An ESF co-funded project to reform VET curricula and occupational standards led to the creation of

12 Sectoral Expert Councils (SECs), with co-operation between social partners, educational institutions and the government, and designed to facilitate adapting curricula to future skill needs. These reforms are promising even if it is still too early to assess their effectiveness. SECs should be further strengthened, in particular by encouraging active participation among employers, who have traditionally been reluctant to invest in workers' training.

Work-based learning and apprenticeships remain under-developed

Vocational education in Latvia is largely school-based and typically includes little company-based learning. Formal apprenticeships are not uncommon, but they are often too short (sometimes not longer than two weeks) for meaningful skills investments to take place. Latvian employers have appeared generally reluctant to embrace a more encompassing system of apprenticeships and company-based learning. Positive results from a recent pilot project involving work-based learning underline that Latvia would benefit from a more systematic approach and an institutionalised (and better regulated) system of apprenticeships. The main hurdles are related to the – necessary – requirements to enter into a formal contracts with the apprentice, to establish clear training obligations and, importantly, to pay the statutory minimum wage at the same rate as for all other employees in Latvia.

One effective way of addressing these barriers would be to introduce specific employment contracts for apprentices with a lower minimum wage as in place in a number of EU countries (e.g., France, Germany, Portugal). However, more flexible wage provisions should remain firmly embedded in a well-regulated apprenticeship contract. For instance, simply extending the scope of internships, or allowing employers to pay “stipends” rather than wages governed by labour law could further weaken the bargaining power of workers, and would likely undermine the government’s intensified efforts to reduce underreporting and ensure compliance with the labour law.

Carefully targeted financial incentives to promote apprenticeships could be used to promote work-based learning, especially for the large majority of small employers. They range from direct subsidies to tax rebates and reductions in social security charges. Such public support should be designed to stimulate necessary investments by employers, not substitute for them. Incentives would also require a suitable enforcement framework that can credibly prevent abuse.

Reducing labour market inequality

At 74.6%, overall labour force participation is high compared to the OECD average (71.2%). However, Latvia's labour market is highly heterogeneous, with very sizeable regional disparities and large minority groups who sometimes face specific labour market problems. In addition, there exists a marked age gradient of skill-related employment problems, for instance unemployment among workers aged 55 to 64 is 9.9%, nearly twice the OECD average. This pattern is partly driven by the very different work and education experiences of different cohorts that entered the labour market before and during Latvia's transition to a market economy.

The incidence of low-paid employment in Latvia is higher than in any OECD country. Skills premia have been very high for tertiary educated workers, especially during economic upswings, indicating both labour shortages and skills mismatch. Although wages of the top 20% fell substantially during the crisis, wage dispersion in the upper half of the pay spectrum also remains significantly above the OECD average. Latvia's overall earnings inequality is the highest among European OECD countries.

Ensuring fair wage agreements, in line with productivity

Volatile labour market conditions, informality and a low union coverage with no tradition of strong collective bargaining in the private sector weaken the bargaining power of lower-productivity workers in particular.

Weak worker representation and collective-agreement in the private sector

The Trade Union Confederation of Latvia (LBAS) has around 100 000 members - down from 275 000 in 1995 - and 20 industry-level affiliate trade unions. In 2015, only around 14% of Latvian workers belonged to a trade union and Latvia is among the European countries with the lowest incidence of official employee representation in establishments of all sizes. Employee representation at the workplace is either through unions or through elected workplace representatives. However, with low levels of union membership and reluctance among employees to elect workplace representatives, most private-sector workplaces have no employee representation at all.

Even though collective bargaining can take place at industry, regional and company/organisational level, collective agreements at industry level are rare and thresholds for extending collective agreements are relatively high (50% of employees in a given sector, or employer turnover of at least 60% of the entire sector). Extensions currently are in place only for three

essentially public sectors: railway workers, teachers and health. Overall, only a 20% of salaried workers are covered by collective agreements. There is no reliable information on the use of collective agreements in the small and medium enterprise (SME) sector, which accounts for more than 99% of all enterprises.

The statutory minimum wage has a central role in the overall wage-setting process

Latvia has a unified statutory minimum wage. Unlike in many OECD countries, there is no differentiation by region or group of workers. Levels are reviewed every year by the National Tripartite Cooperation Council, a body with representatives of the government and the social partners. A recent OECD comparison shows 14% of formal-sector workers earning at or below the minimum wage, more than in any European OECD country. In the context of significant downward wage adjustments for other wage earners, the minimum has increased significantly since 2007 and Latvia is among the EU countries with the biggest increase in the minimum wage relative to the median.

In a labour market characterised by wide wage disparities, a generous minimum wage that applies across the board risks pricing first-time labour market entrants and other lower productivity workers out of formal employment, especially in the country's lowest-income regions. About one half of OECD countries with a statutory minimum wage set lower rates for teenagers. In Latvia, lower minima should be introduced for apprentices and labour market entrants with no or little work experience. But age-specific minimum wage provisions may need to go beyond lower minima for youth, as lower-productivity employment is also concentrated among some groups of older workers. By contrast, there are considerable practical difficulties of introducing any differentiation of minimum wages by region. These difficulties, combined with the large regional wage disparities in Latvia, underline the need to exercise great caution when deciding on across-the-board minimum-wage adjustments, in order to avoid negative employment effects in lagging regions.

An important step towards greater differentiation of wage floors would be to promote the role of social partners in the wage-setting process. Greater collective bargaining coverage and possibly greater use of sector-wide wage agreements, including sector-specific minima, would facilitate adjustments of wage floors that are in line with the labour market situation and productivity trends in each industry. However, the effectiveness of such collectively-agreed minima rests on constructive dialogue among the social partners, on the existence of adequate structures of representation, and on a sufficiently high share of employees covered by collective agreements.

Tackling informality requires careful co-ordination across ministries and government agencies

A share of employment activities operates outside the labour law or applicable tax provisions

While the size of the informal economy is very large, probably around a quarter of GDP, employment that is completely unregistered has been estimated at only 8% of the labour force. While informality cannot be measured with precision, this very large gap indicates that informality affects not only the labour market, and that informal employment largely takes the form of earnings under-reporting and underpayments.

New OECD estimates suggest that 17% of workers receive more than 50% of their total wages informally, in the form of “envelope wages”. But misreported working hours (e.g. unpaid overtime or false part-time employment), and violations of applicable minimum-wage provisions are further channels of misreporting that result in underpayments for the worker.

The different forms of informal employment raise concerns about tax enforcement, but they have much broader implications for productivity, the functioning of labour markets and worker wellbeing. For instance, “false” part-time employment and underpayments of wages are particularly damaging for job quality and worker’s incomes. Interventions to tackle informality and misreporting therefore require careful co-ordination across different government agencies and should be based on three main pillars: increasing the benefits of formal employment, reducing the costs of formalisation, and optimising tax and labour inspection enforcement methods.

Recent reforms have strengthened enforcement and tightened sanctions for employers

The Labour Inspectorate works in close partnership with the State Revenue Service, exchanging information and co-ordinating actions. Staff resources of both agencies have been increased and considerable progress appears to have been made at tightening the enforcement of applicable labour and tax regulations. One key continuing challenge is credible enforcement in small firms. As small employers have low levels of trade union activity and worker representation, a credible role of the labour inspectorate may often be the sole channel for guaranteeing worker rights and labour standards.

To facilitate credible inspections, employers now must register new workers and their working hours electronically well before employment

commences. Other reporting requirements were tightened as well and several recent initiatives aimed at addressing what is often described as the “cultural problem” of tax evasion. These include PR campaigns, the introduction of more severe fines for employers and the exclusion of offending employers from public procurement and some forms of state support. These efforts are welcome, and should be maintained and strengthened further.

But a lack of penalties for workers may contribute to maintain an accepting attitude towards informality

Unregistered employees, or workers whose employers underreport their earnings, face neither legal sanctions nor back payments of evaded taxes or social contributions. Although workers already suffer reduced social insurance coverage and entitlements as a result of underreporting, the lack of credible penalties for employees complicates the task of changing attitudes towards informality. For instance, half of Latvian workers who said in a survey that they carried out undeclared work stated that both parties benefit from such an arrangement. Since opportunities for employers and employees to collude do exist, balanced and credible legal consequences for both employers and workers should become part of the strategy to make misreporting and evasion less attractive and less socially acceptable.

It is, however, important to avoid stigmatising groups whose position in the labour market is already weak and who already suffer disadvantages resulting from underreporting. Fines and back payments for employees can and should be designed in a proportionate way and be targeted at all workers, including high-paid employees.

Concerns that fining employees may stop workers from reporting infringements by their employers are valid and should be considered carefully. But penalties and back payments could be introduced in such a way as to minimise these problems and even strengthen reporting incentives (e.g., by credibly announcing the imposition of fines or other penalties from a certain future reference date, together with amnesties for past infractions that are reported before then).

An overreliance on policy levers other than enforcement risks creating further labour market distortions

A number of regulatory hurdles are aimed at cutting off specific channels of misreporting. One prominent rationale for repeated significant minimum wage increases was that legal wage floors would make wage underreporting more difficult by forcing employers to report at least the statutory minimum, thus “reducing the size of the envelope”. A continued

focus on minimum wages as an instrument to strengthen enforcement and tax revenues could, however, risk losing sight of the broader strengths and limitations of the legal minimum wage as a labour market policy tool. In particular, setting the minimum wage too high risks pricing low-skilled workers out of the formal economy altogether.

A minimum social contribution is a related measure that is currently under discussion. Under the proposal, social contribution liabilities would amount at least to those of a full-time minimum wage worker, regardless of actual hours worked. The measure is, in part, inspired by a similar provision that is in place in Estonia, and is designed to deal with hours underreporting, a practice that employers are thought to have used in response to minimum-wage increases in order to contain labour costs. If it were adopted, the minimum contribution would make genuine part-time work (which is already low in Latvia) much more expensive and would risk pricing lower-productivity workers, and those with a strong preference for part-time work, out of employment. It would also make it more costly for employers to respond to business fluctuations through legal means (a reduction in working time) and, like a hike in the minimum wage, might create incentives for entirely unregistered informal employment.

Latvia also has experience with targeted incentives to encourage formalisation of small business activities. In 2010, Latvia introduced simplified tax and contribution rules for firms with a total turnover below EUR 100 000 per year, so-called “micro-enterprises”. The initiative yielded mixed results, however. First, insofar as micro-enterprises substitute for dependent employment in larger firms, the lower social contributions go hand in hand with significantly weaker social protection for the workers affected. Second, it is difficult to prevent abuse. For instance, larger firms often find ways to reorganise their activities into smaller units in order to make use of preferential tax provisions.

Tailoring policies to tackle labour market problems of specific groups

Women’s labour force participation is high, but a significant gender wage gap persists

Labour force participation of Latvian women is approximately 72%, some 10 percentage points above the OECD average. But women are strongly over-represented among low-wage workers. A substantial gender pay gap (17%) remains when comparing wages of men and women with similar age, education levels and other characteristics, and earnings differences between men and women are especially sizeable in the informal sector. Encouraging women to move to higher-paid occupations in the

formal sector is essential for improving family incomes and for furthering productivity growth in the economy as a whole.

Latvia's individual income-tax system is in principle well-placed to ensure that family tax burdens do not rise disproportionately when second earners, who are typically women, take up employment or move to a better-paying job. Families may, however, lose entitlement to tax-free allowances that are available for dependents, including spouses with no or very low (declared) earnings. These tax-free allowances have become more generous, and could represent a significant disincentive for women to engage in formal work or earn more. To avoid such disincentives, the government has recently decided to abolish the dependents tax-free allowance for adults who are able to work. This is welcome as it helps to make work pay for families. The resulting budgetary savings could be invested into suitably targeted support measures for two-earner couples.

Many older workers found it difficult to adapt their skills to the evolving needs of the labour market

The economic restructuring and privatisation since the beginning of Latvia's transition to a market economy led to major employment shifts and increasing earnings stratification between generations. The younger and better-educated, sometimes termed the "winner generation", were better able to adapt to and drive the transition, while older generations (and those in economically less dynamic rural areas) were frequently left behind and suffered extremely high levels of unemployment.

The transition dynamics continue to shape labour market circumstances today. Working age individuals who are now aged around 45 years or older completed all their primary and secondary schooling in the Soviet system before independence, and also some or all of their early working careers or tertiary education. Older Latvian workers, who account for a growing share of Latvia's working age population, remain one of the two age groups with the largest proportions in the poorest 10% of the population (the other group is children).

To facilitate active participation of older workers, existing employment and income support schemes should be based more systematically on an expectation of longer working lives, and tailored more closely to the situation and needs of older workers. For instance, senior jobseekers should be offered specialised additional assistance by the SEA (possibly on the basis of a specific profiling process) and should be brought directly in contact with employers through measures such as job fairs and work trials. Given a high incidence of health problems among senior workers, parallel improvements of the disability assessment system, as currently planned by

the government, are also crucial, and should be prioritised. With the support of the European Union, the Ministry of Welfare is carrying out a comprehensive evidence-based assessment of the labour market challenges faced by older workers and identify suitable policy tools.

The labour market situation of national minorities remains a legitimate concern for policy

Employment rates are lower among national minorities than among ethnic Latvians, and the incidence of unemployment and long-term joblessness is higher. National minorities were also less likely to benefit from the labour market recovery that began in 2010. The relative labour market disadvantages of minorities are, in part, a result of differences in age and education levels compared with the rest of the population. But closer analysis shows that they persist after accounting for these differences (by “controlling” for the most relevant characteristics in the statistical analysis). As in many OECD countries, this indicates that belonging to a minority remains a significant driver of poorer employment outcomes in Latvia and, hence, a concern for labour market policy.

Workers from national minorities also tend to earn less than the rest of the population in the same regions with similar jobs, education, age, experience and a wide range of other characteristics. The gap is wider for non-citizen workers, who earn some 10% less than otherwise similar ethnic Latvians, while the gap is 7.4% for national minority groups with citizenship. Earnings gaps are smaller than in Estonia, which has similar minority groups. But, contrary to expectations, earnings gaps affecting national minorities in Latvia do not appear to decline among younger generations, despite linguistic abilities likely being less of a barrier for the more recently educated cohorts.

A range of factors contribute to above-average employment difficulties of minority groups, in addition to differences in age, education or region of residence. Some groups of national minorities face formal restrictions for certain types of employment. Non-citizens are barred from holding a range of public-sector jobs and some private-sector occupations. In addition, there are possible employment barriers related to insufficient proficiency of the Latvian language, even if the latter should become less of a constraint as language gaps are shrinking.

As in virtually all OECD countries, Latvia has established laws to combat discrimination on both gender and ethnic grounds. Nonetheless, enforcement of these regulations is essentially based on workers’ willingness and ability to claim their rights. The probability of detecting infringements of relevant provisions is likely linked to any broader

enforcement issues of applicable labour law and the extent of informality. For national minorities as for other relevant groups, raising public awareness of existing legal safeguards, and strengthening incentives for victims to lodge complaints should be among the pillars of Latvia's policy strategy in this area.

Making social protection a key policy priority

Major reforms to social protection policies in the 1990s successfully addressed the pressing fiscal challenges arising from a relatively generous social protection system in the context of the large income and employment losses that accompanied the transition to a market economy. The reforms also aimed to strengthen work and reporting incentives by introducing strong links between earnings histories and support entitlements, removing the strongly redistributive elements that were a defining feature of social protection during the Soviet era.

Government programmes do little to alleviate inequality

Together, government taxes and transfers in Latvia do comparatively little to make incomes less unequal. Inequalities of market incomes in Latvia are similar to Finland or Germany, but with limited redistribution, the distribution of disposable incomes (after taxes and public transfers) is more unequal than in the large majority of OECD countries. Public perception echoes the limited effectiveness of government policies in this area. Latvians consistently report very low levels of satisfaction with the way in which inequalities and poverty are addressed, highlighting the need for sustaining reforms efforts in this area.

Today, social protection in Latvia is largely built on social insurance principles, both on the financing side, and as a central entitlement criterion for those claiming support. But coverage is very limited for some groups and benefits. For instance, the number of unemployment benefit recipients was less than half the number of jobseekers before the crisis, and by 2012 only around one in of every five jobseekers received unemployment benefits.

Social insurance programmes are complemented by a State Social Security benefit which can act as a benefit floor for some groups, by universal family transfers, and by modest and locally funded means-tested cash social assistance (Guaranteed minimum income, GMI) and housing benefits with very strict income limits. Partly as a result of the strict income limits, a majority of income-poor or materially deprived individuals do not receive support from any of the main income replacement benefits.

Ensuring an adequate resource base for social protection

Social spending is low

At just over 16% of GDP, public social spending in Latvia is well below the OECD average of 21%. Spending on old-age pensions and survivor benefits is similar to the average OECD country, but expenditures in all other categories are markedly lower. In 2012, when household incomes were still near their post-recession low, cash transfers to working age individuals and their children stood at roughly three quarters of the OECD country average. The resource gap is biggest, however, in the services category. Relative to GDP, spending in this category, which also includes health, was slightly above Mexico's and lower than in any high-income OECD country. Expenditures on social services other than health (including housing, social work, childcare and ALMPs) are less than half the OECD average.

Social protection as a central element in inequality-alleviation strategies

The government's longer-term policy documents, such as the National Development Plan 2014-2020, highlight tackling inequality, increasing employment and reducing labour tax burdens as broad priorities. Recent government budgets have increased some social protection funding relative to earlier years (e.g., funds for supporting families with children).

These individual measures are welcome. But the budget planning process currently does not appear to fully account for revenue requirements of ongoing major social security reforms, such as an ambitious, but necessary, GMI reform recently developed and proposed by the Ministry of Welfare. Likewise, the impact of revenue-side measures on inequality and on social budgets is not systematically assessed or spelled out.

Strong reliance on contribution-based financing creates specific challenges

The current financing mix suggests that bringing social spending closer to the OECD average will remain difficult. Despite still-depressed wage incomes in 2012, social insurance contribution on wages accounted for 61% of all social protection financing, the fifth-highest share in the EU27.

The strong reliance on contribution-based financing creates challenges that are specific to Latvia's socio-economic context. A contracting labour force, a large share of low-wage earners, and considerable wage-underreporting make it difficult to maintain adequate revenues, while keeping contribution burdens on labour incomes at acceptable levels. The total social contribution rate is currently 34.09% of gross earnings. With a

flat income tax schedule, the resulting overall tax wedge is high in international comparison, especially for low-wage workers. A “thin” middle class means that this group cannot generate as much revenue as in other countries. And Latvia’s volatile economy increases risks of long-lasting income shocks hitting large parts of the population. This makes risk pooling and diversification more difficult and weakens the effectiveness of a largely contribution-based welfare state.

Strengthening redistribution

Earnings-related social insurance provisions are well-suited for smoothing individual risks when career interruptions are relatively short and infrequent. But Latvia’s structurally high inequality has strengthened the case for bolstering redistribution across income groups, and for making employment-oriented social support more broadly accessible for those with no or limited contribution histories. Volatile economic growth and periods of substantial long-term unemployment further underline the role of needs-based assistance benefits and associated services as essential complements to contribution-based social provisions.

Overall, under 3% of transfer spending is devoted to programmes that are largely means-tested. Latvia’s policy configuration is unusual in this respect, as with comparatively low spending levels, effective targeting is crucial to make the most of available resources. OECD countries with equally low spending make much more use of income targeting.

A close link between entitlements and incomes requires reliable income information and therefore hinges on the government’s progress in tackling informality and envelope wages. However, targeting does not need to rely exclusively on income-testing but can use other indicators of need, such as family size or willingness to actively participate in job search measures.

Reinforcing targeted safety nets

Spending on the Family State Benefit is about twice as high as for the main GMI benefit and tighter targeting, e.g., by phasing out benefits for families with above-average incomes, would create additional fiscal space for channelling support to children in low-income households and at risk of poverty. The decision to boost family benefits for larger families, by increasing benefit amounts for second, third and further children, starting in 2015, is welcome as these larger families who are overrepresented among low-income groups.

The government has taken steps to reinforce means-tested minimum-income (GMI) benefits and to make them more accessible. The Ministry of

Welfare’s ongoing reforms of minimum-income benefits and raising unemployment benefit and pension floors are particularly welcome. But they remain incomplete and mainly focussed on benefit levels, and less on the more difficult but crucial issues of ensuring equality of access, financing the proposed benefit increases, further integrating income support with employment and rehabilitation services, and improving governance and co-ordination between state and local institutions. In addition, medium-term budget planning does not fully account for this strategic social protection priority, creating risks that the reform may be scaled back or delayed. Overall, efforts to reform and strengthen income safety nets should be stepped up, including agreements with municipalities on the crucial co-financing arrangements to fund the reform.

To reduce the strain on minimum-income benefit provisions, the government should consider ways to make unemployment benefits more accessible. They are the most suitable type of support for jobseekers, and a powerful gateway to job search assistance and related employment support. Given the current low coverage rates, last-resort benefits cannot provide adequate income support for all unemployed who do not have access to unemployment benefits. Reform of the unemployment benefit system could include a combination of longer benefit durations with benefit levels that fall over time, or a possible introduction of a means-tested unemployment assistance for those who are not, or no longer, entitled to insurance benefits.

The income tax system could play a bigger role in tackling inequality

Latvia taxes income at a single flat rate of 23% and income taxes are currently one of the least progressive in Europe and the OECD. A tax-free allowance that declines at higher income levels, as recently announced by the government, would make tax concessions more targeted and income taxes more progressive at a lower revenue cost. The scope of these measures could usefully be extended to other groups, however; notably to pensioners. The 2016 budget also includes provisions for a “solidarity tax” for high-income earners. This is welcome and would essentially undo the regressive effect of the ceiling on social contributions.

Monitoring the effects of public policies on inequality

Latvia already undertakes evaluations of the distributional impact of individual policy measures. But systematic incidence analyses encompassing the entire fiscal system are missing. In view of Latvia’s high inequality, they should be made routinely when developing and preparing major fiscal reforms on both the spending and the revenue sides. Currently, the absence of inequality impact assessments from key strategic documents,

such as the 2015 Inclusive Employment Strategy, weakens the government's ability to monitor progress towards the explicit policy objectives of reducing inequality and making growth more inclusive.

Social protection needs to be crisis-proof

For social protection to strengthen economic security it needs to be able to respond to recessions. Much of Latvia's social spending has been pro-cyclical, possibly exacerbating rather than dampening the instability of family incomes. For instance, even though employment fell much more than in most comparator countries, spending on working age support barely increased in the four years after the economy peaked.

Latvia's modest income safety nets were left severely over-stretched by the enormous need for well-targeted support during the recent deep downturn. The government swiftly implemented an emergency public works programme and started to co-finance safety net benefits administered by local governments to make last-resort income transfers more accessible to Latvians in the poorer parts of the country. These temporary emergency programmes provided vital and timely income support. But the sharp expenditure reductions enacted as part of a dramatic fiscal consolidation programme, meant that reforms undertaken in immediate response to the crisis were not – and arguably could not be – designed to fill structural gaps in the social protection system.

A carefully targeted social support system makes social protection more crisis-proof, both by facilitating the build-up of fiscal reserves during upswings, and by strengthening automatic stabilisers during future recessions. Approaches in OECD countries offer pointers as to how policies in Latvia could be made more responsive to changing economic conditions and to household needs. For instance, Ireland's out-of-work benefits are well targeted and were allowed to operate to the full extent by keeping them accessible to a rapidly growing number of jobseekers.

Preventing old-age poverty

Low birthrates, ageing and emigration trends have been the principal drivers of pension reforms in Latvia and other Baltic countries since the 1990s. Latvia's far-reaching reforms to maintain the financial sustainability of pension promises transferred longevity, labour market and capital market risks from social insurance and state budgets to individual members. In 1996, it was one of the first countries in Europe to start introducing a multi-pillar system consisting of a mandatory notional defined contribution (NDC) public "1st pillar" that is financed on a pay-as-you-go (PAYG) basis, a

mandatory defined contribution (DC) “2nd pillar”, and a voluntary private-pension “3rd pillar”.

Pension levels and public spending on old-age pensions are low in international comparison and are projected to fall further in the medium term. Based on current policy parameters, future public pension expenditures are estimated to fall from 7.7% of GDP in 2013 to 4.6% in 2060. The minimum contribution requirement under the 1st pillar is 15 years, rising to 20 years in 2025. A modest minimum pension is available to retirees with short contribution histories or low NDC entitlements. The current legal retirement age is 62.5 years for both men and women, rising in annual steps to 65 years by 2025.

Although the system is fiscally sound on a technical level, the risks of significant income gaps for future retirees create uncertainty about its social sustainability. In the medium term, this uncertainty also translates into potential risks for fiscal sustainability, as increasing numbers of pensioners can add to political pressures for ad-hoc changes and for additional expenditures beyond those currently projected. To reduce these risks, a comprehensive review should systematically assess the effectiveness and adequacy of current pension provisions in the context of Latvia’s expected demographic trends and labour market developments.

Closing the pension gap

Future pension entitlements in the unfunded 1st pillar will be markedly lower than today, with average (gross) replacement rates in the earnings-related public pension projected to halve from 38% in 2015 to 19% by 2060. The drop is in part a result of the increasing life expectancy at retirement, which will result in lower annuities for future retirees. Future replacement rates in the 1st-pillar notional defined contribution (NDC) system will be low even for those retiring on a full career (36% by 2059, against an OECD average of 53%).

Low projected replacement rates in the 1st-pillar scheme affect future retirees at all earnings levels, leaving a sizeable income gap to be filled by the 2nd and 3rd pillars. Membership in the mandatory 2nd-pillar DC scheme has indeed expanded strongly. But projected future pay-outs fall well short of the spending reductions in the public pension scheme. With unchanged policies, any remaining gaps would have to be primarily filled by substantial expansions of the voluntary 3rd pillar private pension, or through significant additional public expenditures outside the state social insurance system.

Maintaining incentives to build up pensions capital

Recent economic and policy developments since the onset of the financial crisis suggest that closing the pension gap will remain a significant challenge. For instance, the difficulties of financing ongoing pension benefits in the 1st-pillar scheme with a much smaller number of contributors during the crisis led the government to effectively channel mandatory contributions away from the 2nd pillar. As a result, the retirement capital of workers accrued at a much lower rate than initially planned. The volatility of contribution rates also made it more difficult for members to anticipate future retirement savings and may have contributed to the erosion of confidence in the overall pension system.

The government recognises the need to bolster income provisions for the lowest-income pensioners in particular, including through raising minimum-pension levels. But even with the very low current minimum pensions, minimum pensioners already accounted for 13.6% of new pension claims in 2014 (up from 4% in 1996). A further large increase in the number of retirees qualifying for minimum pensions or broader means-tested safety nets would undermine the earnings link of the Latvian pension system, and possibly the incentives to contribute to it.

Introducing or strengthening redistributive elements that maintain incentives for building up pension capital would be more in line with the system's internal logic and could relieve pressures on minimum-pension claims. This could include measures to make the pension formula more progressive for those with entitlements above the minimum pension. Increasing minimum-pension provisions with age, say at age 70 or 75, could be another option for alleviating old-age poverty while maintaining incentives to contribute during working age.

Box 0.1. Summary of recommendations for Latvia

In the context of enhancing job opportunities and wellbeing for all, the Latvian Government is invited to consider the following items as part of its strategy to tackle the demographic challenge, reduce inequality in the labour market, strengthen productivity, and further develop inclusive and active social policies. Some suggested policy reforms imply a rise in public social spending and will require improvement in tax policy and tax enforcement or a shift in the composition of government spending towards labour market and social policies.

Managing emigration and a shrinking population

- More efforts should be made to ensure Latvians abroad, especially Latvian graduates abroad, remain informed about job opportunities in Latvia, both through more active listing of vacancies, and the development of a platform for registering the profiles and contacts of Latvians abroad.
- Longer-term measures to maintain contact with the diaspora should be reinforced and expanded, including youth summer programmes and outreach to foreign spouses and partners. A more strategic sector approach to diaspora entrepreneurs should be taken.
- Labour migrants should be actively targeted to help address projected skills shortages, including through outreach activities to non-EU nationals by the State Employment Agency. Occupational language requirements for initial visas should be examined in light of sector shortages and priority areas. Policy discourse should contribute to a favourable climate for international recruitment.
- Retention of foreign talents in Latvia should be improved. The Latvian language education infrastructure should be used to improve opportunities for labour migrants to learn the language and stay. Provisions to encourage international graduates to remain in Latvia should be implemented.
- The investor programmes should be evaluated with a view to shifting the target towards investors in productive businesses, favour resident investors, and ensure that real estate thresholds are appropriate. Language requirements for foreign investors could be eliminated to ensure that this is not an obstacle, and to signal openness to businesses serving foreign markets.

Supporting jobseekers into productive employment

- The resource base for active labour market policies should be strengthened. While continued access to co-funding from the European Social Fund is essential, core services, routine programme evaluation and monitoring should be financed through adequate allocations from the state budget. Funding levels should be made responsive to labour market conditions, e.g., by considering a suitable automatic link between unemployment levels and resource allocations.

Box 0.1. Summary of recommendations for Latvia (cont.)

- Co-ordination between the State Employment Agency (SEA), social service providers and educational institutions should be enhanced to maximise administrative efficiency, help social assistance recipients attain productive employment, and facilitate school-to-work transitions. The distribution of resources for integration and employment-support programs to SEA and municipal welfare offices should be closely aligned with their de-facto responsibilities. To better articulate incentives for formal work, means-tested income transfers should be withdrawn gradually as family incomes increase when benefit recipients start to work.
- Resource allocations for active labour market programmes should be linked more closely with their performance, through more systematic programme evaluation and monitoring, and by making greater analytical use of existing rich administrative data.

Developing workers' skills

- A modern system of apprenticeships should be promoted by introducing employment contracts for apprentices that are tailored to the needs of students and employers. Such contracts should provide for the possibility of paying wages below the regular minimum wage, enable and encourage effective on-the-job training, and ensure that apprentices are suitably protected by safeguards as defined in labour law.
- The government could consider specific and carefully targeted financial incentives to promote work-based learning, especially among smaller employers. Such public support should be designed to stimulate necessary investments by employers, not substitute for them. Pooling of apprenticeships, whereby firms can share apprenticeship places, could be considered.

Addressing labour market inequality and informality

- The suitability of a single minimum wage for all workers should be reconsidered in the light of the employment barriers of different groups, notably youth, older workers and labour market entrants. Maintaining employability in the formal sector should be a primary consideration when deciding on minimum-wage adjustments.
- Efforts to strengthen enforcement of labour law and tax provisions should be redoubled, building on the experiences with recent policy initiatives. The language requirements for a wide range of occupations, and the enforcement of such provisions, should be assessed against possible consequences of discouraging formal work among individuals with sub-threshold language skills.
- Reducing the high labour tax wedge on low-paid formal workers resulting from substantial social contribution burdens at low wage levels remains a priority. However, effective measures to strengthen progressivity through targeted tax-wedge reductions will require significant progress in tackling informality and under-reporting.

Box 0.1. Summary of recommendations for Latvia (cont.)

- Financial penalties for employees receiving unreported employment income should be considered as part of a sustained strategy to tackle informality and “envelope wages”. Any such penalties need to be proportionate, however, and can be combined with amnesties to encourage the reporting of past infringements. The policy discourse should highlight informality as a national issue while being careful to avoid stigmatising specific groups of workers.
- The proposed minimum social contribution, which aims at reducing underreporting of working hours, should be avoided as it would make genuine part-time work much more costly and would be potentially complex to administer.

Making social protection a key policy priority

- Efforts to reform and strengthen the main income safety nets, notably the guaranteed minimum income, should be stepped up, including by working towards a sustainable co-financing arrangement between central and local governments to fund the reform and ensure equality of access across regions. Income safety nets should be further integrated with employment and rehabilitation services.
- Coverage of unemployment benefits should be improved, e.g., by combining longer benefit durations with benefit levels that decline over the unemployment spell, or by considering a form of means-tested unemployment assistance benefit for jobseekers who are not, or no longer, entitled to unemployment insurance.
- Systematic incidence analyses encompassing the entire fiscal system should be made more routinely when developing and preparing major fiscal reforms on both the spending and the revenue sides. Currently, the absence of comprehensive inequality impact assessments from key strategic documents is not consistent with the government’s policy objectives of reducing inequality.
- Concrete policy options should be developed to strengthen redistributive elements in the pensions system, while maintaining incentives for building up pension capital. This could include measures to make the pension formula more progressive for those with entitlements above minimum-pension levels, or increasing minimum-pension provisions with age (e.g., at age 70 or 75). To inform policy efforts in this area, a comprehensive review should analyse the consequences of the expected old-age pensions gap for poverty and income adequacy during old age.

Chapter 1

A volatile economy heightens Latvia's social challenges

During the pre-2008 boom years, per-capita GDP growth in Latvia was among the highest in the European Union, averaging some 8.5% per year between 2000 and 2007. But highly volatile economic growth, one of the highest levels of income inequality in the European Union and a rapidly declining population create a pressing need for effective social policies. They also highlight the importance of well-functioning labour market institutions that support a continuation of Latvia's economic transformation, while encouraging the creation of employment opportunities for groups that remain underrepresented in the labour market.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

1. Strong growth and remarkable resilience, but major policy challenges ahead

Latvia is a small open economy with strong but volatile income growth, high inequality, and a population of around 2 million that is declining due to ageing and emigration. Like other transition economies in Eastern Europe, Latvia has undergone major economic and social change since the early 1990s. The country's newly gained independence in 1991 along with its transformation from planned to market economy were accompanied by fundamental reforms of its political institutions, integration into the European Union and, in 2014, the accession to the euro zone. Over the past two decades, economic growth has been impressive, narrowing the income shortfall relative to wealthier OECD countries from 80% to well below 60% (Figure 1.1, Panel A).

Economic progress in Latvia has, however, been unequal and highly volatile – much more so than in most comparator countries (Figure 1.1, Panel B). Growth rates in the pre-2008 boom years were among the highest in the European Union, and while income gaps within Latvia grew enormously, even groups at the lower end of the income distribution saw improvements in their living standards. The recession associated with the global financial crisis resulted in one of the worst output losses in the world, dramatic fiscal consolidation measures, linked also to Latvia's determination to join the euro, and unprecedented nominal wage adjustments accompanied by soaring unemployment. In two years, aggregate wages in the economy plummeted by more than a third (Figure 1.1, Panel C).¹

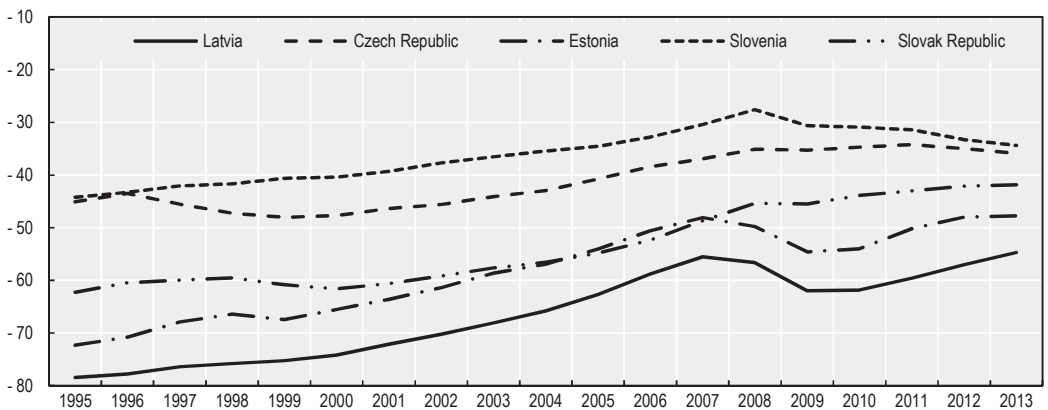
Since 2011, output recovery in Latvia has once again been among the fastest in the European Union although growth has recently slowed and national income still stands some 10% below its pre-crisis peak. Workers' incomes started to climb only later and by much less. While total wage earnings in most comparator countries are not far from their pre-recession highs, the recovery of earnings losses experienced during the recession in Latvia is projected to take several more years.

Despite the remarkable narrowing of national-income gaps relative to comparator countries, Latvians reported very low degrees of life satisfaction during the boom years, with subjective wellbeing measures remaining lower than in OECD countries with similar or lower GDP per capita (Figure 1.2, Panel A). In part, these patterns are a legacy of the large drop in life satisfaction from already low levels during the turbulent early years of independence in Latvia and in other transition countries and parts of the former Soviet Union (Realo, 2009; Inglehart and Baker, 2000; and Lelkes, 2006, who describes the phenomenon as an “iron curtain of unhappiness”).

Soaring unemployment led to a growing perception of economic and social exclusion, in a context of social norms that traditionally stigmatised non-working individuals. Partly as a result, subjective wellbeing was low among older cohorts in particular. But, in addition, high and increasing inequality, combined with the economic uncertainty resulting from repeated boom-and-bust cycles are among the reasons why strong economic growth failed to translate into bigger and more widespread improvements in life satisfaction (Easterlin, 2009; Guriev and Zhuravskaya, 2009).

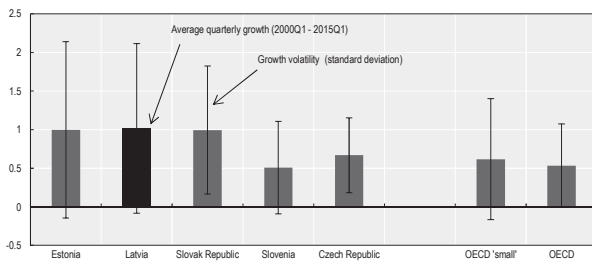
Figure 1.1. Large but uneven income gains

Panel A. National income gaps have narrowed but remain wide
GDP per capita, gap to upper half of OECD countries, in percent



Panel B. Volatile GDP growth has affected the labour market

Average quarterly GDP growth rate from 2000Q1 to 2015Q1
and volatility



Harmonised unemployment rate,
% of total labour force

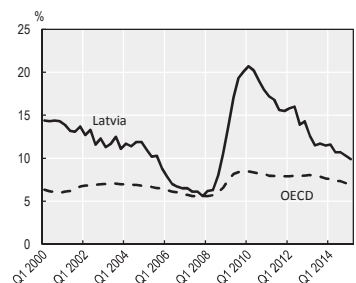
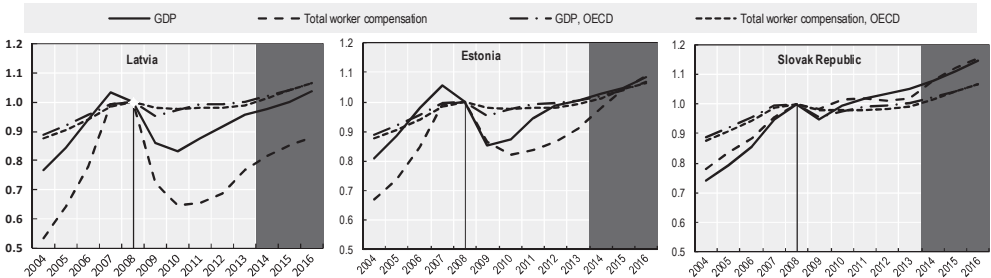


Figure 1.1. Large but uneven income gains (cont.)

Panel C. Economic output is recovering quickly but workers’ earnings lag behind (2008=1)

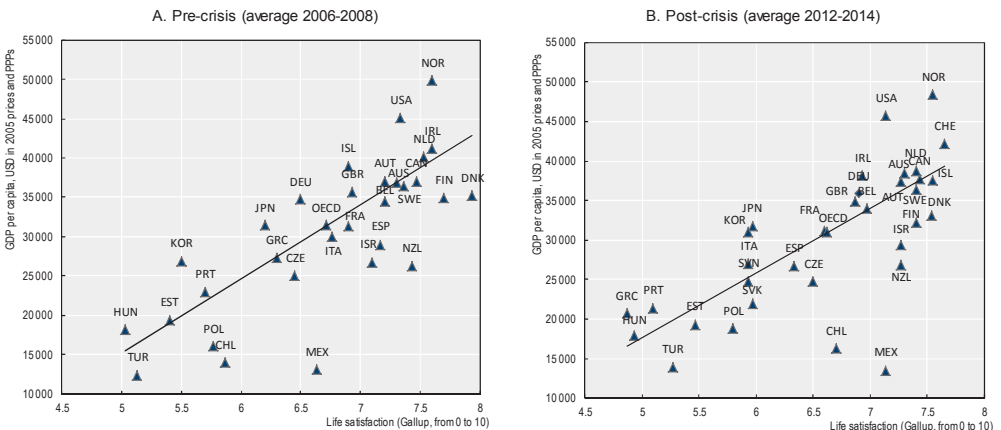


Note: All values are in real terms. *Panel B*: Quarterly GDP growth rates are in real terms, annualised and seasonally adjusted. Countries are ranked in decreasing order of volatility; “OECD ‘small’” refers to the average of the ten least populous OECD countries. *Panel C*: OECD averages include only countries that saw a drop in annual GDP at least once between 2007 and 2009. Australia, Israel, Korea and Poland are therefore excluded. Turkey is also excluded as data on worker compensation are not available.

Source: OECD (2015), *OECD Economic Surveys: Latvia 2015*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264228467-en>, and OECD Secretariat calculations using *OECD Economic Outlook Database*.

Figure 1.2. Subjective wellbeing remains very low, despite being remarkably resilient during the crisis

Income and life satisfaction



Source: World Gallup Poll and *OECD National Accounts Database*.

The most recent international comparisons of subjective wellbeing measures continue to rank Latvia towards the bottom of OECD and EU countries. In the 2013, some 28% of Latvians said they were “happy none or little of the time” – the third-highest share in the European Union after Greece and Bulgaria.² Latvia’s low ranking in international comparisons of subjective wellbeing is also apparent other data sources. The low scores appear to be related to longer-term economic and social trends, and not to a major deterioration during the crisis. Despite plummeting living standards after 2007, household wellbeing was remarkably resilient and, unlike in most other crisis-hit countries, average reported wellbeing has recently started to increase (Figure 1.2, compare Panels A and B). These short-term changes in average reported life satisfaction are, however, somewhat difficult to interpret as large numbers of Latvians have emigrated during this period.

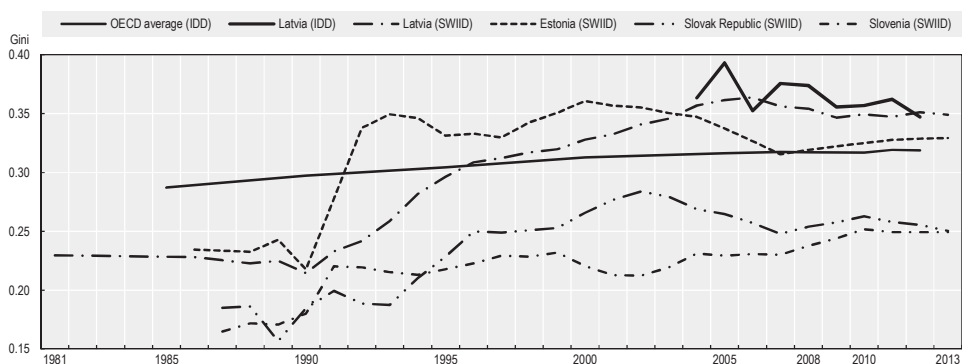
Latvia’s short-term growth prospects remain sensitive to developments affecting its trading partners, where significant downside risks persist (OECD, 2015a). The exposure to weakening or volatile regional prospects, combined with Latvia’s history of pro-cyclical fiscal and financial policies translate into continued risks of “boom and bust” cycles, which carry significant social costs and have reinforced existing social and labour market challenges in the past:

- Over the past 25 years, uneven growth patterns were accompanied by rapidly rising inequalities (Figure 1.3, Panel A). As disadvantaged households struggle to hedge against economic uncertainty and the consequences of economic downturns, those facing prolonged or repeated hardship may find it difficult to take full advantage of economic opportunities during an upswing (Fofack and Monga, 2004). After an unusually long and marked widening of income disparities, inequality is now among the highest in the OECD area. Without counteracting policies, there is a risk that inequality remains at a very high level, or could even increase further, as was the case during earlier recoveries (e.g., after the 1998 Russian financial crisis).
- Volatile labour markets also complicate progress towards narrowing the substantial productivity gap relative to comparator countries (Figure 1.3, Panel B). Risks of informality, long-term joblessness and skills depreciation are exacerbated when large cyclical swings overwhelm the capacity of formal labour market institutions to facilitate an efficient re-allocation of jobs towards high-productivity sectors – notably from Latvia’s large shadow economy, estimated at close to 25% of GDP, where productivity tends to be low.³ A quick succession of labour shortages and high unemployment also makes workforce planning difficult for employers, and may reduce incentives to invest in productivity-enhancing training and workforce development.

- Unfavourable and uncertain economic conditions at the level of individual families are a likely contributing factor to low birth rates and high emigration. All transition economies saw declining birth rates from 1990, and Latvia was no exception. Steady net emigration, which spiked during the crisis and remains high, exacerbates the effect of shrinking youth cohorts. The total population and the working age population have been falling, and even with the most optimistic estimates of slower emigration, the working age population is projected to be almost 10% smaller in 2020 than in 2010 (Figure 1.3, Panel C).

Figure 1.3. Key challenges: Inclusiveness, demographics, and productivity

Panel A. Income growth was accompanied by a very steep increase in inequality



Panel B. Labour productivity continues to lag behind comparator countries
GDP per hour worked, 2000 and 2013

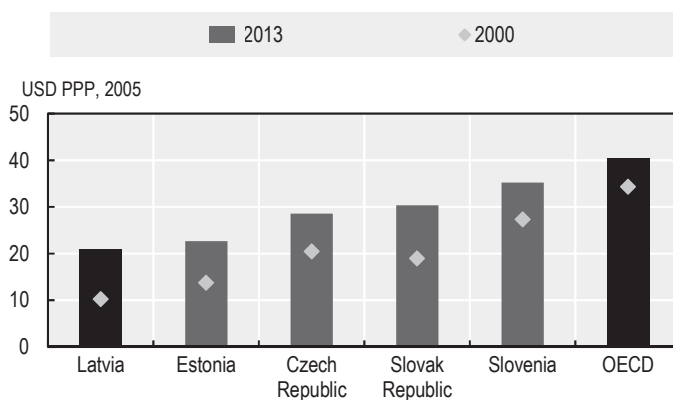
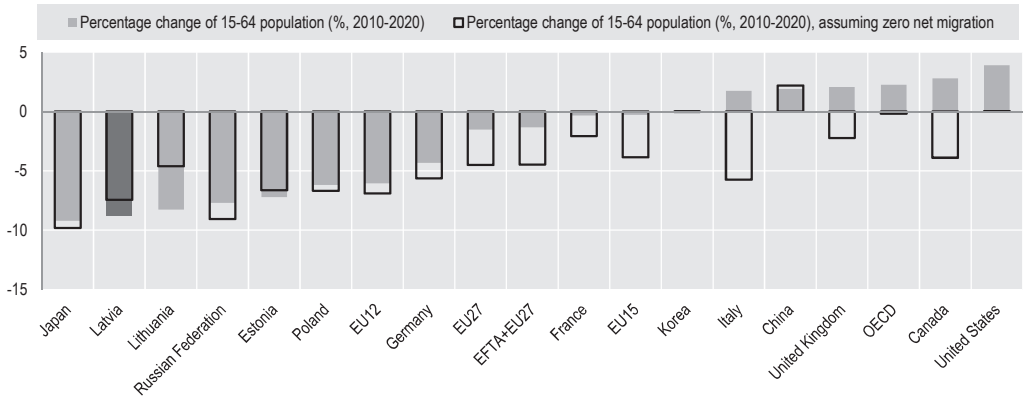


Figure 1.3. Key challenges: Inclusiveness, demographics, and productivity (cont.)

Panel C. The working age population is declining rapidly, driven by emigration and decades of low birth rates



Note: The *OECD Income Distribution Database (IDD)* relies on micro-data sources to collect income distribution data using a common methodology across countries. The *Standardized World Income Inequality Database (SWIID)* is a secondary synthetic data compilation using on regression-based procedures to estimate complete time series from existing inequality data sets that can come from a range of different micro-data sources and may include significant breaks or gaps.

Source: Panel A: *OECD Income Distribution Database (IDD)* and *Standardised World Income Inequality Database (SWIID)*. Panel B: *OECD Productivity, OECD National Accounts and OECD Economic Outlook Databases*. Panel C: United Nations (2011), “World Population Prospects – The 2010 Revision: Highlights and Advance Tables”, United Nations, New York, <http://www.un.org/en/development/desa/publications/world-population-prospects-the-2010-revision.html>, accessed 22 May 2013; and EUROPOP2010.

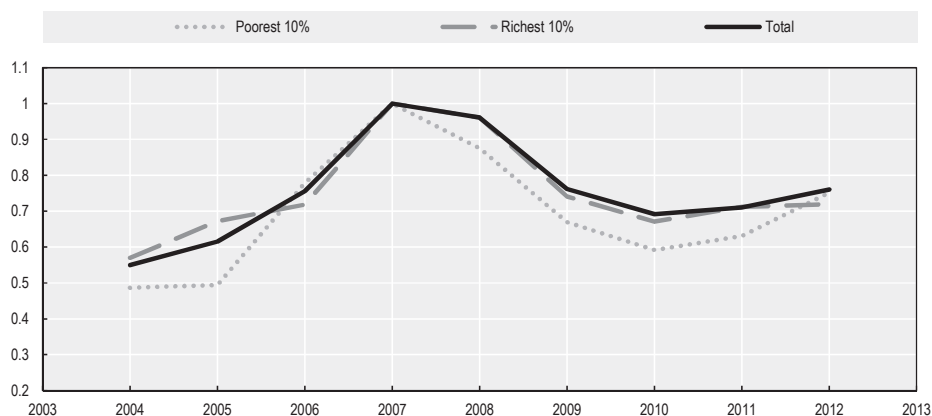
2. Inequality has reached very high levels

As in other transition countries, income inequality in Latvia soared during the early 1990s as the country underwent major realignments of labour, financial and product markets. Over a short period, central planning with near-full employment, low wage inequality and small differences in non-labour incomes was progressively replaced with a market economy featuring privatised production, accompanied by wage differentiation and several years of rapidly growing unemployment.⁴ The marked rise in inequality lasted much longer than in comparator countries, however (Figure 1.3). For instance, while inequality in Estonia stabilised in the mid-1990s and started falling afterwards, it continued to climb in Latvia and kept rising even as many new jobs were created during the boom years prior to the 2000s before falling for a short period before the crisis.⁵

During the crisis, inequality stabilised at a very high level; sharp falls in earnings and other market incomes permeated all parts of society, and social benefits shielded some groups, notably pensioners, from larger losses. With a flat income tax, relatively weak social safety nets and comparatively low social spending, the tax-benefit system provided only limited income cushioning for working age households. They saw especially sizeable income losses, affecting not only the poverty headcount but also the depth of poverty (Figure 1.4). Incomes of working age households, including the poorest 10%, started to recover in 2011 but remain markedly lower than before the recession.

Figure 1.4. Low-income groups benefited from the pre-crisis boom but fared badly during the recession

Trends in disposable incomes of working age households, in constant prices, 2007=1



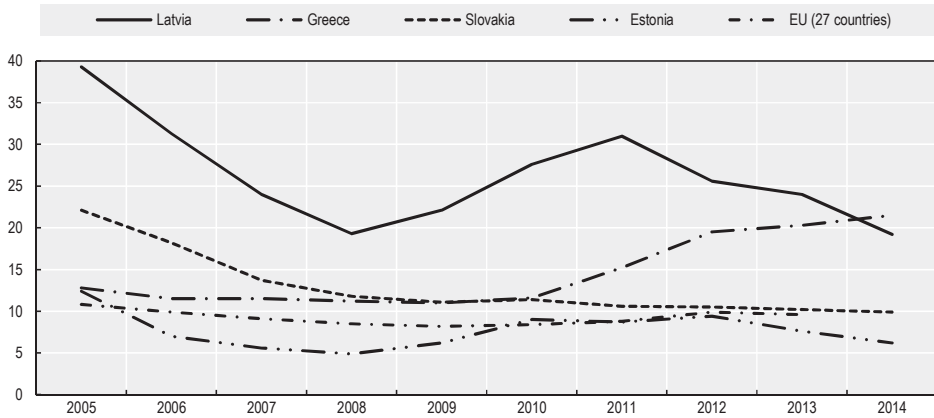
Note: Average incomes of individuals living in households with at least one adult aged 15-64.

Source: OECD Income Distribution Database (<http://oe.cd/idd>).

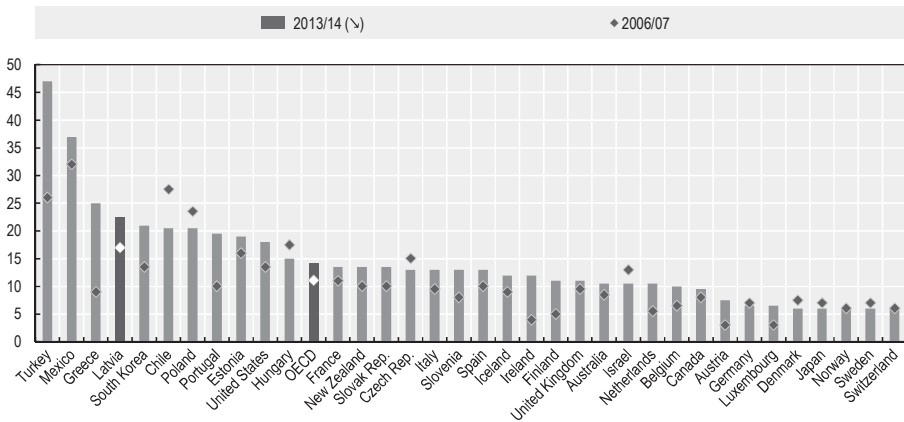
The strong income gains during the pre-crisis boom years quickly lowered rates of material deprivation, albeit from a very high level (Figure 1.5, Panel A). But with household wealth holdings extremely low by international standards, Latvians lacked the financial buffers to absorb the major income losses that followed during the deep recession.⁶ The crisis therefore had a direct and immediate impact on households' material wellbeing. Large income losses, and the additional financial difficulties created by declining real-estate prices, led to a quick rebound of deprivation rates. Data from different sources indicate that close to 20% of Latvians remain severely materially deprived and face acute problems in acquiring necessities such as food (Figure 1.5, Panels A and B).

Figure 1.5. Income fluctuations cause hardship for many Latvians

Panel A. Severe material deprivation is declining but remains much higher than in comparator countries



Panel B. More than one in five Latvians say they are not always able to afford sufficient food



Note: Panel A: The severe material deprivation rate represents the proportion of people living in households that cannot afford at least four of the following nine items: mortgage or rent payments; utility bills; hire purchase instalments or other loan payments; one week’s holiday away from home; a meal with meat, chicken, fish or vegetarian equivalent every second day; unexpected financial expenses; a telephone (including mobile telephone); a colour TV; a washing machine; a car; and heating to keep the home sufficiently warm. *Panel B:* Share of “yes” responses to the question “Have there been times in the past 12 months when you did not have enough money to buy food that you or your family needed?”. Results are shown averaged over a two-year period to minimise the impact of year-on-year fluctuations.

Source: Eurostat <http://ec.europa.eu/eurostat/web/income-and-living-conditions/data/main-tables>, OECD Secretariat calculations based on Gallup World Poll, <http://www.gallup.com/strategicconsulting/en-us/worldpoll.aspx>.

Key dimensions of inequality in Latvia

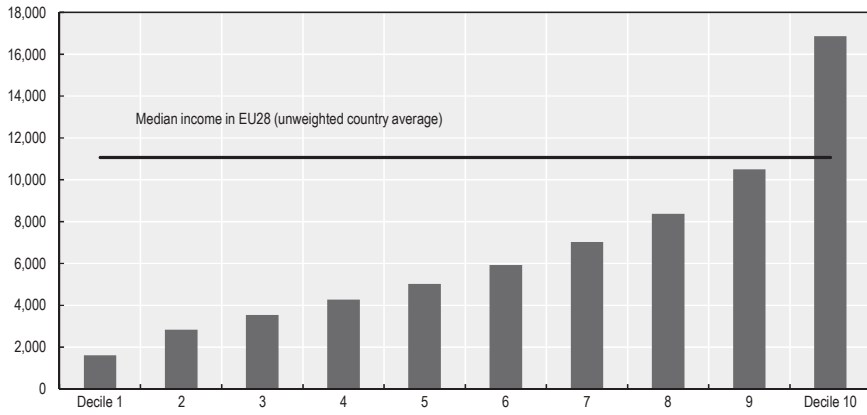
Gaps between low and high-income earners are very large in Latvia (Figure 1.6, Panels A and B). In 2012, the disposable incomes of Latvian households near the top of the income distribution (the “90th percentile”, or the point where 90% of Latvians have lower incomes) were five times as high as those of households near the bottom (the “10th percentile”). This is a bigger gap than in any European OECD country and significantly exceeds the OECD average ratio of four to one.

Inequality in Latvia cannot be fully understood by focussing on the gap between the rich and the poor alone, however. Indeed, one of the defining features of the income distribution in Latvia is the very small size of what might be termed the middle class. Just over half of Latvia’s population (53%) have income between 75-200% of the median (Figure 1.6, Panel C); they are not rich, but are well above the poverty line, which is often set at 50 or 60% of the median (Atkinson and Brandolini, 2011). Pre-transition institutions were designed to guarantee that most people’s incomes were close to the average. But today, the size of this socially, economically and politically important group is far smaller in Latvia than in most other European countries for which similar data are available.

The “thin” middle class is one reason for Latvia’s position at the top of international comparisons of inequality measures such as the Gini coefficient. The unusual shape of the income distribution is also reflected in the way Latvians see their country. During the economic crisis, more than two-thirds of them thought their society resembled one with “a small elite at the top, very few people in the middle and the great mass of people at the bottom”; this was the highest proportion among 40 countries surveyed.⁷ Progress at reversing the trend rise in measured inequality, and Latvians’ perceptions of living in an economically divided society, requires reducing income gaps between rich and poor. But it also requires addressing the reasons for a “vanishing middle”.

Figure 1.6. Large gaps between rich and poor, and a very “thin” middle class

Panel A. Average annual income by decile group, in EUR, 2012



Panel B. Income disparities: Top versus bottom of the income distribution

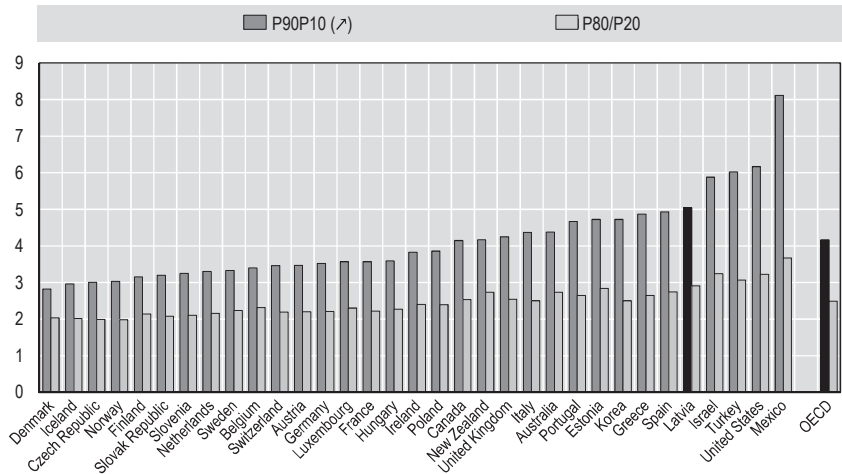
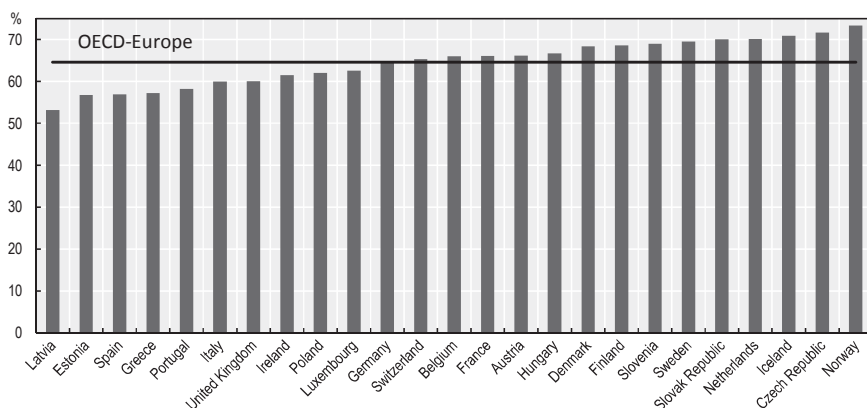


Figure 1.6. Large gaps between rich and poor, and a very “thin” middle class (cont.)

Panel C. Share of population earning 75-200% of median income, 2012



Note: EU median income in Panel A is the unweighted average of countries’ national median, after adjusting each country value for price level differences relative to Latvia. The P90/P10 and P80/P20 ratios express the incomes of someone towards the top of the income distribution (e.g., the “90th percentile”, or “9th decile”, i.e., the point in the distribution where 90% of Latvians have lower incomes) as a multiple of the income of someone towards the bottom (e.g., the “10th percentile” or “1st decile”). Incomes are after taxes and transfers and are equalised using the “square root of household size” scale to account for differences in family size.

Source: OECD Secretariat calculations using *OECD Income Distribution Database* (<http://oe.cd/idd>) and EU-SILC.

Who are the low and high-income groups?

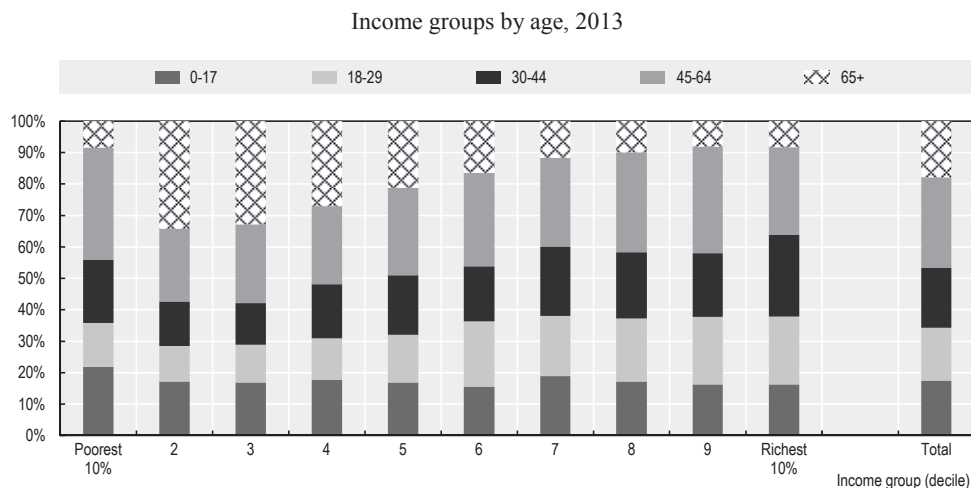
The social and economic patterns underlying Latvia’s unequal incomes are complex. They include the legacy of major breaks in people’s education and earnings opportunities during the transition, and the resulting income differences between generations. Moreover, low fertility, rapid ageing and mass emigration have changed the demographic makeup of the country, with incomes of older workers and retirees becoming a more important driver of overall inequality. A low labour income share in the economy,⁸ a highly dispersed wage distribution, and large regional disparities in economic activity are among the factors that translate into persistent inequality among the current working age population. At the same time, high rates of poverty among children and adolescents cause hardship among the youngest generation and risk compromising their opportunities as future employees.⁹

Along with rapid economic growth in Latvia and other Baltic States during the 1990s, restructuring and privatisation led to major employment

shifts and increasing income stratification between generations and regions. The younger and better-educated, sometimes termed the “winner generation”, were better able to adapt to and drive the transition to a market economy (Titma, 1999; 2002), while older generations and those in economically less dynamic rural areas were frequently left behind and suffered extremely high levels of unemployment.

The transition dynamics continue to shape labour market circumstances today. Working age individuals who are now aged around 45 years or older completed all their primary and secondary schooling in the Soviet system before independence, and also some or all of their early working careers or tertiary education. Young adults between the ages of 18 and 30 did all of their education after the transition and are underrepresented in the low-income groups, despite having suffered significant labour market setbacks during the recent crisis (OECD, 2015b). Indeed, 61% of these younger adults have incomes in the upper half of the income distribution (Figure 1.7). By contrast, a large majority (70%) of retirees over 65 have incomes in the bottom half of the income spectrum. But unlike in other countries, they currently have only a small risk of being in the lowest income group.

The poorest 10% of the population includes the greatest proportion of children and of older Latvians prior to retirement (the 45-64 year-olds in Figure 1.7). The overrepresentation of children under 18 is, in part, due to the low incomes of large families: up to half of all families with three or more children belong to the bottom 10%. Older Latvians prior to retirement account for a growing share of Latvia's working age population and remain significantly overrepresented in the lowest income group – accounting for 28% of the entire population, but as many as 35% of the poorest 10%. These patterns indicate that many of them found it difficult to adapt their skills to those demanded by the evolving market economy, and that realising the productive potential of older workers remains an important challenge.¹⁰ At the same time, just under 50% of 45-64 year-olds belong to the upper half of the income distribution: birth cohort alone is not sufficient for understanding why some groups were less able to benefit from the transition.

Figure 1.7. Older workers and children are among the most disadvantaged

Note: Household disposable income after taxes and transfers, adjusted for household size.

Source: OECD Income Distribution Database (<http://oe.cd/idd>).

Regional and ethnic diversity

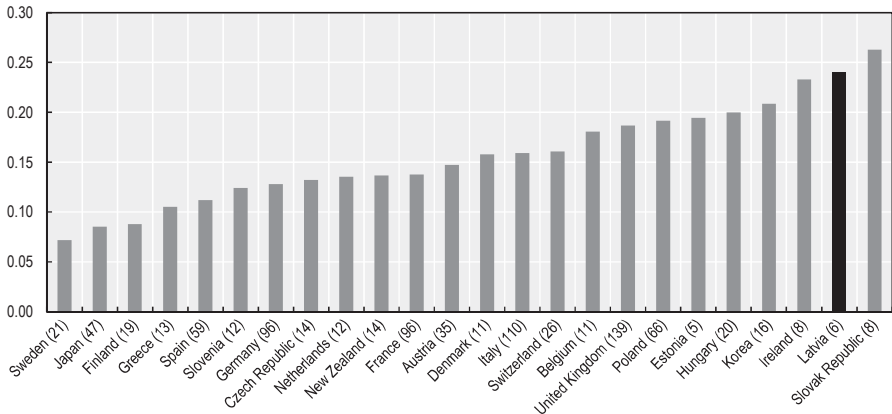
Levels of economic development vary enormously across regions in Latvia translating into major challenges for social and labour market policy. The capital Riga accounts for just under one-third of the population, but for some two-thirds of the country's GDP, employment and job vacancies. Regional inequality is much higher than in most OECD countries and social indicators vary strongly across regions as well (Figure 1.8, Panels A and B).¹¹ Poverty rates in Latgale in the East and in Vidzeme in the North are more than double the rate in the capital and the surrounding Pieriga region. Regional poverty disparities, which remain high and have so far changed little during the recovery, are in part related to the geographic concentration of Soviet-era industries, which then contracted strongly during the transition phase.

Large regional disparities are a long-standing structural problem. For instance, Masso et al., 2014, report that during the transition period in the first half of the 1990s, "it was not at all unusual for practically the entire working age population of a region to be unemployed" (p. 101). Income levels are associated with the regional concentration a range of population characteristics, such as age or education level, that are typically highly correlated with employment status and income levels.

There is a strong regional aspect to minority languages, ethnicity and non-citizenship (Box 1.1). Ethnic minority groups account for 35% of the population, and 37% of Latvian residents use Russian as the main language at home. Groups who belong to national minorities are on average older than ethnic Latvians and have lower rates of tertiary education (EU-SILC data, 2011-2013).¹² Although around 45% of these minorities live in the Riga region, relative concentrations are on average much higher in low-income regions in the South-east (Figure 1.8, Panel C). Partly as a result, ethnicity is one of the characteristics that are strongly correlated with different forms of labour market disadvantage, as discussed in the next sub section below.

Figure 1.8. Large regional differences in income levels, poverty and concentration of ethnic minorities

Panel A. Dispersion of GDP per capita between regions, Gini index for small regions, 2012



Panel B. Relative poverty rates

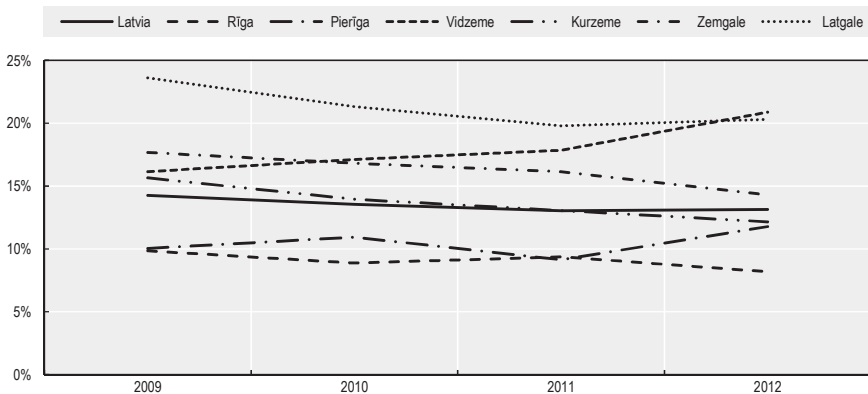
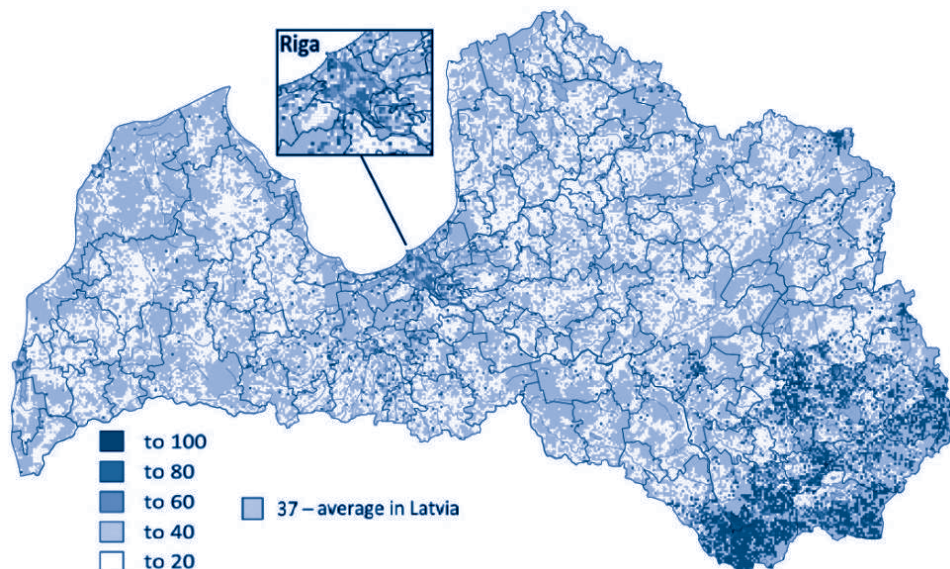


Figure 1.8. Large regional differences in income levels, poverty and concentration of ethnic minorities (cont.)

Panel C. Regional concentration of Russian speakers:
Share of resident population (%) by use of main language at home, 2011



Note: Panel A: Territorial Level (TL) 3, number of regions in parentheses. *Panel B:* Relative poverty rates refer to the share of people with household incomes below 50% of the national median. *Panel C:* density of speakers is indicated per 1 km².

Source: Panel A: OECD calculations using OECD Regional Statistics, Regional Accounts (http://www.oecd-ilibrary.org/urban-rural-and-regional-development/data/oecd-regional-statistics_region-data-en); *Panel B:* OECD calculations using EU-SILC; *Panel C:* 2011 Census: Central Bureau of Statistics, <http://www.csb.gov.lv/en/statistikas-temas/kartes/language-usage-daily-basis-42745.html>.

Box 1.1. Nationality, ethnicity and language in Latvia

Three important distinctions overlap in today's Latvia:

1. **Citizenship:** There are Latvian citizens (some 85% of the resident population), “non-citizens” of Latvia (12%) and foreigners (just below 3%). This information is recorded in the population register.
2. **Ethnicity,** defined officially as “historically resident” populations with a distinct language, culture and religion, and considered “national minorities” in Latvian terminology: Russians are the largest national minority group, accounting for 26% of the population. Belarussians account for 3%, and Ukrainians and Poles for 2% each. 62% of the population are ethnic Latvians. This information is recorded in the population register.
3. **Language:** Without counting non-responders (10%), 62% of respondents to the 2011 census reported Latvian as the “language mostly spoken at home”, while 37% reported Russian. Information on language abilities is not otherwise available in administrative data, although sporadic surveys provide some information on multi-lingualism.

Non-citizen status was granted to persons primarily resident in Latvia in 1990 who had immigrated to Latvia during the period of Soviet occupation – and their descendants – who were not eligible for automatic acquisition of Latvia's citizenship and who lost their USSR citizenship after the dissolution of the Soviet Union. The status is “former citizens of the USSR without the citizenship of the Republic of Latvia or any other country”, and is referred to as “non-citizens” in this report.

Most non-citizens are ethnic Russians and Russian speakers, although most (82%) of the 575 000 ethnic Russians, and most Russian speakers, have become Latvian citizens.

Ethnic Russians and Russian-language speakers largely overlap, although Russian-language ability is widespread among ethnic Latvians. The foreign-born also overlap with non-citizens, although some non-citizens were born in Latvia. About 14% of the population was born in another country, mostly the CIS countries. Almost all foreign-born residents over the age of 15 have been in Latvia for more than ten years, yet only 27% of them are Latvian citizens.

There is a strong regional aspect to minority languages and ethnicities and non-citizenship. Non-citizens, members of ethnic minorities and Russian-speakers are disproportionately urban, concentrated in Riga and in the Southeast of the country (Latgale region). Riga is about half ethnic Latvian and only 40% of the households primarily speak Latvian. In Daugavpils, the main city of Latgale, less than 10% of residents speak Latvian at home. However, most members of minority groups speak at least some Latvian: 94% of those surveyed in 2014 had at least the basic ability to communicate in Latvian, more than three-fourths of minority youth (18-24) had excellent or good knowledge of Latvian, and most of the remainder has some knowledge. Older minority residents are less likely to have good knowledge of Latvian. The 2012 Eurobarometer language survey found that overall at least two-thirds of Russian-speakers were able to converse in Latvian.

Box 1.1. Nationality, ethnicity and language in Latvia (*cont.*)

The official language is Latvian and all official public documents are only in Latvian. Certain recognised minorities have the right to education through secondary level in their language: Russians, Poles, Jews, Ukrainians, Estonians, Lithuanians, Belarusians, and Roma. There are about 100 schools implementing minority education programmes in Russian. Secondary schools must have at least 60% of the education in the Latvian language. Students in minority education programmes may choose between Latvian and Russian for the non-language components of the examination held at the end of secondary school.

Latvia has put in place a series of measures to encourage and facilitate the public use of the official language:

- Naturalisation requires B2 level (in the Common European Framework – CEF, B2 corresponds to the ability to understand, speak and write to the point that communication is natural and clear).
- There are a series of specific language requirements for occupations which represent most employment, and failure to comply results in a fine for employers (and self-employed). Occupations which involve direct contact with the public, or information provision to governmental institutions (e.g., by business owners), are subject to specific language requirements. More than 400 occupations are subject to language requirements at B2 level and 2 000 at C1 (advanced proficiency). The 340 occupations with the highest (C2) requirement include elected officials, heads and senior officials of governmental and municipal institutions, directors of schools, colleges, universities, and all public-sector employment. 110 largely basic occupations are subject to only A1-level requirements. Some 800 occupations are subject to A2 requirements and 300 to B1 (including artisans and skilled trades).
- The state supports the acquisition of the official language. Latvian language courses are subsidised by the PES, primarily for the unemployed. The public Latvian Language Agency produces material and offers targeted courses with outside funding, including from local authorities. Free courses are also offered by the Society Integration Foundation.

High overall labour force participation, but employment problems for specific groups

Overall labour force participation in Latvia has increased since 2007 and now stands at 74.6%, 2 percentage points above the OECD average (Figure 1.9, Panel A). The situation, however, varies significantly across socio-demographic groups. The employment rate of older workers (56.4%) is close to the OECD average, while that of young workers (32.5% in 2014) is significantly lower (the OECD average is 40%). At 64.3%, women's employment rates are high, as are those of high-skilled workers (85%), but those of low-skilled workers are very low (51%, 4 percentage points below the OECD country average).

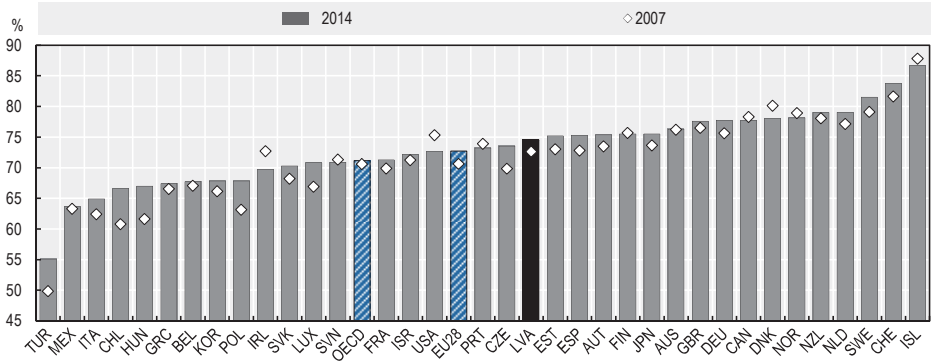
Patterns of differences in unemployment and inactivity relative to the pre-crisis period further highlight challenges faced by certain socio-demographic groups (Figure 1.9, Panel B). Among youths (15-24), the non-employment rates (the share of people in this age group without work) and labour market inactivity rates (those without work who are not available for work or not actively looking for a job) have grown equally for young men and women, but most strongly for young workers with upper secondary education. This pattern, which is also observed in other transition countries, might indicate that the skills produced by the education system do not well match those demanded by employers.

Among prime-aged workers (25-54), the pattern is reversed, with the increase in non-employment being less pronounced among highly educated workers. Non-employment rates of older workers (55-64) grew significantly over the period, largely among men. This contrasts with comparator countries, where non-employment rates among older workers fell. While in other countries the crisis pushed older workers to join the labour market or delay retirement, in Latvia the employment opportunities available for senior workers appear to have contracted drastically over the period. Overall, the crisis triggered a significant increase in non-employment in Latvia. These untapped resources represent an important source of growth that should be exploited more effectively; and policy makers should be careful in assessing differences across socio-demographic groups to target their policy interventions.

Non-citizens and non-native Latvian speakers face formal barriers in the labour market. Non-citizens are barred from holding a range of public-sector jobs and some private-sector occupations (see Section 3). For all residents, there are possible employment barriers related to insufficient proficiency of the Latvian language (Box 1.1), even if the latter should become less of a constraint as language gaps are shrinking. Evidence based on the Latvian Labour Force Survey shows that employment rates are lower among national minorities, and the incidence of unemployment and long-term joblessness is higher (Lehmann and Zaiceva, 2015a). The results also show that national minorities were less likely to benefit from the labour market recovery that began in 2010. The relative labour market disadvantages of minorities are, in part, a result of differences in age and education levels compared with the rest of the population (see endnote 12). But closer analysis shows that they persist after accounting for these differences (by “controlling” for the most relevant characteristics in the statistical analysis). As in other countries (OECD, 2008), this indicates that belonging to a national minority remains a significant driver of employment outcomes in Latvia and, hence, a concern for labour market policy.

Figure 1.9. Job prospects of youth, older men and low-skilled workers deteriorated sharply during the crisis

Panel A. Labour force participation in Latvia is above the OECD average



Panel B. Non-employment has increased significantly for some demographic groups

Change in the shares of people without work, by age group, sex and education level, Q4 2007-Q4-2014, in percentage points



Note: “L”, “M” and “H” refer to less than upper secondary, upper secondary, and tertiary education, respectively, according to the International Standard Classification of Education 2011 (ISCED-11).

..: Not reported due to small sample size.

a) Unweighted average of the Czech Republic, Estonia, the Slovak Republic and Slovenia.

Source: OECD calculations based on the European Union Labour Force Survey (EU-LFS).

Large wage and earnings differentials are fundamental drivers of inequality

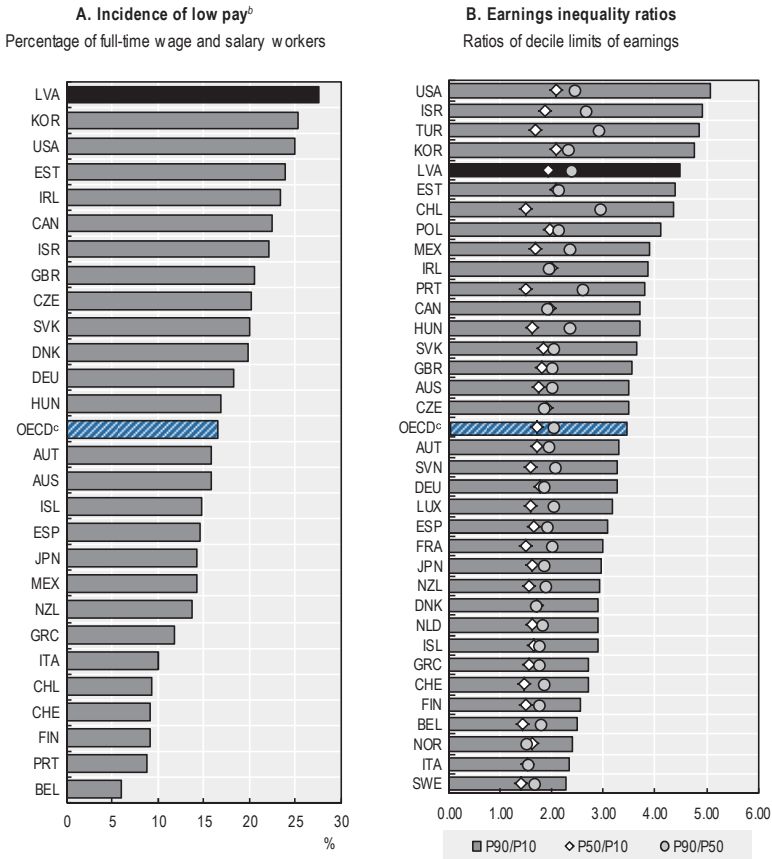
Job losses during the recession disproportionately affected disadvantaged groups, such as youth or low-skilled workers, who typically account for a large part of low-paid employment. Despite the resulting fall in the share of low-paid jobs, the incidence of low-paid employment in Latvia remains higher than in any OECD country (Figure 1.10, Panel A). Although wages of the top 20% fell substantially during the crisis (Bičevska, 2012), wage dispersion in the upper half of the pay spectrum also remains significantly above the OECD average (Panel B). Latvia's overall earnings inequality is the highest among European OECD countries.

A number of explanations have been put forward for Latvia's very high wage inequality, in both the bottom and top halves of the distribution. Low levels of unionisation and a high incidence of informal or only partly-registered employment weaken the bargaining power of low-paid workers in particular. Returns to tertiary education are very high by international standards and widen pay disparities in the upper parts of the wage distribution (Hazans, 2003). Across the wage spectrum, inequality may be related to a continuing fundamental imbalance between the demand and supply of labour and skills. Large-scale restructuring and job losses in a heavily industry-based economy drove inequality trends in the 1990s, but labour market mismatches continue to push up pay disparities today: as a result of mismatches, wage inequality has soared during periods of skills shortages during past economic upswings (Masso et al., 2014).

Overall wage inequalities also reflect considerable earnings disparities between industries (highest in the financial service industry and lowest in basic service sectors, agriculture and fisheries), as well as earnings differences across socio-demographic groups. Statistical analysis undertaken and commissioned by the OECD identifies a number of key patterns (Falco et al., 2015a, forthcoming; Lehmann and Zaiceva, 2015a). There are high returns to tertiary education: controlling for other key individual characteristics, workers with upper-secondary education earn 21.6% less than those with tertiary education (Figure 1.11). But the earnings premia for upper secondary education (compared to basic education) are limited.¹³ Gender wage gaps are also large, with women earning nearly 17% less on average than men with similar education, age, etc. In addition, and again in line with findings for other countries (OECD, 2015c), workers with informal jobs earn significantly less (about 12.2%) than formal workers with similar characteristics (Falco et al., 2015a, forthcoming, not reported in Figure 1.11). The gap is much larger among women (26.9%) than men (8.5%).

Figure 1.10. High wage inequality at the bottom and at the top

Full-time wage and salary workers, 2013 or latest^a



Note: Estimates of earnings used in the calculations refer to gross earnings of full-time wage and salary workers. However, this definition may slightly vary from one country to another. Further information on the national data sources and earnings concepts used in the calculations can be found at: <http://www.oecd.org/employment/outlook>.

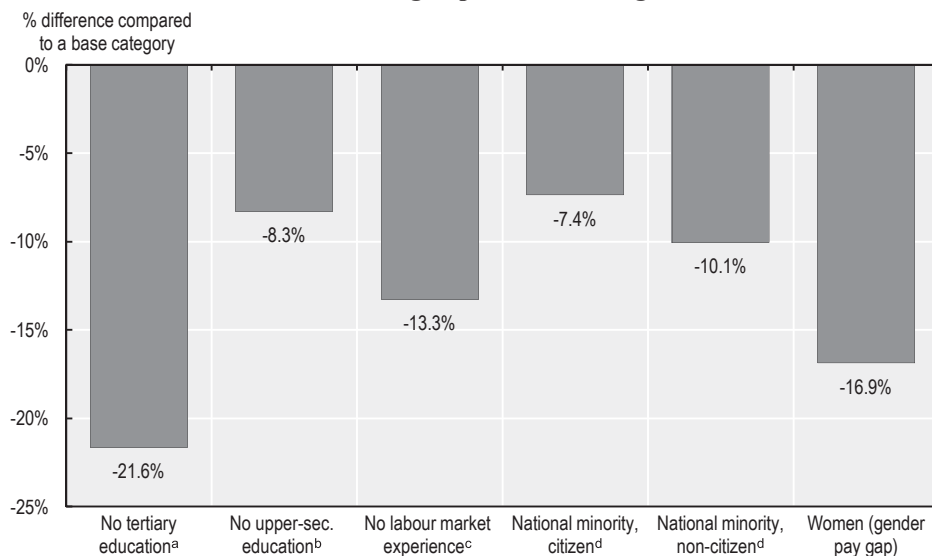
a) 2010 for Estonia, France, Latvia, Luxembourg, the Netherlands, Slovenia, Switzerland and Turkey; 2011 for Chile, Iceland and Israel; 2012 for Belgium, Germany, Greece, Italy, Poland, Portugal, Spain and Sweden; 2014 for Canada and the Czech Republic. Data on the incidence of low-pay workers (Panel A) are not available for France, Luxembourg, the Netherlands, Norway, Poland, Slovenia, Sweden and Turkey.

b) The incidence of low pay refers to the share of workers earning less than two-thirds of median earnings.

c) Unweighted average of countries shown excepted Latvia.

Source: OECD Earnings Distribution Database, <http://www.oecd.org/employment/emp/onlineoecdemploymentdatabase.htm>.

Figure 1.11. Gender, education, labour market experience and citizenship have strong impacts on earnings



a) Upper-secondary education vs tertiary.

b) Basic (below upper secondary) education vs upper-secondary.

c) Compared to ten years of experience.

d) Compared to ethnic Latvians. Results based on OLS regressions including controls for worker characteristics, contract type, firm size, sector, region and hours worked. Models that account for selection into wage employment produce results that are largely similar. Results for alternative specifications are presented in the full paper (see source).

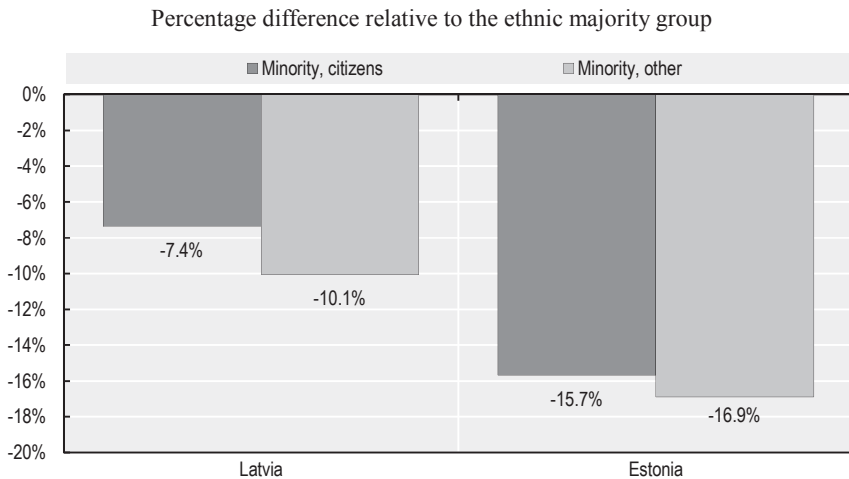
Source: Falco, P. et al. (2015), “Ethnicity and Earnings in the Latvian Labour Market”, OECD, forthcoming, using EU-SILC 2011-13 data.

Workers belonging to national minorities also tend to earn less than the rest of the population in the same regions, with similar jobs, education, age, experience and other characteristics. The gap is wider for non-citizen workers, who earn some 10% less than otherwise similar ethnic Latvians, while the gap is 7.4% for national minority groups with citizenship.¹⁴ Figure 1.11 helps interpreting the magnitude of these differentials by contrasting them with earnings differences by education, experience and sex. For instance, the earnings difference associated with being a non-citizen is about half as big as the earnings premium associated with tertiary education.

An association between minority status and labour market disadvantage is a common finding across countries, including other transition countries

(OECD, 2008). Replicating the above analysis using similar Estonian data shows that earnings gaps between minority and non-minority groups tend to be smaller in Latvia (Figure 1.12): Estonian workers belonging to ethnic minorities earn nearly 16% less than the rest of the population if they have Estonian citizenship, and nearly 17% less if they do not have citizenship. The reasons for the different results in the two countries require further investigation but possibly include the high rate of inter-marriage between national minorities and ethnic Latvians, which may contribute to reducing language and other barriers.

Figure 1.12. Estimated earnings shortfalls of national minorities are somewhat smaller than in Estonia



Note: See Figure 1.11.

Source: Falco, P. et al. (2015), “Ethnicity and Earnings in the Latvian Labour Market”, OECD, forthcoming, using EU-SILC 2011-13 data.

Contrary to expectations, further results indicate that earnings gaps affecting national minorities in Latvia are not smaller among younger generations, who have been educated more recently and should therefore face lower linguistic barriers (one might also expect that they could attract an earnings premium if they speak both Latvian and Russian).¹⁵ This finding is not consistent with labour market barriers for national minorities being primarily due to language skills, and suggests that the underlying reasons for the observed gaps remain relevant for younger generations. In addition to differences in linguistic abilities, the measured earnings differences may be due to other unobserved worker traits, to self-selection into different

occupations, or to other factors. A common finding for other countries is that unreported forms of discrimination (i.e., the unequal treatment of equally productive individuals on account of their membership in a specific group) may play a role, but this cannot be confirmed with available data.^{16,17}

As virtually all OECD countries, Latvia has established laws to combat discrimination on both gender and ethnic grounds. Nonetheless, enforcement of these regulations is essentially based on workers' willingness and ability to claim their rights. The probability of detecting infringements of relevant provisions is likely linked to any broader enforcement issues of applicable labour law and the extent of informality (see Chapter 3). More generally, public awareness and incentives for victims to lodge complaints have been emphasised as crucial elements of an effective anti-discrimination policy strategy (OECD, 2008).

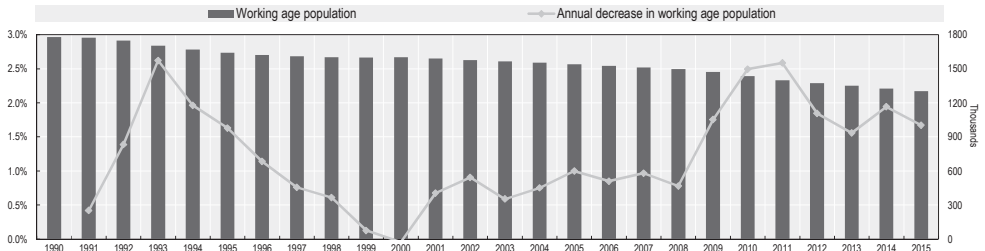
3. An unfavourable demographic situation exacerbated by high emigration

Latvia faces major structural challenges resulting from a bleak demographic situation. The population has fallen from 2.66 million in 1990 to 2.37 million in 2000 and 2.07 million at the 2011 census. The estimated population in 2015 is 1.99 million inhabitants, meaning the population has declined by 25% in a space of 25 years.

Several OECD countries have started to face the consequences of a shrinking working age population. For example, Japan has seen declines of over 1% annually in the past five years. Both Finland and Korea both have started to see small declines in the size of the working age population, as baby boom cohorts reach retirement age. The situation in Latvia is already more severe, however, and the working age population is shrinking faster than in any OECD country except Japan; in some years its population loss has exceeded that of Japan in relative terms. The population aged 15-64 has declined every year since 1990, except in the year 2000. Since 2009, the annual decline in the working age population has been over 1% (Figure 1.1).

Figure 1.13. The working age population has been shrinking

Working age (15-64) population and annual decline (%)



Source: Centre Statistical Bureau.

The two factors driving these trends are smaller birth cohorts and large-scale net negative migration. This is evident in the population pyramid (Figure 1.14). The working age population has fallen from 1.6 million in 2000 to 1.33 million in 2014, and there are large cohorts moving into retirement age. The population projections shown in Panel C of Figure 1.3 above appear optimistic in light of post-census corrections; the working age population in 2010 was 100 000 smaller than the number used by the United Nations as a baseline for its projections.

Figure 1.14. A trough in births post-1990 contributes to a declining population

Age structure and size of population in Latvia, 2000-14, in thousands



Source: Informative report of Ministry of Economy “Informatīvais ziņojums par darba tirgus vidēja un ilgtermiņa prognozēm” (Informative note on mid-term and long term forecast of labour market), <http://polsis.mk.gov.lv/LoadAtt/file62526.doc>.

Shrinking youth cohorts contribute to a rapidly declining working age population

The shrinking working age population is partly driven by the smaller birth cohorts following 1990. In 2000, the number of children aged 0-4 years was just short of half that of the same cohort in 1990. The total number of births has somewhat rebounded since 2000 due to a bulge in the number of women in peak child-bearing years. However, the overall negative trends in the lower number of births in Latvia is driven by a collapse in the fertility of younger women, especially those aged 20-24, relative to the past. This group had more than 15 births per hundred women in the late 1980s and early 1990s, compared with 5.5 per hundred in the 2010s (the number of teenage mothers has also fallen dramatically). Women over 30, on the other hand, are more likely to have children than in the past. This is a general phenomenon in OECD countries as childbearing is delayed, but it is not enough to reverse population decline (e.g., because delayed childbearing is associated with having fewer than the desired number of children).

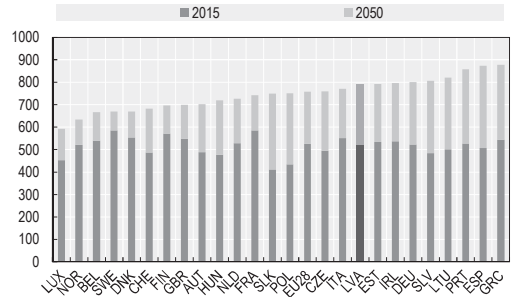
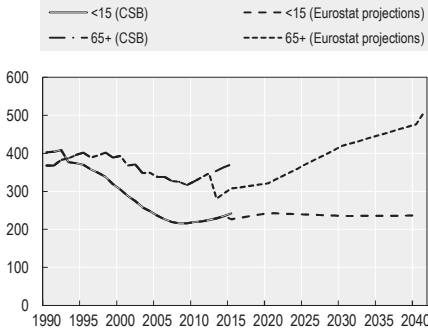
The ageing population is driving an increase in the dependency ratio (the number of people under 15 and over 65 relative to the working age population) and this has been a principal motivation of Latvia's large-scale pension reforms to ensure fiscal sustainability (see Chapter 4). Figure 1.15 below shows the dependency ratio for youth (below working age) and older people (above working age), but Eurostat forecasts based on a much more positive assessment of the current situation should be revised upwards. The old-age dependency ratio of 370 older people per 1 000 working age individuals in 2015 will rise by at least 20% in the next decade, while the youth dependency ratio (240 per 1 000 in 2015) is unlikely to decline much further, so that the overall dependency ratio is likely to reach 70% in a decade once Eurostat projections (Figure 1.15, Panel A) are revised to reflect the most current data. The figure for 2050 (Figure 1.15, Panel B) will also likely rise.

The fall in the tertiary-educated population has been less dramatic than for the overall population, as the younger generation has tended to be better educated and the share of tertiary-educated in youth cohorts has therefore increased. Even so, from 2013 there has been a decline in the tertiary-educated population (age 15-74) as well, and from now on the absolute size of the tertiary-educated population will fall, although its share in the total population could increase unless emigration rates for the tertiary educated rise.

Figure 1.15. The dependency ratio is rising quickly, driven by population ageing

Panel A. Dependency ratio, 1990-2015 and forecast to 2040

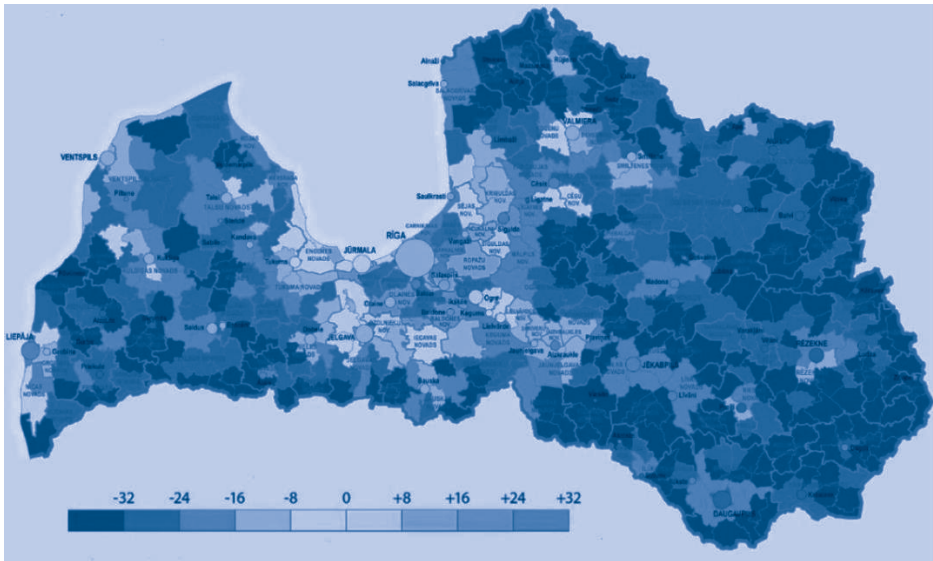
Panel B. Age dependency ratio (0-14 and 65+ per 1000 15-64)



Source: Central Statistical Bureau, Eurostat (EUROPOP2013).

Figure 1.16. Population decline is concentrated in rural areas and outside greater Riga

Forecast population change (%) by region, 2011-30, based on 2011 census and 2000-11 trends



Source: Grupa93 (2014). www.varam.gov.lv/files/text/Petijums_1%20starpatskaite.pdf. Projections apply the same annual rate of change from 2000 to 2011.

The demographic changes have disproportionately affected certain parts of the country, with only the suburban areas of Riga showing population gains in the past decade. Forecast population changes in the next 15 years, based on current trends, indicate dramatic declines in all regions but those surrounding Riga. Population declines of over 30% in rural areas are foreseen, as are smaller but significant declines in all urban centres but Riga. The country is thus likely to become older in the coming decades, and the population will be even more concentrated around the capital.

Emigration is a major contributor to population decline

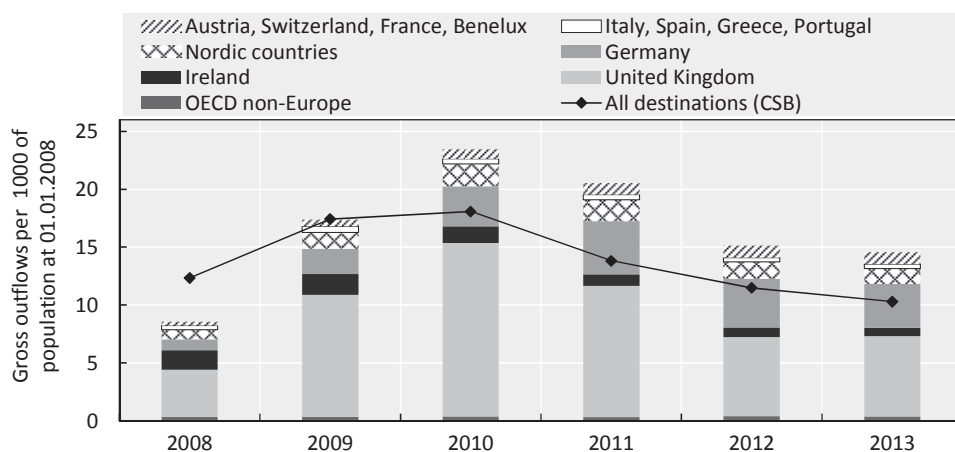
The exact magnitude of emigration is difficult to measure directly. The 2011 census led to an 8% correction of the population size due to underreporting of emigration in the population registry. All analyses, however, point to negative net migration which exceeds mortality since 2000. Latvia's population declined by about 16% between 2000 and 2012, of which 10% was due to negative net migration and less than 6% due to natural decrease. Emigration was particularly intense during 2009-12, accounting for one-third of the overall (migration plus natural) population decline over the entire 2000-12 period. Estimates of gross emigration from Latvia are about 40 000 (close to 2% of the population) annually in 2009-10 (Figure 1.17). Although outflows have since declined they remain above 25 000 annually, which is still higher than pre-crisis levels.

The main destination countries of emigrants are the United Kingdom and Ireland, as well as Germany. The latter, in particular, has become a more important destination since it removed all restrictions on labour market access for Latvians in 2011.

Youth cohorts were overrepresented among emigrants. In 1990, there were 209 000 residents aged 0-4. By 2015, the size of this resident cohort dropped to 145 000 (those aged 25-29 in 2015, Figure 1.18). Mortality accounted for 1 percentage point of this decline, while the remaining 29 percentage points can be attributed to negative net migration. Figures are similar for other young cohorts: the cohort aged 0-34 in 1990 lost 29% of its size by 2015: there are at least 350 000 fewer people in the age range 25-59 than would have been expected with zero net migration.

Figure 1.17. Latvians are now emigrating mostly to European countries

Gross emigration of Latvian nationals to main EU and OECD destinations, 2008-13

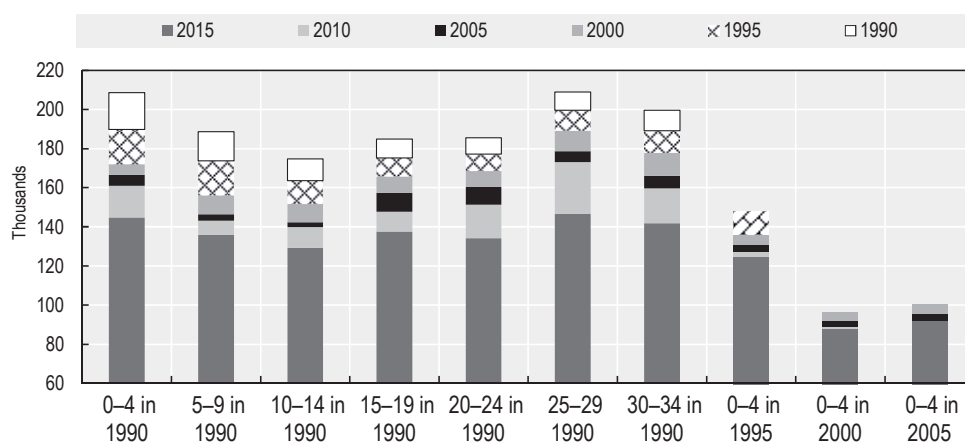


Note: Figures are based on destination country data and exclude non-citizens of Latvia.

Source: Hazans, M. (2015), "Migration Experience of the Baltic Countries in the Context of Economic Crisis", in M. Kahanec and K.F. Zimmermann (eds), *Labor Migration, EU Enlargement, and the Great Recession*, Springer (forthcoming).

Figure 1.18. Youth cohorts show decline due to high emigration

Columns show the size of each cohort resident in Latvia as it ages, 1990 through 2015



Source: Central Statistical Bureau.

The left-hand columns of Figure 1.18 show that the decline of younger cohorts was particularly large from 1990-2000, reflecting the departure of entire families with their children. Declines were more limited in the 2000-10 decade, although working age people left the country more than children did. Birth cohorts were smaller in 1995, 2000 and 2005 (right-hand columns), as noted above.

One issue facing many countries with large-scale labour emigration is that of “left-behind” children, whose parents have departed and left their children in the care of other family members, either formally or informally. Compared with some other European countries – especially Romania – children left behind do not appear to be a major issue for Latvian social services, although concrete figures about children left with guardians are not available. One possible explanation is that Latvians emigrate to work in countries where family benefits are more favourable, reducing the incentive or need to leave children behind for longer periods of time.

Emigration trends are likely to continue at a less dramatic rate than during the crisis as already shown in Figure 1.17. But migration intentions remain high. The recent Gallup World Survey for Latvia suggests that about one in twenty Latvians above age 15 is taking concrete steps to leave the country in the next 12 months. Prior to the crisis, migration largely involved single people seeking temporary work abroad. Since 2008, the trend has been towards individuals seeking permanent work abroad and planning to bring their families. Families with the largest demographic potential are indeed more likely to emigrate (Hazans, 2013).

Emigration has already had an amplified demographic effect in Latvia as today's later childbearing age corresponds to the peak emigration period, so that children of these parents are frequently not born in Latvia. An estimated 500 Latvian children were born in Ireland in 2014, and more than 2 000 in the United Kingdom, compared with 21 000 in Latvia itself. The total fertility rate (TFR) for Latvian women in England and Wales in 2011 was 2.51, compared with 1.44 in Latvia: Latvian women abroad are more likely to have (more) children than those who stay home.¹⁸

Migration to Latvia by foreigners has been and remains low, with fewer than 800 foreigners receiving a first temporary residence permits for employment in 2013, and fewer than 700 for the purpose of family reunification or formation. As many of them do not stay in Latvia, the inflows are currently entirely insufficient for counteracting the large migration outflows of Latvians. Return migration of Latvians and non-citizens, discussed below, is also far below outflows.

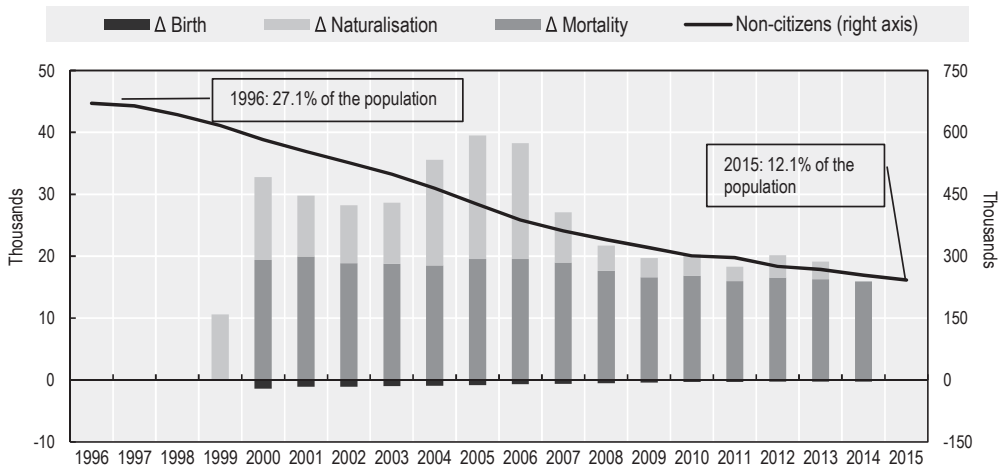
Latvia has a large but declining non-citizen population

A notable feature of the Latvian population is the large share of non-citizens. In 1991, Latvian citizenship was granted to those who were citizens of Latvia as of 17 June 1940, along with their descendants. This excluded a large number of individuals, and their descendants, who came from outside Latvia during the Soviet period. With Latvian independence, those who were not granted Latvian citizenship and also did not become nationals of other countries received the status of “non-citizens”, a status that grants indefinite permanent residence, including the right to return to Latvia at any time for those who leave to reside permanently in a foreign country (however, any non-citizens who receive the nationality of another country lose their non-citizen status).

Non-citizen status was meant to be temporary, and indeed in the space of a generation, the number of people in this status has sharply diminished. Non-citizens numbered 730 000 in 1995, comprising 29% of the population, but the number has since fallen to 242 000 in 2015, comprising 12.1% of the resident population. As older generations are more likely to be non-citizens, much of the decline has been due to mortality. But naturalisations (some 142 000 since 1995) also contributed significantly.¹⁹ Since 2000, migration of non-citizens has been more limited than migration by Latvian citizens: 8 700 left between 2011 and 2014, compared with 3 900 who returned. The number of newborn non-citizens, which was not very large even in the 1990s, has not been a significant factor in the evolution of this population (Figure 1.20): only 1.9% of the children born in Latvia in 2014 had at least one non-citizen parent and no Latvian parent, down from 10.1% in 2000.²⁰ Since 2013, newborn children of non-citizens obtain citizenship quasi-automatically (consent of one parent is sufficient). Most do, and the number of newborn non-citizens is therefore very small. As parents can make this choice up until their child's fifteen birthday, the new provision may also further reduce the small under-15 cohort of non-citizens.²¹ The current younger generation is also growing up with more exposure to the Latvian language, which should enable them to more easily pass the language test necessary for naturalisation at any age.

Figure 1.19. The non-citizen population is declining

The non-citizen population of Latvia, 1996-2015, and estimated components of population change



Note: Mortality figures include foreign nationals. Birth figures are to two non-citizen parents. Migration is not included in the estimate. Figures on naturalisation missing for 1996-98 and 2015. Figures on mortality and births missing for 1996-99 and 2015.

Source: Central Statistical Bureau.

Non-citizens face a number of obstacles in the labour market. The main formal barriers are the exclusion from positions in the public sector, and from a number of occupations in the private sector. In the public sector, non-citizens are excluded from jobs relating to justice, law enforcement, security and government. In the private sector, they cannot hold some positions in the legal sector and some security-related positions (e.g., guards or positions requiring a weapons permit). This also rules out enrolment in certain specialised higher-education institutions. In addition to legal barriers, non-citizens appear to face a degree of labour market disadvantage related to a combination of factors that may be job-related, including language skills. Factors that are not job-related (e.g., discrimination by employers that goes undetected) may play a role for national minorities more generally (as they do in other countries) but are difficult to establish with certainty (see Section 2).

Non-citizens can travel in the Schengen area visa-free, but they do not enjoy the same labour market access in other EU countries as EU citizens do. In the principal countries of Latvian labour migration (the United Kingdom, Ireland and Germany) non-citizens are subject to the same work-permit requirements as those imposed on third-country nationals. This ties

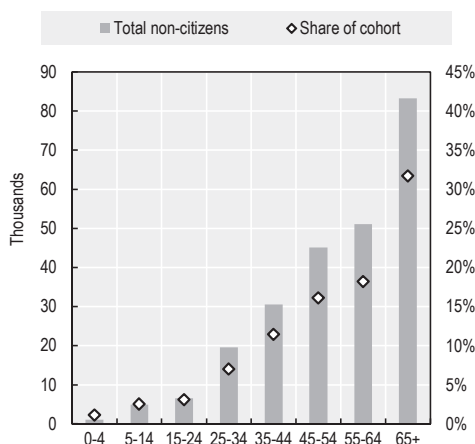
them to the Latvian labour market to a greater extent than Latvian citizens, by cutting off or reducing opportunities for employment abroad.²² Emigration is often a motivation for naturalisation, and naturalisation is often the prelude to emigration for this group (Ivļevs and King, 2012).

As the population of non-citizens is disproportionately older (Figure 1.20, Panel B) and non-citizens make up about one-third of the over-65 population in Latvia, any remaining differences in access to social protection targeted at the elderly potentially have a sizable impact on this group. The main difference between citizens and non-citizens in this regard has been the treatment for pension purposes of employment outside of Latvia prior to 1990.^{23,24} Data on the number of pensioners affected by this distinction were not available to the OECD Secretariat. But a considerable number of Latvian residents are foreign-born (13% of the population over age 15, but most are older). About 150 000 residents over age 60 were born in other states of the former Soviet Union (29% of that age group), at least two-thirds of foreign-born older residents are non-citizens, and many of them had some employment before coming to Latvia. It was only in 2011 that the Russian Federation, the main foreign country where non-citizen residents were likely to have been employed during the Soviet era, signed a bilateral agreement on social security with Latvia. Non-citizen residents who are not eligible for a Latvian insurance-based pension due to insufficient contribution years (the minimum contribution period for the public earnings-related pension is currently 15 years, see Chapter 4) may, under the agreement, count years of employment in Russia towards the requirement. The amount of the pension is calculated only on the insurance paid in Latvia but retirees may be entitled to a Russian pension as well.²⁵ Similar provisions are in place with several other states of the former Soviet Union. As a result, and although no retroactive compensation is available for pensions paid prior to the 2011 agreement, the treatment of employment outside of Latvia for pension purposes is now no longer a principal driver of low income during old age.

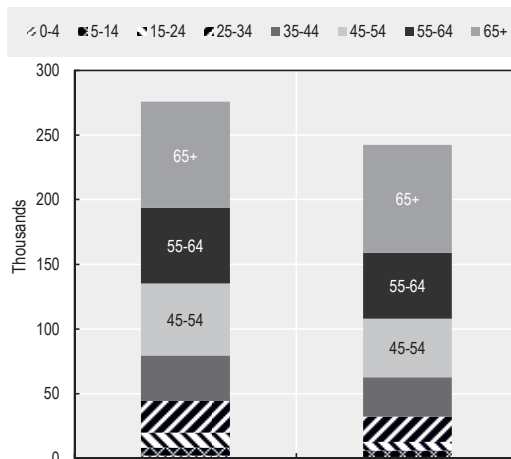
In summary, the number of young non-citizens is shrinking fast and this is already evident in the youth population (Figure 1.20). The number of school age (5-14) non-citizens fell from 6 000 in 2012 to 5 000 in 2015,²⁶ and the number of prime university-age non-citizens (20-24) fell from 8 100 to 4 100. While the number of non-citizens is diminishing quickly in the younger cohorts, it is currently increasing among pension-age residents. As this group appears unlikely to make the time investment in learning the language or to undertake the naturalisation exam (Ivļevs and King, 2012), naturalisation is not expected to be a main driver for the decline of the non-citizen population in the future.

Figure 1.20. Most non-citizens are older and the younger non-citizen population is shrinking further

Panel A. Age distribution and share of age cohorts of the non-citizen population, 1/1/2015



Panel B. Age composition of the non-citizen population of Latvia, ten-year cohorts 5-64 and 65+, 1/1/2012 and 1/1/2015



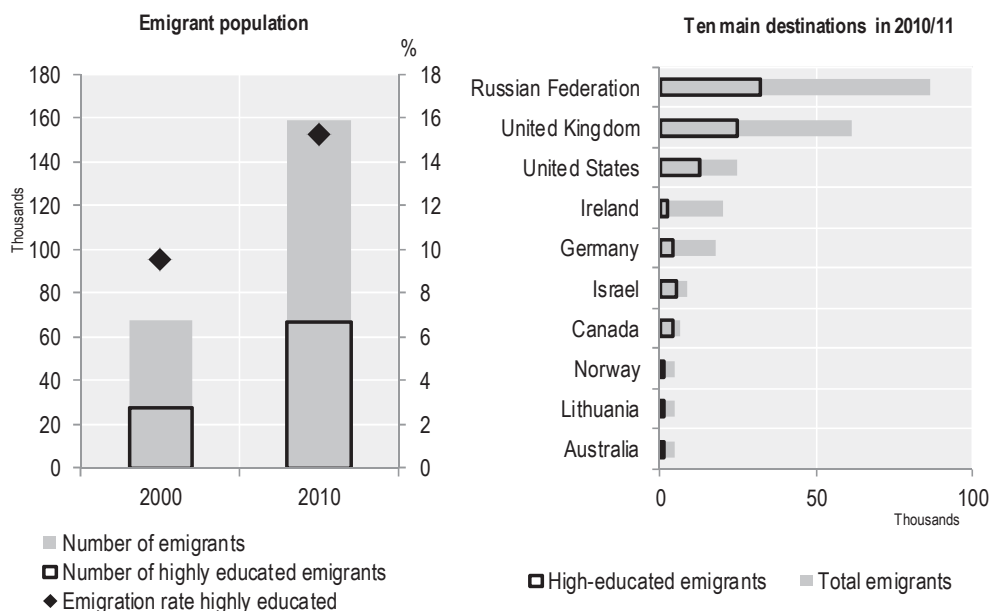
Source: Central Statistical Bureau.

The Latvian diaspora has grown due to emigration

According to the *Database of Immigrants in OECD Countries*, there were 270 000 Latvian-born people age 15 and over living in other countries. The Russian Federation and Belarus accounted for about 100 000. The emigration rate – the share of people born in Latvia living abroad – was about 12%. There were 159 000 Latvian-born living in OECD countries. The main countries of residence of Latvian-born migrants in 2010/11 were the Russian Federation, the United Kingdom, the United States, Ireland and Germany (Figure 1.21).

Figure 1.21. A large and growing emigrant population

Persons born in Latvia living abroad



Source: OECD Database of Immigrants in OECD Countries (DIOC), 2015.

The Latvian diaspora can be divided into several main groups. The older diaspora, primarily in the United States, Canada and Australia, but with some representatives in European countries, dates back to emigration during the Soviet period. This diaspora comprised many political exiles; some returned after 1990, but most remained in the countries where they settled. This generation is growing older, and the number of Latvian-born is in fact declining in non-European OECD countries. The second group of Latvian-born emigrants are minorities who left after 1990, settling largely in Russia and in Israel; this group is also declining. The third and growing group comprises emigrants who left to seek work in European countries, especially after accession to the European Union and during the crisis years. The OECD DIOC data shown in Figure 1.21 is based on censuses and does not fully capture the most recent outflow of Latvians. By 2013, in fact, there were about 80 000 Latvian citizens living in the United Kingdom, 25 000 in Germany and more than 20 000 in Ireland. About 10 000 Latvians were in Norway and about 5 000 each in Sweden and Denmark.

Recent emigrants from Latvia are disproportionately young and well-educated. They also represent a significant share of Latvia's recent university graduates. A comparison of graduation figures with labour force survey (LFS) data suggests that out of the roughly 166 000 in the cohort who graduated in Latvia between 2002 and 2009, as many as one-third (55 000) were no longer in Latvia in 2014. The LFS analysis suggests further that many of the new graduates between 2010 and 2014 also left after graduation. An emigrant survey found that about 50 000 Latvians under age 30 living abroad in 2014 had graduated in Latvia.

Despite the size of the diaspora, there is little sign of large-scale return. In fact, the majority of Latvians abroad do not intend to return to Latvia (Table 1.1). Their employment rates abroad are relatively high (about 69% in 2010). Even the high over-qualification rate (60% of the 40 000 high-educated Latvians working abroad are employed in jobs for which they are overqualified) is not driving return, in part due to a perception of limited opportunities in Latvia.

Those who say they are likely to return are disproportionately under 30, men, and less educated. Those who are not employed in qualified jobs, whose training or experience is in agriculture or who originate from rural areas are also more likely to consider returning, as are those without children but with family in Latvia, and those who live in CIS countries rather than in the OECD area.

Table 1.1. Most recent emigrants do not plan to return

Share (%) who plan to return within the next five years, among those who emigrated in 2000 or later, by education

	Less than upper secondary	Upper secondary	Higher education
Definitely yes	7.4	7.3	4.6
Probably yes	12.5	9.8	8.2
Possibly, given the right circumstances	32.7	33.1	28.4
Probably no	26.7	23.9	30.8
Definitely no	20.7	26	27.9

Source: “The Emigrant Communities of Latvia: National Identity, Transnational Relations, and Diaspora Politics”, University of Latvia.

4. The productivity challenge has its roots in the labour market

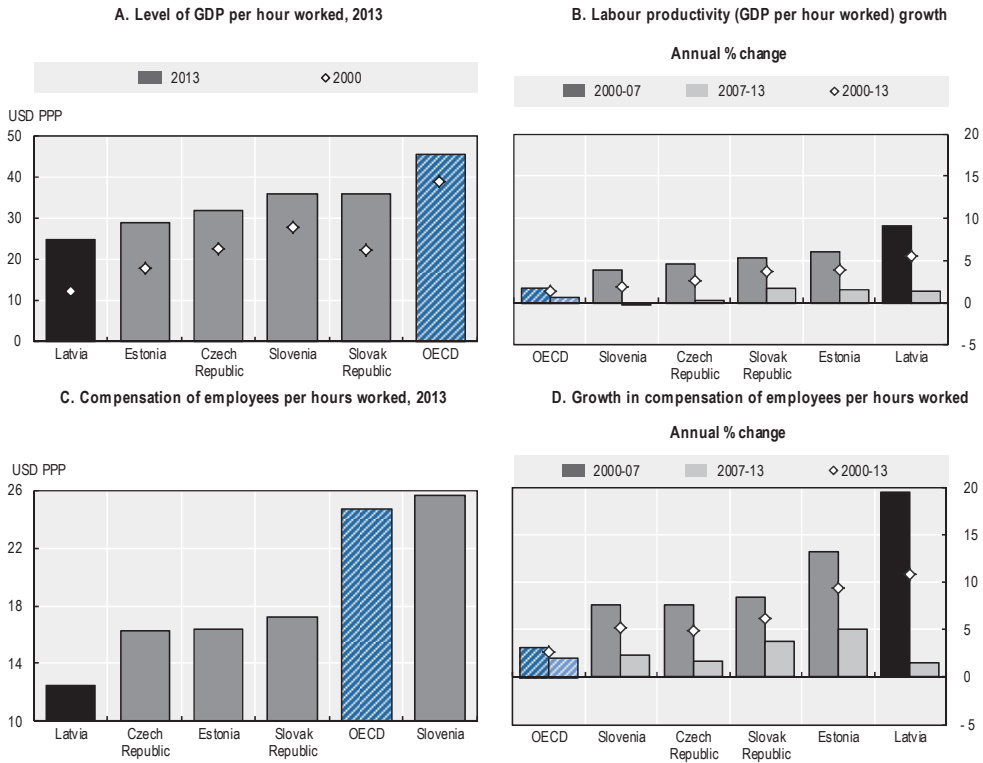
With an adverse demographic outlook and a sizeable productivity gap relative to OECD countries, Latvia's future growth prospects rest on its ability to raise labour productivity. The education system plays a crucial role in generating the new skills demanded by the economy. In addition, high rates of long-term unemployment, inactivity among youth and limited access to good-quality employment opportunities for certain socio-demographic groups indicate that a better allocation of labour and skills is key to boosting the productive potential of the economy.

After several years of fast catch-up, productivity has slowed down significantly

Labour productivity currently lags behind the OECD average (Figure 1.22, Panel A). The years prior to the crisis saw rapid productivity growth (over 7% a year), which outpaced average trends in the OECD area (with an increase of less than 2% a year) and other Eastern European countries (Figure 1.22, Panel B). However, increasing productivity in Latvia was accompanied by an even faster growth in real hourly compensation, by some 13% a year. Since the beginning of the crisis, productivity growth has slowed down markedly (to just above 1% between 2007 and 2013), but still outpaced the OECD average. Real wage growth was negative during this recent period, as a result of the significant wage cuts that followed the crisis (Figure 1.22, Panel D). Since 2007, the increase of minimum wages drove labour costs trends at the bottom of the wage distribution; over the 2007-13 period, the ratio of minimum to median wages increased by over 10 percentage points.

Following a prolonged period of low investment since the onset of the financial crisis, many OECD countries saw a slow-down in productivity growth (OECD, 2015d). The drop in growth rates was especially pronounced in Latvia. Labour market policies play a crucial role in this context, insofar as they can help activate idle resources, ensure that workers' existing skills are used efficiently and improve the skill mix of the labour force.

Figure 1.22. Productivity growth has fallen and remains lower than in comparator countries



*: Weighted average of 32 OECD countries (excluding Chile and Turkey).

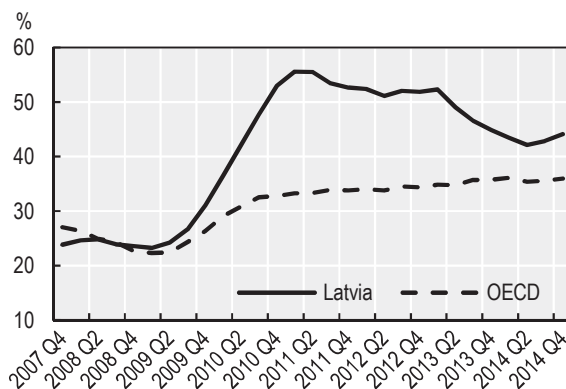
Source: OECD Productivity, OECD National Accounts and OECD Economic Outlook Databases.

High rates of long-term unemployment erode the productive potential of the workforce

After climbing to a dramatic peak (20.5%) in early 2010, unemployment in Latvia has been falling steadily. It reached 9.7% in Q1 2015, which was, however, still significantly above the OECD average of 7%. Long-term unemployment, in particular, remains stubbornly high and is rising again after a temporary decline between 2012 and 2014. In Q4 2014, 44.2% of Latvian unemployed workers had been seeking employment for at least 12 months. This is below the EU average of 49.9% but substantially higher than the OECD average of 36%. Long-term unemployment not only lowers households' current living standards, but also exposes them to a significant risk of skill depreciation, reducing future earnings and the productive

potential of the economy. In Latvia, the demographic outlook makes tackling this challenge even more crucial than in other countries.

Figure 1.23. The incidence of long-term unemployment remains high

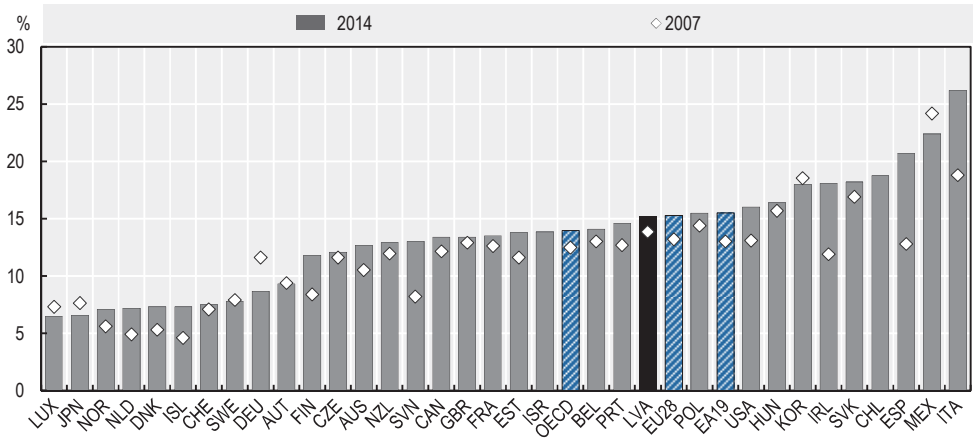


Note: OECD is the weighted average of 33 OECD countries excluding Chile.

Source: OECD Short-Term Labour Market Statistics (database), <http://dx.doi.org/10.1787/data-00046-en> and national labour force surveys.

NEET rates remain very high, lowering youth's opportunities and the economy's productive potential

The rapid fall in unemployment since the crisis peak has been particularly marked among youth, from 39.3% in early 2010 to 15.7% in Q1 2015, in sharp contrast with worrying trends in most EU and OECD countries. Yet, Latvia continues to have a significant rate of youth not in employment, education or training (NEET), who represent 15.2% of the 15-29 population (the OECD average is 14%, Figure 1.24). The situation is more dramatic if one considers that without the unprecedented out-migration of the past few years, inactivity rates among youth would have likely been much higher. Young workers risk being permanently scarred by prolonged periods of inactivity, especially early on in their careers, which may severely harm their skills and opportunities. Recent OECD work shows that the first ten years of experience in the labour market, during which human capital is accumulated most rapidly, are fundamental for a successful career (OECD, 2015c). The policy implications of high NEET rates among youth are discussed in detail in Chapter 3, and in a recent OECD report on youth in Latvia (OECD, 2015b).

Figure 1.24. NEET rates among youth are significant

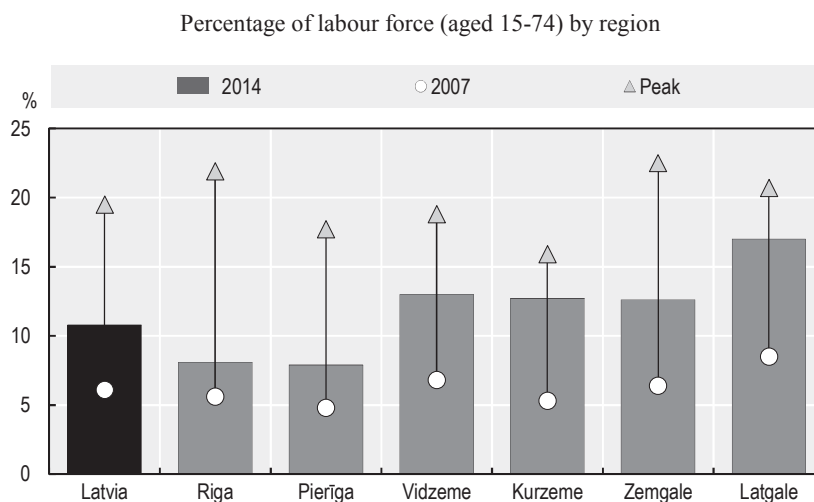
Note: OECD is the weighted average of 31 countries (excluding Chile, Israel and Korea).

Source: OECD estimates based on national labour force surveys.

Regional disparities reflect inefficiencies in the allocation of labour and capital

Persistent regional disparities are both a major driver of inequality and an indication of resource misallocation, dragging down the productive potential of the economy. This is clearly reflected in the wide disparity in unemployment rates across regions (Figure 1.25), partly as a result of high transportation costs and limitations of the public sector infrastructure.

Mobility between jobs varies significantly across regions. In the years following the crisis (2011-12) the rate of job loss increased faster outside Riga, while the likelihood of finding a job has significantly increased in the capital relative to the rest of the country. Overall, the labour market of the capital is much more dynamic and resilient. It has recovered much faster from the crisis and workers have a higher likelihood to find stable jobs.

Figure 1.25. Strong disparities in unemployment across regions

Source: National labour force survey.

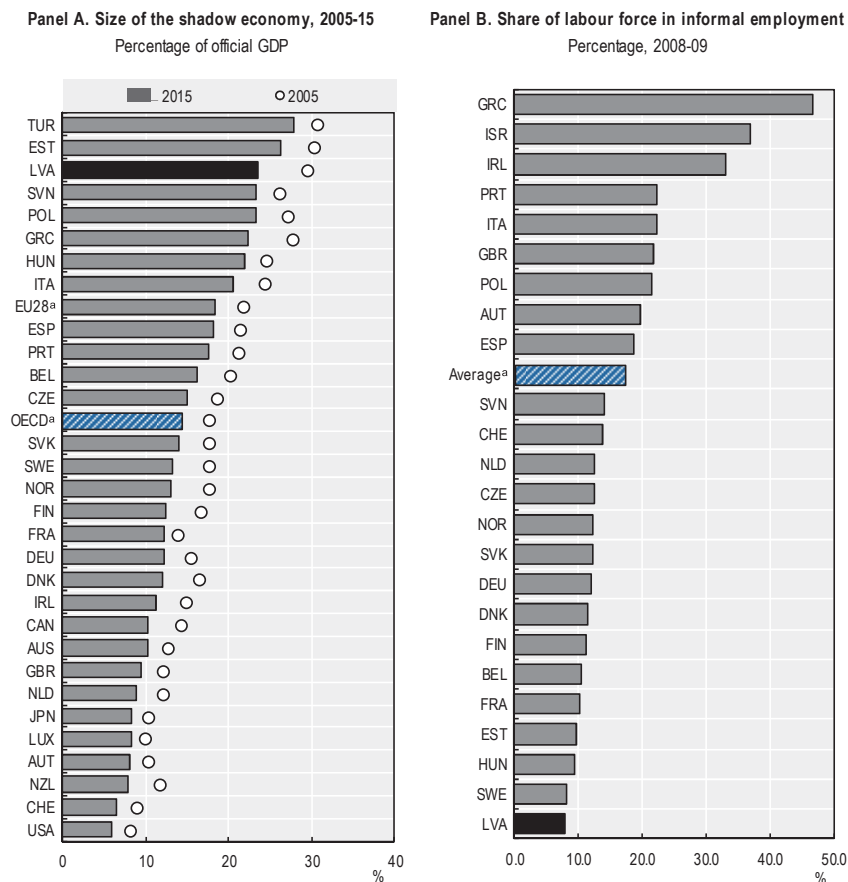
A large share of the economy remains informal, dragging down productivity

Another heavy drag on productivity is the very high share of economic activity that takes place in the informal sector. Informal firms tend to be less productive and skill-intensive than formal ones and informal workers earn less and receive less training. Furthermore, informality is generally harder to escape for disadvantaged groups and, as such, reduces upwards mobility and preserves marginalisation (Chapter 5, OECD 2015b; Jütting and de Laiglesia 2009; La Porta and Shleifer, 2014). In line with international evidence, certain socio-demographic groups in Latvia face a particularly high risk of working informally, most notably low-skilled workers and those with the most elementary occupations in agriculture, construction, hotels and restaurants, real estate and other services (Lehmann and Zaiceva, 2015a, forthcoming).

The size of Latvia's informal economy is estimated at around 24% of GDP, compared with an OECD average of 14.4% (Figure 1.26).²⁷ The share has fallen over the past decade, but remains very large albeit similar to the size of the informal sector in the other Baltic States. By contrast, existing estimates of entirely unregistered jobs are low, with one of the few available studies pointing to around 8% of the labour force during the height of the economic crisis in 2008-09 (Hazans, 2011).²⁸

This apparent contradiction reflects not only the difficulties of documenting informality with any degree of precision, but also the widespread phenomenon of “envelope wages”, i.e. formally registered workers receiving a, possibly sizeable, part of their pay informally. New OECD estimates show envelope wages to be sizeable in Latvia, with 28% of workers under-reporting their earnings by more than a quarter, and 17% of workers under-reporting by more than one half (Falco et al., 2015b, forthcoming).²⁹ A further channel for informal activity in the labour market is underpayment of wages, e.g., in the form of underreported working hours and unpaid overtime (with firms pocketing the difference as untaxed profits). For instance, according to data from the State Revenue Service, 20.3% of employees received less than the minimum wage in February 2015.

The incidence of informal employment in Latvia appears to be procyclical, as opposed to other countries where the size of the informal sector shrinks when the economy booms, and vice-versa (Hazans, 2011; Loyaza and Rigolini, 2006; Bosch and Maloney, 2008). This pattern may suggest that informal work is to a significant extent driven by demand from employers, who may use informal work as a capacity buffer, and not primarily a voluntary choice by workers. It also means that informal workers are particularly exposed to labour market volatility.

Figure 1.26. The shadow economy represents a large share of the Latvian economy

a) OECD is the unweighted average of 30 OECD countries (excluding Chile, Iceland, Israel and Mexico); EU28 is the unweighted average of the 28 member countries and “Average” (Panel B) is the unweighted average of OECD countries shown.

Source: Panel A: Schneider, F. (2015), “Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2015: Different Developments”; Panel B: Hazans, M. (2011), “Informal Workers across Europe: Evidence from 30 European Countries”, World Bank (using European Social Survey Data).

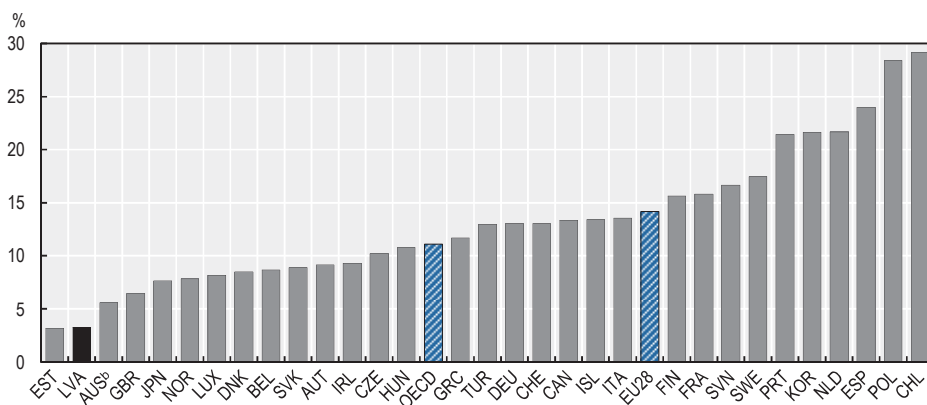
Few Latvian workers have temporary employment contracts, and transition rates to permanent employment are high

The share of employees on temporary contracts is very low relative to OECD countries (3.3% in 2014, 11.1% on average in the OECD). Young and less educated workers are two categories with the highest likelihood of

temporary employment and temporary contracts are far more common among those with less than one year of tenure in the labour market. Most temporary employment is involuntary and this is especially so for less educated workers. But transition rates from temporary to permanent employment are high (Lehmann and Zaiceva, 2015b, forthcoming) indicating that relatively few workers remain trapped in fixed-term jobs, in sharp contrast with several OECD countries (OECD, 2014b, Chapter 4). This pattern highlights the potential of lifelong learning policies and, especially, for employers' investments into their workers' skills, which, despite a large share of permanent contracts, is currently very low.

Figure 1.27. Incidence of temporary contracts^a in OECD countries

Percentage of employees, 2014^b



a) Temporary employees are wage and salary workers whose job has a pre-determined termination date as opposed to permanent employees whose job is of unlimited duration. To be included in these groups are: i) persons with a seasonal job; ii) persons engaged by an employment agency or business and hired out to a third party for carrying out a “work mission”; iii) persons with specific training contracts (including apprentices, trainees, research assistants, probationary period of a contract, etc.). National definitions broadly conform to this generic definition, but may vary depending on national circumstances.

b) 2013 for Australia.

Source: OECD Labour Force Statistics Database,
<http://www.oecd.org/employment/onlineoecdemploymentdatabase.htm>.

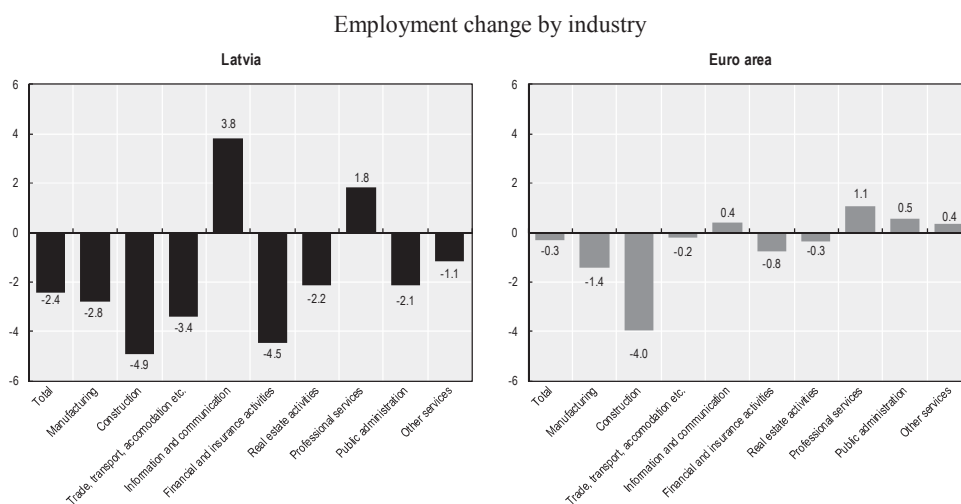
A rapidly changing industrial structure creates the need for new skills

One of the keys to sustained growth in Latvia is an adequate supply of sufficiently skilled labour that meets the needs of a rapidly changing sectoral composition of economic activity. This will not only result from improving the education system, but it will importantly rest upon effective

co-ordination between educational institutions and employers, to foster new forms of work-based learning for all age groups.

The pace of Latvia's industrial transformation is apparent from the recent changes in employment across industries (Figure 1.28). Apart from construction and financial activities, which were most directly exposed to the crisis, manufacturing, as well as trade, transport and accommodation, have shrunk significantly over the past decade. These are two of the most traditional (and relatively less skill-intensive) sectors of the economy. Information and communication services, and professional services have experienced a period of rapid growth, at a significantly quicker rate than in other eurozone countries. A continuation of these trends is evident from the projected changes in employment for different sectors (Cedfop, 2010). Among the countries analysed, Latvia is the one with the largest projected relative employment loss in manufacturing and construction between 2010 and 2020.

Figure 1.28. Changes in employment across sectors



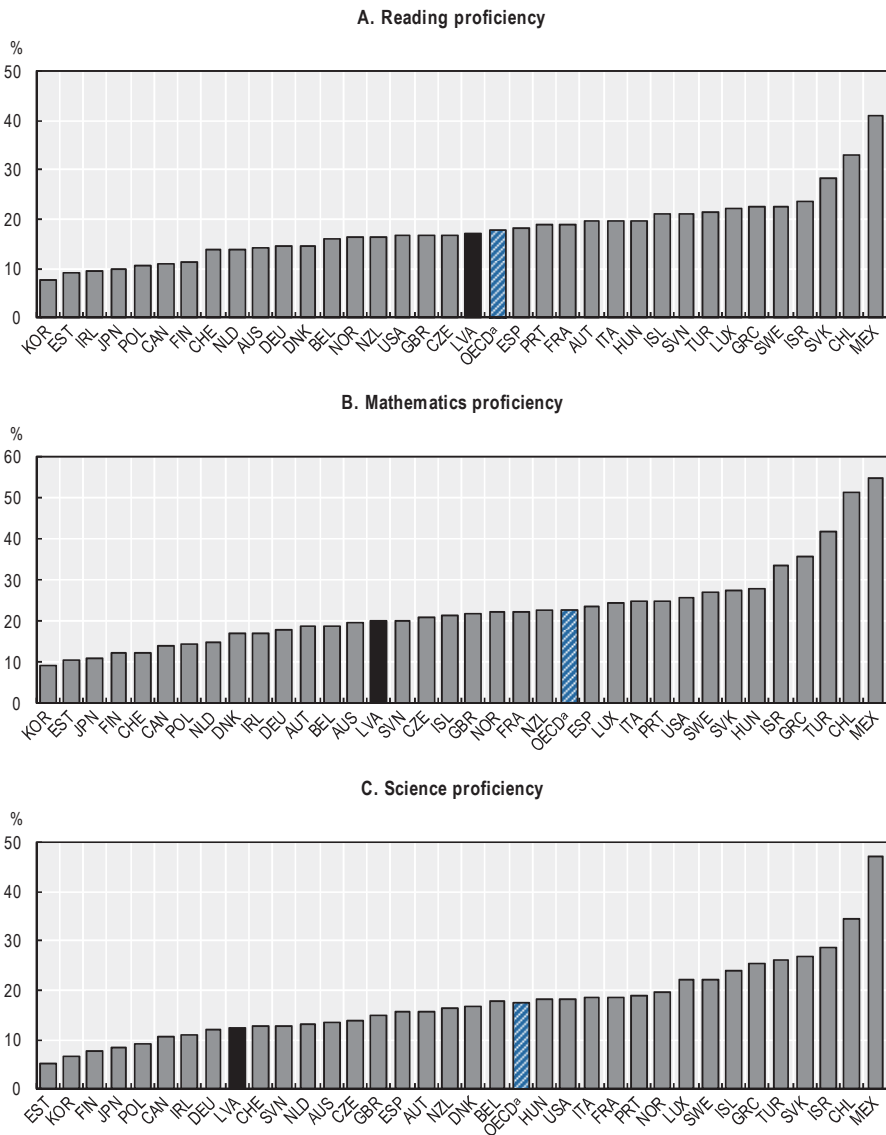
Source: OECD calculations based on Quarterly National Accounts database from Eurostat.

Basic education achieves good results, but enrolment rates are falling dramatically as a result of emigration and low birth rates

Results from the OECD Programme for International Student Assessment (PISA) show that Latvian students tend to fare relatively well in mathematics and, especially, science proficiency, while their reading proficiency tends to be weaker (Figure 1.29). The quality of basic education is unlikely to be a major constraint for Latvian productivity.

Figure 1.29. The share of students lacking basic skills is relatively low

Percentage of students at below level 2 of proficiency

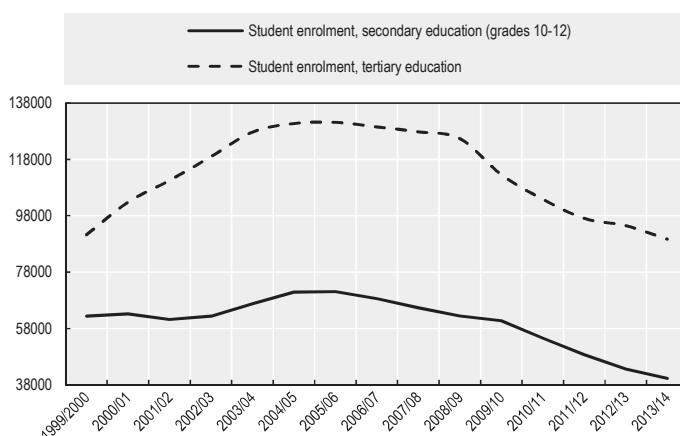


a) OECD average.

Source: OECD (2014), *PISA 2012 Results: What Students Know and Can Do* (Volume I, Revised edition, February 2014), Tables I.4.1a, I.2.1b and I.5.1b, <http://dx.doi.org/10.1787/9789264208780-en>.

However, a shrinking population implies that the quantity of skilled workers may be insufficient to cater to the needs of the labour market. Figure 1.30 shows that student enrolment in general secondary and tertiary education has declined dramatically over the past decade, in line with the rapid fall in birth rates registered in recent years as discussed in Section 3.

Figure 1.30. Strongly declining enrolment in secondary and tertiary education



Source: Central Statistical Bureau.

The quality of vocational education and training is perceived to be low

While general competences are on par with or above the OECD average, Latvia is lagging behind when it comes to generating specific technical skills. This is reflected in the very poor perception of the vocational education and training system's image and quality; Latvia scores at the bottom of the EU countries in a recent Eurobarometer report by the European Commission (Figure 1.31). Improving the quality of vocational education and training rests crucially on strengthening the link between schools and firms, including by incentivising employers to directly participate in the design of academic curricula. In particular, it will also be important to promote a modern and more effective system of apprenticeships to strengthen links between education and work (see Chapter 3). Currently, the share of youth who combine education with work remains low in Latvia, relative to OECD countries (Figure 3.10 in Chapter 3).

Figure 1.31. Perceived quality of vocational education and training


Source: European Commission (2011), “Special Eurobarometer 369, ‘Attitudes towards vocational education and training’”, Report, September 2011.

Low participation in life-long learning

The rapidly ageing population also highlights the importance of facilitating a system of lifelong learning that is suitable for ensuring that senior workers maintain skill sets that are relevant and demanded by the labour market. Changes in both policies and attitudes towards older workers are required to meet this significant challenge. Participation in lifelong learning is low in Latvia, with less than 5% of workers between 25 and 64 participating in formal training and only 30% participating in non-formal education or training in 2011 (Eurostat, Adult Education Survey). In the same year, in countries like the United Kingdom and Sweden, close to 15% of workers in the same age group were in formal training, and more than 65% of workers underwent some form of non-formal education or training in countries like Sweden and Luxemburg (OECD, 2015a).

Notes

1. See Purfield and Rosenberg (2010) for an account of fiscal and wage adjustments in Latvia and other Baltic countries during the Global Financial Crisis 2008-09.
2. EU-SILC, wave 2013.
3. Details and sources are in Section 4.
4. At the beginning of the transition process, the pace of the privatisation of large companies was significantly slower in Latvia than in Estonia.
5. The short decline was, in part, a result of one-off changes to redistribution policies. For instance, the government bolstered support for farmers and some mainly child-related social transfers prior to the 2006 parliamentary elections.
6. Both household asset stocks and net financial wealth were the lowest of any EU country already before the crisis (see Meastri et al., 2014; and Eurostat Financial Balance Sheets). Reasons for low wealth holdings include the limited opportunities for wealth accumulation during Soviet times, the specificities of the privatisation and denationalisation process that followed, and macroeconomic and financial-market volatility, including a banking crisis in 1995 that led to a complete loss of deposits for many Latvians (on the latter, see de Castello Branco et al., 1996).
7. The share was 68% in Latvia, compared with 39% in the Slovak Republic, 31% in Estonia, and 28% in the Czech Republic and Slovenia (ISSP 2009 – Social Inequality).
8. See OECD (2012) and Razgune and Lazutka (2015).
9. 29% of Latvians aged 12-17 were “at risk of poverty” in 2013 according to the Eurostat definition (household income below 60% of the median).
10. Ferré et al. (2013) report that four out of nine identified clusters with persistent labour market difficulties during 2007 to 2010 mainly consisted of individuals aged over 45. See also World Bank (2015).
11. Regional GDP disparities in Latvia also exceed differences of national income between EU countries: According to Eurostat data for 2012, the

- Gini coefficient of national GDP per capita in purchasing power parities in the European Union was 0.20.
12. Differences in levels of tertiary education among employed individuals are always statistically significant. When assessing differences between minorities and non-minorities for the entire population, they are statistically significant among women, and among non-citizen men.
 13. Inequality in educational attainments and school quality are important drivers of economic inequality. Several PISA indices measure equity in education and reveal that the Latvian system is relatively equitable compared with many OECD countries. Variation in performance across schools is relatively low, but there is relatively high variation in performance within schools. Moreover, socio-demographic segregation in education has increased since 2003 and should raise some concerns in the face of increasing returns to education and rising economic inequality.
 14. Using conventional significance thresholds, the earnings difference between minority citizens and non-citizens is not statistically significant for women.
 15. According to the a recent survey, 97.6% of people aged 18-24 consider having at least a satisfactory command of Latvian and 77.3% an excellent or good knowledge of the language.
 16. The earnings gaps persist when comparing workers within the same sector (and with the same contract type), suggesting that earnings gaps are not driven by difficulties in accessing well-paid occupations, but rather by different opportunities within sectors.
 17. An effective way to detect discrimination against minorities would be a correspondence test, whereby fictitious applicants that are identical in all respects, except national minority status, apply for the same jobs. Differences in their success rates then provide an informative measure of discrimination (OECD, 2013). No such test has been carried out in Latvia to date.
 18. <http://www.ons.gov.uk/ons/rel/fertility-analysis/childbearing-of-uk-and-non-uk-born-women-living-in-the-uk/2011-census-data/index.html>.
 19. The total of 142 000 between 1995 and 2015 also includes naturalisation for other reasons. A small number of non-citizens took foreign nationality, principally Russian, and became resident foreigners.
 20. 250 children were born to two non-citizen parents in 2014, and 170 to a non-citizen and foreigner.

21. This automatic procedure does not apply to children of Latvian non-citizens born outside of Latvia, which may affect migration decisions by young non-citizen families.
22. Non-citizens are more likely to work abroad for short spells, precisely because this is essentially only possible on an informal basis (Hazans, 2015). Non-citizens may also work in other EU countries if they qualify for a work permit under the prevailing regulations for third-country nationals, or if applicable as the spouse of a Latvian or EU national. Spouses of EU nationals are granted labour market access under EU rules.
23. In contrast to Latvian citizens, non-citizens' employment outside Latvia prior to 1990 is not considered for the purpose of calculating eligibility and pension amounts. The ECHR, in *Andrejeva v. Latvia* (2009), found that Latvia had violated the rights of a non-citizen whose years of employment outside Latvia prior to independence had been counted differently from those of Latvian nationals (<http://hudoc.echr.coe.int/sites/eng/pages/search.aspx?i=001-91388>). Since then, bilateral agreements with most (but not all) CIS countries have largely resolved this problem, but it is likely to have played a role in income differences for older residents prior to the implementation of these agreements.
24. Earnings received outside of Latvia prior to 1990 are also assessed differently for citizens and non-citizens for purposes of calculating entitlements to unemployment insurance benefits. However, this distinction plays no role in practice as the earnings reference period for calculating unemployment benefits is 12 months and any earnings prior to 1990 are therefore irrelevant.
25. The agreement states that for employment or equivalent periods which have been accumulated within the territories of Latvia or Russia until the 31st of December, 1990, the pension is granted by the party in which the pension claimant is residing at the moment of the pension request. However, for employment or equivalent periods accumulated after the 1st of January, 1991, the pension is granted by the party in whose territory the period has been accumulated.
26. Non-citizens who are members of a national minority may choose to enrol in a minority education programme.
27. The informal economy is defined as the sum of “all economic activities and income earned that circumvent government regulation, taxation or observation. More narrowly, the shadow economy includes monetary and non-monetary transactions of legal nature, hence all productive economic activities that would generally be taxable were they reported to the state (tax) authorities.” (Schneider and Buehn, 2012).

28. Hazans (2011) defines informal employment as the sum of informal self-employed and informal employees. The former include “all non-professional self-employed operating solely, as well as employers with five or fewer workers. The latter are employees working without a contract (or those uncertain of their contract).” Informal employment, such defined, may be found both in formally registered enterprises (i.e. in the formal sector) and in unregistered (informal) firms.
29. The results are based on a sample that excludes all workers who work in enterprises with no more than five employees, have a calculated monthly income from earnings that does not exceed EUR 700 and whose annual social security contributions represent less than 10% of their annual employee income.

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Chapter 2

Responding to the decline of Latvia's population

Latvia's population is declining at a rapid pace due to ageing and very high emigration. Emigration has slowed after peaking during the recent economic crisis, but continues to exceed natural population decrease and has been higher than in any OECD country over the past decade. The working-age population has also been shrinking faster than in any OECD country, and the old-age dependency ratio is expected to increase by some 20% over the next decade. Approximately 12% of Latvian-born people now live abroad and many of them are unlikely to come back. To stem the negative impact of falling population numbers on economic progress and social cohesion, Latvia should invest significant additional efforts to strengthen links with Latvians abroad, retain talent in Latvia, actively target labour migrants to help address skills shortages, and review existing barriers to labour migration, such as formal language requirements.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

1. Finding effective ways to reduce negative net migration

The bleak demographic prospect summarised in Chapter 1 raises the question whether and how Latvia can stop its population from declining. The effects of a shrinking working age population on the labour force can be addressed in a number of ways: increasing participation; increasing productivity; and increasing international migration. This chapter focuses on the last point, examining which policy levers can be used to best manage the demographic decline in terms of labour market composition.

The combination of lower fertility and high levels of emigration have put the country in too negative a position to recover in the short or medium term without a profound reversal of net migration. Even if this were possible, ending large-scale emigration would not be sufficient for stabilising population levels and countering ageing. Increasing migration from abroad – whether through return migration or through international labour migration – is one means of reducing negative net migration. This chapter presents present and future emigration flows, and explores the Latvian policy framework to 1) help and encourage emigrants to maintain economic and family links in Latvia; and 2) attract both return migrants and immigrants from other countries.

Emigration from Latvia will likely continue

Emigration from Latvia, as seen in Chapter 1, has been at a high level, higher than in any OECD country, over the past decade. The emigration rate peaked at about 1.7%-1.9% annually in 2009-10 and has since fallen only slightly. The share of the population abroad is at least twice that of Poland, the OECD country which has dominated post-accession European migration and which had an estimated 5% of its population abroad in 2013.

The well-developed networks created by recent Latvian emigrants have contributed to lower the opportunity costs for today's and future migrants, since the established Latvian community can help identify jobs and provide social support during the initial phase. Emigration has become a normal option for Latvians, in the face of any labour market difficulty (unemployment, but also low wages) as well as in transitions such as from school to work. The wages for less qualified employment in emigration countries such as the United Kingdom or Germany are at least four times higher than in Latvia (in Norway, as much as eight times higher); for young people who speak a foreign language, it may also be easier to find entry level employment abroad than in Latvia.

Unemployment, however, has not driven emigration: most emigrants left Latvia despite having a job. About 85% of the emigrants between 2004 and

2008 were employed, and even at the peak of the crisis this remained at 80% (Hazans, 2013). Employed Latvians emigrated because of low wages or the perception of better career opportunities abroad. Employers also note that one of the main reasons for losing personnel is emigration. This is true for employees who leave for better wages, and also emerged as an issue when employers attempted to rehire workers who were laid off during the downturn, and discover they have gone abroad and cannot be enticed back. Wage growth has not been sufficient to fundamentally change this calculation.

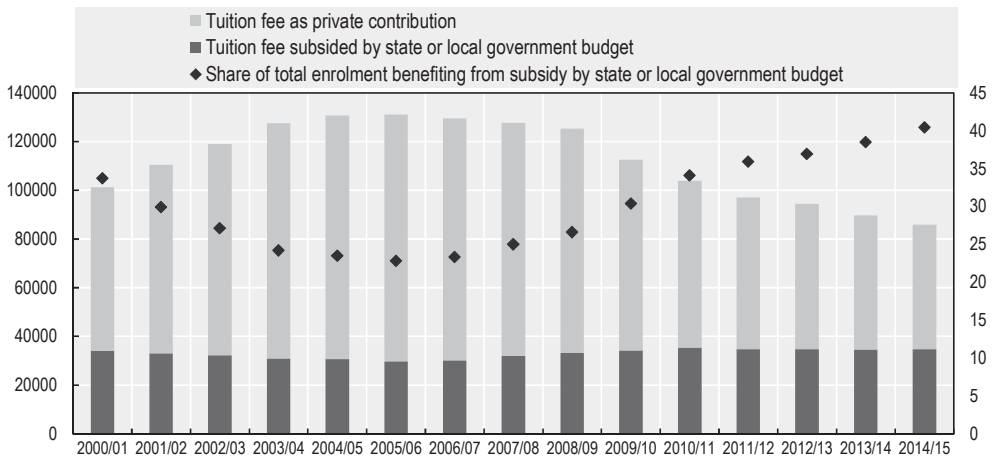
Emigration intention remains higher among less educated Latvians, but young people of all education backgrounds have high emigration intentions. The characteristics of emigrants are changing, with a larger share of young people and young couples. This is visible even among the very young. According to CSB, the number of Latvians age 15-24 leaving the country stood at 4 200 in 2012, 4 300 in 2013, and 3 400 in 2014, 1.6%, 1.8% and 1.5% respectively of the total population 15-24 in each year.

Many young people are spurning Latvian universities or leaving the country after graduation

University enrolment has been falling faster than the decline in the youth cohort. From the mid-2000s to the mid-2010s, the enrolled population fell by about one-third, from 131 000 to 86 000 (Figure 2.1). In Latvia, the state subsidises a certain number of higher education places in selected fields and programmes, for which students must compete for them. Those who do not score high enough or study in non-subsidised programmes pay tuition, which is set freely for non-subsidised places by the university of reference. State-subsidised places are decided every year at central level by the Ministry of Education and Science following a consultative process including labour market actors, in accordance with the labour market demands and long-term priorities.¹ Recently, the focus has been on natural sciences, mathematics and engineering. In 2013/14, there were about 30 000 state-subsidised places. The number of subsidised places has remained constant, while the number of self-paying students has fallen, from 101 000 to 51 000. EU nationals (as well as Latvian non-citizens and other permanent EU residents) may compete for subsidised places in university, although the language of instruction is Latvian.

Figure 2.1. The decline in student enrolment has mostly been in self-paying students

Student enrolment, by state-subsidised places and self-paying, relative to youth cohort size



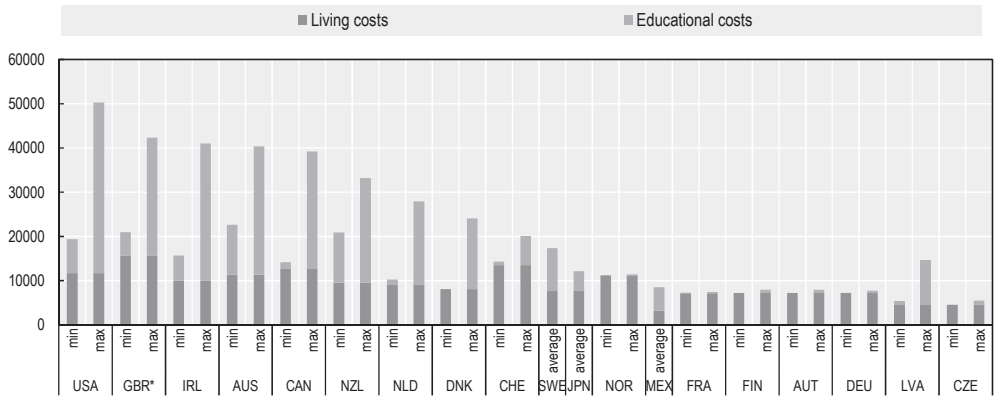
Source: Central Statistical Bureau.

Fees range widely, from about 700 to more than EUR 5 200. Full-time programmes at the University of Latvia range from about EUR 2 000 for most degrees to much higher costs for medicine and dentistry (EUR 50-60 000 for the entire degree programme). Engineering programmes are also more expensive.² This can be compared with fees in other EU countries (Figure 2.2), for which Latvian nationals pay the same costs as EU students; costs are lower in most countries (in Germany and France fees are nominal, and Scotland imposes no fees) but higher-paid work opportunities can often offset higher living costs, and allowances may be available (e.g., in France).

Migration intentions are particularly high for students; two-thirds report planning to live abroad (Hazans, 2013). In addition, many Latvian students bypass the national higher education sector and enrol directly abroad. The number of Latvian students studying abroad has in fact been increasing sharply. In 2007, there were 3 620 Latvian students enrolled in tertiary education in OECD countries, primarily in the United Kingdom and Germany. In 2011, this figure had risen to 6 650, with almost 3 000 in the United Kingdom alone, and other countries (Denmark, the Netherlands, Ireland) showing sharp increases.³ There is no evidence that these students are returning to Latvia after graduation.

Figure 2.2. International study in Latvia is relatively inexpensive

Annual living costs and educational costs for international students in selected countries, in EUR, 2013



* Excludes Scotland, min refers to lower bound of educational costs, max refers to an upper bound of educational costs.

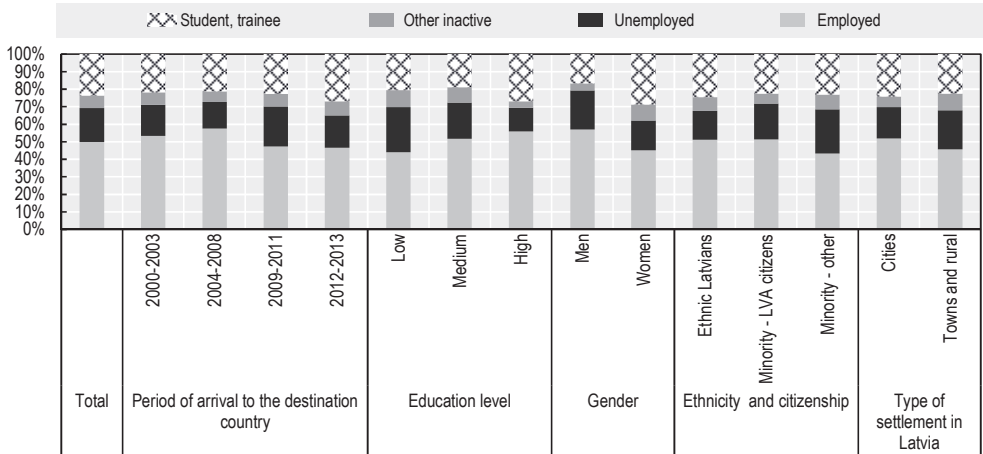
Source: OECD (2013), *Education at a Glance 2013: OECD Indicators*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/eag-2013-en>; Usher, A. and J. Medow (2010), “Global Higher Education Rankings 2010. Affordability and Accessibility in Comparative Perspective, Higher Education Strategy Associates”, Toronto; and national governmental and university websites.

About 24% of all the emigrants who left Latvia since 2000 was a student or trainee before they left – and 27% of all tertiary educated Latvians, suggesting that one in four highly-educated Latvian emigrants went abroad after graduating without ever working in Latvia (Figure 2.3). The analysis presented in Chapter 1 shows that overall, about one-third of recent graduates have left Latvia in the years shortly after graduation.

Latvia has begun to devote policy attention to this area. The Latvian Education Development Guidelines 2014-2020 envisage a number of grant schemes for graduates; importantly, eligibility would be extended to those graduating from foreign institutions. The ESF programmes focused on attracting human resources to science have included foreign and re-migrated scientists among the targets. These are, however, small ambitions yet to be achieved, and would also require an information campaign abroad. More active outreach to Latvians studying abroad could be provided by creating a list of Latvian students abroad and by hosting information meetings in the main study destinations. One possible model could be to support private networks along the lines of those which exist for German researchers, the GAIN and GSO, which support recruitment efforts of German research institutes and prepares German researchers for application (OECD, 2015). These networks compile databases and subsidise trips to Germany to interview for open positions.

Figure 2.3. More than one in five recent emigrants was a student or trainee before emigrating

Latvian emigrants (as of 2014), by period of arrival, demographic characteristics and last labour market status in Latvia



Source: Hazans, M. (2015), “Emigration from Latvia: Return intention of post-2000 emigrants from Latvia”, paper for the OECD. Based on the project “The Emigrant Communities of Latvia: National Identity, Transnational Relations, and Diaspora Politics” implemented by the Institute of Philosophy and Sociology, University of Latvia in co-operation with the Faculty of Economics and Management, University of Latvia and supported by ESF Project 2013/0055/1DP/1.1.1.2.0/13/APIA/VIAA/040.

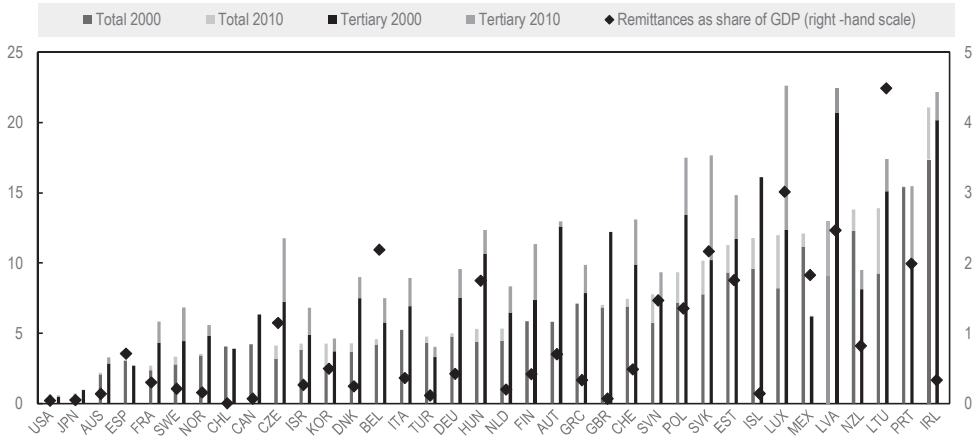
2. Diaspora policy needs to be bolstered, but cannot reverse emigration

The exact magnitude of emigration and the Latvian diaspora is not known. Latvian residents leaving the country are required to report their departure, but many do not. Following the 2011 census, emigration figures for the prior decade were revised upward by 8%.

Statistics from destination countries paint a detailed picture of the Latvian diaspora (Figure 2.4). According to the *Database of Immigrants in OECD Countries*, there were 270 000 Latvian-born people, age 15 and over, living in other countries in 2010/11. This yields an emigration rate, or share of the population 15+ born in the country and living abroad, of 13%. Only New Zealand, Portugal and Ireland had a higher emigration rate. The emigration rate for highly-educated Latvians rose from 9.5% to 15.3% over the decade, as the number of tertiary-educated Latvians living abroad more than doubled.

Figure 2.4. Latvia's emigration rate is higher and faster growing than for almost all OECD countries

Emigrant rate (share of persons 15+ born in country living abroad), 2000/01 and 2010/11, and remittances as a share of GDP, 2013



Source: OECD Database of Immigrants in OECD Countries (DIOC), 2015.

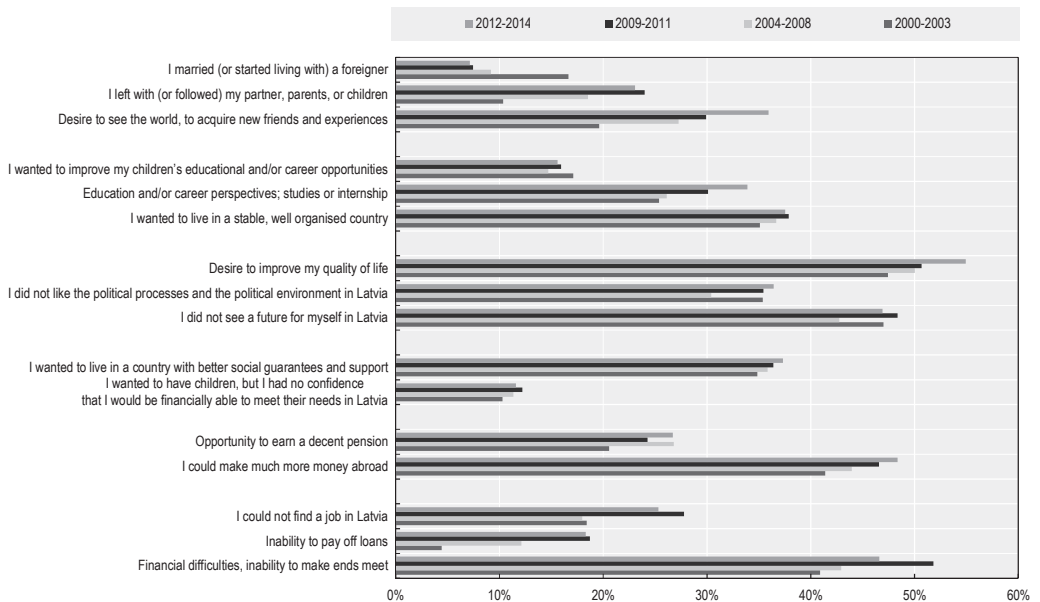
While the Latvian-born population abroad in 2000 was largely related to national minorities leaving Latvia in the 1990s, the 2000s saw the share resident in the OECD become the majority. In 2010, the Russian Federation and Belarus accounted for about 100 000 of the Latvian-born, down about 5% from the 2000 figures. In contrast, there were 159 000 Latvian-born living in OECD countries, up from 63 000 in 2000/01. The main countries of residence of Latvian-born migrants in 2010/11 were the Russian Federation, the United Kingdom, the United States, Ireland and Germany.

This division reflects the different history of the Latvian diaspora, discussed in Chapter 1. The post-war exiles in English-speaking OECD countries are no longer the bulk of the diaspora, and return from this group (and their descendants) has declined sharply. The Latvian-born in the Russia Federation, other CIS countries and in Israel comprise almost entirely emigrants who are not ethnic Latvians; this population is also diminishing. Today's diaspora largely comprises ethnic Latvians working in European countries, most of whom left post-2004.⁴ As noted in Chapter 1, in 2013, according to national sources, they were mostly residing in the United Kingdom (80 000), Germany (25 000) and Ireland (20-30 000), and Nordic countries (about 20 000).

Information on the characteristics of the post-2000 emigrants is available from a large-scale survey of about 12 500 Latvian emigrants

(including national minorities) conducted in 2014 and reported in Hazans (2015).⁵ On average, respondents indicated a number (four or five on average) of motivations out of 17 possibilities. The main motivations (Figure 2.5) have been financial difficulties, a difficulty in making ends meet, the difficulty of imagining a future, and the promise of better earnings. Women tend to cite fewer factors than men, and more often report having emigrated because a family member or partner was abroad. While certain factors were cited more frequently by emigrants who left during the crisis years – debt, financial issues and the promise of higher wages – there was little decline in these motivations for emigrants who left after the worst period of the crisis had passed.

Figure 2.5. Reasons for emigration of emigrants, 2000-14, by period of emigration

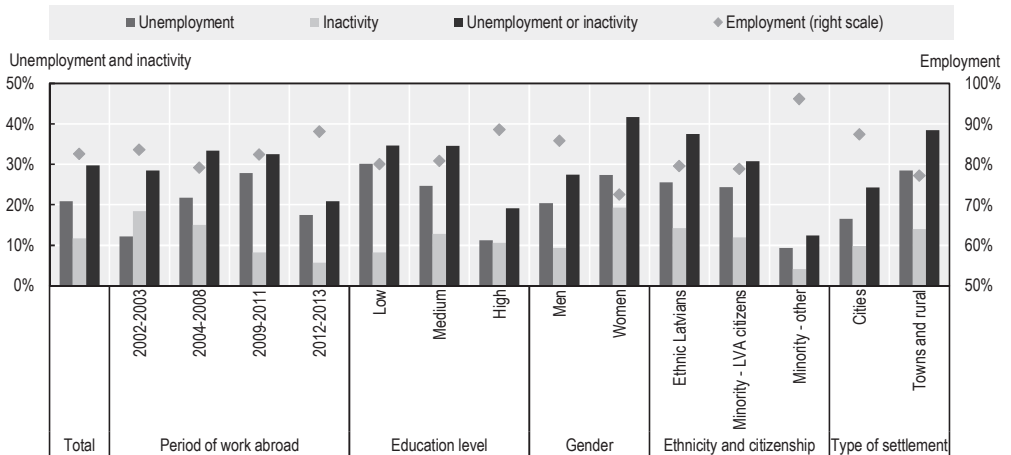


Source: Hazans, M. (2015), “Emigration from Latvia: Return intention of post-2000 emigrants from Latvia”, paper for the OECD. Based on the project “The Emigrant Communities of Latvia: National Identity, Transnational Relations, and Diaspora Politics” implemented by the Institute of Philosophy and Sociology, University of Latvia in co-operation with the Faculty of Economics and Management, University of Latvia and supported by ESF Project 2013/0055/1DP/1.1.1.2.0/13/APIA/VIAA/040.

Difficulty in finding employment in Latvia has not been one of the main push factors cited by emigrants. This mirrors the findings from the labour force survey (LFS) which covers people who have left to work abroad but are still considered members of a household resident in Latvia (Figure 2.6). Most (83%) of these “guest workers” were employed in Latvia prior to

emigration. More recent “guest workers” are even more likely to have been employed in Latvia. Although low-educated and residents of rural areas and towns were more likely to go work abroad following unemployment than higher educated and urban dwellers, the share of those who were unemployed in Latvia did not exceed 30%.

Figure 2.6. Incidence of spells of employment, unemployment or inactivity in Latvia during the previous year among Latvian guestworkers, 2002-13



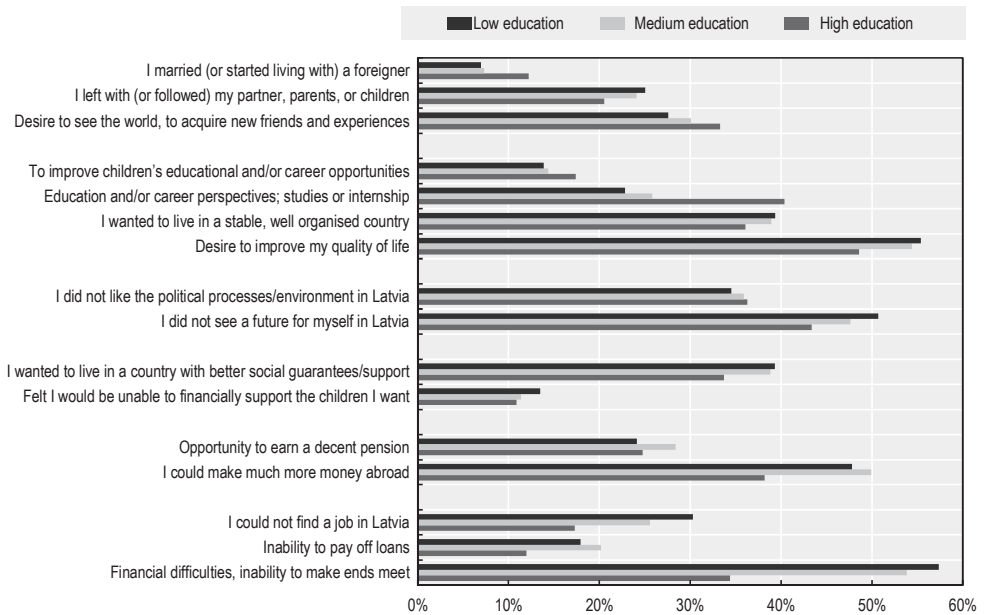
Note: “Guestworkers” are labour emigrants still considered household members back home.

Source: Labour force survey.

For higher educated Latvian emigrants, economic reasons were much less of a factor pushing them to leave than they were for low-educated emigrants (Figure 2.7). Economic push factors were cited by 42% of high-educated Latvian emigrants, compared with 62% of low-educated emigrants.

Figure 2.7. Higher educated emigrants sought more than just employment abroad

Motivation for emigration, by education level, period of emigration

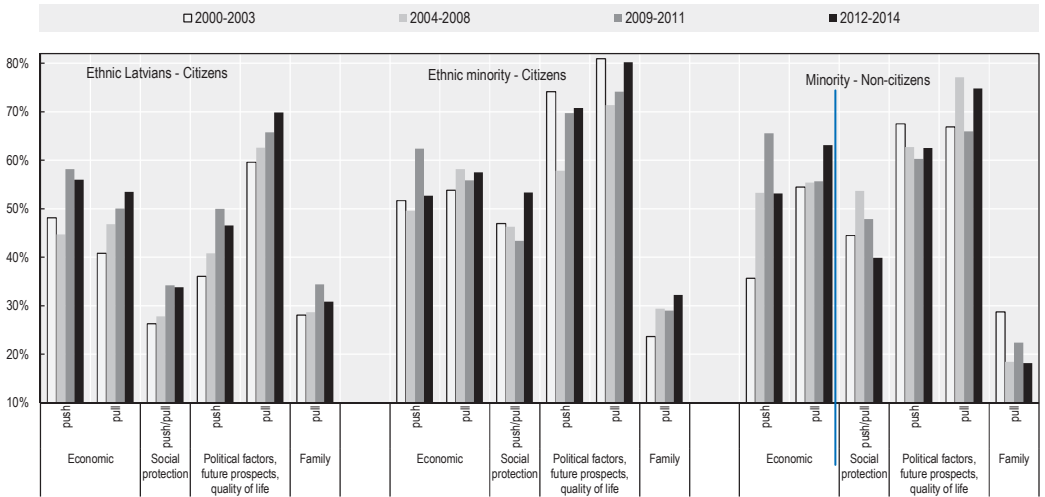


Source: Hazans, M. (2015), “Emigration from Latvia: Return intention of post-2000 emigrants from Latvia”, paper for the OECD. Based on the project “The Emigrant Communities of Latvia: National Identity, Transnational Relations, and Diaspora Politics“ implemented by the Institute of Philosophy and Sociology, University of Latvia in co-operation with the Faculty of Economics and Management, University of Latvia and supported by ESF Project 2013/0055/1DP/1.1.1.2.0/13/APIA/VIAA/040.

Ethnicity and nationality also affect the decision to emigrate. Ethnic Latvians who left were less troubled by the political situation in Latvia (Figure 2.8), while these were frequent push factors for those belonging to a national minority, even if they held Latvian citizenship.

Figure 2.8. National minorities and non-citizens are more likely to cite political and social security factors in their emigration decision

Motivation for emigration, by ethnicity, citizenship and period of emigration



Source: Hazans, M. (2015), “Emigration from Latvia: Return intention of post-2000 emigrants from Latvia”, paper for the OECD. Based on the project “The Emigrant Communities of Latvia: National Identity, Transnational Relations, and Diaspora Politics” implemented by the Institute of Philosophy and Sociology, University of Latvia in co-operation with the Faculty of Economics and Management, University of Latvia and supported by ESF Project 2013/0055/1DP/1.1.1.2.0/13/APIA/VIAA/040.

According to estimates by Hazans (2015), the emigrant stock comprises about 10.9% of the 2000 Latvian resident population. While Latvian regions – and particularly rural areas – have seen the sharpest decline in population, they are neither the main regions of emigration nor the regions which have the highest emigration rates as a share of population (Table 2.1). In fact, Latvia’s cities and towns have the highest outflow rates. Rural regions may be losing population to internal migration – to the capital, particularly – but it is the urban centres from which emigrants are departing.

Table 2.1. Emigration rates are higher from urban areas

International emigration rate since 2000, by place of residence in Latvia (as of the end of 2014, in % of population at the beginning of 2000)

Main cities	14.9
Riga	14.3
Other towns	15.7
Small towns	12.2
Rural settlements	3.9
Latvia	10.9

Source: Hazans, M. (2015), “Emigration from Latvia: Return intention of post-2000 emigrants from Latvia”, paper for the OECD. Based on the project “The Emigrant Communities of Latvia: National Identity, Transnational Relations, and Diaspora Politics” implemented by the Institute of Philosophy and Sociology, University of Latvia in co-operation with the Faculty of Economics and Management, University of Latvia and supported by ESF Project 2013/0055/1DP/1.1.1.2.0/13/APIA/VIAA/040.

The recent emigrants show low propensity to return

Return intention appears low. Of post-2000 emigrants, about 16% intend to return to Latvia in the short and medium-term (within five years), and an additional 31% could be convinced to return if conditions are right. Using estimates of the emigrant population, this suggests that about 40 000 of today's emigrants intend to return, with a further 80 000 under the right conditions.⁶ The remainder would only consider returning for retirement, or not at all. Return intentions are much higher in the initial emigration period and for emigrants who have been abroad for less than one year: 36% compared with 15% for those who have been abroad for more than a year. Those who intend to return are generally dissatisfied with their life abroad, rather than those who wish to seek new opportunities in Latvia.

The estimates on return potential may be overly optimistic: across countries, return probability declines sharply after five years abroad (OECD, 2008). While no such comparable survey exists for other OECD countries with large recent emigrant populations, a smaller-scale survey of Polish emigrants in four major destination countries found in 2012 that about 60% of emigrants intended to return, down from 82% in 2007, as durations of stay grew longer (Chmielewska, 2015). The clear implication for Latvia is that migrants who left during the peak emigration years of the crisis are increasingly unlikely to return if they have not done so already.

Latvians are reluctant to return for a wide variety of reasons (Table 2.2). Quality employment (in terms of wages and matching qualifications) is the main reason across gender, education and population groups, but equally important is the perception of a weak social support system in Latvia. The benefit system is more generous in many of the destination countries of emigrants. For example, even during the Irish economic downturn, when unemployment spiked among Latvian labour migrants, Latvians had a low return rate from Ireland. Further, for almost three out of four emigrants, their lives are established abroad already, making it difficult to uproot themselves again and return. Language is cited by relatively few ethnic Latvian emigrants as a factor preventing return, but is more of an issue for minorities and particularly for non-citizens.

Table 2.2. Many factors prevent Latvian emigrants from returning

Factors preventing Latvians from returning: Percentage who find it very important or fairly important

Factor	Total	Gender		Education		Minority/Citizen		
		Men	Women	Low	High	Non-minority, citizen	Minority, citizen	Minority, non-citizen
I cannot find a decent job in Latvia	78.7	77.4	79.2	83.4	76.3	76.5	80.2	82.4
I would not get adequate social support (benefits, pension, etc.) in Latvia	76.7	73.5	78.0	77.7	74.1	71.2	81.1	78.0
I have settled down here, in my current country of residence	71.6	66.1	74.9	68.1	73.4	68.9	73.6	70.7
I have no opportunities for professional/career growth or entrepreneurship in Latvia	66.6	65.9	66.8	65.5	69.0	64.8	68.0	67.3
I am disillusioned with the Latvian state	62.7	64.6	60.7	65.5	58.8	57.0	67.7	64.3
I am not sure my child(ren) will receive adequate support while adapting to the Latvian system of education	51.7	52.3	51.7	58.9	48.7	46.4	57.5	56.0
Most of my family and friends do not live in Latvia	41.6	36.5	45.1	45.8	39.8	37.9	45.0	44.7
I have outstanding mortgage and/or other loans in Latvia	17.5	17.8	17.7	20.3	15.0	18.8	17.5	7.1
I would have language difficulties in Latvia	11.6	11.6	11.1	10.5	12.0	6.0	15.8	25.7

Source: Hazans, M. (2015), “Emigration from Latvia: Return intention of post-2000 emigrants from Latvia”, paper for the OECD. Based on the project “The Emigrant Communities of Latvia: National Identity, Transnational Relations, and Diaspora Politics“ implemented by the Institute of Philosophy and Sociology, University of Latvia in co-operation with the Faculty of Economics and Management, University of Latvia and supported by ESF Project 2013/0055/1DP/1.1.1.2.0/13/APIA/VIAA/040.

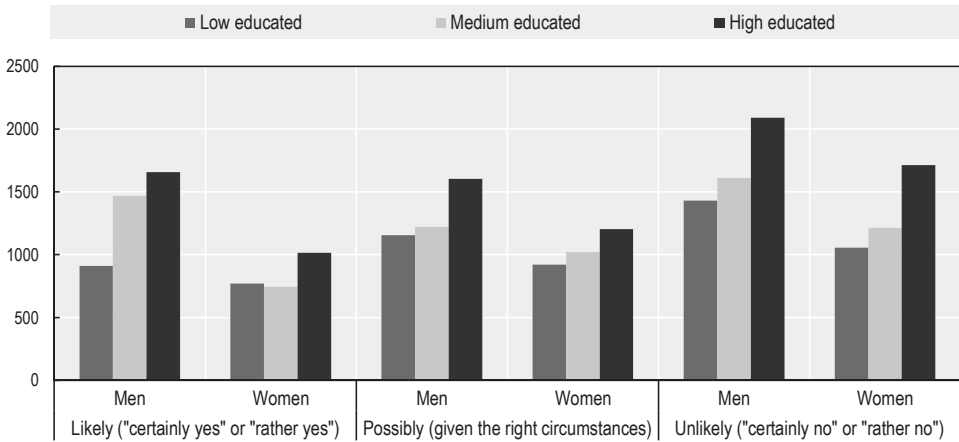
As the difficulty of finding a decent job is one of the main factors preventing return, one way to increase return would be to make it easier for emigrants to be matched with quality jobs and Latvia has taken steps in this direction. In Estonia, a project (“Talents Back Home”) supported by the ESF aimed at matching Estonian employers with candidates abroad with a high level of qualifications, and Latvia has also joined this programme to build a database of talents abroad, and raise interest from employers. There are a number of other examples of programmes promoting job offers to emigrants. In Romania, demand from employers has been concentrated in trades, leading the employment service to organise job fairs in countries with large numbers of Romanian emigrants. In Poland, national policy

sought to reduce obstacles to return rather than to affect individual decisions (Kaczmarczyk, 2013). A number of regional programmes ran prior to the economic downturn, including presentations in London by cities interested in attracting and supporting return migrants.

Finding a matching job is, however, not enough; salary requirements are also important. The 2014 emigrant survey asked labour migrants to state the salary for which they would be willing to return (Figure 2.9). On average, this was well above the median Latvian salary, even if it was below the salaries in the country of residence. For high educated men who were already thinking of return in the next five years, the figure was above EUR 1 650. For women it was substantially lower, however. Interest in job fairs by Polish and Romanian emigrants, respectively, did not lead to recruitment back to home-country employers when wages remained far below those in the host country (Mereuta, 2013). This suggests that return will depend on wage growth.

Figure 2.9. Reservation wage for emigrants is higher for men

“What is the minimum salary/wage/pay per month that could interest you in a job in Latvia?”: Responses by education, gender and likelihood of return, in EUR



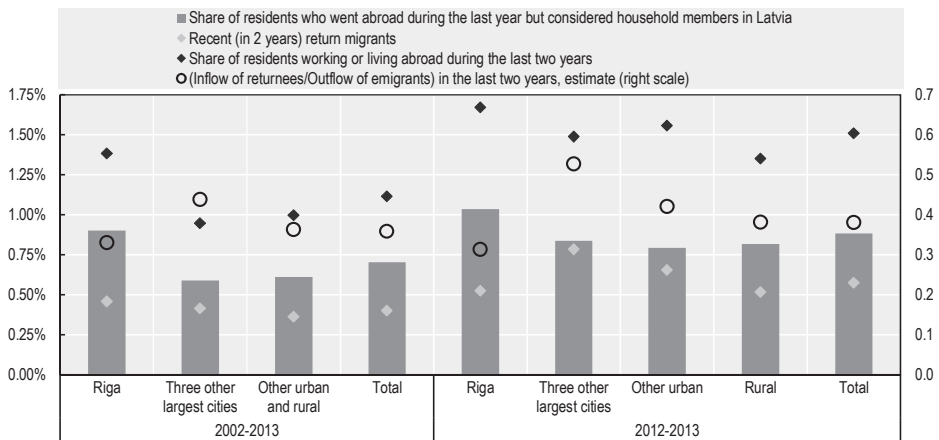
Source: Hazans, M. (2015), “Emigration from Latvia: Return intention of post-2000 emigrants from Latvia”, paper for the OECD. Based on the project “The Emigrant Communities of Latvia: National Identity, Transnational Relations, and Diaspora Politics” implemented by the Institute of Philosophy and Sociology, University of Latvia in co-operation with the Faculty of Economics and Management, University of Latvia and supported by ESF Project 2013/0055/1DP/1.1.1.2.0/13/APIA/VIAA/040.

Not all Latvians who go abroad to work or study remain abroad, in fact. Analysis of the LFS by Hazans (2015) suggests that about half of guestworkers – those who go abroad for work, but whose household is still in Latvia – return (Figure 2.10). This share is higher in peripheral cities, and

lowest in the capital. While the impact of emigration on rural areas is less than it is on cities, the return rate so far is also lower.

Figure 2.10. About half of temporary workers abroad with household in Latvia return

LFS-based estimates of outflow of emigrants and inflow of returnees, by type of settlement



Note: “Other main cities” here refer to the three largest cities after Riga (Daugavpils, Jelgava and Liepaja), while all other urban settlements (population below 55 000) are “small”.

Source: Hazans, M. (2015), “Emigration from Latvia: Return intention of post-2000 emigrants from Latvia”, paper for the OECD. Based on the project “The Emigrant Communities of Latvia: National Identity, Transnational Relations, and Diaspora Politics” implemented by the Institute of Philosophy and Sociology, University of Latvia in co-operation with the Faculty of Economics and Management, University of Latvia and supported by ESF Project 2013/0055/IDP/1.1.1.2.0/13/APIA/VIAA/040, using LFS microdata.

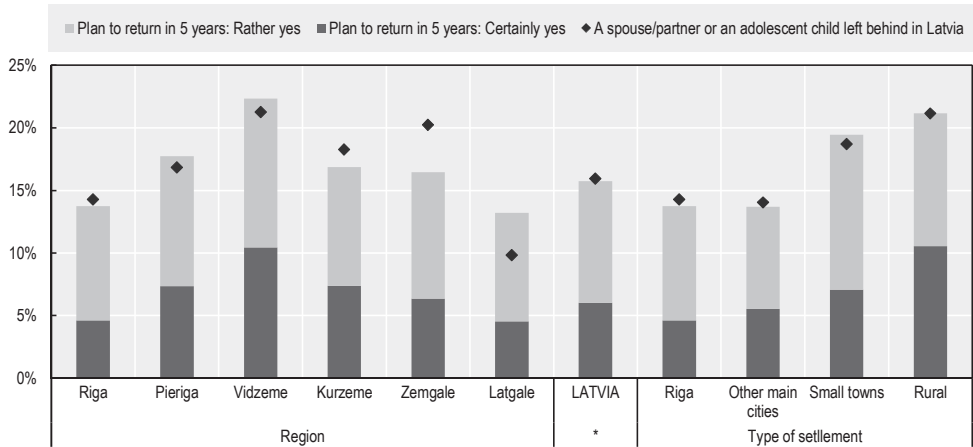
The share of emigrants who plan to return is, as noted above, low: about 16% of all recent emigrants. Those least likely to return are from Riga and from the Latgale region (Figure 2.11). In part this is because many are from national minorities, who have a lower return propensity than ethnic Latvians. Emigrants with some minority background (national minority, non-Latvian mother tongue, Russian-speaking spouse or partner, etc.) are less than 5% of the emigrant population, and substantially less likely to return than ethnic Latvians without minority background. They are more likely, however, to plan a return within six months, as they do not enjoy free labour market access in the European Union (Hazans, 2015).

There is a difference in migration from urban and from rural areas. Migrants from rural areas, who were more likely to leave for shorter term employment abroad, have a higher propensity to return. Most returning Latvians go back to the city or region from which they left, rather than gravitate exclusively towards the capital. This means that the in an economy

increasingly centred on the capital, skills acquired abroad and brought by returning emigrants will be more difficult to utilise, as these migrants tend to return to rural areas where their family awaits, but employment opportunities are much more limited and where they left financial problems which may not be resolved. Further, as this group tends to emigrate due to an inability to find work, they are likely to leave again if the job market has not improved in their home region. Emigrants from urban areas, on the other hand, were more likely to leave due to non-economic factors, such as dissatisfaction with the political process in the country – factors which are associated with reluctance to return. While internal mobility is increasing the concentration of Latvians in the capital, the capital and the other large cities are also losing a larger share of their population to emigration than the rest of the country, indicating that even the broader opportunities available in the capital are not enough to stop emigration.

Figure 2.11. Emigrants’ plans to return and family members left behind in Latvia

Share of recent emigrants (since 2000) who say they are likely or very likely to return to Latvia



Source: Hazans, M. (2015), “Emigration from Latvia: Return intention of post-2000 emigrants from Latvia”, paper for the OECD. Based on the project “The Emigrant Communities of Latvia: National Identity, Transnational Relations, and Diaspora Politics” implemented by the Institute of Philosophy and Sociology, University of Latvia in co-operation with the Faculty of Economics and Management, University of Latvia and supported by ESF Project 2013/0055/1DP/1.1.1.2.0/13/APIA/VIAA/040.

The higher propensity to return among less educated Latvians is also visible in the characteristics of return migrants: 27% of departing Latvians are tertiary-educated and only 18% of those returning. Programmes to reintegrate returning Latvians, then, will have to take into account the lower education level of the larger share of returnees.

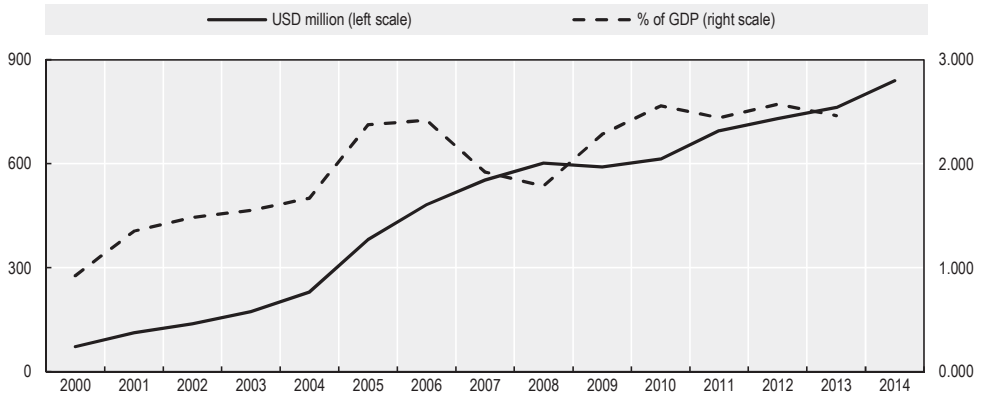
Family formation abroad is one of the main obstacles to return. About half of post-2000 emigrants live abroad with a spouse or partner, or an estimated 136 000 Latvians. At least one in three of these partners are foreigners.

Other major emigration countries in the OECD have a one-stop website with information for prospective returnees (e.g., powroty.gov.pl, a specialised website run by the Polish PES). Latvia does provide information on its portal (latvija.lv) for prospective returning emigrants, mostly by pointing them elsewhere. Specific measures for returning emigrants could be made clearer.

Remittances will likely decline from their present levels

The substantial emigrant population is an important provider of remittances to Latvia; remittances account for about 2.5% of GDP and have increased since the crisis (Figure 2.12). Among OECD countries, only in Luxembourg do remittances account for a larger share of GDP, and this is due to cross-border financial transfers rather than emigrants (Figure 2.4 above).

Figure 2.12. Remittance flows provide a major contribution to GDP



Source: World Bank remittances data.

Calculating remittances in income is also an issue for means-tested benefit eligibility. If a family member is declared as resident abroad, the burden of proof falls on the family members in Latvia to show no income from the absent partner. However, many emigrants – especially less educated Latvians working shorter periods abroad – do not register their emigration.

For the moment, remittances clearly provide an important contribution to Latvian households. Overall, the EU-SILC indicates that transfers (a proxy for remittances) comprised 1.5% of household income in 2012, but for the 9% of Latvian families receiving them, remittances comprised 20% of income. Inter-household transfers accounted for a growing share of household income among poorer households, although this varied through the crisis (Table 2.3).

Table 2.3. Remittances are a key component of household income for one in ten poor families

Contribution of inter-household transfers to Latvian families, by decile, 2007-13

Year	Decile					Share of total income (%)	Share of households receiving transfers (%)	Share of income for households receiving transfers (%)
	Bottom	2nd	3rd	4th	5th			
2007	3.5	1.4	4	4.2	2.6	1	11.8	10.5
2008	2.3	1.6	3.5	4.5	4.1	1.4	10.8	16.2
2009	2.9	1.7	3.7	4.1	3.1	1.5	10.5	16.6
2010	7.5	1.8	2.2	2.8	2.9	1.4	11.5	15.2
2011	7	2.9	2.2	3.1	2.9	1.7	11.5	17.2
2012	6.5	1.6	1.7	2.8	2.9	1.5	9.2	20.2
2013	4.8	1	1.7	2.8	2.1	1.4	9.1	18.8

Note: Transfers include other sources such as alimony payments. Deciles are equalised by the square root of the household size. Both regular inter-household cash transfer received(gross) and household gross income are equalised.

Source: EU-SILC.

As emigrants bring their families to join them, and more Latvians emigrate as a family unit, remittances will decline, with impact on the broader economy. A decline in remittances to the poorest families will create more pressure for anti-poverty measures. The challenge in this area is to shift remittances from household transfers to broader investments in Latvian development. Remittances also go to higher income households, who may be interested in such products as “diaspora bonds” (of little use in times of low borrowing costs) or local infrastructure project financing.

A concerted policy for diaspora relations needs to be expanded

Latvia inherited a social, cultural and political infrastructure for contact with its diaspora from the exiles who left the country after the Second World War. The World Federation of Free Latvians, founded in the 1950s, now has a Memorandum of Understanding (MoU) with the Ministry of Foreign

Affairs. The Ministry of Foreign Affairs also has a MoU with the European Latvian Association. This diaspora network has been growing in countries of new Latvian migration (e.g. Luxembourg, Belgium and Austria). The existence of long-standing representative bodies facilitates relations with the diaspora. These bodies are not representative of all registered Latvians abroad, since they are based on activism and voluntary participation, nor do they play a statutory role in Latvia.

The institutional framework for diaspora relations was weak until the early 2010s, based on co-operation with traditional diaspora associations. The most concrete policy was a programme for people of Latvian origin to come and settle in Latvia, the Repatriate programme (see Box 2.1). The early post-independence migration coincided with an economic boom, so little attention was given to emigration issues. With the subsiding of the crisis, it became clear that many recent emigrants would not return, and policy has shifted to how to maintain relations with this new diaspora. Emigration issues have recently become the object of policy.

Policy attention is still focused on return, although alternatives are now considered

In 2013, the Cabinet of Ministers approved a “Remigration Support Measure Plan 2013-2016” to support Latvian nationals and their families living abroad in returning to Latvia, as well as those who wish to open businesses in, or maintain business ties with, Latvia. The Plan, which draws on the experience of diaspora outreach programmes in other countries, covers a wide range of actions and objectives. Some of these are meant to smooth the path to employment in Latvia for labour migrants, by creating one-stop information sources for Latvians abroad on return and improving information on the Latvian labour market to Latvians abroad. Others are aimed to support Latvians who return with families they have acquired or raised abroad: Latvian language support for returnee family members and support for reintegration of returning students of Latvian families. A third domain is that of trying to reach highly educated emigrants, with a proposal to provide grants to high-skilled Latvians abroad to return, including potential student debt forgiveness; and to ensure that the public procurement and civil service hiring process is accessible to Latvians abroad. Fourth, these are co-operative efforts with other actors to expand business network development with the Latvian diaspora.

An Action Plan for the Diaspora 2015-2017 was introduced by the government in 2014, and covers four pillars:

- *Identity*: Reinforcing Latvian identity, through summer camps, media, and other outreach initiatives. Supporting the Latvian Language and Literature, both abroad and for returning Latvians who have not been in the Latvian system.
- *Civic and political engagement*: Latvians enrolled in the electoral register have the right to vote abroad. In the 2014 elections, there were 98 precincts abroad, and 23 000 voters out of 78 000 eligible, a record high level of participation but only half the participation rate in Latvia (59%).
- *Co-operation*: Working towards co-operation in economics, culture, education and science. This brings together schools, associations, the Latvian Youth Forum. The Ministry of Foreign Affairs has held World Latvian Economic and Innovation Forums in 2013 and 2015. The Ministry of Culture hosts an annual diaspora conference. It also organised the First World Latvian Economic and Innovation Forum in July 2013, to bring together entrepreneurs and investors from the global diaspora. This is in line with good practice in this area across OECD countries.
- *Assistance*: Providing assistance to those who wish to return as repatriates or those re-migrating, including the integration of their children into the Latvian education system.

These plans contain elements of positive action plans taken by a number of OECD countries in response to large-scale emigration. Limited funding – a few hundred thousand euros in the first years – has meant that only those actions which imply the lowest costs – such as improved relations with diaspora organisations – have been implemented.

There are a number of domains in which Latvia is working to adjust. The Ministry of Education and Science, which oversees Latvian language education policy, found that material developed for the older diaspora was no longer appropriate for the recent emigrants, necessitating new curricular material. The ministry also had to take responsibility for scholastic reintegration of children of Latvians returning from abroad. In 2013, almost 500 Latvian children returned to Latvia (one-fourth from the United Kingdom), of whom 40% had never been in school in Latvia. For these children, three years of additional support (in language and in culture) is provided, tracked by the ministry.

In light of the central role of the Latvian language, improving prospects for return will also depend on ensuring that emigrants' children are familiar with the language. Language education for this group is supported by the Latvian Language Agency, which grew out of a UNDP programme of Latvian as a Second Language. Language support is provided, with about

100 Latvian-language “weekend schools” in the main emigration countries, of which 70 schools are in Europe.⁷ The Latvian Language Agency provides direct financial support to 35-40 schools and to Latvian language summer camps. Until the mid-2000s, a “social integration secretariat” funded the teachers, but these salaries are now subsidised by the World Federation of Latvians.

In Latvia itself, support was provided through a national integration centre for third-country nationals, which provides legal support, translation and language support. This centre was created in 2012 due to the availability of targeted and earmarked funds from the European Union – meant for immigrant integration – and served about 700 users annually. While not originally designed for returning Latvians, it served as the structure to provide expanded services to returning Latvians. The integration centre operated until June 2015. In October 2015, Shelter Safe House, a non-governmental organisation, was tasked with the integration of third-country nationals.

One of the main and traditional areas of investment for diaspora relations is the cultural sphere. The Ministry of Culture supports festivals (essentially, song and dance), as well as “3x3 camps” which bring three generations of diaspora to Latvia together. A social integration foundation funds summer camps for 250 children of Latvians abroad. These initiatives can be particularly useful to maintain contact with diaspora, although there is the risk that these benefit only emigrants who already feel a strong desire to maintain contact with the home country. Subsidised summer camp experiences in particular should be targeted at youth who are less active in diaspora communities and whose knowledge of the language or culture is weaker. Youth visits have been shown in Israel, for example, to have the strongest long-lasting effects among the least connected diaspora youth. Non-subsidised places could be offered as well to parents abroad who wish to send their children to Latvia. Programmes for less connected emigrants will become more important as the diaspora settles definitively in other countries.

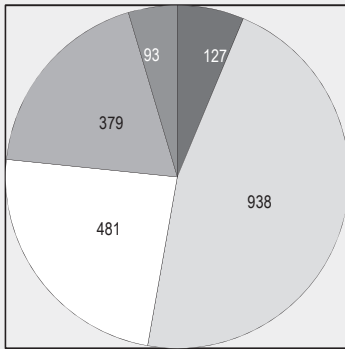
Relative to the exiles of the post-War period and their children, the recent wave of emigration is less educated, and less prone to speak Latvian with their children or invest in Latvian culture in the new country. Latvia must seek new forms of cultural outreach to reach this less attached and motivated population. The National Electronic Media Council, which oversees radio and television, has a pilot competition for diaspora television. The programme, “the Fifth Region”, is shown on Latvian television.

Box 2.1. Latvia offers repatriation to foreigners of Latvian origin

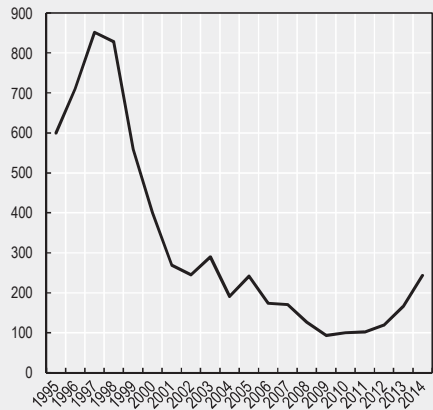
Latvia has a legislative framework for “returning Latvians” – those of Latvian origin who left Latvia prior to May 4, 1990 and their descendants. The “Latvian origin” requirement excludes a large part of the Latvian-born population – mostly in the Russian Federation, Israel and Belarus – who do not qualify as citizens or as of “Latvian or Livonian descent”. This programme is similar to ethnic repatriation programmes which existed in a number of OECD countries, such as Hungary, Greece and Finland. Once recognised, repatriates may bring their household goods duty-free, receive up to EUR 710 to cover travel and shipping costs, and are potentially eligible for financial assistance from the Ministry of Interior during the first six months (equivalent to the 90% of the unemployment benefit). The programme saw a significant number of repatriates in the mid-1990s and the number has remained low since then. Most of the repatriates came from FSU countries or from North America, with recent repatriates almost entirely from the Russian Federation and Ukraine. Repatriates receive permanent residence permits and are eventually eligible for naturalisation under the same conditions as other foreigners.

Repatriates’ source countries, 2003-14

- OECD Europe
- Other FSU
- Other
- Russian Federation
- OECD non-Europe



Annual repatriations, 1995-2014



Source: Office of Citizenship and Migration Affairs.

Note: There is no evidence on the retention rate of repatriates. Geopolitical crises may lead to increases in interest from eligible candidates in nearby countries, but the programme is likely to make only a marginal contribution to net migration in the future.

Regarding return support, the Ministry of Economy has identified a number of issues for returnees: information; access to the labour market; weak support for the high-skilled, especially academics and scientists. Among the target areas of action are to provide support for post-graduate study, an e-learning web-based language platform; and support for entrepreneurs, through a business start-up programme. These are all dependent on a diaspora plan which is not fully funded. There appears to be a strong potential for business contacts. The 2014 emigrant survey in 2014 identified some entrepreneurship or business potential in at least one in three post-2000 emigrants from Latvia (Table 2.4), although non-response on certain questions led to exclusion of half the sample. The survey found that 3.6% of the emigrants have a business in Latvia and 23% have plans to establish such a business or to help their employers to establish co-operation with partners in Latvia.

Table 2.4. Many Latvians abroad have the potential to create and develop businesses in Latvia

Share of post-2000 Latvian diaspora who are self-employed, have business plans or businesses, by destination, 2014

Characteristics	United Kingdom	Ireland	Germany	Rest of EEA	Rest of the world	Total
Self-employed, no plans in Latvia	6.8	4.8	10.5	8	16.7	8.2
Plans business or co-operation in Latvia, not self-employed	16	19.9	19	20.6	18	18.1
Self-employed & plans business or links in Latvia	2.1	0.3	2.3	2.7	3.6	2.2
Has a business in Latvia but no further plans	3	1.2	4.6	3.6	3	3.2
Has a business in Latvia and further plans	1.7	0	2.2	2	2.7	1.7
None of the above	70.5	73.8	61.4	63.1	55.9	66.5
Total	100	100	100	100	100	100

Note: For about half of respondents, insufficient information was available to determine business potential. These are excluded.

Source: Hazans, M. (2015), “Emigration from Latvia: Return intention of post-2000 emigrants from Latvia”, paper for the OECD. Based on the project “The emigrant communities of Latvia: National identity, transnational relations, and diaspora politics” implemented by the Institute of Philosophy and Sociology, University of Latvia in co-operation with the Faculty of Economics and Management, University of Latvia and supported by ESF Project 2013/0055/1DP/1.1.1.2.0/13/APIA/VIAA/040.

This proportion is lower in the UK (30%) and Ireland (26%) but higher in Germany (39%) and other non-English-speaking EEA destinations (37%), but especially in non-EEA destinations (44%). The differences between destinations are mainly due to different self-employment rates. Emigrants working in construction are over-represented among those with business potential. The current global business outreach could better target certain sectors and destination countries to ensure that intentions of emigrants are fully supported.

Return policy will not be the main driver of return decisions

Based on what is known about return intentions and those Latvians who have returned, the impact of these support policies is likely to be limited on both the propensity to return and the likelihood that emigrants will not re-depart. Their ability to address emigrant-specific issues is limited. The main reason given for interest in returning to Latvia currently is the presence of family ties. Returning Latvians go to their home areas, often rural areas in which employment opportunities are poor. Returning migrants were often overqualified for their job abroad and have suffered deskilling. Job matching tools could be improved, as could a means for emigrants to stay in the pool of candidates. For equity reasons, salary top-offs for returning workers have not been included in the package of return policy, nor are there facilitations for foreign spouses of returning Latvians. Among the proposals discussed in Latvia is one to write off loans for Latvians who studied abroad in fields of priority interest in Latvia. This would help counterbalance the lower income in Latvia for highly qualified emigrants who studied abroad, but only to the extent they have outstanding loans. Latvians who study in other EU countries are unlikely to have outstanding study-related debt.

Finally, other countries (e.g., Ireland and Poland) have also devoted resources to supporting those emigrants who are most in need and in difficulty – unemployed, ill or otherwise vulnerable – assisting them to return home when they have no resources. While the return of indigent emigrants may not be of immediate economic benefit, it can be an important component of diaspora outreach and has seen uptake where it is available.

3. Latvia has yet to start the uphill battle to attract labour and economic migrants to Latvia

Although labour market slack has yet to vanish, and increasing employment rates is a higher priority, a tight labour market seems likely by the late 2020s due to population declines. The European Commission assumes that there will be net positive migration from 2025 in its 2012 Ageing Report, even if it does not expect this to counteract the decline in the working age population (European Commission, 2012). The Latvian mid-term labour market forecasts (2014) even more optimistically assume net positive migration from 2016, with net positive migration driven by immigration of non-Latvian citizens, rather than returning nationals, from 2020. The Ministry of Economy forecasts net migration of about 5 000 foreigners annually from 2020, with a focus on selective labour migration for gaps in the labour market. This scenario is at odds with both current migration trends and the absence of policy activity in this area.

International migration to Latvia, excluding nationals, is low relative to the OECD average. According to the national definition, inflows of foreigners were equivalent to 1.6 per thousand inhabitants in 2012-13, against outflows of 2.1 in 2012 and 1.5 per thousand in 2013. This compares with permanent migration flows into OECD countries of about 6 per thousand – with much lower outflows – and about 2.5 per thousand – excluding intra-European mobility – in OECD Europe.

Excluding students and focusing on the categories most closely related to economic and labour force activity, most initial temporary permits to Latvia are issued for investors, a category which has increased sharply since its introduction in 2010 (see Box 2.2). Latvia's investor programme is larger than that in other OECD countries, relative to the population and economy, yet does not appear to have led to business development. Most recipients do not actually take up residence in Latvia. Attracting investors as residents involves more than providing visas, since investors are drawn by political, legal and environmental stability and an infrastructure for their families such as international schools.⁸ Visas alone are not enough to bring entrepreneurs and business investors, while the economic climate and context are predominant among considerations. Further, Latvia requires a high level of Latvian language certification for most management positions, posing an obstacle for foreign investors whose business operations require interaction with Latvian authorities and the public. Since one resource of Latvia is its multilingual workforce, every effort should be made to prevent language requirements from hindering development of businesses serving foreign markets.

After investors, the main groups of foreigners receiving permits are workers who do not meet the threshold for the highly qualified, family members of permit holders, and, lastly, skilled employees (Table 2.5).

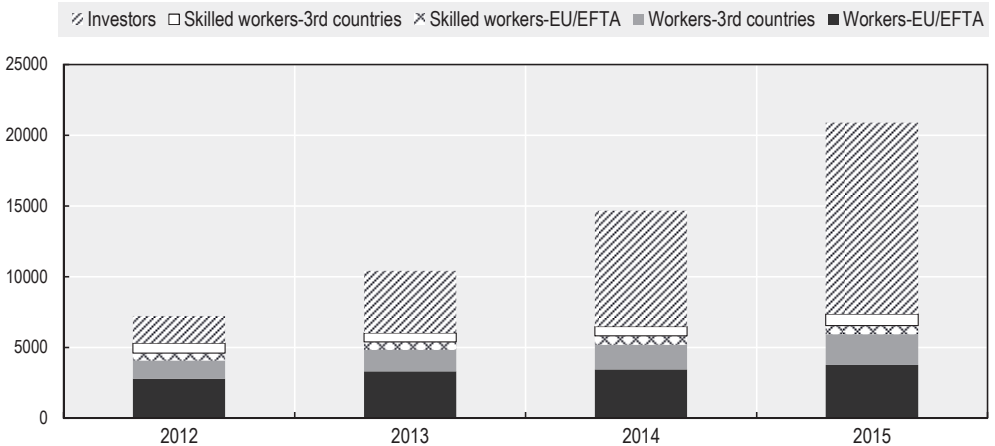
Table 2.5. Foreigners in Latvia: Inflows (first temporary permits) by permit category, selected categories, 2004-14

Category	Nationality	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Workers	EU	311	515	511	921	944	275	162	297	418	447	411
	Non-EU	169	255	508	1648	1411	395	343	627	732	814	1055
Skilled/Employers	EU	90	18	66	89	51	69	126	92	56	53	38
	Non-EU	211	202	221	310	331	169	211	215	177	181	286
Family reunification	EU	88	92	76	79	71	52	43	55	58	63	77
	Non-EU	334	406	409	533	483	322	310	392	441	524	654
Investors	EU							0	0	0	1	0
	Non-EU							155	1674	2575	3904	5605

Source: Data provided by the Office of Citizenship and Migration Affairs.

Most of the increase in temporary permit holders in Latvia has been in the investor category (Figure 2.13). The stock of foreign workers (holding a temporary permit for employment) has increased slightly since 2012. Most foreign workers in Latvia are general workers category rather than the highly skilled category, especially Bulgarian, Belarussian, Ukrainian and Russian nationals working in construction and in the shipbuilding industries.

Figure 2.13. Valid temporary permits, by reason, 1 January 2012-15



Source: Data provided by the Office of Citizenship and Migration Affairs.

In 2015, 2.8% of the resident population in Latvia held a foreign nationality. Most of these were nationals of the Russian Federation, and some were non-citizens who had acquired Russian nationality, rather than migrants. The number of permanent residents has been increasing, from 44 300 in 2012 to 51 000 in 2015; all but 500 of this increase were nationals of the Russian Federation. As 10 000 new permanent residence permits were issued over the period, about 3 000 permanent residents left Latvia in 2012-15.

Box 2.2. Latvia's Investment Permit Scheme has issued permits but not brought many residents

Latvia introduced an investor permit scheme in 2010; it has since become one of the largest schemes in the OECD in terms of annual issuances relative to the size of the economy. When created, investors could buy property (valued at LVL 50 or 100 000, depending on the location); invest in a business; or purchase government bonds. In exchange, they would receive a temporary renewable visa allowing stay in Latvia and granting mobility in the Schengen area. They would be able to work and become eligible for permanent residence under the same conditions as other temporary permit holders. Most investors opted for the real estate purchases, as the threshold was set quite low. In the first four years, there were about 4 000 primary applicants, and about 11 000 family members applying by November 2014, and 11 750 active permits issued. Most (10 000) were for Russians, followed by Chinese, Ukrainian and Uzbek nationals.

Conditions were tightened in 2014, first with the imposition of a quota and the increase in the fees (to EUR 25 000), and then, in September 2014, by higher investment thresholds. The threshold now stands at 250 000 for bonds, 150 000 for real estate and 80 000 for businesses. In practice, according to the Ministry of Interior, most property purchases even under the lower threshold were for high-value property (above 250 000). Investors generally use intermediators, and several banks have produced investment products for foreigners interested in the visa.

The investor permit scheme is considered to have brought in much-needed investment – about EUR 1.2 billion, concentrated in the property sector – but the investment programme cannot be linked with an increase in foreign business. Estimates of the number of investor who actually reside in Latvia range from 7% to 10% of the total holding permits, although permit holders renew assiduously their permits every year. This reduces the benefit from expenditures by high net worth individuals.

Investor programmes such as the Latvian one have been put in place in many OECD countries, but are difficult to evaluate (OECD, 2011). Due diligence on the source of capital is complex. While there is a competition among countries to offer favourable terms to investors, it can be difficult to set a price on the value of a residence permit – especially if it leads to long-term residence, naturalisation and family members settling in the country. Relative to its size, Latvia issues far more investor permits than most OECD countries, and with a lower threshold. Spain, for example, introduced a similar visa in 2009, setting the property value threshold at EUR 160 000. This was lifted to 500 000 in 2013. Spain's bond purchase threshold was set at 2 million, and investment projects required to be “of general interest”. Spain issued 490 permits to property-buyers in the first 15 months of the higher threshold (mostly buyers from China). Portugal also introduced a property-purchase visa, in 2012, with a threshold of EUR 500 000. In the first 30 months, about 1 800 visas were issued for real estate purchases, mostly to Chinese buyers. The United Kingdom also has an investment visa, set at GBP 1 million; it issues a record 1 170 in 2014 annually. Following advice from the UK Migration Advisory Committee, the minimum was doubled in 2015. The United Kingdom also has a visa for entrepreneurs with a much lower threshold – GBP 50 000 – although other criteria are strict. More than 1 000 entrepreneurs were admitted annually in 2013 and 2014.

The migration policy framework is under-developed

The policy environment for modernising the labour migration framework in Latvia is unfavourable. Among EU countries, public opinion regarding migration is consistently among the most negative, whether measured in the Eurobarometer survey or in national polls (e.g., SKDS polling). In the November 2014 Eurobarometer survey, 79% of Latvian respondents had a negative opinion of non-EU migration to Latvia, and 63% had a negative opinion of EU migration, making Latvia the most hostile to immigration among EU countries. In the European Social Survey, Latvia is one of the countries where migration is least likely to be seen as having a positive economic effect. Opinion surveys also indicate a generally negative attitude towards integration. Akule (2007) attributes this to association with the integration of the Russian-speaking population and a perception that immigrants are a source of problems. At the same time, immigration is not considered to be one of the major issues facing Latvia, which is not surprising given the very low levels of recent immigration to Latvia.

As a result, the political sphere in Latvia has not considered immigration of non-Latvian citizens to be an important policy issue, and even in the context of drastic declines in the working age population, policy initiatives in the area have been limited and largely driven by European directives, requirements and funding, or in reference to specific initiatives not related to demographic development or the labour market. The admission of high-skilled foreign workers is subject to fewer restrictions than that of less qualified foreign workers, but the country takes no further efforts to be attractive, such as accelerated access to permanent residence or relaxed family reunification conditions. Concern over maintaining the majority of the “titular nation” may explain some of the reluctance (e.g., Mensah, 2010; Akule, 2007). Even in a context of low immigration, political parties are resistant to any initiatives which might favour immigration. The paradox for Latvia is that the most likely recruitment pool for labour migrants by Latvian employers is the CIS countries: geographically close, with well-known education systems and the use of a language still widely spoken in Latvia. These countries still represent a large share of labour migrants. In light of the policy objective to strengthen the use of the Latvian language, explicitly targeting recruitment from this pool would require more political consensus.

The difficulty of policy making in this area is reflected in the discussion of a Labour Migration Concept, which began in 2006. A first draft Concept was drawn up for 2007, but was not approved. Elements of the draft concept have been absorbed into legislation, particularly a reduction in permit fees (Silina-Osmane, 2010). Discussion of a general migration concept is still

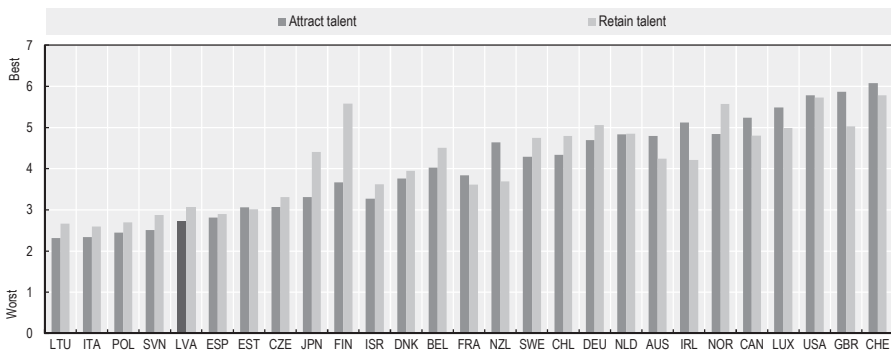
continuing in 2015. Political and historical issues thus hinder access to what would otherwise be natural labour recruitment channels in post-Soviet countries.

Latvia's approach contrasts with the policy initiatives taken, and attention given, in neighbouring Estonia, which faces similar – albeit less severe – challenges to sustaining the working age population. Basic infrastructure to attract skilled migrants has been put in place – an information portal, for example – as well as policy measures such as job search extensions for international graduates, and facilitations for skilled workers in obtaining residence permits. A report from the Estonian National Audit Office (2014) examined migration policy choices in light of the structural difficulties of attracting foreign workers to Estonia, and identified additional areas for policy action.

Attracting highly skilled migrants – even if the policy framework were more favourable – would still be difficult. The Global Competitiveness Index provides a measure on the perception of a country as able to attract and retain talent. Latvia scores poorly on both counts relative to other OECD countries, although its neighbours fare similarly (Figure 2.14).

Figure 2.14. Latvian entrepreneurs do not think Latvia can attract or retain talent

Capacity of selected countries to attract or retain talent, 2013-14



Source: Global Competitiveness Index, 2014-2015 edition, http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2014-15.pdf.

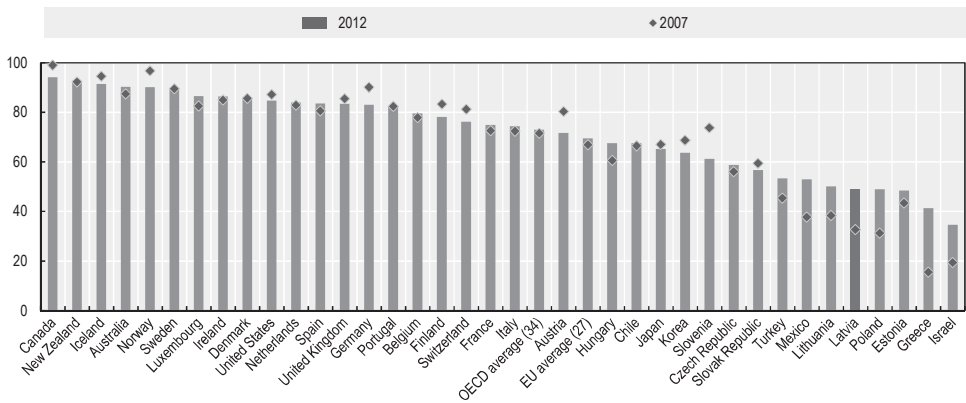
Latvian respondents also do not see their country as a good destination for migrants from other countries (Figure 2.15).

The permit framework in Latvia is largely determined by the requirements and standards of European directives, and does not in itself present an obstacle to labour migration. A salary threshold for work permits is set at the average monthly salary (about EUR 800), and a labour market

test – involving a one-month publication requirement with the public employment services – is imposed. Contracts must meet average wage requirements, registration requirements, as well as any conditions applying to regulated professions where relevant. Temporary foreign workers are not covered by the public health insurance scheme, even if they are regularly employed. The sectors which were driving work-permit requests during the boom years – construction, shipbuilding and even restaurants – have seen large declines in hiring. Most labour migrants are technical trade staff on shorter term positions. R&D is not a driver of their recruitment: the research sector has shrivelled since 1991, from 16 000 employees to 4 000, so that this is not a driver of high skilled migration. To combat the risk of undeclared work, certain sectors (construction, forestry and security) have an ID card requirement, showing the name of the worker and the subcontractor.⁹ This measure was not developed specifically to prevent abuses of foreign workers, but such requirements in other OECD countries (Finland and Norway, for example) have improved compliance, reduced chain contractor abuse, and provided greater protection for vulnerable foreign workers.

Figure 2.15. Latvians do not think that their country is a good place for migrants from other countries

Share of the population who think that their city or area of residence is a good place for migrants from other countries to live, 2007 and 2012



Source: Data provided by the Gallup World Poll 2012.

For all professions, the standard Latvian language requirements are applied to foreign workers; these requirements apply, as noted, to many occupations. Language requirements are applied to foreign workers on temporary permits only in a few non-European OECD countries. Most

countries see such requirements as potentially limiting investment by multinationals or export-oriented firms. In Latvia, however, there remains scope for recruiting non-Latvian speaking foreign workers in positions not considered of public interest, as long as these workers have no communication with the public or with government authorities. It would thus be possible for businesses serving clients abroad (call centres, service firms) to hire staff working in foreign languages. Likewise, it would be possible to recruit workers for back-office or internal tasks as long as the managers or foremen meet the official language requirements. Indeed, there is no evidence that most new recruits from abroad receiving work permits have Latvian language skills.

Regarding the integration framework, until now, most resources devoted to integration of immigrants have been in response to European guidelines and funding. In fact, even the crude measures provided by the legislative benchmarking exercise MIPEX show that the Latvian framework for integration is, while compliant with European obligations, the least favourable regulatory framework for integration in the European Union (MIPEX 2014). European and other external funding is the main support for language and other initiatives targeted at third-country nationals.

A weak integration framework has implications for the return initiatives promoted for Latvians abroad. As noted above, the survey of Latvians abroad conducted in 2014 estimated that about 50 000 Latvians abroad had a non-Latvian partner. Return to Latvia would require integrating this spouse (usually a foreign husband) and any children; this is one of the largest obstacles to return. Attention to structures and programmes for the integration of foreign workers would extend to this group and could reduce this obstacle. As Latvians abroad with a foreign partner are disproportionately highly educated (62% compared with 42% for those with no foreign partner), they are a resource to attract to address skills shortages.

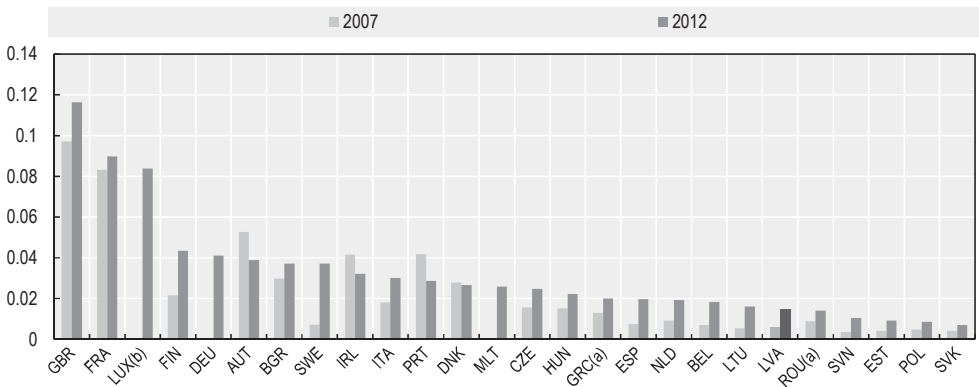
The potential resource represented by international students is underutilised

There are many reasons why most OECD countries are making increased efforts to attract international students. In countries where there are shrinking student enrolments, as well as closure of higher education institutions, attracting students from abroad can help maintain enrolment and institutions. High fees for foreign students also contribute to university budgets in many countries. In Latvia, declining enrolment has not yet led to a decline in the number of institutions, and higher fees for non-EU international students are set only to take into account the additional cost of services such as pre-course preparation and support during studies. The overall cost, as noted above, remains relatively competitive (Figure 2.2).

However, internationalisation of higher education is one of the Ministry of Education and Sciences policy development agenda. Further, the Sustainable Development Strategy of Latvia to 2030 sets a goal of raising the share of foreign students in higher education institutions to at least 10%.¹⁰ The State Education Development Agency provides information and administrates scholarships¹¹ for international students interested in studying in Latvia. Latvia still has a very low number of international students relative to major European destinations (Figure 2.16), but comparable to the enrolment in neighbouring countries.

Figure 2.16. There are relatively few international students in higher education

Share of international students among total enrolment, 2007 and 2012



a) Most recent values from 2011.

b) Most recent values from 2010.

Source: UNESCO Institute for Statistics, education database, <http://dx.doi.org/10.1787/d3abd071-en>.

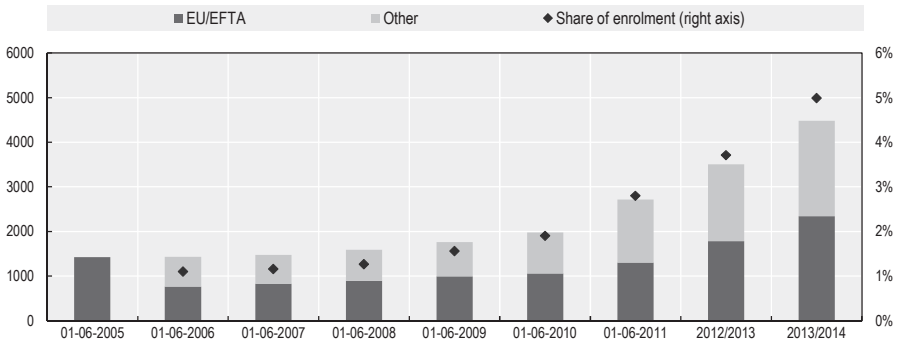
Recent years have seen a sharp increase in the number of foreign students (Figure 2.17), from about 1% in the post-accession years to about 5% of enrolment at the end of 2014 (including resident non-citizens, about 6.4%). In part this reflects falling overall enrolment.

Of the about 5 000 international students in 2014, 1 000 were studying medicine, and about 800 engineering. Many of these students are in programmes where the language of instruction is Latvian, and in fact must learn Latvian to enrol. This group of graduates is a potential resource for Latvia, but very few international students remain in Latvia following their studies. From 2008 to 2011, only 13 third-country nationals remained in Latvia after their studies for the purpose of employment. There is no legislation favouring the transition from study to employment. No job search period is provided to international students graduating, nor is there a labour market test exemption. This is in contrast to the policy trend in most

OECD countries (OECD, 2014) and reflects the general lack of interest or support for labour migration policy in Latvia. There is an objective in the 2014-20 ESF to retain 90 foreign PhD graduates as academics; to achieve this would represent a major improvement over past results.

Figure 2.17. The number of international students is increasing

International students by nationality, 2005-14



Note: No nationality data available for 2005.

Source: Data provided by the Central Statistical Bureau.

Usually, requiring foreign students to study in the national language is a factor encouraging their post-graduate stay. This does not appear to be the case for Latvia, even though language policies currently require students to study in Latvian (20% of the credit points of a study programme may be implemented in other EU official languages), and foreign academic staff also need to develop proficiency in Latvian (visiting lecturers are exempt). Changes to allow the use of EU and other languages at public tertiary education institutions, ease requirements concerning Latvian language competence, and simplify visa and residence permit procedures would increase the internationalisation of higher education. One objective is to provide more PhDs with an opportunity to stay after graduation as foreign staff, who are exempt from language requirements. Without a corresponding relaxation of language requirements in the labour market, however, more instruction in EU official languages would probably not help post-graduate retention, especially in the longer term.

A favourable policy framework can help improve the stay rates of international students. The stay rate for employment for international students in Estonia, for example, is 24% for EU nationals and 17% for third-country nationals (National Audit Office, 2015), although only about one-third of these were still in employment in Estonia after 18 months. This suggests that a 10% overall retention rate is not an unreasonable target for Latvia. While increasing the retention of international students cannot

compensate for the declining tertiary-educated youth workforce, it is an additional way to benefit from the internationalisation of the tertiary sector and should not be ignored.

The language training infrastructure in Latvia can help with integration

Latvia encourages proficiency in the official language through both restrictive measures and widespread availability of language courses. As Latvian language skills are essential and must be certified for many occupations, the minimum level of language proficiency must be acquired prior to employment, rather than on-the-job. In most OECD countries, employers have more discretion in deciding whether workers have an appropriate language level for jobs – especially less skilled jobs. There is a clear trade-off between encouraging rapid labour market entry and postponing language acquisition; in general, longer-term employment outcomes are better where barriers to initial employment are lower (OECD, 2014). Nonetheless, immigrants in Latvia can take advantage of a well-developed existing language training infrastructure designed to increase Latvian language knowledge among all residents.

There are a number of different services providing Latvian language education, including the Latvian language education provided by the Language Agency through diaspora outreach and the small integration centre. Most Latvian language education is provided through the PES to the unemployed.¹² 65% of all those taking the National Certification Exam do so after a PES course. Its focus has been on residents who do not speak Latvian, rather than immigrants.¹³ Until recently, most of the PES demand for language training has been from participants with no Latvian skills, but this has shifted to those with basic Latvian skills seeking to improve them.¹⁴ The number of participants in PES language training courses peaked in 2010 at 11 000, but has fallen since.

The PES spent EUR 1.7 million on Latvian language courses in 2014, when more than 6 400 participants took Latvian language courses.¹⁵ About two-thirds of the participants were unemployed. Language training is conducted through tenders. All VET and other professional training offered through PES subsidies must be conducted in Latvian, so Latvian language classes are the first step for any professional training through private training centres. Participants seeking basic courses – e.g., computer skills, or English – must first pass a basic Latvian language class, something which is not always simple and pass rates can be low, especially for older students. The pass rate in 2014 was 85% for level A, 79% for level B and 69% for level C. The PES pays providers for the first three levels of language instruction (150 hours each, including 30 hours of “applied Business Latvian”). The PES does not set a pass rate for classes to be funded, so that

there is no incentive to pass students who do not qualify. The PES courses occupy a privileged position relative to other private providers, since only the PES courses provide certificates (others give an attestation). Latvian language classes are also offered under the ESF Youth Guarantee.

The Society Integration Foundation conducts outreach to third-country nationals and non-citizens. It had set a target of 600 per year for language training, but fewer than 50 third-country students have actually undertaken the programme, and these are largely re-immigrants and their children, non-citizens who have returned after a period abroad. Overall, the SIF has more than 1 000 non-citizens participating in its programmes. One of the main sources of funding for integration services in Latvia are the European funds earmarked for integration of third-country nationals.

Latvian language certification is required for many occupations in Latvia, including most skilled and semi-skilled occupations. Concrete language requirements vary. The 2000 State Language Law extends the requirement to occupations which affect the “lawful interests of the public (public security, health, morality, health care, protection of consumer rights and employment rights, safety in the work place and public administration supervision)”. The absolute minimum threshold applied to occupations is B2 in the Common European Framework (CEF). For jobs considered of public interest – a list of 2 400 occupations, which expanded rather than contracted in recent years – most (2 000) have a minimum level of C1¹⁶. This includes many technical occupations in IT and engineering, limiting the possibility of using a foreign-language staff. Further, for a number of occupations, C2 – near-native proficiency – is required.¹⁷ Third-country nationals do take language courses, especially for university admission: enrolment requires C1 level. In 2014, there were about 400 third-country nationals who took the university admission test in the Latvian language, mostly from Russia, China and Ukraine.

The interaction of the official efforts to limit the use of the Russian language in the public sphere can run up against the fact that certain parts of the private sector labour market still sometimes demand Russian language skills. According to a 2012 Eurobarometer survey (European Commission, 2012), when asked which two languages other than their mother tongue were important to learn for their personal development, 70% of Latvian residents who were not native Russian speakers thought it was useful to learn Russian for their personal development. Only English was ranked higher, at 75% of all residents. When asked about what languages would be useful for their children, two-thirds of non-native Russian speakers said Russian language was useful, a small increase from 2005. As shown, the Latvian language skills of the Russian-speaking minority have improved since 1990, but the Russian language skills of the Latvian majority have grown weaker. The share of native Latvian speakers age 15 and over able to

conduct a conversation in Russian fell from 70% in 2005 to 67% in 2012 (European Commission, 2012). 27% said they spoke “very good” Russian. Of those who spoke Russian, 42% used it on a near-daily basis. Bilingual ability may be expected for service sector jobs in Riga, although 2012 regulations prohibit vacancy listings from indicating Russian language skills as a requisite, unless it can be proven essential.¹⁸ It is not possible to look at the returns to bilingualism, as there are no datasets providing information on bilingualism, only on household use of language (see Chapter 1). The PES offer Russian language courses as part of their training for the unemployed.

Private sector demand for bilingual Latvian-Russian staff has implications for Latvian emigrants and their prospects for return. Many of the potential returnees today grew up in the 1990s when Russian language education in school had lost its priority (English became the required second language, and only at sixth grade could students choose a third language) in schools where instruction was in the Latvian language. For those who emigrated from rural areas, especially, Russian language skills are lacking, which can be an obstacle to their labour market re-integration, although courses are provided by the PES.

More broadly, as noted, restrictions on the public use of the Russian language may also affect the ability to Latvia to attract third-country labour migrants from what would be – in the absence of political reluctance and reservations – the natural pool of reference for labour migrants: former Soviet countries. The 2014 Estonian National Audit Office report noted that in the case of Estonia, poor information provision for residents who speak Russian was preventing recruitment and integration of Russians. Since a large number of immigrants to Estonia are Russian speakers, they are penalised by linguistic isolation from services and the labour market. In practice, public sector website information in Latvia is often provided in the Russian language, and public offices (e.g., social workers or tax agents) usually have Russian-speaking staff, so that a Russian-speaking public is not isolated. This should be considered a strong point for helping any Russian-speaking immigrants in integration, although Latvia does not promote this persistent multilingual capacity as a factor of attraction.

Finally, language requirements for occupations should be measured against shortages, especially in technical and scientific fields where personnel are highly mobile and the workplace language is often English. Attention should be given to whether high language thresholds for occupations in hospitality and tourism especially are appropriate, and whether enforcement is practical or effective.

Notes

1. Other stakeholders are involved. Past performance by institutions as well as budget constraints are taken into account. The Ministry of Education and Science (MoES) accepts other ministries' recommendations for places in tertiary education institutions that fall under their supervision.
2. Fees for non-EU nationals are generally higher; see below.
3. This does not include Erasmus exchange students from Latvia, of whom there were 2 100 in 2011-12.
4. Hazans (2013) separates the post-2000 emigrants into three waves: pre-accession; post-accession; and crisis-driven. Their characteristics are different, but most left for economic opportunities elsewhere.
5. "The emigrant communities of Latvia: National identity, transnational relations, and diaspora politics" implemented by the Institute of Philosophy and Sociology, the University of Latvia in co-operation with the Faculty of Economics and Management, University of Latvia and supported by the European Social Fund Project 2013/0055/1DP/1.1.1.2.0/13/APIA/VIAA/040.
6. The total – 120 000 – corresponds to the forecast new vacancies projected by 2030, according to the 2012 Ministry of Economics scenario – vacancies the ministry aims to fill preferentially by return migrants rather than new immigrants.
7. There are also three summer schools (one in Australia and two in the United States).
8. Latvia does have two international schools in Riga.
9. The security sector is, however, not authorised for foreigners and non-citizens.
10. As part of the internationalisation of the higher education sector, Latvia has also set a target of 5% of foreign staff.
11. In 2015/16, Latvia provided about 50 scholarships for studies to international students.
12. In previous years, life-long learning language courses supported by the ESF were also offered for employed persons.

13. According to demand, Latvian language courses have also been offered with English as the language of instruction.
14. Outside of the Russian-speaking zones, Russian language niches survive in some post-Soviet industrial contexts, as long as the factory is still operating. The language requirements do not apply for many occupations as long as there is no public interest and the job does not require interaction with the general public or with public authorities. For example, in Liepaja, the closure of the metalwork plant forced a long-standing Russian-speaking community of 200 workers with no Latvian skills to enter the broader labour market and thus to seek to improve language skills.
15. The PES also subsidises English language courses (a prerequisite is knowledge of Latvian). One of the main motivations among requests for subsidised English-language courses is to prepare for employment abroad. According to research among EURES clients in Latvia, foreign language knowledge among those seeking jobs abroad improved markedly during the crisis period (Ribakova, 2009).
16. Some critics have taken issue with the expansion of this “public interest” list to include professions where the need for C1-level language is not immediately evident, such as piercing specialist, sports instructor, photographer, electrician, kitchen chef, etc. (Council of Europe, 2012)
17. Very strict language requirements are allowed under EU rules, but should not be disproportionate; the European Union is not concerned with employment access for nationals as much as with barriers to mobility (free movement of EU nationals for employment).
18. According to 2012 amendments to the law, “it is prohibited to indicate a skill of specific foreign language in a job advertisement, except when it is justifiably necessary for the performance of work duties”.

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Chapter 3

A more productive labour force in Latvia

With a challenging demographic outlook, future growth prospects rest on Latvia's ability to make the most of its available human resources. Although labour productivity has increased significantly since 2000, a number of structural barriers slow a further narrowing of the remaining gap relative to well-performing OECD countries. Factors that hold back Latvia's productivity growth include a very sizable shadow economy, long-term joblessness, as well as significant skills shortages and mismatch. To tackle productivity barriers and reduce labour market inequality, active labour market policies should be strengthened and upskilling strategies should be more directly linked with the needs of employers. Efforts to curb informality and under-reporting of earnings should be maintained and stepped up further, including by reviewing a range of regulatory provisions that may push some groups of workers into informal employment.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

1. Making the most of Latvia's human capital: Challenges ahead

Despite its remarkable short-term resilience, the Latvian labour market is characterised by a number of structural challenges that may prevent it from attaining its full potential. After a deep crisis and some four years of recovery, unemployment remains above the OECD average and around 40% above the pre-recession low. Long-term unemployment is particularly high (43.1% of the unemployed have been out of work for one year or more, compared to an OECD average of 35.2%), indicating that many people continue to face significant labour market obstacles.

The assessment in Chapter 1 shows that the situation is especially difficult in Latvia's peripheral regions, where unemployment continues to be much higher than in Riga (over twice as high in the poorest region of Latgale, see Figure 1.25). Older workers, who have faced specific challenges arising from necessary restructuring and changing skill requirements, and youth, have been hit particularly hard by the crisis. Unemployment among workers aged 55 to 64 is 9.9%, nearly twice the OECD average. Unlike in most OECD countries, labour market inactivity among older working age individuals has also increased strongly relative to the pre-crisis period and now stands at 37.4%. The significant share of young people not in employment, education or training (15.2%) is a major concern, as being excluded from the labour market at a young age can be extremely detrimental for workers' skills and future career prospects. Low-skilled workers face very low earnings and unstable employment. Additional challenges exist among national minorities and non-citizens who frequently belong to the broader risk groups mentioned above (for instance, national minorities account for 54.5% of the population in Latgale). But as shown in Chapters 1 and 2, they also face labour market hurdles that are minority-specific.

With a sizeable productivity gap relative to OECD countries, Latvia needs to make the most out of its human resources. The worrying demographic situation, with a shrinking population and a looming risk of skill shortages, makes it all the more urgent to tackle employment market barriers, to ensure a good match between jobs and workers' existing skills, and to enable Latvian workers to build new skills and adapt them to the evolving needs of the labour market.

Following an overview of Latvia's labour market policy setting, this chapter discusses strategies to activate people into formal employment, and ensure workers' existing skills are employed productively (Section 2), policy measures to improve workers' skills before they enter the labour market and at all stages during their careers (Section 3), and specific hurdles for youth and older workers (Section 4).

Key elements of labour market policies and institutions in Latvia

Jobseeker registration and active labour market policies (ALMPs) are administered by the State Employment Agency (SEA), which is placed under the authority of the Minister of Welfare, and has 28 regional offices across the country. In recent years Latvia has devoted increasing attention to ALMPs, which range from career counselling and job placement services to training programmes and hiring subsidies. Several of these initiatives, such as the Youth Guarantee scheme, are specifically targeted to disadvantaged groups. But despite still challenging labour market conditions, overall ALMP spending is low (0.22% of GDP, compared with an OECD average of 0.55% in 2013) and employment services can be difficult to access as a result, especially for more disadvantaged workers. Regular contact between jobseekers and employment offices is hampered by very low coverage of unemployment benefits (see Chapter 4).

Trade union density is low and has been declining since the 1990s. The Trade Union Confederation of Latvia (LBAS) has around 100 000 members, down from 275 000 in 1995, and 20 industry-level affiliate trade unions. In 2015, only around 14% of Latvian workers belonged to a trade union and Latvia is among the European countries with the lowest incidence of official employee representation in establishments of all sizes (Eurofound, 2015). Employee representation at the workplace is either through unions or through elected workplace representatives. However, with low levels of union membership, particularly in the private sector, and reluctance among employees to elect workplace representatives, most workplaces have no employee representation at all. Even though collective bargaining can take place at industry, regional and company/organisational level, collective agreements at industry level are rare and thresholds for extending collective agreements are relatively high (50% of employees in a given sector, or employer turnover of at least 60% of the entire sector). Extensions currently are in place only for three essentially public sectors: railway workers, teachers and health. Overall, only a relatively small minority of salaried workers (about 20% in 2011) are covered by collective agreements (Visser, 2011). There is no reliable information on the use of collective agreements in small and medium enterprises (SMEs), which account for 99.6% of all enterprises.

Latvia has a unified statutory minimum wage; unlike in many OECD countries, there is no differentiation by region or group of workers. Levels are reviewed every year by the National Tripartite Cooperation Council, a body with representatives of the government and the social partners. With high inequality, relatively weak collective bargaining and a large number of low-wage earners, the minimum wage affects a sizeable number of workers and therefore has a major role in the overall wage-setting process. A recent

OECD study shows that, at around 14%, Latvia has a higher share of formal-sector workers earning at or below the minimum wage than any other European OECD countries (OECD, 2015d). A special aspect of minimum-wage policy in Latvia is its link with strategies to counter wage underreporting: one prominent objective of minimum-wage policy in recent years has been to make underreporting in the form of envelope wages more difficult by increasing the minimum that firms must pay (“reducing the size of the envelope”).

Income taxation in Latvia is less progressive than in the average OECD country (see Chapter 4) and places a relatively heavy burden on minimum-wage workers and other low-wage earners. This creates significant disincentives for formal employment and may hamper efforts to address under-reporting.

Employment protection legislation (EPL) is slightly more stringent than the OECD average.¹ However, it does not appear to constitute a major constraint to rapid labour market adjustments. The pattern is consistent with arguments that non-compliance with applicable rules are a major reason behind *de-facto* labour market flexibility in Latvia (Krasnopjorovs, 2013; Zasova, 2011). Recent reforms were aimed at increasing *de-jure* flexibility, including by an extension of the period over which temporary contracts can be renewed from three to five years. Yet, the share of temporary employment contracts is nevertheless small by international comparison (3.2%, compared to an OECD average of 11.1%).² Upon dismissal, all workers are entitled to severance pay, including employees on short-term contracts, who receive one month of their average salary as compensation.³ For those on short-term contracts, this is relatively generous by OECD standards, while compensations for dismissal of workers with longer tenure is around the OECD average (*OECD Employment Protection Legislation Database*). These provisions therefore reduce the relative cost advantage of short-term contracts to employers, and this may be one reason for the low incidence of temporary employment contracts.

The vocational education and training (VET) system is currently undergoing a major transition, from a highly centralised model to a more flexible one that seeks to promote collaboration between employers and schools. At the same time, provision has been consolidated by significantly reducing the number of VET schools, creating regional VET “hubs” (large Vocational Education Competence Centres providing vocational education in a wide range of subjects, as well as support for smaller training institutions in more remote areas) and focussing infrastructure investments on these hubs.⁴ In addition, VET curricula have been significantly revised in co-operation with employers, in the framework of Sectoral Expert Councils, which facilitate co-operation between social partners, educational

institutions and the government, in assessing future skill needs. These reforms and ongoing legislative initiatives (such as amendments to the Vocational Education Law that entered into force in May 2015) move in the right direction. Nonetheless, important barriers to deepening and extending VET and ensuring active employer participation remain. For instance, apprenticeships can only be either completely unpaid, or they require employers to pay the minimum wage, resulting in high labour costs. The share of workers participating in lifelong learning is low by international standards (see Figure 3.11). Overall, work-based learning schemes and formal apprenticeships remain comparatively under-developed.

2. Helping workers find productive employment in the formal sector

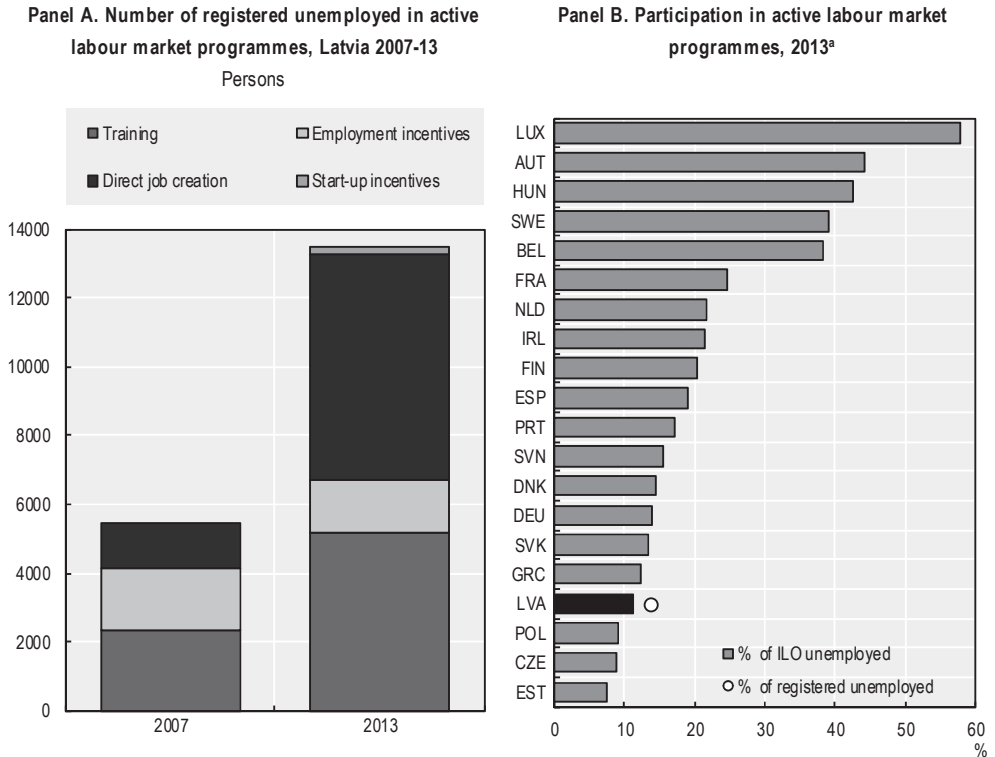
An effective policy mix to help Latvian workers find productive employment in the formal sector needs to address a number of key challenges. First, active labour market policies should be strengthened and better focused, consolidating the programmes that have worked best (e.g. on-the-job training) while reviewing resource allocation to those that are typically found to be less cost-effective (e.g. public works programmes or hiring subsidies). Overall funding levels for ALMPs should be adequate and resources adaptive to labour market conditions, in order to allow for effective long-term planning. Second, efforts to curb informality and encourage accurate wage reporting should be sustained and intensified. Third, and related, adverse incentives for formal employment due to relatively high tax burdens on low-wage earners should be addressed more decisively. Finally, careful attention should be paid to the possibility that minimum-wage hikes could lead to the exclusion of the least productive workers from the formal labour market.

Strengthening active labour market policies

Participation in employment support programmes has increased but remains low

Over the past decade, the number of participants in ALMPs has increased significantly, from 5 442 jobseekers in 2007 to almost 13 467 in 2013 (Figure 3.1, Panel A). In the context of the strong increase of unemployment during the crisis, the rise in programme participation was largely due to a significant expansion of direct job creation programmes and training, while participation in employment incentive schemes (such as wage subsidies), fell over the period.

Figure 3.1. Participation in ALMPs has increased, but remains low by international standards



Note: ILO unemployment comprises all persons not in paid employment (or self-employment) during the week prior to the survey, who are available for work during the next two weeks and who have actively sought work in the past four weeks or had already found a job to start within the next three months.

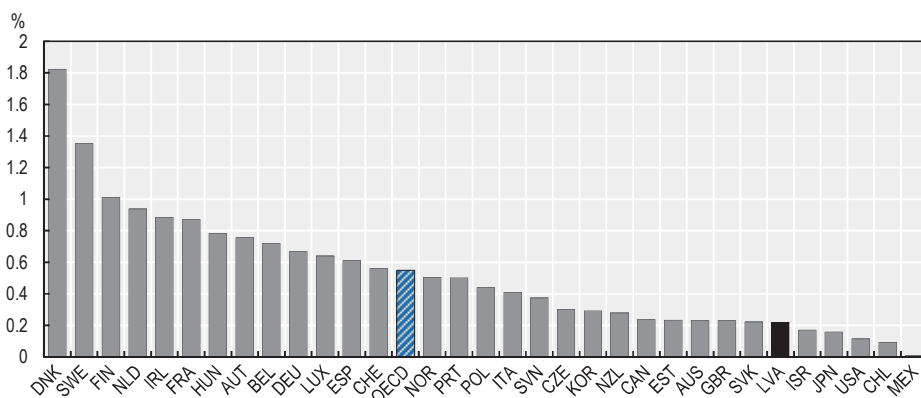
a) 2010 for Greece; 2011 for France and Ireland; 2012 for Austria, the Czech Republic, Hungary, Luxembourg, Portugal and Spain.

Source: OECD/Eurostat Database on Labour Market Programmes, <http://dx.doi.org/10.1787/data-00312-en>.

However, both participation rates and total spending on ALMPs remain low by international standards. Participation among the unemployed is often several times higher in other European countries (Figure 3.1, Panel B). Not all Latvians who are actively seeking and available for work (the “ILO unemployed”) are registered as unemployed; ALMP participation is therefore somewhat lower when assessed against the internationally

comparable ILO definition of unemployment. In 2013, only five OECD countries spent lower shares of GDP on ALMPs; despite above-average unemployment, Latvia's share was less than half the OECD average (Figure 3.2).

Figure 3.2. Expenditure on ALMPs is low



Source: OECD/EC Labour Market Programme Database, Labour market programmes: Expenditure and participants (database).

As in most OECD countries, ALMP budgets in Latvia have undergone deep cuts since the beginning of the crisis (Figure 3.3, Panel A). As unemployment increased, ALMP resources per jobseeker were severely affected by the budget pressures resulting from the drastic fiscal consolidation programme during the early phase of the crisis (Figure 3.3, Panel B). Spending reductions have been particularly sharp in the area of labour market services (e.g. placement and career guidance), reflecting significant budget cuts for public employment services. In 2009, the SEA underwent a 24% reduction in its operational budget compared with 2008, with severe repercussions on both staff numbers and remuneration, at a time when unemployment was still growing rapidly (De Jong and Vanags, 2009). Caseloads per SEA officers surged as a result (to around 200 jobseekers per counsellor in 2009), reducing their capacity to devise and monitor effective activation strategies. Some evidence exists of jobseekers cycling through the system, periodically renewing benefits, without adequate verification from caseworkers (OECD, 2015a). Despite the recent fall in unemployment, the situation remains challenging, especially since those who remain unemployed are likely to be the hardest to place.⁵

Capacity constraints have also affected municipalities as the primary providers of social services (European Commission, 2014a),⁶ with negative

implications for their ability to contribute to activation strategies that require addressing multiple barriers. Social workers are in principle well-placed to assess and address employment problems that are primarily a result of health, social or family-related problems. But to be effective, this requires adequate resources and close co-ordination with the SEA. Partly to align activation strategies between different levels of government, a newly launched collaborative programme between municipalities and the Ministry of Welfare provides specific training to social workers.⁷

Latvian ALMPs have relied heavily on external funding sources, notably the European Social Fund. While this provided crucial resources during the crisis, it arguably complicates longer-term budget planning. In 2014, and well into Latvia’s recovery, the ESF still covered 80% of total ALMP expenditures. A more structured approach to financing ALMPs, with regular and more sizeable allocations from the state budget, would contribute to maintaining adequate resources for this crucial area of labour market policy throughout the economic cycle. For instance, in view of Latvia’s volatile labour market, there is a strong case for introducing some form of automatic link between LMP budgets and labour market conditions, as in place in Australia, Denmark and Switzerland (OECD, 2009).

Figure 3.3. Despite a large increase in unemployment, ALMP spending declined

Panel A. Annualised average percentage change in real expenditure, 2007-13^a

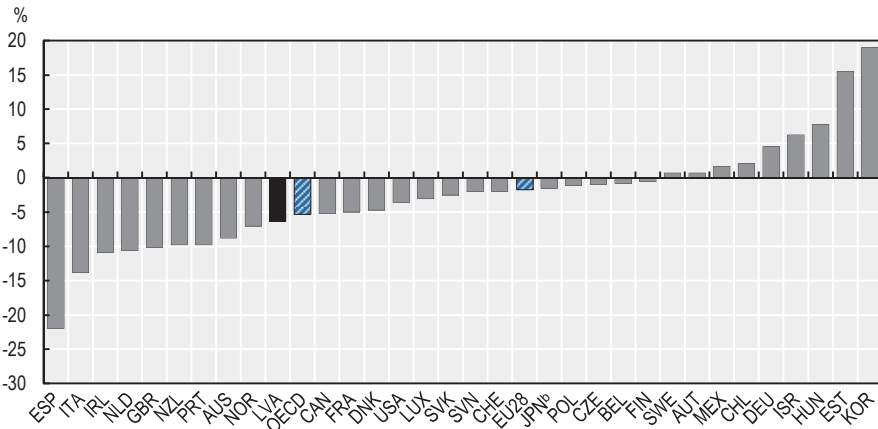
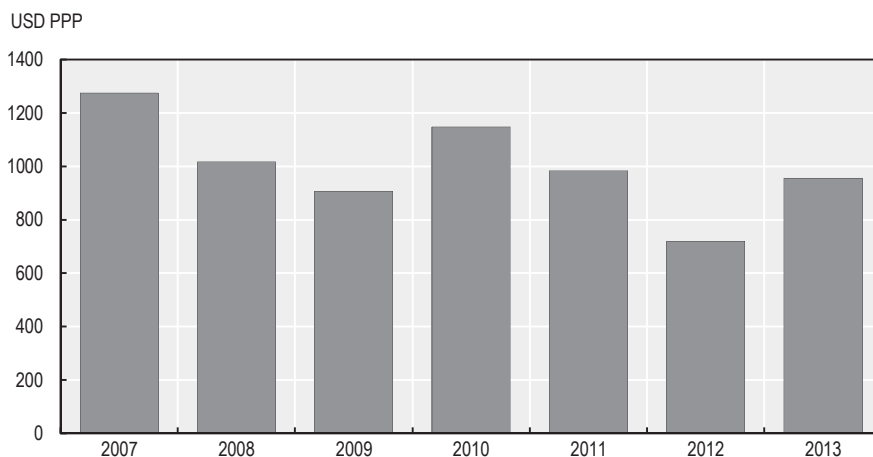


Figure 3.3. Despite a large increase in unemployment, ALMP spending declined (cont.)

Panel B. ALMP expenditures per registered unemployed in Latvia
USD, constant PPP, constant prices, OECD reference year (2010)



Note: OECD is the weighted average of the 31 OECD countries reported in this figure (excluding Greece, Iceland and Turkey).

a) 2008-13 for Chile; 2007-11 for Israel and the United Kingdom; 2007-12 for France, Korea, New Zealand, Poland and Spain. Fiscal years for Australia (starting on 1 July), Canada (starting on 1 April), Japan (starting on 1 April), New Zealand (starting on 1 July), the United Kingdom (starting on 1 April), and the United States (starting on 1 October). Real expenditure in USD at constant (PPP) prices (2010).

b) Short-time work schemes (Employment Adjustment Subsidies and Employment Continuation Benefit of the Employment Insurance) are included in the active labour market spending for Japan.

Data on unemployment for Israel have been adjusted to be consistent with the data published since 2012 using the chaining coefficient provided by the national authorities.

Source: OECD estimates based on the *OECD/EC Labour Market Programme Database*, Labour market programmes: Expenditure and participants (database), <http://dx.doi.org/10.1787/data-00312-en> and OECD Short-Term Labour Market Statistics (database), <http://dx.doi.org/10.1787/data-00046-en>.

Public work programmes work best as temporary emergence measures but still account for a substantial share of ALMP resources

Among the different types of ALMPs, public works programmes (included in the “direct job creation” category in Figure 3.1) have been scaled up the most during the crisis. They served as a crucial income safety net during the initial phase of the recession (see Chapter 4) and remained a significant part of ALMP spending during the recovery (nearly 30% in 2013). Together with Hungary and Slovenia, Latvia is among the EU countries where this type of measure received the most funding

(Eurostat, 2015). Social welfare officers cite anecdotal evidence that temporary public works programmes have worked well for some of the most disadvantaged jobseekers, providing participants with valuable work experience and contacts that lead to regular employment. More systematic assessments of Workplaces with Stipends, a major public works programme introduced during the crisis, have shown that they effectively mitigated the impact of job loss resulting from the crisis and, in the short term, significantly raised incomes in participating households (Azam et al., 2012). Subsequent monitoring of job search activities and unregistered employment also points to possible positive impacts on formal employment after programme completion (Ministry of Welfare, 2011).

However, while this evidence contains useful pointers for designing public works programmes as emergency measures, the scope of the results was strictly limited to an extraordinary crisis situation. The suitability of direct job creation for addressing more structural labour market problems is not well documented and is difficult to assess based on these results. In view of Latvia's volatile labour market, it does seem appropriate to maintain an ability for quickly scaling up public works programmes should the need arise. However, current allocations of Latvia's limited ALMP resources should be based on a careful review of national and international evidence regarding the merits of public works programmes relative to other forms of ALMPs. On balance, the international evidence suggests that, while widely used as a redistributive tool and an effective employment buffer during crisis periods, public works programmes tend to have little to no positive effect on participants' longer-term employment outcomes (Cahuc et al., 2014). Based on this evidence, Latvia probably devotes too large a share of the overall ALMP budget on public works programmes.

Training programmes promote productive employment

Training programmes were scaled up significantly in Latvia after 2007; and by 2012 they accounted for 45% of total spending on active measures (OECD, 2015a). This expansion was timely, as the effect of training on workers' chances of employment is typically stronger in recession periods (OECD, 2009). A recent study of Latvian training programmes confirms that unemployed workers who underwent occupational training in 2008-11 significantly outperformed non-participants (as well as participants in other short-term ALMPs) in terms of their chances to be in employment within 18 months of programme completion (Hazans and Dmitrijeva, 2013; World Bank, 2013). A new programme to raise the qualifications of the unemployed through vocational training (including informal courses) is currently being launched and is to remain in effect until 2021. The exact features of the programme are not yet clear, however.

The introduction of a voucher system in 2011 has given training recipients greater freedom of choice across programmes. The main objective is to improve the quality of courses by facilitating competition, while expanding capacity through the market entry of private providers. For vouchers to be effective, it is important to provide sufficient and accessible information on available programmes and their characteristics in order to encourage active use of vouchers and enable recipients to effectively assess the suitability of different training opportunities before enrolling in them (Huber et al., 2015). In Latvia, the SEA provides information on the quality of different programmes online, showing both client satisfaction and subsequent labour market outcomes of programme participants. While this is welcome, it is desirable to systematically evaluate if, compared with direct assignment of clients to training courses by SEA caseworkers, vouchers result in a better match between costly training courses and client needs, and for which client groups vouchers work less well.

A new profiling system is a good basis for more tailored activation measures

A new profiling system was introduced by the SEA in 2013, to assist its officers in designing the most appropriate job search strategy for newly registered unemployed (including recipients of municipality-administered safety net benefits who also have to register with the SEA). Profiling is based on a personal interview with a caseworker, in which the jobseeker provides a self-assessment of skills and training needs, and prepares a CV. The resulting information also provides inputs into the development of individual action plans during the first meeting with the SEA, which specify a detailed sequence of measures that become increasingly more intensive at later stages of the unemployment spell.

The profiling system groups clients into 13 principal categories depending on their job finding opportunities, self-assessment of skills, motivation to look for job, and motivation to co-operate with the SEA. The SEA has pre-selected appropriate measures for each different group, but SEA officers can fine-tune the resulting selection on the basis of individual needs. With the new system in place, the intake procedure for registering new unemployed has become more thorough, lasting around 15-30 minutes on average, compared with only 5-10 minutes in 2010. However, judging from the experience in other countries, this is still short for a sufficiently thorough screening to take place, and may be indicative of capacity problems in terms of the number of SEA frontline staff.

But behavioural requirements may not be fully effective at ensuring active job search

All able-bodied claimants of unemployment benefit or the municipality-administered guaranteed minimum income (GMI) benefit are required to register with the SEA and need to comply with a range of responsibilities, including active job search, participation in measures foreseen in individual action plans, and accepting suitable job offers.⁸ There is evidence, however, that a single job application sent over a two-month period is considered sufficient; and that in the most depressed rural areas SEA caseworkers may not systematically terminate a person's jobseeker status, even if the worker cannot deliver proof of *any* job search activity (OECD, 2015a).⁹

There are valid arguments for providing caseworkers with some room for interpreting behavioural requirements and guidelines for associated benefit sanctions, e.g., to account for the social and family circumstances of claimants, or for the specificities of local labour markets. In addition, an overly strict monitoring of benefit conditionalities can be resource- and time-intensive and, hence, counter-productive when the capacity of employment offices or programme providers is overstretched by large inflows of new jobseekers, or a sizeable pool of long-term unemployed. However, such discretion should not result in a systematic erosion of the credibility of the rights-and-responsibility framework for specific benefit claimants or in specific regions. Continually improved profiling methods and ALMP resources that are more adequately responsive to labour market conditions should be primary channels for relieving caseworker pressures in this respect.

The provision of career guidance remains weak

The capacity of the SEA to provide effective career guidance remains limited, and recent budget cuts have weakened it further. Before the introduction of the Youth Guarantee in 2014, there were only about 40 career counsellors country-wide. Out of more than 96 000 young people under 30 registered with the SEA in 2010, less than 15% (about 13 000) participated in career consultations (SEA, 2011). The implementation of the Youth Guarantee has begun to improve the situation and increased the number of career consultants in Latvia to 71 in 2015 (not all of whom are employed full-time).

While career guidance services currently remain under-funded, new initiatives to establish comprehensive career counselling system are being developed. Expected changes include amendments to the Education Law to provide a clear framework for guidance principles and the provision of services in schools, at the SEA, and also at the municipal level (OECD, 2015a).

Co-ordination between PES and Municipal Social Services should be further improved

Since ALMPs and unemployment benefits are administered by the SEA and the Social Insurance State Agency, while social assistance and a large part of social services are the responsibility of municipalities, effective co-operation between these different institutions is crucial for maximising administrative efficiency and achieving good outcomes for jobseekers. In particular, co-ordination should ensure that jobseekers and benefit recipients obtain consistent employment and social support and have clear incentives for re-establishing self-sufficiency. As in other countries, ensuring consistency across institutions with different objectives, political responsibility and budgeting procedures is not straightforward, however. Currently, co-ordination is not sufficiently systematic and varies across municipalities. For instance, while the SEA is formally in charge of all jobseekers, municipal social welfare offices point out that it is not uncommon for employment-related support to more “difficult” cases to be effectively transferred to them, without a corresponding transfer of resources. Municipalities, in turn, have no legal mandate to provide employment services for this group.¹⁰ Any remaining misalignment of responsibilities and resources exacerbates capacity problems in lower-income municipalities in particular.

A national pilot project to improve inter-agency co-ordination was launched in 2013 with a specific focus on the long-term unemployed. The aim is to promote information sharing, co-ordinated client assessment, a concerted design and implementation of individual action plans, as well as shared responsibility for monitoring clients’ activities and progress. SEA local officers were given more room to experiment with different forms of co-operation and a wide range of novel approaches was tried, including more frequent institutionalised contact between SEA and social workers, technical information sharing, and joint meetings between the two agencies, the unemployed and, if applicable, prospective employers. By the end of the pilot, programme participants had a significantly higher likelihood to be employed than non-participants.¹¹ Unfortunately, participants were not assigned randomly, however, and it is therefore difficult to judge whether this positive result was driven by the programme or by the characteristics of programme participants.

The profiling system mentioned above also contributes to effective information sharing as it is accessible by both SEA and welfare offices (who can, for instance, make benefits conditional on clients’ regular visits at the PES, or on compliance with individual action plans). In another example of intensified cross-institutional co-operation, specific measures have been

undertaken to improve services for jobseekers affected by addiction or related substance-abuse problems (see Box 3.1).

Despite these efforts, several sources of significant co-ordination problems remain. First, ALMPs remain heavily focussed on the most employable workers (e.g. the most motivated, better skilled ones). With limited ALMP resources, there is little systematic incentive for the SEA to actively invest in clients with more significant labour market barriers or who require a careful combination or sequence social services and ALMPs.

Second, despite having a joint database with client profiles, recent OECD work suggests that there is still limited evidence of close institutional co-ordination of services or activation strategies (OECD, 2015a). Third, social service workers should provide additional incentives for disadvantaged workers to register with the SEA. For instance, there appears to be little practical help provided by municipal social services to NEETs who want to register with the SEA, and only about half of all NEETs do so (OECD, 2015a).

Scientific evaluations of active labour market programmes should become standard practice

Despite valuable evaluations in selected policy areas, such as training, a lack of evaluations makes it difficult to draw firm conclusions on the effectiveness of different ALMPs in Latvia, and limits the government's ability to direct resources towards the most cost-effective measures. Existing studies are a useful basis for identifying programmes that are likely to succeed. But evaluation efforts are currently not systematic. While data collection and analysis have accompanied selected policy reforms and pilot projects, particularly when co-financed by the European Social Fund (ESF), translating the results of these monitoring efforts into policy actions is frequently hampered by an absence of clear counterfactuals that are needed for a policy-relevant causal interpretation of measured programme effects.

In view of Latvia's volatile labour market and highly heterogeneous labour force, the specific selection of programme participants, and the timeframe of the evaluation, is likely to have a particularly sizeable effect on measured programme results. Programme results should therefore be measured relative to carefully defined control groups.

Latvia has recently made considerable technical and legislative efforts to provide policymakers with high-quality and up-to-date information on programme participants, and to create the organisational and legal pre-requisites for combining information recorded by different institutions

and levels of government, including SEA, the Social Insurance State Agency and municipal social assistance administrations. The resulting rich administrative data provide an excellent basis for continued policy learning based on systematic evaluations of both past and ongoing policy reforms. The data have already been made available for analytical purposes (e.g., Hazans and Dmitrijeva, 2013; World Bank, 2013). However, to realise its analytical potential, the government should match its commendable investments into data infrastructure with equivalent efforts to promote systematic use of available data sources for policy evaluations.

Box 3.1. Tailoring activation measures to the needs of jobseekers with addiction problems

The incidence of disabilities in the Latvian labour force is close to the European average (Figure 3.4, Panel A). In the adult population, disabilities are particularly frequent among less educated people and among those above the age of 45 (Figure 3.4, Panel B). Integrating assistance with activation measures for disabled clients has been an important policy concern and recent reforms have sought to bring disability assessments more in line with employment objectives (see Chapter 4).

Particular efforts have been made to help unemployed people with addictions to alcohol, drugs and psychoactive substances. The incidence of alcohol dependence among individuals above the age of 15 is relatively high by international standards: 7.6% among men and 1.3% among women (WHO, 2010).

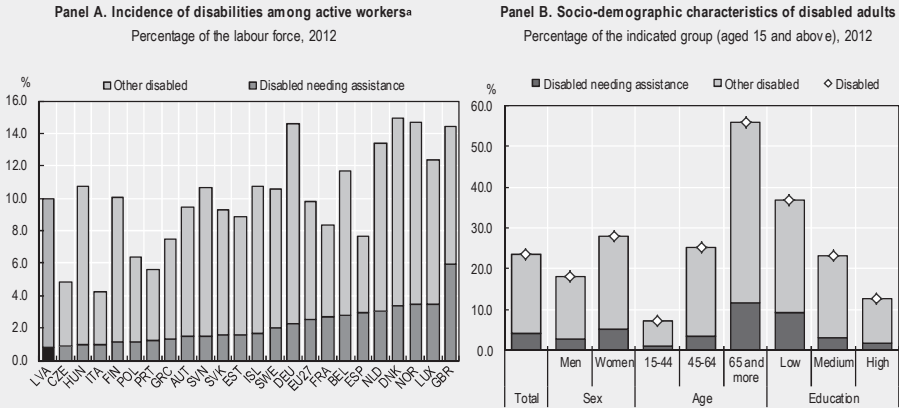
An important recent initiative is the “Minnesota 12-step Program”, introduced in 2012 to provide a new framework for assisting jobseekers with addiction problems. The programme was initially targeted to those with unemployment spells of at least 12 months, but in 2014 the target groups was broadened to include those with at least three months of unemployment. Once addiction problems are certified by a doctor, the SEA can direct the jobseeker to a registered (private) medical institution where he/she receives treatment and accommodation for 28 days at no cost to the individual (expenses are covered by the SEA). In addition to medical treatment, participating clients may receive assistance from a psychologist, a psychotherapist and a career consultant.

Once treatment is completed (93.1% of respondents completed the full 28-day cycle in 2014, the rest dropped out before the programme ended), the person returns to the SEA and resumes job placement and related employment support activities.

With 204 participants in 2014, the programme remains small but has shown some encouraging results: 56% of participants engaged in other active labour market measures after programme completion and 14.6% obtained a permanent job or became self-employed (EurWork, 2014). There is also evidence that the programme reduced the incidence of addictions and strengthened participants’ ability to work.

Box 3.1. Tailoring activation measures to the needs of jobseekers with addiction problems (cont.)

Figure 3.4. The incidence of disabilities is significant



Note: According to the biopsychosocial model used in the survey, people with disabilities are those who face barriers to participation in any of the ten life areas, associated inter alia with a health problem or basic activity limitation. Therefore, a person identifying a health problem or basic activity limitation as barrier in any life domain is categorised as disabled. The more severe form of disability (“in need of assistance”) is assessed on the basis of the need for specialised equipment or personal help.

a) Active workers are either employed or actively looking for work.

Source: OECD calculations based on Eurostat, Environment Health and Safety Information System (EHSIS).

Reducing informality

A large informal economy not only weakens public finances, but also hampers growth and aggravates inequalities. A culture of informality and underreporting may also facilitate other types of tax evasions or avoidance, including strategies by better-paid employees to convert labour earnings into dividends which are taxed at a lower rate and not subject to social contributions.

Available estimates indicate that 8% of the Latvia labour force is in unregistered informal employment (see Figure 1.26 in Chapter 1). This is low by international comparison, and much lower than suggested by the substantial size of the informal economy, estimated to be close to a quarter of GDP. One prominent explanation for this apparent inconsistency is that informal work largely takes the form of under-reported earnings such that payments to workers exceed the wages that are reported to tax authorities,

with the remainder being paid informally (“envelope wages”). A recent Eurobarometer report indicates that, among EU countries, Latvia has the highest proportion of workers who report receiving envelope wages (European Commission, 2014b) and new OECD estimates also point to a large extent of under-reporting (see Chapter 1).

Envelope wages result in illegal tax advantages for both employers and employees, but they also erode workers’ social protection entitlements that depend heavily on past social contributions (see Chapter 4). Recipients of unreported or underreported wages suffer other disadvantages, such as difficulties obtaining mortgages or loans due to insufficient official income. Wage underreporting also diminishes the bargaining power of workers, as there exists little legal recourse against non-payment of informally agreed wages. Certain forms of underreporting, such as unpaid overtime or “false” part-time employment, are especially costly to workers. Underreporting working hours not only reduces employers’ tax burdens but also circumvents applicable minimum-wage provisions, working hours regulations or collective agreements. Available data for Latvia suggest that underreporting of working hours is indeed significant. For instance, while LFS data show that less than 7% of workers (aged 15 and above) report working part-time (less than 30 hours), data provided by revenue authorities show that reported earnings are less than the full-time minimum-wage for 20.3% of employees (data from the State Revenue Service for February 2015).

Interventions to tackle informality and under-reporting require careful co-ordination between different government agencies and should be based on three main pillars: increasing the benefits of formal employment, reducing the costs of formalisation, and optimising enforcement methods (OECD, 2008; OECD, 2015b).

Recent reforms have strengthened enforcement and tightened sanctions for employers

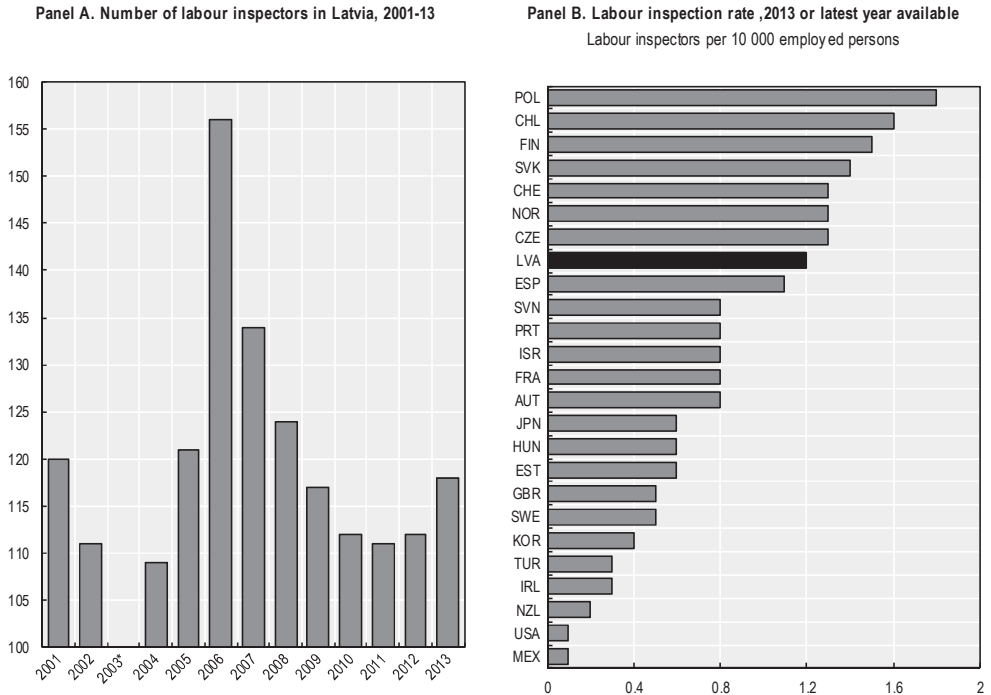
The Latvian government has shown a strong commitment towards these objectives.¹² While underreporting remains very widespread, Eurobarometer data show that Latvia is among the four EU countries that have attained the largest reduction in the proportion of workers who are paid envelope wages between 2007 and 2013 (about 6 percentage points, see European Commission, 2014b). Macro-economic trends may have contributed to this decline, but a number of welcome policy initiatives have played a role as well.

To tackle the different forms of non-reporting or underreporting, including misreporting of working times, enforcement activities need to be

closely co-ordinated between labour inspectors and tax authorities. Co-operation between the Ministry of Welfare and Ministry of Finance has indeed been strengthened in recent years. The Labour Inspectorate works in close partnership with State Revenue Service, exchanging information and co-ordinating actions. Staff resources of both agencies were increased and considerable progress has been made at tightening the enforcement of applicable labour and tax regulations. In the past, the highly volatile number of labour inspectors made it difficult to plan and implement a consistent longer-term enforcement strategy (Figure 3.5, Panel A). But despite very large reductions in the number of labour inspectors after the pre-crisis peak of 2006, the number of labour inspectors per 10 000 workers (including informal workers) is relatively high by OECD standards (Figure 3.5, Panel B). Strengthening the capacity and effectiveness of the Labour Inspectorate continues to be crucial for the functioning of Latvia's labour market. One key challenge is enforcement of applicable labour regulations in small firms, where very low levels of trade union activity mean that many workers may not benefit from any legal protection other than that provided by the inspectorate.

To make audits more credible and effective, employers now need to register new workers electronically well before employment commences. Other reporting requirements were tightened as well and several recent initiatives aimed at addressing what is often described as the “cultural problem” of tax evasion. These include PR campaigns, the introduction of more severe fines for employers (including for hours-underreporting), and the exclusion of offending employers from public procurement and some forms of state support. The campaigns targeted specific sectors, as well as schools to promote awareness of the problem among new labour market entrants. These efforts should be maintained and strengthened further, as new evidence shows that attitudes to tax evasion in Latvia continue to show a large degree of acceptance and have in fact softened since 2007 (European Commission, 2014b). Nevertheless, authorities cite some evidence which could indicate that recent enforcement efforts have been effective. For instance, social insurance revenues have increased more strongly than employment since the start of the recovery, although the extent to which this is driven by enforcement efforts is difficult to disentangle from the effects of other policy changes, such as increasing minimum wages.

Figure 3.5. Despite cuts after the crisis, the number of labour inspectors is relatively high



* Data not available.

Source: European Agency for Safety and Health at Work and ILO, ILOSTAT Database.

But several obstacles continue to discourage formalisation

Incomplete or uneven sanctions

Legal penalties for failing to declare earnings are currently borne entirely by employers, while evading employees face neither legal sanctions nor back payments of evaded taxes or social contributions. Public opinion may largely see informal employment as an involuntary outcome for employees, and workers' weak bargaining position suggests that informal work is indeed often not a choice of workers, notably during periods of slack labour markets. Imposing fines on workers indiscriminately is therefore not only politically difficult, but probably counter-productive as it can discourage employees from reporting employers' infringements of applicable labour and tax laws. There can also be a risk that a policy discourse on fining recipients of unreported or underreported wages could

stigmatise certain groups of workers whose position in the labour market is already weak and who already suffer disadvantages resulting from underreporting.

However, the lack of any credible penalties for workers severely complicates the task of changing attitudes towards informality. For instance, according to Eurobarometer data, half of Latvian workers who report carrying out undeclared work state that a reason for doing so is that both parties benefit from such an arrangement (European Commission, 2014b). Since opportunities for employers and employees to collude do exist, balanced and credible legal consequences for both employers and workers should become part of the strategy to make misreporting and evasion less attractive and less socially acceptable.

Fines and back payments for employees can and should be designed in a proportionate way (for instance, as is already the case for employers, workers who are found to underreport could also be temporarily excluded from certain types of state-provided cash support or services). Financial and legal consequences can also be tailored to the type of misreporting (for instance, fines should not apply to employees working unpaid overtime). Although there are valid concerns that fining employees may stop workers from reporting their employers, fines, back payments and other penalties can be designed in such a way as to minimise these problems and even strengthen reporting incentives (e.g., by credibly announcing the imposition of fines or other penalties from a certain future reference date, together with amnesties for past infractions that are reported before then).

Minimum wages and minimum social contributions

In addition to enforcement, the policy debate in Latvia has put significant emphasis on the role of statutory minimum wages (which is discussed in more detail below) as a policy tool for alleviating underreporting problems. Increasing the minimum wage is perceived as an effective instrument to fight under-reporting, as a well-enforced wage floor reduces the margin for unregistered payments (i.e., it “reduces the size of the envelope”). Minimum-wage hikes may therefore generally be welcomed by the revenue authorities. But a focus on minimum wages as an instrument to strengthen enforcement and tax revenues could risk losing sight of the broader strengths and limitations of the legal minimum wage as a labour market policy tool. In particular, setting the minimum wage too high risks pricing low-skilled workers out of the formal economy and may encourage them to work informally.

There is therefore a trade-off between reducing wage underreporting among workers who are in fact paid above the minimum wage, and reducing

formal employment among low-productivity workers, who would not be hired at wages at or above the statutory minimum, and for whom further minimum-wage increases represent a genuine employment barrier. Such trade-offs may be particularly pronounced in the context of Latvia's very heterogeneous labour market and a unified minimum wage without differentiation by age, region, occupation or sector.

The government is currently also considering the introduction of minimum social contributions. Related to the push for “reducing the size of envelopes” through higher minimum wages, this approach is intended to inhibit evasion of social contributions in the form of under-reported working hours. The proposal is similar to a system that is in place in Estonia, with minimum social contributions calculated in relation to the full-time minimum wage, regardless of actual hours worked. While this approach would close off one channel of underreporting, it would also make genuine part-time work much more expensive. The share of part-time workers in Latvia is already low in international comparison and this new tax would risk pricing certain labour force groups out of employment, including low-productivity workers, and those with a strong preference for part-time work. It would also heighten poverty risks in households where part-time employment is the main source of income, and would make it more costly for employers to respond to business fluctuations through legal means.

While the minimum contribution burden would be binding for a large proportion of part-time employees, it would only address underreporting in the lower half of the earnings distribution and would not avert underreporting resulting from unpaid overtime. The experience in Estonia suggests that exemptions from minimum-contribution provisions are needed in order to prevent damaging the employment prospects of disadvantaged groups, such as the registered unemployed. Convincing arguments can also be made for exempting other groups, such as older workers (World Bank, 2015) or parents returning to work after a child-related career break. In all cases, these exemptions would add to administrative complexity and, in a context of remaining enforcement challenges, can be expected to trigger further attempts to exploit any resulting loopholes.

Costs of formalising

As in other countries with a large informal economy, red tape and certain costs of starting or running a business may also play a role in discouraging formality in Latvia. According to the World Bank Doing Business report 2016, Latvia ranks a good 22nd out of 189 countries with respect to the overall ease of doing business (World Bank, 2016). Over the year covered by the report (June 2014-June 2015), Latvia was among the countries that improved contract enforcement, facilitated property transfer, eased labour market

regulation on fixed term contracts, and enhanced access to credit by improving its credit information system. However, the report also notes changes that can increase costs, citing added complexity implied by some tax-related provisions, and longer procedures for obtaining building permits. The ease of doing business is also determined by regulations of market entry and competition in the marketplace. OECD data show Latvia to be close to the average OECD country with respect to the strictness of its product-market regulations. Areas of potential improvement include reducing administrative burden on corporations and sole proprietor firms, as well as facilitating license and permit acquisition (*OECD Product Market Regulation Database*, 2013).

In an attempt to facilitate and incentivise formalisation of small business activities, Latvia introduced simplified tax and contribution rules for firms with a total turnover below EUR 100 000 per year. The micro-enterprise tax consists of a single payment equal to 9% of the total enterprise turnover, which replaces personal income tax, social contributions (for both employees and enterprise owner) and corporate tax. A large share of revenues from the tax (69.4%) is used to cover social security contributions, but the total amount raised is lower than under the standard fiscal regime. The creation of such microenterprises was actively facilitated during the crisis and their numbers expanded quickly and approximately 43 000 exist today. The initiative yielded mixed results however as it has weakened social protection entitlements for a large number of workers employed by micro-enterprises (currently approximately 20% of private-sector employees).¹³ It is also difficult to prevent abuse of micro-enterprise provisions (e.g., if bigger employers split up in order to claim the advantages associated with micro-enterprise status). In a context where enforcement of firms' reporting obligations still faces challenges, it is likely that larger firms will find ways to reorganise activities into smaller units, with negative consequences for tax revenues and an increasing number of workers with only limited access to social protection measures.

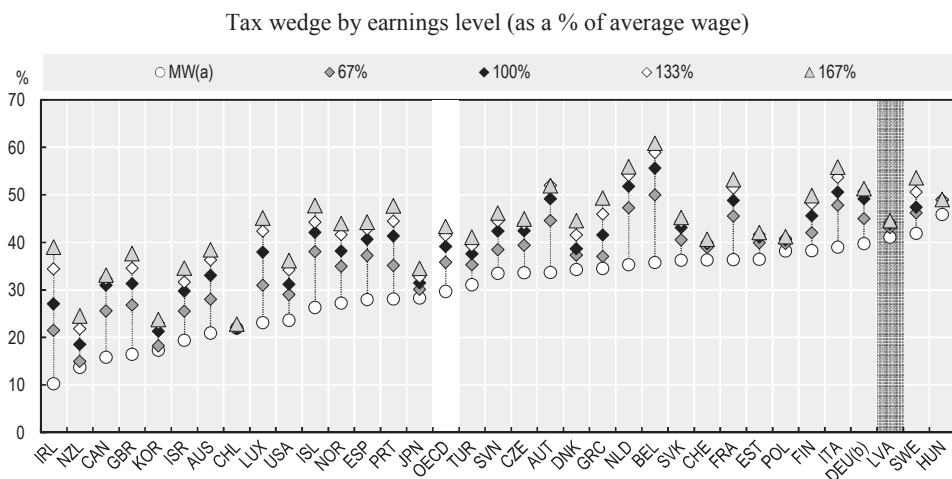
Strengthening financial work incentives

Fiscal burdens on low-wage earners discourage employment and complicate activation strategies

In comparison with OECD countries, the composition of tax revenues in Latvia is skewed towards labour. Personal income tax and social security contributions account for 53% of total revenues, compared with 50% in the OECD area; while corporate income tax and property taxes account for about 8%, compared with an OECD average of 14% (OECD, 2015c). Moreover, taxes on labour income are less progressive than in the average OECD country, with very little variation in fiscal pressure between workers

who earn the minimum wage and those in higher segments of the income distribution (Figure 3.6). At 40% of labour costs for a minimum-wage earner, the tax wedge for low-wage workers is one of the highest in the OECD. The high tax pressure on formal workers at the bottom end of the wage ladder represents an important obstacle to boosting employment rates among lower-skilled workers and may partly be responsible for the widespread practice of earnings under-reporting.

Figure 3.6. Fiscal pressure on labour is high, especially for low-paid workers



Note: Tax burdens are calculated for a full-time worker in a single-person household. Full-time refers to usual full-time hours in each country. Employer and employee social contributions also include any mandatory payments to private insurance for health, retirement pensions, etc. Countries are ranked in ascending order of the tax wedge at the minimum wage level in Panel B. OECD is the unweighted average of 33 OECD countries (excluding Mexico).

a) For countries with no statutory minimum wage (i.e. Austria, Denmark, Finland, Iceland, Italy, Norway, Sweden and Switzerland), data refer to 33% of the average wage (AW).

b) Germany: the minimum-wage level in 2015 is expressed as a proportion of the projected 2015 median and average wage. Projections are based on the *OECD Economic Outlook Database*.

Source: OECD Tax-benefit Models (<http://www.oecd.org/social/benefits-and-wages.htm>), and *OECD Minimum Wage Database*, <http://dx.doi.org/10.1787/data-00313-eng>.

At the same time, informality squeezes the tax base and, hence, contributes to higher tax burdens on low-wage workers in the formal sector. The government has acknowledged these problems and has reduced the flat personal income tax rate from 25% to 24% in 2013 and to 23% in 2015. The combined employer and employee social security contribution rate was reduced by 1 percentage point to 34.09% in January 2014. In addition, the tax allowance for dependants was increased in 2014 and recent decisions as part of the 2015 state budget include a new income-dependent progressive tax-free allowance and a solidarity tax for those earning above the social contributions ceiling (see Chapter 4). However, with much of the labour tax burden due to social contributions, overall progressivity remains very limited. For instance, OECD (2015a) estimated that despite these changes, the tax-wedge of low-paid workers is set to remain well above the OECD average.

Work incentives could be boosted by reducing social security contributions for some low-wage earners

Reducing social security contribution burdens for low-wage earners represents a further option for strengthening progressivity and for linking tax burdens more strongly to taxpayers' ability to pay. This type of measure is costly but has yielded positive results in a number of OECD countries such as France and Belgium (OECD, 2011). However, it presents a number of specific challenges in Latvia. First, to avoid a rise in the incidence of low-wage employment, the reduction in the social contribution rate should be coupled with better monitoring and tax enforcement. Second, to reduce overall costs, it is likely that targeted reductions in social contributions would need to be limited to specific underrepresented groups (e.g. longer-term unemployed, youth or older workers with labour market problems). Third, in view of the strong contribution link in Latvia's pension system, care is needed in order to avoid undermining the stability of social insurance budgets and a further decline in pension adequacy (see Chapter 4). This could, for instance, be achieved by shifting some additional portions of pension financing to the state budget.

Tax allowances for non-working spouses may contribute to the over-representation of women in low-wage jobs

At 71.6%, labour force participation of Latvian women is some 10 percentage points above the OECD average and gender employment gaps are not a major issue. However, women are strongly over-represented among low-wage and informal workers and a large gender pay gap remains when comparing wages of men and women with similar education level (women earn nearly 17% less than men on average and those who work in

the informal sector face a very large earning gap compared to workers in registered employment). Encouraging women to move to formal sector and higher-paid occupations is therefore a priority for improving family incomes and furthering productivity growth.

Latvia's individual income tax system is in principle well-placed to ensure that family tax burdens do not rise disproportionately when second earners, who are typically women, take up employment or increase their earnings. Families may, however, lose entitlement to tax-free allowances that are available for dependents, including spouses with no or very low (declared) earnings. Since recent state budgets have made these tax-free allowances considerably more generous, they could now represent a significant work disincentive for women in particular. To avoid such disincentives, the government has recently decided to abolish the dependents tax-free allowance for adults who are able to work. This is welcome as it helps to make work pay for families and strengthens income-reporting incentives. The resulting budgetary savings could be invested into suitably targeted support measures for two-earner couples.

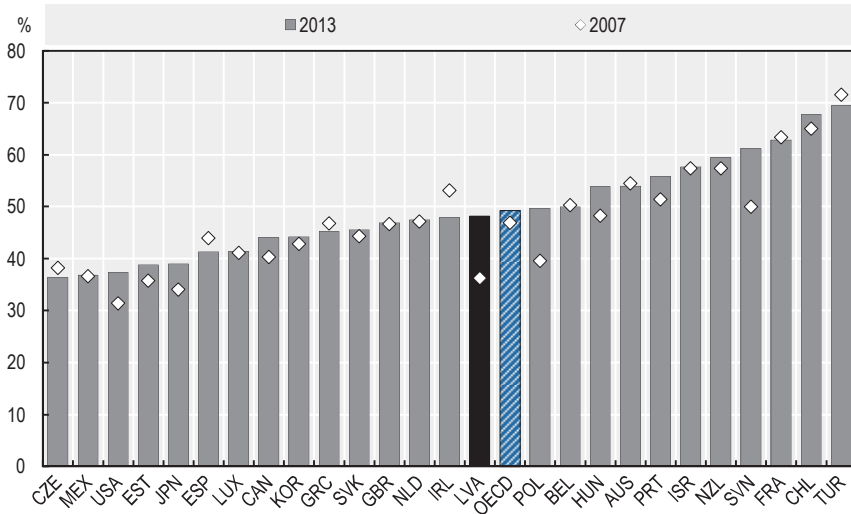
Setting and adjusting the minimum wage

Minimum wages are substantially higher than before the crisis, both in absolute terms and relative to median wages

The economic crisis has resulted in strong downward pressures on workers' earnings and several countries have turned to the minimum wage as a policy tool for slowing or inhibiting real earnings losses at the bottom of the wage distribution (OECD, 2014a, Chapter 2). Together with Slovenia and Poland, Latvia is among the countries with the biggest relative increase in the minimum wage between 2007 and 2013 (OECD, 2015b, Chapter 1). The minimum wage has increased by about 32.2% in real terms, while median wages fell by 0.7% in real terms over this period. As a result, the gap between minimum and median wages narrowed by more than 10 percentage points (Figure 3.7), bringing Latvia's minimum wage (expressed as a share of the median wage) close to the OECD average.

Figure 3.7. The minimum wage has increased significantly since 2007

Minimum wages as a percentage of median wages of full-time employees (in gross terms)



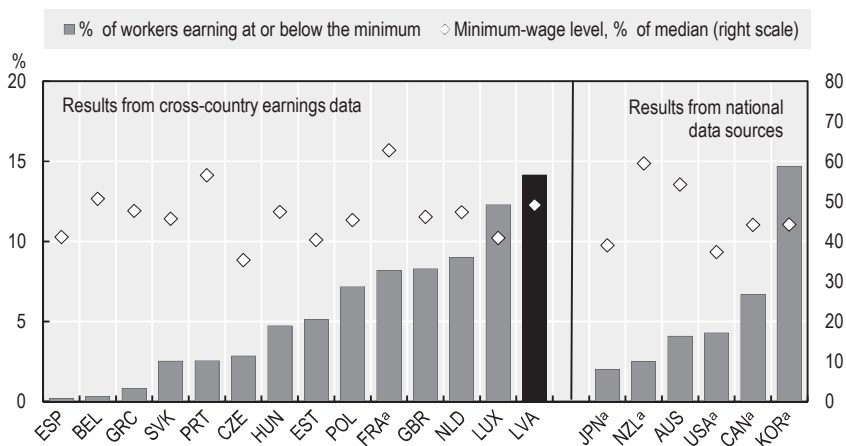
Note: Countries are ranked in ascending order of the MW/Median ratio in 2013.

Source: OECD Minimum Wages Database, <http://dx.doi.org/10.1787/data-00313-eng>.

The minimum wage affects a large share of the Latvian labour force

The share of workers affected by the minimum wage varies markedly across countries, as it depends not only on the level at which the MW is set, but also on the categories of workers included, and on enforcement and non-compliance (as well as on other wage-setting institutions).¹⁴ Latvia is among the countries with the highest share of workers earning at or below the legal minimum (Figure 3.8). On average across the countries for which data are available, 5.5% of workers earned at or below the minimum wage in 2010, the latest year for which comparable data are available. At 14.2%, Latvia's share was more than twice as high, and also higher than in any other of the European countries shown in Figure 3.8. As a result, changes in minimum-wage provisions can be expected to have a strong impact on the labour market.

Figure 3.8. The proportion of workers earning at or below the minimum wage is high
2010 or as stated



Note: The number of minimum-wage earners cannot usually be established with certainty and can vary between data sources and studies. Counts of minimum-wage earners are commonly based on survey data, which are affected by measurement error, both in earnings and in working hours. It is therefore common to include those with wages below the minimum, or slightly above it. Data sources and approaches differ however. Results reported in the “cross-country” group are from the EU Structure of Earnings Survey (SES) and refer to those earning less than 105% of the legal minimum applicable to each worker’s age group. Importantly, SES data exclude workers in small firms with fewer than ten employees. As minimum-wage workers tend to be overrepresented in small firms, their share can be substantially higher than reported. “Country-specific” results are from a range of sources and generally include those employed in smaller firms but may not include workers earning less than the legal minimum.

a) 2013.

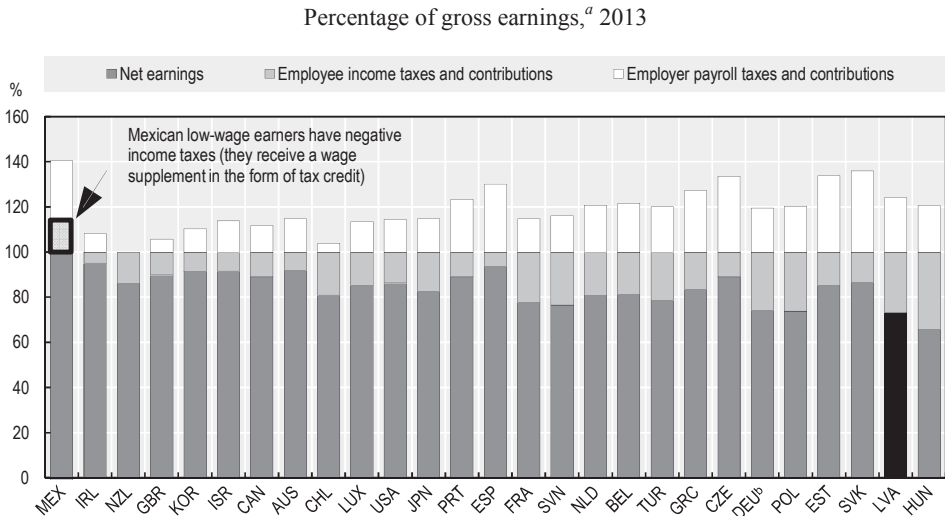
Source: OECD (2015), “Minimum Wages After the Crisis: Making them Pay”, <http://www.oecd.org/social/Focus-on-Minimum-Wages-after-the-crisis-2015.pdf> using the 2010 EU Structure of Earnings Survey and national sources.

The minimum wage is a blunt instrument for fighting poverty

In Latvia and in other countries, increasing the minimum wage is often presented as a tool to fight poverty and reduce inequality. However, in and of themselves, minimum wage hikes are a blunt instrument to attain these objectives. This is due to several factors, including the fact that the poorest families are jobless and therefore do not immediately benefit from a minimum wage increase.¹⁵ In Latvia, low-income individuals also include informal workers, who also do not benefit from minimum-wage hikes. In addition many minimum wage workers live in households with above-

average incomes, and across countries, in-work poverty is often the result of low working hours, rather than low wages (OECD, 2009). In addition, the high tax burdens on low-wage earners in Latvia mean that only a smaller proportion of any minimum-wage increase ends up adding to households' net incomes (Figure 3.9). As a result the minimum wage is not very effective in reducing poverty.

Figure 3.9. The tax wedge for minimum wage earners is among the highest in the OECD, 2013



Note: Countries are ranked in ascending order of the tax wedge.

* Mexican low-wage earners have negative income taxes (they receive a wage supplement in the form of a tax credit).

a) Tax burdens are calculated for a full-time worker in a single-person household earning a minimum wage at the standard (adult) rate. Full-time refers to usual full-time hours in each country. Employer and employee social contributions also include any mandatory payments to private insurance for health, retirement pensions, etc.

b) Minimum wage levels refer to 2015 for Germany.

Source: OECD (2015), "Minimum Wages After the Crisis: Making them Pay", <http://www.oecd.org/social/Focus-on-Minimum-Wages-after-the-crisis-2015.pdf>.

In-work benefits can be an effective complement to minimum wages

Complementing minimum wages with in-work benefits or tax credits, as done in several OECD countries, can be a more effective way of addressing poverty, since those additional measures do not push up labour costs and therefore avoid any possibly dis-employment effects.¹⁶ They can be more

tightly means-tested on the basis of family incomes. Their design, however, needs to be carefully tailored to the Latvian context (and available resources) and should, in particular, avoid generating adverse reporting incentives.

In a heterogeneous labour market, the uniform minimum wage presents a significant challenge

The statutory minimum wage in Latvia is the same for all wage earners in the country. In a highly heterogeneous labour market with big wage disparities across regions and groups of workers, this strategy risks pricing first-time labour market entrants and other lower productivity workers out of formal employment, especially in the country's lowest-income regions. For younger workers, the risk is aggravated by the fact that workers under the age of 18 are subject to a higher hourly minimum wage than those above 18. This is due to the fact that under-age workers are mandated to work fewer hours per week (35 hours), while the monthly statutory minimum is the same as for older workers.

A uniform minimum wage also appears problematic in light of large regional differences, a regional concentration of certain industries, and high unemployment outside of Riga. These large disparities make it unlikely that the same wage floor is equally appropriate across all groups of workers, industries and regions. About one half of OECD countries with a statutory minimum wage set lower rates for teenagers (OECD, 2015b, Chapter 1), as labour market entrants without work experience are typically less productive. Such a concern is consistent with existing international evidence showing that negative employment effects of minimum-wage hikes tend to be concentrated among low-skilled youth. In Latvia, any age-specific minimum-wage provisions may need to go beyond lower minima for youth, as lower-productivity employment is also concentrated among some groups of older workers. Some countries further differentiate the minimum wage by sector/occupation (e.g. Japan and Mexico) and lower rates are sometimes set for workers on training/apprenticeships, and for disabled workers.

Differentiating minimum wages by region is very common in emerging economies where regional inequality is high (e.g., in Mexico), but it is also applied in several high-income countries (typically federal countries, such as Canada, Japan and the United States). By contrast, in a small country like Latvia, there are considerable practical difficulties of introducing geographic differentiation of minimum wages. These difficulties, combined with the large regional wage disparities in Latvia, underline the need to exercise great caution when deciding on across-the-board minimum-wage adjustments, in order to avoid negative employment effects especially in lagging regions.

Promoting collective wage setting could make wage floors more responsive to labour market conditions

An alternative way to introduce greater differentiation of wage floors is to promote the role of social partners in the wage setting process. More widespread collective bargaining would ensure better representation of worker interests in the wage setting process and remuneration in line with productivity for a larger number of workers. Greater use of sector-wide wage agreements, including sector-specific minima, would facilitate adjustments of wage floors that are in line with the labour market situation and productivity trends in each sector. While a modest national minimum wage is a useful backstop for collective bargaining and would continue to provide an absolute floor across all sectors (as well as for those not covered by a collective agreement), differentiation of sectoral minima could be left largely to social partners.

However, the effectiveness of such collectively-agreed minima rests on constructive dialogue among the social partners, on the existence of adequate structures of representation including effective representation of worker interests by unions, and on a sufficiently high share of employees covered by collective agreements. In Latvia, the marginal role of sector-wide extensions of collective agreements constitutes a major obstacle to a more decentralised determination of suitable minimum wages. It is not clear whether the poor record of Latvia's union sector in maintaining or increasing membership is due to internal weaknesses of existing unions, or to *de-facto* barriers they face in extending representation to new and existing workers. However, to facilitate an effective wage-bargaining system that is based less on nation-wide wage floors, and more on the economic realities in different industries or firms, the government should consider ways to more strongly articulate unions' incentives to both extend membership and represent the interests of existing members. This could include measures that allow workers more choice in the representation that is suitable for them.

3. Skills needed to boost productivity in the face of adverse demographic trends

Economic growth rests crucially on an adequate supply of sufficiently skilled labour; and in a modern economy this should be attained through a careful mix of school-based education and participatory (work-based) learning. Current projections point to significant labour shortages in Latvia in the coming decades, including for workers with medium and higher level vocational education and among senior specialists in science and engineering, ICT, agriculture, forestry and fishery. Over-supply is projected

for specialists in the humanities and social sciences (European Commission, 2014c). Policymakers are aware of this imbalance and important reforms have been set in motion to address them.

Since Latvia's independence, the education system has undergone radical changes. One of the main policy objectives has been to raise efficiency and quality by introducing greater flexibility and devolving responsibilities to schools, e.g. by granting schools greater input into selecting teaching content, methods and textbooks (OECD, 2015a; OECD, 2016b). In recent years, particular attention has been devoted to strengthening the VET system. Tertiary education has also been subject to important reforms to raise the international competitiveness of Latvian universities (see OECD, 2015e for a detailed discussion).¹⁷ Much remains to be done, however, to ensure that the education system can readily respond to the demands of the labour market.

Maximising school enrolment and completion

As a result of falling fertility rates and migration, the number of students in Latvia has fallen dramatically over the past decade. Enrolment in general upper-secondary education has fallen from 62 411 in 1999/2000 to 40 085 in 2013/14, or nearly 36% (Figure 1.29 in Chapter 1). A drop of this scale has major implications for future skills shortages in the labour market and makes minimising school dropouts and raising enrolment in VET and higher education an urgent priority. It also highlights the importance of maximising the labour market relevance of curricula.

Moreover, OECD work shows a strong relationship between a young person's risk of being NEET (and of remaining NEET for longer) and low educational attainment (OECD, 2015a). Ensuring that all young people obtain upper-secondary education is, therefore, crucial to address their labour market difficulties. In 2014, about 34 000 young people (aged between 20 and 29) had obtained at most lower secondary education (ISCED level 2, i.e. lower secondary education) and were no longer enrolled in school. This represents about 12% of the entire age group and is similar to the OECD average. However, this overall share conceals large socio-demographic differences and a significant gender gap. Young Latvian men are twice as likely as women to leave school without completing upper secondary education (the OECD average is 1.4 times) and this is one reason for higher NEET rates among men. In addition, early drop-out rates in rural areas are about twice as high as in urban areas (Ministry of Economics, 2014).

Despite noticeable improvements in recent years (OECD, 2015e), additional efforts should be devoted to reducing the incidence of early dropouts. In its "Europe 2020" national reform programme, the Latvian

government committed to reducing the share of early school leavers (Ministry of Economics, 2011) and a number of reforms have been identified as likely pre-requisites for attaining that objective:

- ***Better information sharing between schools, municipalities and employment services.*** Local governments need to be able to react quickly in case of premature school drop-out. They should therefore be provided with relevant details on all children of compulsory school age in the municipality well ahead of the enrolment period. At the same time, introducing compulsory and transparent monthly reporting of school attendance by educational establishments to national authorities would provide the latter with an effective monitoring tool and generate precious data for policy makers (e.g. to evaluate school performance and identify the drivers of early school leaving). Central authorities currently have limited access to school attendance data and municipalities have an incentive to over-report enrolment rates, because educational funding depends on it (OECD, 2015a).
- ***Systematic follow-up with school leavers*** to help raise school completion rates and facilitate students' access to the labour market. Strengthening career guidance with a system of regular follow-ups with school leavers would provide youth at risk with timely information and advice on alternative educational or professional pathways early on. It would also facilitate their contacts with the SEA.
- ***Widen options for “second-chance” education.*** Those who have dropped out of basic or secondary education currently have limited options to access “second-chance” education programmes, despite a boost in recent years (the most prominent options are evening classes, distance education and extramural programmes, i.e., those taking place outside educational institutions). Such programmes have proven effective in reconnecting dropouts with the labour market in other OECD countries (e.g. in France). However, they are an imperfect substitute for regular education and they require a particularly high degree of self-discipline and motivation, precisely what is often lacking among discouraged students (OECD, 2015a). Short-cycle programmes, as recently developed and offered by VET institutions in co-operation with the State Education Development Agency (SEDA), appear to be more suitable for many drop-outs. These programmes typically last 1 to 1.5 years and they target youth of 15 to 29 years, providing them with basic professional qualifications.

Strengthening links between schools and employers

Vocational education and training (VET) is an essential part of a broader education strategy. They equip students with a valuable mix of general competences and job specific ones, and facilitate a good match between their skills and those demanded by the labour market. To achieve these objectives VET systems should be based on a careful balance between classroom learning and practical training, as well as close co-operation between firms and schools in the design and implementation of curricula.

The Latvian VET system has suffered from a poor reputation and, as a result, was generally considered less attractive than other educational pathways, both by potential students and by employers. As discussed in Chapter 1, only 63% of respondents to a 2011 survey administered in EU27 countries considered learning in vocational schools to be of high quality and only 60% perceived VET to have a “positive” image (European Commission, 2011). Fewer respondents than in other participating countries felt that VET professions are highly demanded in the labour market (60%, third-lowest value), that career opportunities are good for VET graduates (57%, fourth-lowest value), or that existing VET facilities provide students with suitably modern equipment (76%, sixth-lowest value).

The share of students enrolling in VET programmes after basic education has remained fairly constant in recent years, at around 35% (Ministry of Welfare data), and in 2013/14 students in VET programmes accounted for 44% of all students in secondary education (OECD, 2015a). These ratios appear low in international comparison. The government is committed to increase the share of students enrolling in VET programmes after basic education to 50% by 2020 and has recently introduced a number of important reforms. A fundamental change that was implemented over a longer time period was a significant consolidation of the VET system, with a substantial reduction in the large number of different professions and specialisations that partly dated back to the Soviet period. Smaller, single-subject vocational schools were merged into more comprehensive educational establishments (OECD, 2001), and the number of vocational schools in the country nearly halved, from 120 to 66, between 2000 and 2013 (CSB data).

More recently, larger VET institutions have acquired the status of Vocational Education Competence Centres (VECC) and their facilities have been upgraded and modernised, effectively turning them into regional VET “hubs”, providing vocational education in a wide range of subjects. VECCs support smaller institutions in their region (who can access their technical equipment and facilities). They also offer career guidance, adult education and training for the unemployed. Furthermore, they serve as

examination centres and validate professional skills acquired outside formal education and without official certification (such as short courses and non-formal training, often undertaken on the job). By early 2015, 15 educational establishments had become VECCs and three more are to be established by the end of 2015.

Reforms of VET curricula and occupational standards recently took place in the framework of an ESF-funded project, which led to the creation of 12 Sectoral Expert Councils (SECs). SECs involve representatives from the government, the Free Trade Union Confederation (LBAS) and the Employers' Confederation (LDDK) in all major sectors of the economy, and are tasked with assessing future skill demands in the labour market. They also facilitate closer co-operation between employers and VET institutions in running the VET programmes (e.g., by providing a platform for co-ordinating classroom and practical activities).

While it is still too early to assess the effectiveness of these reforms, they are welcome and go in the right direction. Looking ahead, the Latvian government should closely monitor the performance of VECCs and assess whether the recent consolidation process has increased the overall quality and take-up of VET among both students and employers. While progress has been made in raising the attractiveness of VET to students and providing an institutional framework for closer involvement of employers, the success of these measures ultimately rests on employers adopting VET as a core element of their human resource and skill-development policies. SECs should be strengthened by encouraging active participation among employers, who have traditionally been reluctant to invest in workers' training.¹⁸ Such reluctance is arguably in part related to employers' past experience of skilled workers moving abroad, and needs to be seen in the broader context of Latvia's migration challenges. But labour market related policy factors, including an incomplete institutional framework for apprenticeships, also play a crucial role and point to the need for close co-ordination across policy areas.

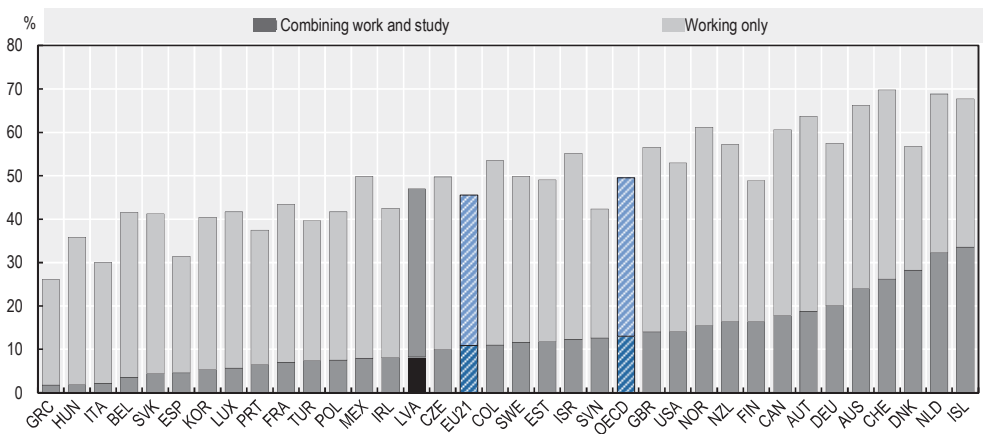
Fostering work-based learning and promoting a modern system of apprenticeships

Vocational education in Latvia is largely school-based and typically includes little company-based learning. In comparison with other countries relatively few Latvian youths combine work with education (Figure 3.10). The Law on Vocational Education prescribes that VET programmes at basic and secondary level should include a 50% practical component; but according to estimates from the Ministry of Education and Science, only 27% of the practical training in vocational education effectively takes place in companies (OECD, 2015a).

Formal apprenticeships are not uncommon, but they are often very short, in many cases not longer than one or two weeks. Since their content is not regulated, their educational value for students is often limited.¹⁹ Craft apprenticeships in more traditional sectors represent an exception, as they are better regulated and their educational content is richer, but they operate on a very small scale (Cedefop, 2015).

Figure 3.10. The share of youth combining education and employment is relatively low

Percentage of youth (aged 15-29), 2013



Source: OECD (2014), *Education at a Glance 2014: OECD Indicators*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/eag-2014-en>.

Positive results from a recent pilot project involving work-based learning underline that Latvia would benefit from a more systematic approach and an institutionalised (and better regulated) system of apprenticeships on a larger scale (in the private and, possibly also in the public sector).²⁰ However, Latvian employers continue to be generally reluctant to embrace a more encompassing system of apprenticeships and company-based learning. The main hurdles are that apprenticeships require firms to formally contract students, establish clear training obligations and, importantly, pay the minimum wage. Essentially, employers face a choice between unpaid internships and hiring apprentices on standard minimum-wage contracts. Employers frequently opt for the internship option, but unstructured and unpaid internships are not well-suited for fostering employers' investment in longer-term apprentices that are seen as valuable future employees.

An effective way of addressing these barriers would be to introduce specific employment contracts for apprentices including, as discussed in the previous section, minimum-wage provisions that take into account the role of apprenticeships as crucial staff investments and learning opportunities. There are several examples of such provisions in OECD countries (e.g., Australia, France, Germany, Korea, New Zealand and Portugal). In the Latvian context of substantial informality or underreporting, it is especially important that a more flexible apprenticeship contract is nevertheless well regulated, and does not open a further channel for underreporting or underpayment. For instance, simply extending the scope of internships, or allowing employers to pay “stipends” rather than wages governed by labour law, would appear counter-productive for strengthening apprenticeships, would further weaken the bargaining power of employees, and would likely result in attempts by some employers to use the new provisions as a possible additional channel for underreporting.

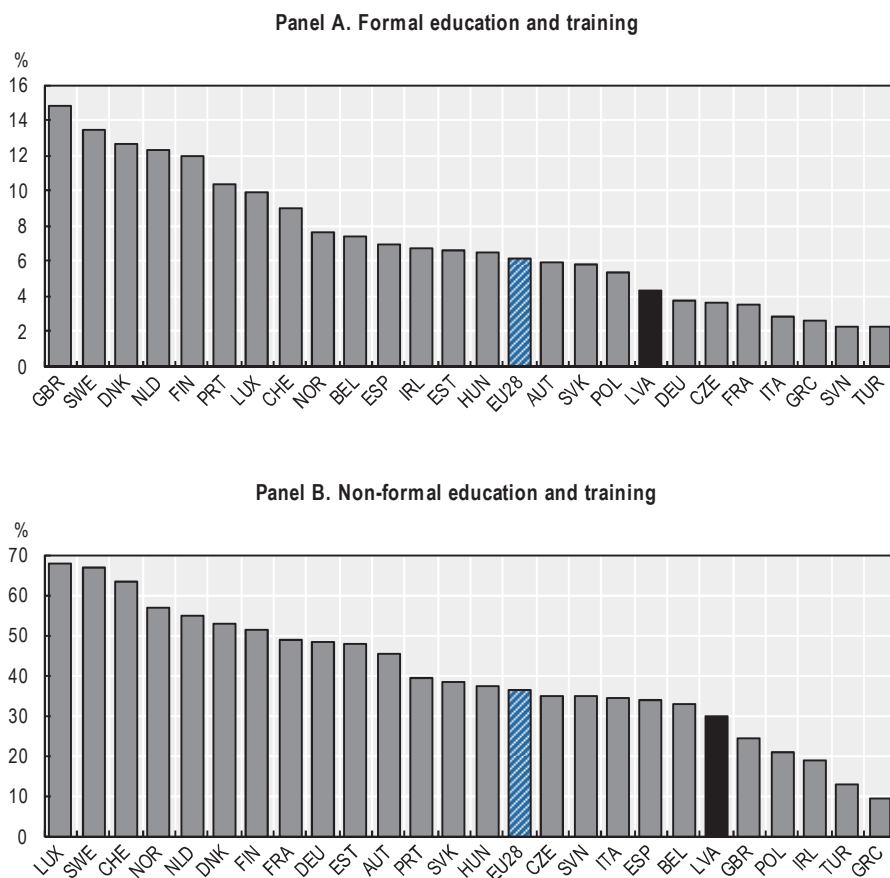
Specific financial incentives could play a role in promoting apprenticeships. They range from direct subsidies to hire apprentices (as currently provided in the United Kingdom and Australia), to tax rebates and reductions in social security charges (as in Canada and France, where the rebate increases if employers hire disadvantaged students). However, a strong monitoring framework and enforcement of applicable eligibility criteria for entitlement to subsidies, is essential to prevent abuse of financial incentives. One effective way of financing incentive schemes would be to institute an “apprenticeship fund”, to which all employers are mandated to contribute.²¹ Similar cost-sharing mechanisms are in place in Norway (shared apprentices) and in Australia, where group training organisations have been created to cover the costs of recruiting and contracting apprentices, who are then placed them with a “host” employer (OECD, 2016a).²² Such cost sharing mechanisms could be particularly valuable for the large number of very small employers in Latvia, who often lack the resources to bear the costs of setting up formal apprenticeships.

Enhancing lifelong learning

An effective education strategy should not only focus on new labour market entrants, but also provide viable learning opportunities for workers at later stages in their careers. This is particularly important in the context of volatile labour markets and a rapidly changing industrial structure, which has resulted in the displacement of workers whose skills are no longer demanded by employers.

In Latvia, participation in lifelong learning is among the lowest in Europe (Figure 3.11), and a study by the World Bank shows that fewer than 40% of employers provide training, compared with 50% in Lithuania and 77% in Estonia. Over 80% of workers not engaged in training in Latvia believe that training is not needed for their job. Firms who do not provide training declare that they already have workers with the necessary skills to perform all the required tasks and that they would prefer hiring new people to training their existing employees (World Bank, 2015).

Figure 3.11. Participation in lifelong learning is low



Note: Based on the adult education survey (AES). The reference period for AES is the 12 months before the interview. 2007 data for Turkey.

Source: Eurostat database.

To encourage participation in lifelong learning, the perception of training and adult education must change, especially among older people, and this requires raising both the quality and the accessibility of training programmes. OECD work has identified key components of such a strategy, including carefully tailoring available training programmes to employer needs and employee circumstances, and favouring real work activity and participatory learning methods (OECD, 2014).

4. Addressing the needs of youth and older workers

Several of the policy measures discussed should be further tailored to the needs of specific socio-demographic groups. First, as in most OECD countries, the situation of youth, and in particular of young NEETs, deserves special attention, as the economic crisis has hit them particularly hard. Second, older workers, who represent a large and growing share of Latvia's labour force, have faced employment difficulties since the transition period of the 1990s, as deep industrial transformations exposed the mismatch between newly demanded skills and those developed during the Soviet era.

Easing youth's access to the labour market

Youths have borne the brunt of the crisis and many have lost contact with the labour market

Young Latvians have borne the brunt of the economic crisis. Employment among workers aged 15-24 fell from 38.1% in 2007 to 25.4% in 2010, while their unemployment rate more than tripled over the same period (from 10.6% to 36.2%). Despite a fast recovery in recent years, youth unemployment in 2014 remained almost twice as high as its pre-crisis level.

Even the recent improvements should be interpreted with caution, due to the bleak demographic situation. In fact, the dramatic job losses observed during the crisis were not matched (in absolute terms) by corresponding gains during the recovery, and the recent fall in the unemployment rate was, to a large extent, the result of a shrinking population.²³

Moreover, the rate of labour force participation among Latvian youth has been persistently below the OECD average, pointing to structural labour market problems for younger workers. In 2014, the share of youths aged 15 to 29 who were not in employment, education or training (NEET) was 15.2%. Out of all NEETs more than half are not looking for work (OECD, 2014a), and the majority of NEETs (about 70%) remain out of employment and education for more than half a year.²⁴ These figures highlight the importance of looking beyond unemployment rates when assessing the

labour market situation of youth and underscore the fundamental role of specific policies to encourage activation of young workers.

Recent reform initiatives have culminated in the Youth Guarantee

Giving youth a better start in the labour market is at the forefront of the international policy agenda and the OECD Action Plan for Youth, which sets out a comprehensive range of measures that OECD countries are committed to undertake (OECD, 2013c). In Latvia, the main policy initiatives have focused on widening the availability of career counselling, facilitating geographic mobility, subsidising youth employment and, in particular, raising skills. An important objective has been to raise the effectiveness and accessibility of labour market programmes for youth. Most recently, as part of an EU-wide initiative, these measures have been reinforced by the introduction of a comprehensive Youth Guarantee (targeting people between 15 and 29), which operates in three stages (see Box 3.2).

Box 3.2. The Youth Guarantee in Latvia

Following the experience of other EU countries, Latvia introduced a Youth Guarantee scheme in 2014, targeting people between the age of 15 and 29. The scheme operates in three stages:

1. Reinforcing the availability of active measures for unemployed youth.
2. Developing “second chance” training programmes for low-skilled youth with the support of VET schools.
3. Promoting outreach activities to re-engage inactive youth.

The first stage concentrates on getting unemployed youth back into work through reinforced employment services and active labour market policies. The second stage is primarily concerned with bringing low-skilled youth into vocational education. The third one focuses on better identifying and monitoring inactive youth, and organising outreach activities that help raising their motivation to return to studies or to the labour market. In order to access support through the Youth Guarantee, participants need to register with the SEA or apply to a VET school for participation in a second chance program.

The Guarantee aims to provide each client with a good quality offer of employment, an opportunity of continued education, an apprenticeship or a traineeship within four months of registering. Most of the planned initiatives are supported by the ESF and the Youth Employment Initiative (YEI), which was launched by the European Commission in 2013 to provide extra support to young people aged below 25 and living in regions where youth unemployment was higher than 25% in 2012. The total budget of the YEI is EUR 6.4 billion for the period 2014-20.

But its impact is still unclear and further improvements are needed.

While it is too early to assess the full impact of the Youth Guarantee in Latvia, some results are already visible. Since 2014, participation of youth in active programmes has increased significantly, particularly in the area of short training programmes, where the percentage of participants among newly registered unemployed grew from 50% to 66% between 2013 and 2014 (OECD, 2015a). Despite these encouraging results, a number of further improvements are needed to translate higher accessibility into positive labour market outcomes for participants.

The Youth Guarantee is expensive and priorities have to be set to make it as effective as possible:

- Career consultations are an important first step in facilitating youth employment, but their provision remains fragmented and not sufficiently co-ordinated between different public agencies (OECD, 2015a). The number of career consultations provided by the SEA to young workers in 2014 reached 31 000, but fell short of the original target of 39 000, and lack of personnel resulted in very high caseloads.²⁵ To be most effective, career counselling should be first provided in schools and an effective consultation system requires co-ordination between PES and educational institutions.
- As discussed in Section 2, understaffing may negatively affect participation rates in ALMPs, particularly among the most disadvantaged groups who need intensive support. High caseload also limits the capacity to enforce the conditions for income support and it constrains the SEA's capacity to follow up on the most disadvantaged youths after programme completion.²⁶ Ideally, a case should not be closed until a follow-up is carried out (e.g., six months after program completion), but in practice follow-ups are rare. A possible approach would be to make part of the caseworkers' pay contingent on carrying out a satisfactory follow-up (OECD, 2015a). To meet the resulting demands on staff's time, however, additional SEA staff resources seem necessary, despite the projected fall in unemployment over the coming years.
- Training programmes developed as part of the YG can be very expensive to administer and run. They should therefore be closely targeted at youth who really need them and are motivated to undertake them. The promotion of complementary youth workshops (short work stints that allow young workers to learn about the educational and professional requirements of different jobs) can be useful for ensuring that participants in training programmes are sufficiently motivated.

- Strengthening the link between VET institutions and local employers would increase the likelihood that participants in second-chance programmes find employment. A link should also be established between career consultants at the SEA (or social service office) and VET schools, to facilitate monitoring and counselling of the most disadvantaged students.

Helping older workers find jobs that suit them

Older workers face the most severe risk of exclusion from the labour market

Older workers in Latvia face unique challenges. On the one hand, their rate of labour market participation is relatively high: in 2014, 62.6% of workers aged 55-64 were in the labour force, compared with an OECD average of 60.5%. On the other hand, their unemployment rate is substantial (9.9% in 2014, vis-à-vis an OECD average of 5.5%) and often prolonged (the incidence of long-term unemployment is 45.5%), as opportunities for re-employment after job loss are scant. Since senior workers were educated and began their careers prior to Latvia's transition to a market economy, substantial skills mismatches are a more frequent problem than for younger generations. Education levels also tend to be lower among older unemployed. Workers who are older than 50 account for one half of those who have suffered from persistent labour market difficulties in recent years, i.e. those who have suffered repeated spells of inactivity, unemployment, or informal/unstable/low-paid employment (Ferré et al., 2013). A sizeable share of this group is also affected by chronic health problems.

From passive to active programmes for older workers

In most OECD countries, older workers are primarily targeted by passive support measures, which do not entail an activation component. Participants in a 2012 European peer review of public employment services (PES) expressed broad agreement on the best means to get the older unemployed back to work (PES-to-PES, 2012): personalised action plans with a focus on active support, together with targeted group activities, were identified as the most effective interventions.

A number of countries have already chosen to eliminate longer-term passive programmes for older workers, as part of their broader activation strategy (see Box 3.5 in OECD, 2014c). In Denmark, workers aged 55 and over, whose unemployment insurance benefits have expired, and who are entitled to early retirement within the next five years are offered a “senior job” provided by their local municipality (OECD, 2015g). Similarly, in

Norway, the general rules governing unemployment benefits for older workers have been brought in line with the entitlements of younger jobseekers, and participation in activation measures is guaranteed to older workers who are close to retirement and cannot find a job (OECD, 2013b).

Older workers are a primary target group of ALMPs, but the mix of programmes needs to be improved

In Latvia, temporary work programmes have been the most common form of ALMPs offered to older workers in recent years and after the crisis in particular. These typically entailed socially useful work in municipalities, associations and foundations; and they were an effective redistributive measure at a time of significant hardship. However, subsidised employment in the public sector can hardly constitute a sustainable strategy to improve the labour market outcomes of older workers; and it might even be counter-productive in the long run if it decreases the attractiveness of participants to private sector employers (this might be the case, for instance, if employers tend to have a negative perception of workers who need subsidised employment). While this is true of public employment in general, the problem is likely to be more severe for older workers, as the underlying demand for their skill-set is generally weaker. It is crucial, therefore, to provide older jobseekers with more opportunities for regular employment. Facilitating access to part-time jobs and flexible work arrangements may be an effective way to enhance older workers' employment and smooth their transition to retirement.

Participation in adult training is too low

Evidence from the OECD International Survey of Adult Competencies (PIAAC) shows that less skilled workers who have received training to enhance their cognitive capacities are less vulnerable to technological change (OECD, 2013a).²⁷ Yet, training take-up is low among older workers (World Bank, 2015) and should be fostered. To attain this objective, programme contents should be carefully tailored to the specific needs of older workers and of the firms that typically hire them. A step in the right direction has been taken in Poland: a National Training Fund was established in 2014 with a short-term priority to reach workers over the age of 45 (OECD, 2015f). Firms should also be incentivised to invest more into training older workers. This could be facilitated by promoting pilot projects to demonstrate that, enhancing workers' qualifications in the second part of their careers yields sizeable dividends for employers, and allows them to better retain productive workers, and address labour shortages in a context of increasing retirement ages and life expectancy. In countries where the employment rate of older workers has increased over the past decade, this

has been primarily achieved through a higher retention rate of workers in their job, especially after the age of 60 (Sonnet et al., 2014). In Latvia, the main focus of the government's upskilling strategies has largely been on labour market entrants, and on the unemployed, and less on existing and older employees.

Improving employers' attitudes towards hiring and retaining older workers

Firms across OECD countries tend to show a bias against hiring senior workers. For instance, according to available evidence from the Norwegian Senior Policy Barometer, 33% of employers think that job applicants should have at least ten years to retirement in order to be invited for an interview (OECD, 2013b). The Latvian SEA recently carried out an analysis of workers' economic potential close to retirement. In a survey of employers only 2.9% of respondents indicated that they would prefer to fill a new vacancy with a worker aged 50 or older. Most worryingly, 35% of all respondents would not be willing to employ a worker aged 50 or older at all.²⁸ These concerns are often misguided as productivity does not necessarily fall with age, and may in fact increase (World Bank, 2015; Börsch-Supan and Weiss, 2011). Employers' misperceptions may be changed by disseminating this information and fostering age-diversity in the workplace. Such policies exist in several countries, including Australia, Finland, France, the Netherlands, Norway and the United Kingdom (OECD, 2006). It may also be useful to devise measures that directly bring jobseekers in contact with employers, helping the latter overcome their prejudices. Such measures include job fairs, speed dating and work trials (as introduced in the Netherlands). Helping older workers obtain an interview and a work-trial has been shown to be an effective way to demonstrate their value to employers (European Commission, 2012). In Latvia, job fairs are among the activities currently organised by the SEA and participation among older workers should be strongly encouraged.

The SEA should be equipped to addresses the specific needs of older workers

SEA offices should have specialised job counsellors who have been trained to deal with the specific needs of older workers (as in Lithuania, since 2012); and it may be desirable to link older jobseekers with counsellors of a similar age, to avoid the feeling of taking guidance from someone who is new to the labour market (World Bank, 2015). Individual action plans that are tailored to the needs of older workers (possibly on the basis of a specific profiling process) should be devised early in the unemployment spell and followed closely. Group counselling and "job

clubs” have also been introduced in a number of countries (e.g. Germany, the Netherlands, Estonia and Belgium) to overcome problems of social isolation and lack of social skills among older workers. In cases of enterprise restructuring that lead to worker displacement, the SEA should be able to provide rapid and intensive job placement services to prevent scarring from prolonged unemployment. When possible, assistance should already be provided prior to dismissal, which in the case of collective redundancies must be notified to the SEA one month in advance. A crucial aspect of a successful job placement strategy is to establish stable partnerships and effective co-ordination between the PES and other institutions that assist older workers, including employer organisations, municipal social services, temporary work agencies, VET institutions, NGOs and advocacy groups.

A new Comprehensive Active Ageing strategy

In order to address the challenges of an ageing population and foster employment opportunities for senior workers, the Ministry of Welfare has devised a new active ageing strategy with support from the European Union. The objective is to carry out a comprehensive evidence-based assessment of the labour market challenges faced by older workers and identify the best policy tools to foster longer and better working lives.²⁹ A wide spectrum of measures is being assessed, ranging from broad activation policies to specific work-place regulations on age-specific equipment, mixed-age teams, working time reductions and lifelong learning. This is a welcome and necessary initiative and a full assessment of policy options should be based on a careful consideration of the study’s results. An important first step, however, is to better customise the provision of existing labour market and income support to the situation of older workers, and make them more employment oriented. Given a high incidence of health problems among senior workers, parallel improvements of the disability assessment system, as currently planned, are also crucial (see Chapter 4).

Notes

1. Latvia shows more stringent regulation in the area of “Protection of permanent workers against individual and collective dismissals”, “Protection of permanent workers against (individual) dismissal” and, in particular, in the area of “Specific requirements for collective dismissal” (OECD Indicators of Employment Protection, 2013).
2. Prior to the reform, “Regulation on temporary forms of employment” was already the only dimension of EPL where Latvia was less restrictive than the average OECD country.
3. The compensation is equal to one month of average pay until the worker reaches five years of tenure and grows thereafter. Different rules apply in case of dismissals following misconduct and when a larger severance pay is specified in the contract or collective agreement.
4. The quality of VET education is monitored by the State Education Quality Service, through the implementation of the European Quality Assurance Reference Framework in vocational education and training (EQAVET).
5. A front-line office worker in Riga deals with about 500 clients in a two-month period and counsellors conduct about 200 sessions per month (OECD, 2015a).
6. Evidence collected by the OECD suggests that social service caseworkers are responsible for about 20 to 70 families at any one time. In Riga, the range is about 60 to 70 families (OECD, 2015a).
7. Social work specialists will be trained to deal in particular with people at risk of social exclusion and facing difficulties to enter the labour market. The training will cover a wide range of competencies, including how to address the needs of long-term unemployed, disabled workers and minority groups.
8. If an individual rejects two suitable job offers benefits should be terminated.
9. Moreover, jobseekers who are offered professional training as part of their activation strategy (usually after a few months of being registered as

- unemployed) can refuse to attend the training if they are not interested, without facing penalties.
10. Except for social rehabilitation measures that may include some employability elements and are required as a pre-condition for receiving Guaranteed Minimum Income benefits.
 11. About 15% of the long-term unemployed benefited from this inter-agency co-operation in 2013. Among them, 62% found a job, compared with only 35% of the unemployed with a similar profile not involved in the programme (European Commission, 2014).
 12. There are two main policy documents; the Ministry of Welfare's "Action Plan for the Reduction of Unregistered Employment" (Ministry of Welfare, 2010) and the Ministry of Finance's "Combating the Shadow Economy" (Ministry of Finance, 2010).
 13. Introducing minimum social contributions for all workers regardless of hours worked is being discussed as a potential remedy, but it carries the aforementioned risks.
 14. Countries with remarkably similar minimum-to-median wage ratios may differ markedly in the proportion of workers earning at or below the minimum wage (e.g. Japan and Korea). In other countries, like Belgium, despite a relatively high minimum-wage, very few employees are actually paid the minimum, in part due to the diffusion of collective agreements setting higher wage floors (OECD, 2015b, Chapter 1).
 15. They may benefit to some extent if household members are not long-term jobless but have unstable jobs and repeated transitions between unemployment and low-wage work.
 16. Several countries use special tax concessions or "in-work benefits" to directly support the income of low-wage earners. For instance, Mexican low-earners receive a supplement in the form of a tax credit. Belgium and the United Kingdom provide generous in-work benefits or reductions in social contributions to all or most low-wage earners. Several other countries attempt to maintain a low tax burden on low-earners by means of progressive income taxes.
 17. The main objectives of recent reforms in tertiary education have been to optimise funding allocation based on performance, ensure better conformity of qualifications and skills with labour market needs, improve the contents of study programmes in co-operation with employers and strengthen the link between educational institutions and enterprises.
 18. Evidence collected during the OECD review mission points to the fact that Latvian employers frequently consider the state to be responsible for

- providing well-trained workers, who are expected to exit the education system fully equipped to work in very specific sectors.
19. Interns are often considered as low-cost, low-skilled labour and assigned simple tasks, and therefore typically entail little learning (OECD, 2015a).
 20. In 2013-14, a pilot project was launched to promote work-based learning in six VET institutions, with employers from a number of sectors (including mechanical engineering, transport, pharmaceuticals and chemistry) providing work-based practical learning. The results were encouraging and the government plans to expand the programme, as outlined in the national Education Development Guidelines for 2014-20 (Saeima, 2014).
 21. Such a strategy is currently adopted in Denmark, where employers contribute a certain amount to the fund for each employee; and in France, where employers pay an apprentice tax that serves to finance workplace training.
 22. A more comprehensive discussion of these measures is provided in OECD (2015a).
 23. The OECD estimates that in the absence of any change in the size of the 15-29 population, the registered drop in the number of people employed from 2007 to 2010 would have translated into a much larger drop in the employment rate, from 50.1% to 36.2% (instead of the observed 40.1%). Similarly, the registered increase in the number of people employed from 2010 to 2013 would have translated into only a very mild recovery in the employment rate, which would have only reached 37.6% in 2013 (10 percentage points less than the observed rate of 47.9%).
 24. More than two-thirds of all inactive NEETs report staying out of the labour market for family reasons, due to enrolment in non-formal education or because of health related issues (OECD, 2015a). The remaining third is inactive for other reasons, most notably discouragement. This is the group that should, above all, attract the attention of policy makers, through improved outreach activities and employment services.
 25. In 2014, there were only 37 career consultants working specifically with young people throughout Latvia, dealing with over 30 000 youths who visited the SEA (with the introduction of the YG, the situation has improved, but additional resources are needed).
 26. A follow-up is crucial to avoid churning, as youths might either relapse into discouragement or find it difficult to keep a newly found job (this holds especially true for youth without prior experience, those who find it hard to cope with new work environments and responsibilities, and those with a history of substance abuse or family problems).

27. The PIAAC survey was conducted in 24 countries, not including Latvia.
28. The main stated reason was that older workers were unable to cope with work demands, not only in physically demanding jobs. A further 16.9% of respondents indicated that older employees have an inflexible way of thinking and have difficulties accepting change and learning; and 11.5% were concerned with health problems and lower productivity.
29. As part of the project, the Ministry of Welfare has signed a strategic partnership with Austria, Poland and Estonia to exchange good practices and experience.

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Chapter 4

Reinforcing Latvia's active social policies

Major reforms of social protection policies in the 1990s addressed the pressing fiscal challenges arising from a relatively generous social protection system during the transition to a market economy. The reforms also aimed to strengthen work and reporting incentives by introducing strong links between earnings histories and support entitlements. Today, Latvia's weakly redistributive government taxes and transfers are one reason why income inequality is significantly higher than in most OECD countries. Public perception echoes the limited effectiveness of government policies in this area, and making social protection more effective and adequately resourced should become a more central element of the government's inclusive growth strategy. Volatile economic growth and periods of substantial long-term unemployment underline the role of needs-based assistance benefits and associated services as essential complements to contribution-based social provisions. Unemployment benefits for active job seekers should be made more accessible, and a comprehensive review should analyse the consequences of the expected pensions gap for poverty and income adequacy during old age.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

1. Making effective social protection a key policy priority

Adequate and well-targeted social protection is needed to help Latvians cope in a volatile economy, and to tackle high inequality. In comparison with OECD countries, government taxes and transfers in Latvia do comparatively little to make incomes less unequal. Inequalities of market incomes in Latvia are similar to Finland or Germany, but with limited redistribution, the distribution of disposable incomes (after taxes and public transfers) is one of the least equal in the OECD (Figure 4.1, Panel A). Public perception echoes the limited effectiveness of government policies in this area. Latvians consistently report very low levels of satisfaction with the way in which inequalities and poverty are addressed, highlighting the need for comprehensive and sustained reforms (Figure 4.1, Panel B).

Major reforms in the 1990s successfully addressed the pressing fiscal challenges arising from a relatively generous social protection system in the context of the large income and employment losses that accompanied the transition to a market economy. The reforms also aimed to strengthen work and reporting incentives by introducing strong links between earnings histories and support entitlements, removing the strongly redistributive elements that were a defining feature of “cradle-to-grave” social protection during the Soviet era.

Figure 4.1. Government programmes do little to alleviate inequality

Panel A. Inequality before and after taxes and transfers, 2012 or latest year available

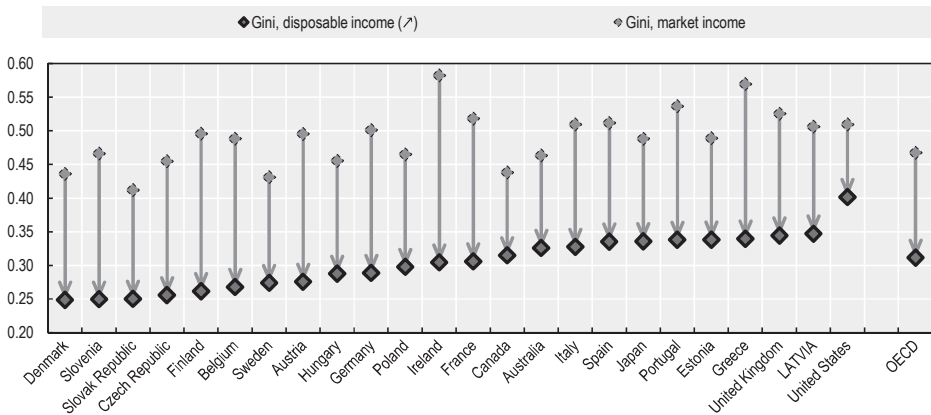
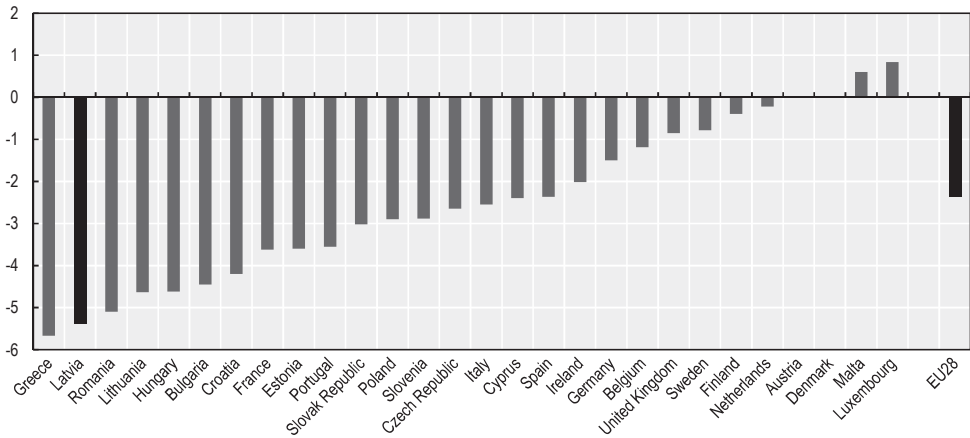


Figure 4.1. Government programmes do little to alleviate inequality (cont.)

Panel B. Dissatisfaction with the way inequalities and poverty are addressed, average 2009-14



Note: Results in Panel B are averages over six waves (2009-14) of an annual survey that asks respondents to evaluate “the way in which inequalities and poverty are addressed”. Survey responses are reported as index values on a scale from +10 (most satisfied) to -10 (most dissatisfied).

Source: OECD Income Distribution Database (<http://oe.cd/idd>) and European Commission (2015), “Special Eurobarometer 418 – ‘Social climate’”, http://ec.europa.eu/public_opinion/archives/ebs/ebs_418_en.pdf.

Main elements of the Latvian social protection system

Today, social protection in Latvia is largely built on social insurance principles, both on the financing side, and as a central entitlement criterion for those claiming social support. Social insurance programmes are complemented by a State Social Security benefit which is funded from the state budget and acts as a benefit floor for some groups (e.g., those with limited contributions), by universal family transfers, and by locally funded means-tested cash social assistance and housing benefits with very strict income thresholds.

Earnings-related ***unemployment insurance benefits*** are available for those with at least 12 months of contributions overall and 9 months during the year before becoming unemployed. The replacement rate depends on the insurance record and ranges from 50 to 65%. Benefit durations are comparatively short and coverage among the unemployed is very incomplete. Benefit claimants must register with the public employment service (State Employment Agency, SEA) and formal requirements for job search, availability for work and participation in active labour market

programmes (see Chapter 3) are relatively strict. There is no follow-up unemployment assistance.

Sickness benefits are available from the second day of illness, without qualifying period, subject to work incapacity as certified by a family doctor. Employers pay between 75 and 80% of insured earnings, without ceiling, for up to ten days. From the eleventh day, social insurance benefits (80% of insured earnings, subject to a ceiling), are normally available for up to 26 weeks (up to 52 weeks in any three-year period). Sickness benefits for up to three weeks are also available to parents caring for sick children under the age of 14.

Disability benefits are available in three different categories, depending on the degrees of disability and need for care. Those who have an insurance record of at least three years and suffer either from the consequences of a work accident/occupational disease or from a certified disability in one of the two higher categories are entitled to a disability pension. Benefit amounts are calculated in proportion to reference earnings in the five years prior to the claim, and increase with the claimant's contribution record. Claimants who are not entitled to insurance benefits receive the State Social Security benefit at a rate of at EUR 64 (equivalent to 18% of the minimum wage) in the lowest category of incapacity, rising to EUR 76 and EUR 83 in the higher categories. Benefits are higher for those with disabilities since birth. In all cases, benefits are paid as a permanent pension. They can be reviewed if the disability category changes but benefit reductions are not common. Upon reaching the legal retirement age, the disability pension is converted into an old-age pension. A separate **disability care allowance** of EUR 213 per month (approximately 60% of the minimum wage) is available for children and adults requiring special care at home as assessed by an expert commission. In addition, parents or guardians of children with a disability receive a supplement to the Family State Benefit (see below) amounting to EUR 107 per month (equivalent to 30% of the minimum wage).

Following fundamental reforms in the 1990s, **old-age pensions** are based on a multi-pillar system consisting of a mandatory notional defined contribution (NDC) public "1st pillar" that is financed on a pay-as-you-go (PAYG) basis, a mandatory defined contribution (DC) "2nd pillar", and a voluntary private-pension "3rd pillar". Pension levels and public spending on old-age pensions are low in international comparison and are projected to fall further in the medium term. The minimum contribution requirement for the 1st pillar is 15 years, rising to 20 years in 2025. A modest minimum pension of around EUR 70-109 per month (equivalent to 20-31% of the minimum wage, depending on contribution years) is available to retirees with short contribution histories or low NDC entitlements. Public pensions granted before 1996 are not taxable. The current legal retirement age is

62.5 years for both men and women, rising in annual steps to 65 years by 2025.

A *survivor pension* is available for minor children (and for certain family members that were supported by the deceased person and are incapable of working). The pension depends on the deceased persons' social contribution and is calculated as a percentage of his or her potential old-age pension, subject to a minimum of 65% of the EUR 64 per month State Social Security benefit (equivalent to 12% of the minimum wage). There is no survivor pension for surviving spouses or partners (spouses of a deceased pensioner receive a single lump-sum payment of two monthly pensions).

Maternity benefits replace up to 80% of lost earnings before and after childbirth, for a total duration of normally 112 days (up to 140 days in case of pregnancy-related institutional care from an early stage of pregnancy and specific health problems or complications). Insured fathers are entitled to ten days of paternity benefit at 80% of insured earnings. *Parental benefit* provides replacement income of 60% of previous earnings to the parent taking childcare leave for one year after child birth, or 43.75% for 1.5 years. The parental benefit can also be combined with income from work; the amount is reduced to 30% in this case. According to the *OECD Family Database*, around 60% of mothers with a child under 1 year of age were either on maternity or parental leave in 2011, while the shares of fathers taking leave were negligible.¹ A tax-financed universal *child raising allowance* amounting to EUR 171 per month (equivalent to 48% of the minimum wage) is provided to parents of children between 1 and 1.5 years of age. Eligibility continues until the child's second birthday but drops to EUR 43 per month from age 1.5 years onwards. The allowance can be cumulated with parental benefit and is also paid to parents of children under 1 year of age who are not eligible to the parental benefit. All family-related income-replacement benefits are free from income tax, and earnings replacement after tax can be close to 100% for parents with low earnings.

The *Family State Benefit* provides a universal flat-rate transfer amounting to approximately EUR 11 per month (equivalent to 3% of the minimum wage) for the first child, twice as much for the second child, and three times as much for the third and further children. It is paid for each child from age 1 until age 15 (i.e., following the first 12 months of parental benefit), and up to age 19 while the child remains in education. There is no additional public cash transfer for *lone parents*, although child support payments from the absent parent to the custodial parent are guaranteed by the state.

A last-resort social assistance benefit (*Guaranteed minimum income*, GMI) is financed and administered by municipalities. The central

government sets minimum standards for GMI benefit levels, which are however very low, not based on an objective assessment of economic needs, and not systematically adjusted over time. Municipalities can set higher benefit levels but few do and, as a result, the GMI programme in its current form does not provide effective poverty alleviation. Benefit recipients must co-operate with social workers of the municipal social service, and those with a capacity to work have to register with the SEA. GMI benefits are granted only for relatively short periods at a time. Longer benefit is possible but requires recertification every 3-6 months. A cash *housing allowance* for low-income households and discretionary *emergency benefits* are also financed and administered by municipalities, but can also be provided in-kind (e.g., firewood).

Responsibility for financing and providing *social services* is divided between the central government and municipalities. Municipalities are responsible for funding social work, home care, social care and social rehabilitation at the place of residence, shelter, crises centres, and housing support for certain groups with functional or mental disabilities. The central government finances institutionally provided social and vocational rehabilitation, institutional long-term social care and social rehabilitation for certain groups with mental disabilities and for certain groups of orphaned children. Some costs of municipality-provided social services (e.g., costs of setting up certain types of physical infrastructure) are co-financed by the central government during an initial phase.

Public *non-parental childcare* is also provided by municipalities. Both municipalities and the central government provide financial support to those parents who must use registered private childcare. Central government support amounts to up to EUR 142 per month and child, but will be stopped after 2015. Pre-school is provided free of charge from age 5. There is some dated evidence that a relatively large proportion of employers provided childcare or childcare-related support to their employees (Anxo et al., 2007). The *OECD Family Database* shows enrolment in formal childcare of around 75% for children aged 3 or 4 in 2010, which is close to the OECD average. But despite relatively low net childcare costs, participation is low for children under 3 (17.7%, just over half the OECD average of 32.6%), pointing to capacity problems and insufficient supply of childcare services even when employment was still very low after the economic crisis.² Partly in response, the government revised the legal framework as of 1 September 2013, with a view to broadening the choice of alternative childcare services. By December 2014, 69 private childcare centres and some 1 200 nannies were registered and have relieved some pressure off waiting lists for publicly provided preschool education in municipalities.

Social spending is low and weakly targeted

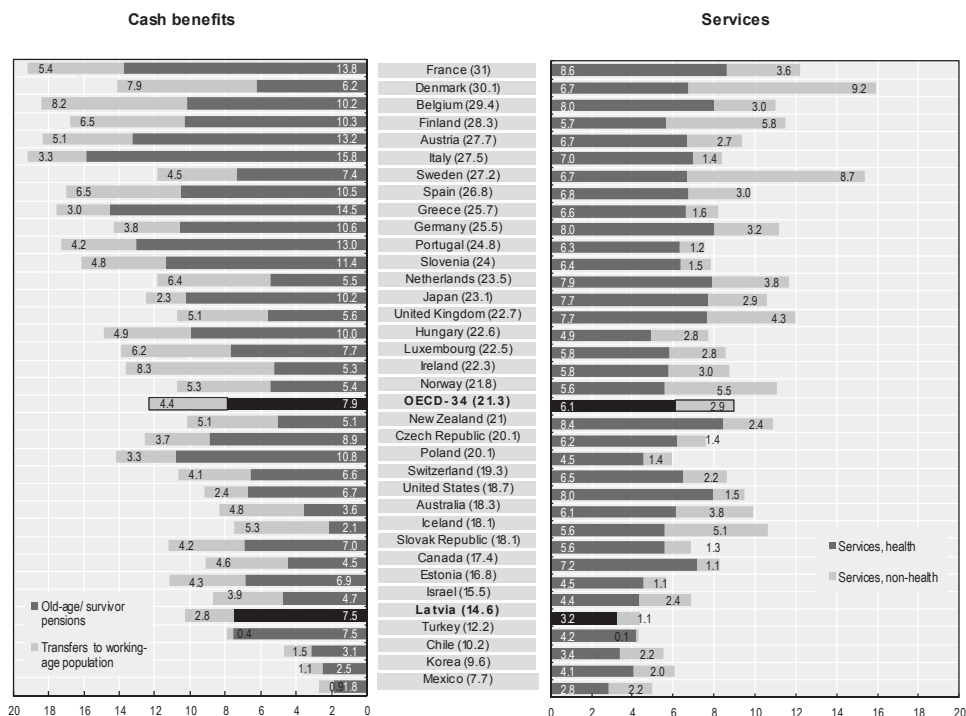
At just over 16% of GDP, public social spending in Latvia is well below the OECD average of around 21% (Figure 4.2). Spending on old-age pensions and survivor benefits is similar to the average OECD country, but expenditures in all other categories are markedly lower. In 2012, when household incomes were still near their post-recession low, cash transfers to working age individuals and their children stood at roughly three quarters of the OECD country average. The resource gap is biggest, however, in the services category. Relative to GDP, spending in this category, which also includes health, was slightly above Mexico's and lower than in any high-income OECD country. Expenditures on social services other than health (including housing, social work, childcare and ALMPs) are less than half the OECD average.

Spending on well-targeted income-safety nets is currently very low, with the guaranteed minimum-income (GMI) benefit and housing allowance together accounting for only 2.2% of all cash benefits and 8% of all “non-elderly” benefits (all cash transfers except old-age and survivors pensions).³ Overall, under 3% of transfer spending is devoted to programmes that are largely means-tested (Figure 4.3). Latvia's policy configuration is unusual in this respect: OECD countries with equally low spending make much more use of income targeting. Although the extent of mean-testing is also very limited in several Eastern European comparator countries, they spend more than Latvia does. As a result, they are more likely to be able to channel needed support to low-income groups even without explicit means-testing.

Redistribution between income groups is limited due to a flat income tax, a strong link between insurance contributions made while in employment and the benefits received when out of work, and very modest assistance benefits for those with persistently low incomes. Earnings-related social insurance provisions are well-suited for smoothing individual risks when career interruptions are relatively short and infrequent. But the strong increase in inequality has strengthened the case for bolstering redistribution across income groups, and for making employment-oriented social support more broadly accessible for those with no or limited contribution histories. Volatile economic growth and periods of substantial long-term unemployment further underline the role of needs-based assistance benefits and associated services as essential complements to contribution-based social provisions.

Figure 4.2. Public social spending is low

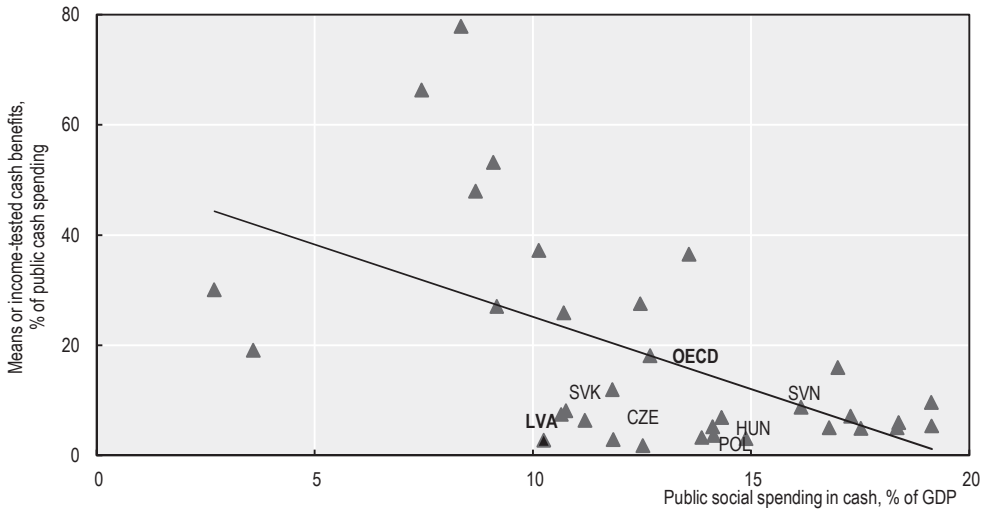
Public social spending by broad policy area, 2012, as a percentage of GDP



Note: Total in parentheses. Countries are ranked in decreasing order of total expenditure. Spending on Housing support and active labour market programmes (ALMPs) includes cash support (such as rental allowances and cash payments to programme participants) but are entirely counted as services as these categories cannot be split. Income support to the working age population refers to spending on the following SOCX categories: incapacity benefits, family cash benefits, unemployment and other social policy areas including social assistance. Data for Australia, Canada, Chile, Israel, Korea, Latvia, New Zealand, and the United States refer to 2012, all others to 2011.

Source: OECD Social Expenditure (SOCX) Database (<http://www.oecd.org/social/expenditure.htm>).

Figure 4.3. Limited use of means-testing is one reason for weakly targeted social protection



Note: 2012 or latest year available. Transfers include all public social cash benefits.

Source: OECD Social Expenditure (SOCX) Database (<http://www.oecd.org/social/expenditure.htm>).

Since the start of the crisis additional support for the poorest, in particular, has been provided. But until now, such measures were mostly ad-hoc and primarily aimed at easing a temporary social emergency situation, rather than systematically addressing longer-term structural challenges. Latvia's modest, uneven and often inaccessible income safety nets were left severely over-stretched by the enormous need for well-targeted support during an extraordinarily deep downturn. With the technical support by the World Bank and financial support from the European Social Fund, Latvia swiftly enacted additional anti-poverty measures in 2009, notably including a temporary public works programme (Azam et al., 2013; Hazans, 2012).⁴ In addition, the government started to co-finance safety net benefits administered by local governments making last-resort income transfers more accessible to Latvians in the poorer parts of the country. These temporary emergency programmes provided vital and timely income support. But the sharp expenditure reductions enacted as part of a dramatic fiscal consolidation programme, meant that reforms undertaken in immediate response to the crisis were not – and arguably could not be – designed to fill structural gaps in the social protection system.

As the recovery took hold, a number of issues have continued to constrain the effectiveness and crisis-readiness of Latvia's social policies.

First, the resource base for social protection is weak and low spending levels make it difficult to ensure that social protection is both accessible and of good quality. While the system's fiscal sustainability appears solid, projected reductions in benefit spending from already-low levels can endanger income adequacy and, with it, the system's longer-term social and political sustainability. Second, to reach those with the greatest need for support, targeting measures should be reinforced and support should be made more responsive to changing economic conditions. And third, the government should intensify efforts to make existing social policies more employment-oriented and more strongly geared towards promoting self-sufficiency, notably by ensuring that both income and employment-related support is available to all who need it.

Strengthening the resource base for social protection

The current financing mix suggests that bringing social spending closer to the OECD average will remain difficult. Despite still-depressed wage incomes in 2012, social insurance contribution on wages accounted for 61% of all social protection financing, the fifth highest share in the EU27.⁵ The strong reliance on contribution-based financing creates challenges for bolstering the resources available for social protection:

- A contracting labour force, the large share of low-wage earners, and considerable wage-underreporting (see Chapter 3) make it difficult to maintain adequate revenues, while keeping contribution burdens on labour incomes at acceptable levels. The total social contribution rate is currently 34.09% of gross earnings and results in a high tax wedge for low-wage workers in particular (OECD, 2015a).
- A “thin” middle class (see Chapter 1) means that this group cannot generate as much revenue as in other countries, as the middle class is typically the key contributor to social insurance finances.
- Latvia's volatile economy increases risks of long-lasting income shocks hitting large parts of the population. This makes risk pooling and diversification more difficult and weakens the effectiveness of a largely contribution-based welfare state.

Strategies for addressing these challenges and reinforcing social protection funding include 1) extending and deepening formal employment to raise revenues and broaden insurance coverage and risk-sharing, 2) easing pressures on social insurance budgets and, hence, the taxation of labour, by shifting certain financing responsibilities to the general state budget; 3) making labour taxes more progressive, 4) tapping additional revenue sources, including suitably targeted property⁶ and environmental taxes to

make revenues less sensitive to cyclical swings in the labour market; and 5) raising the visibility and priority of planned social policy reforms in the medium and longer-term budget planning process.

Latvia has recently taken specific reform steps along these lines:

- Longer-term policy documents, such as the National Development Plan 2014-2020, highlight tackling inequality, increasing employment and reducing labour tax burdens as broad priorities.
- The Ministry of Finance has developed concrete scenarios for making labour taxes more progressive (Ministry of Finance, 2014).
- Recent government budgets have increased some social protection funding relative to earlier years. For instance, support to families with children financed by the Ministry of Welfare has been increased from 1.01% in 2013 to 1.27% of the GDP in 2015. In addition, social contributions were reduced, the (flat) personal income tax rate was lowered, and tax-free thresholds were raised.
- Financing for some parts of pension expenditures (such as supplements paid on pension entitlements that were accrued prior to 1996) were shifted from the social insurance budget to the general state budget (2014 Law on State Pensions).

These individual measures are welcome, but reforms fall short of a broader and consistent strategy to strengthen resources for social protection. The budget planning process currently does not appear to fully account for revenue requirements of ongoing major social security reforms (see, e.g., the discussion of uncertain financing for the GMI reform in the next section below). Likewise, the impact of revenue-side measures on inequality and on social budgets is not systematically assessed or spelled out. For instance, some tax reductions in the 2015 budget were costly but appear weakly targeted (see next section). In view of Latvia's high inequality, policy measures such as these should be carefully examined with respect to their redistributive impact and any foreseen knock-on effect in particular on the social protection budget.

Latvia already undertakes evaluations of the distributional impact of individual policy measures. But systematic incidence analyses encompassing the entire fiscal system are missing and should be made routinely when developing and preparing major fiscal reforms on both the spending and the revenue sides. Currently, the absence of inequality impact assessments from key strategic documents, such as the 2015 Inclusive Employment Strategy, weakens the government's ability to monitor

progress towards the explicit policy objectives of reducing inequality and making growth more inclusive.

Targeting support to those who need it most

With social protection spending comparatively low, effective targeting is crucial to make the most of available resources. This involves prioritising support to lower-income groups (targeting across groups), and adjusting the type and volume of available support to economic conditions (targeting over time). A carefully targeted social support system makes social protection more crisis-proof, both by facilitating the build-up of fiscal reserves during upswings, and by strengthening automatic stabilisers during future recessions.

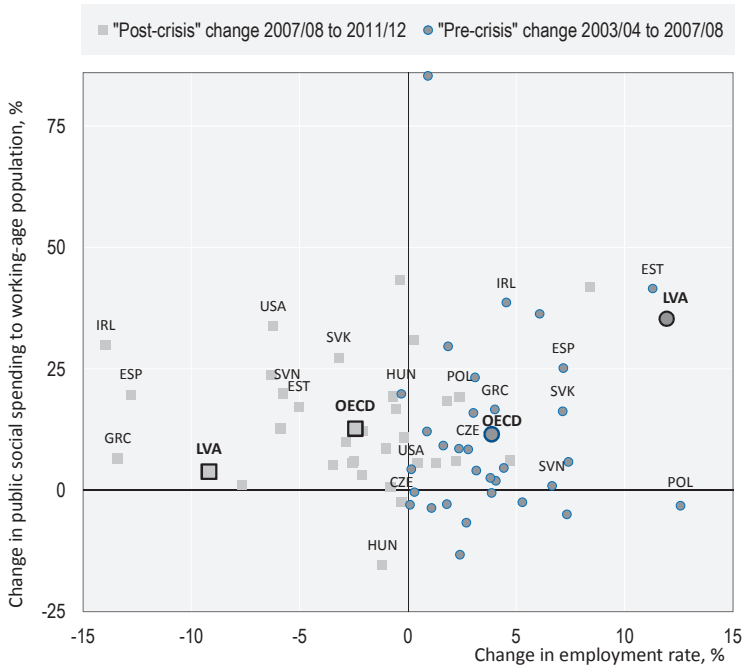
A need for countercyclical policies

Social protection that does not respond to shocks cannot be effective at improving economic security. In general, social policies should adapt as economic conditions change. First, the objective need for support is greater when economies and labour markets are weak and declines when incomes recover (equity argument). Second, economic upswings alone are unlikely to undo the damage inflicted by recessions as income losses may have become entrenched. Countercyclical social policy that alleviates poverty and promotes a return to self-sufficiency will reduce future social and economic costs (efficiency argument).⁷

Exposure to external shocks, however, makes counter-cyclical policy more challenging for small open economies such as Latvia (Cabezon et al., 2015). In fact, much of social spending in Latvia has been procyclical, possibly exacerbating rather than dampening the instability of family incomes (Figure 4.4). Spending grew strongly during the pre-crisis boom. Following the crisis, inflated but poorly targeted public expenditure, was cut or controlled, preventing a countercyclical expansion of income support. Even though employment fell much more than in most comparator countries, spending on working age support barely increased in the four years after the economy peaked. Comparing across countries, spending grew more in Latvia than in the average OECD country during the upswing, and remained well below the average increase during and after the recession.

Figure 4.4. Spending on working age support programmes has been pro-cyclical

Change in social spending versus change in employment rate during boom and recession



Note: Changes in social spending are in real terms and refer to total public social spending minus spending recorded in the old-age and survivors categories. Change in employment rate is in percentage points. “OECD” is the unweighted average across all 34 OECD countries except Turkey.

Source: OECD Social Expenditure Database (<http://www.oecd.org/social/expenditure.htm>) and OECD Labour Force Database.

Approaches in different OECD countries offer pointers as to how policies in Latvia could be made more responsive to changing economic conditions and to household needs. For instance, France, Portugal and the United States actively extended certain out-of-work benefits at the onset of the crisis (see Box 4.1 and OECD, 2014a). Most countries with strong out-of-work benefits in place, including hard-hit countries such as Ireland, allowed them to operate to the full extent by keeping them accessible to a rapidly growing number of jobseekers and so helping to stem income losses. Ensuring that jobseekers benefit quickly from improving labour market conditions requires devoting sufficient resources to public employment offices and related employment-support policies at all stages of the economic cycle. In addition, a balanced package of income assistance and employment support needs to be accessible to all jobseekers. In the context

of large cyclical swings in the Latvian labour market, this also requires flexibly tailoring benefit eligibility criteria and activation strategies to labour market conditions.

Box 4.1. Countercyclical social policy: Automatic benefit extensions in the United States

As in Latvia, out-of-work transfers before the crisis were relatively modest in the United States, where large shares of working age cash payments are directed towards low-income working families. To address the social risks of such a policy configuration at a time when increasing numbers of people were finding themselves jobless for long periods, a number of swift discretionary policy measures were combined with “automatic” policy changes that extended unemployment insurance and safety net benefits during the downturn (Immervoll and Richardson, 2013). Although discretionary measures accounted for the majority of additional spending in both countries, automatic benefit extensions that essentially tie benefit durations to expected unemployment durations, made support significantly more counter-cyclical, and directed extra support to economically more fragile regions.¹ Importantly, such automatic provisions also strengthen the credibility of expenditure reductions in line with the recovery: the fiscal and social sustainability of social protection arrangements can be improved by committing to funding with a long view that balances finances across the economic cycle while maintaining effective income support during extended downturns.

Yet, a credible commitment to counter-cyclical redistribution rests on consistency between social spending and the revenues that finance them. In the United States, the pre-crisis boom years saw a budgetary and arguably a political marginalisation of first-tier transfers (unemployment insurance) and second-tier benefits [e.g. Temporary Assistance for Needy Families (TANF)] for workless individuals and households.² At a time when the recovery was still weak and poverty high, the pre-crisis erosion of revenue sources produced by pro-cyclical tax reductions (notably in the case of unemployment insurance funds) has created strong pressures for across-the-board budget cuts and specific benefit cuts at state and federal levels.

1. The most important automatic provision, extended unemployment benefit durations, were first put in place in 1970. Since job losses during the recent “Great Recession” have exceeded numbers seen in earlier recessions, the relevant provisions were triggered in most states (Vroman et al., 2003). In addition to unemployment insurance, a number of safety net benefits also include provisions that make them more generous, or more easily accessible, once state-level unemployment rates exceed a pre-defined threshold (USDA, 2012). Both discretionary and automatic adjustments need to be designed carefully, in order to avoid such unintended consequences as hindering mobility between regions with high and low unemployment.

2. On TANF policies and the decline in beneficiary numbers, see Anderson et al. (2011); Trisi and Pavetti (2012). For discussions and assessments of policy challenges related to Unemployment Insurance, see Vroman (2011, 2012); McKenna and Wentworth (2011); Evangelist (2013).

Source: OECD (2014), “The Crisis and its Aftermath. A ‘Stress Test’ for Societies and for Social Policies”, *Society at a Glance 2014: OECD Social Indicators*, OECD Publishing, Paris, http://dx.doi.org/10.1787/soc_glance-2014-en.

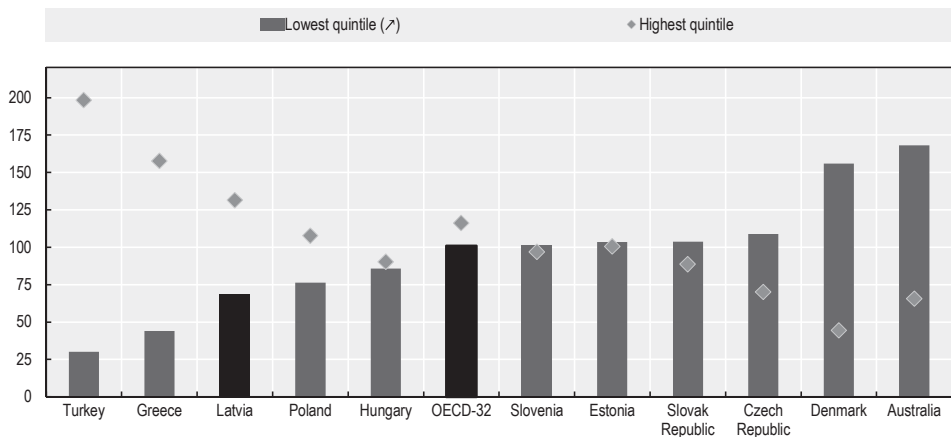
Prioritising support for the most disadvantaged groups

One reason why Latvia's social protection system does not respond more readily to economic downturns is that income-support measures are only weakly linked to people's incomes. As a result, falling incomes do not translate as readily into increasing benefit entitlements as in other countries.

The limited use of means-testing in Latvia is reflected in the low shares of public transfers going to families that struggle economically. Figure 4.5 shows that many low-income households in Latvia benefit less from social transfers than families with average or higher incomes. Cash benefits available to working age families with incomes in the bottom 20% (the bottom "quintile") are almost one-third *lower* than the benefits received by the average household. Better-off households (the top quintile, represented by the diamond-shaped markers in Figure 4.5) get substantially more support. In Latvia's comparator countries, income support is significantly more "pro-poor", and OECD countries such as Denmark and Australia successfully direct the bulk of support to low-income families.

Figure 4.5. Social transfers are poorly targeted

Average total cash transfers received by low- and high-income groups, percentage of average transfers



Reading note: In Latvia, the average cash transfer payments received by low-income families (in the bottom 20% of the income distribution) is 68% of the average payment across all families, and just over half the average benefit payment (diamond-shaped marker) to high-income families, who receive 131% of the average.

Note: 2012 or latest year available. Transfers include all public social cash benefits. Lowest/highest quintile is defined as 20% of the population living in households with the lowest/highest equivalised disposable income. All incomes and transfer amounts are adjusted for household size.

Source: Calculations from *OECD Income Distribution Database* (<http://oe.cd/idd>).

The government has taken a number of steps to reinforce income-related safety net measures and to make them more accessible. The Ministry of Welfare's ongoing reforms of minimum-income benefits and raising unemployment benefit and pension floors (see Section 2 below), are welcome. But they remain incomplete and financing in particular is uncertain and not yet reflected in the published budget plans for the 2015-18 period (see e.g., Ministry of Finance, 2015). If the medium-term budget planning does not fully account for strategic social protection priorities, key reforms may subsequently be scaled back or delayed for financing reasons. Overall, efforts to reform and strengthen income safety nets should be stepped up.

The large majority of the remaining government transfers currently do not employ means testing. Spending on the Family State Benefit is about twice as high as for the main GMI benefit and tighter targeting, e.g., by phasing out benefits for families with above-average incomes, would create additional fiscal space for channelling support to children in low-income households and at risk of poverty.

In addition to benefit reforms, the tax system could play a bigger role in strengthening redistribution in Latvia. Income taxes are currently one of the least progressive in Europe and the OECD, due to the flat rate structure (a single rate of 23%), a very limited tax-free income range and low statutory and effective tax rates on capital incomes (BICEPS, 2014). In a flat-rate tax system, tax-free allowances are one of the few available levers for differentiating effective tax rates in line with taxpayers' ability to pay (Vanags, 2010; Keen et al., 2000). But because tax-free allowances benefits taxpayers at all income levels, increasing them is very expensive. A tax-free allowance that declines at higher income levels, as recently announced by the government, would make tax concessions more targeted and income taxes more progressive at a lower revenue cost. The scope of these measures could usefully be extended to other groups, however; notably to pensioners, whose tax-free thresholds are much higher than for wage earners.

In August 2015, the government also approved provisions for a "solidarity tax" for high-income earners. This measure, which is to take effect from 2016 but remains to be approved by parliament, is welcome and would essentially undo the regressive effect of the ceiling on social contributions that was re-introduced in 2014. However, a flat tax combined with an additional tax for high-income earners and more generous tax-free allowances at the bottom is functionally equivalent to a more traditional progressive income-tax schedule, while being possibly more complex to administer. In addition, current discussions of a minimum social contribution to discourage misreporting of working hours in the form of "false part-time employment" (see Chapter 3) would potentially trigger large

additional labour tax burdens for genuine part-time workers and, hence, reduce overall tax progressivity further.

A key pre-requisite for linking benefit entitlements and tax burdens to incomes, is reliable, comprehensive and timely information on people's earnings and other income sources. The success of reforms aiming to make social protection better targeted and taxes more progressive therefore hinges on the government's progress in its efforts to tackle informality and envelope wages (see Chapter 3).⁸ Strengthening these efforts should accompany measures to link taxes and transfers more closely to people's incomes and ability to pay. However, targeting does not need to rely exclusively on income-testing. Other possible targeting measures include differentiating by demographic characteristics such as family size. For instance, the decision to boost family benefits for larger families, by increasing benefit amounts for the second, third and further children, starting in 2015, is welcome as it provides additional support to families who are overrepresented among low-income groups.

2. Promoting self-sufficiency through accessible and adequate working age support

Beyond well-targeted redistribution and compensation for lost earnings, a primary objective of social protection is to actively foster self-sufficiency. In principle, social insurance provides a suitable basis for combining cash support and related services, with adequate incentives for starting or returning to employment. But broad risk sharing and, hence, wide coverage of the population is a precondition. When large parts of the population are repeatedly or persistently outside the scope of social insurance, access to social support can become segmented into social protection “insiders” and “outsiders”. The first group might have relatively stable employment records, access to adequate social and back-to-work support during temporary out-of-work spells, and reasonable incentives to keep contributing to the social insurance system. The other group with weak labour market attachment, in turn, may become trapped in a cycle of low-paid, marginal or undeclared work, followed by out-of-work spells with very low incomes, poor incentives to take up formal employment, and restricted access to necessary employment or rehabilitation services.

Poorly accessible benefits and fragmented income protection for the poor

Before the recent recession when unemployment was at a low near 6%, the number of unemployment benefit recipients was less than half the number of jobseekers (Figure 4.6). This ratio then dropped further as job losses mounted disproportionately among workers, who due insufficient

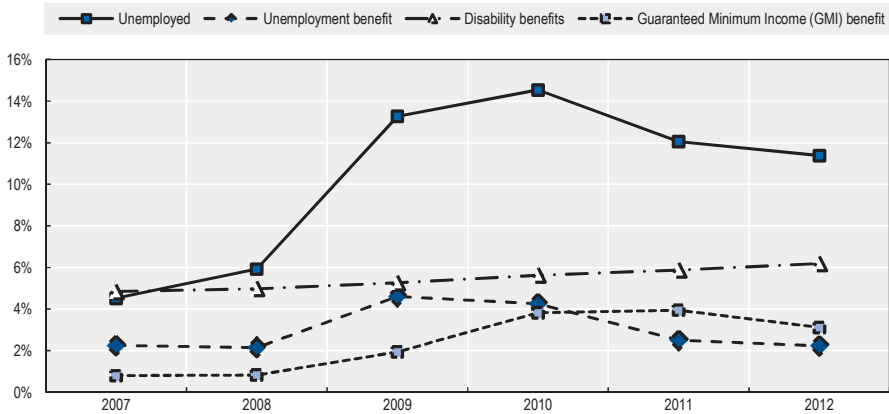
contribution histories did not qualify for benefits, and lengthening unemployment spells caused benefits to expire. Following the start of the recovery, benefit recipient numbers fell back to pre-crisis levels, while unemployment remained much higher than before the crisis. By 2012, only around one out of every five jobseekers received unemployment benefits.

The limited reach of unemployment benefits can be attributed to a number of factors:

- At nine months, unemployment benefit durations are relatively short. Unlike several other countries with short-duration unemployment insurance benefits, Latvia provides no follow-up unemployment assistance. Among European OECD countries, only the Czech Republic and the Slovak Republic have shorter unemployment benefit durations.
- Job finding rates among the unemployed are low meaning unemployed face considerable risks of running out of benefit entitlements. In 2014, 43% of all unemployed had been without a job for more than a year (the OECD average was 35%) and less than a fifth found a job within three months (the OECD average was, again, 35%).⁹
- Short job durations, and alternating spells of work and joblessness, are relatively common. Many workers do not meet contribution conditions when they lose their job, even though contribution requirements for benefit entitlement are not overly strict by OECD standards (nine months within the past year). In addition, job search and other behavioural eligibility criteria for receiving unemployment benefits are relatively stringent in Latvia and the scope for benefit sanctions is greater than in most OECD countries (Langenbucher, 2015).
- Comprehensive enforcement of labour regulations and social contribution payments is complicated by a high degree of informality. Estimates of unregistered employment are moderate but uncertain (see Chapter 3). Yet, a large informal economy (in the order of one fourth of GDP) and extensive wage underreporting (in the order of one-third of total remuneration) indicate that social contribution payments are frequently circumvented, weakening workers' insurance entitlements.¹⁰ Yet, like underreporting, underpayment (e.g., unpaid overtime to limit the impact of minimum-wage increases on labour costs) may also weaken insurance entitlements for low-paid workers who need them most. While the policy discourse may frequently associate underreporting with low-skilled employees, significant possibilities for avoiding or reducing social contributions exist for better-paid employees (e.g., by receiving salaries in the form of dividends) and for self-employed workers whose declared incomes remain below a given threshold (around 90% of the minimum wage).

Figure 4.6. Low social protection coverage among the working age population

Number of unemployed and recipients of selected benefits, in percentage of the working age population



Note: Both benefit recipients and unemployed are shown in percentages of the entire working age population. The rate of unemployed therefore differs from the commonly used unemployment rate which shows the number of unemployed as a percentage of the labour force. The number of unemployed corresponds to the ILO definition (rather than registered unemployment). The underlying administrative data of GMI recipients refer to the number of people living in recipient households, and this needs to be divided by the average size of recipient households to obtain the number of recipient households. The household size of recipient households is not known and was approximated by the size of “working age” households who are income-poor (income below 50% of the national median).

Source: OECD Social Benefit Recipients (SOCR) Database (<http://www.oecd.org/social/recipients.htm>).

The limited accessibility of unemployment benefits was reflected in a high and increasing demand for other types of income support, notably disability allowances and pensions, and GMI benefits. These benefits are, however, not chiefly intended for jobseekers. They may lead to longer or permanent withdrawal from the labour force and can therefore not be considered an appropriate substitute for employment-oriented out-of-work support. To address these issues and make income support more adequate and employment-oriented, reform of the unemployment benefit system could include a combination of longer benefit durations with benefit levels that fall over time, or a possible introduction of a means-tested unemployment assistance for those who are not, or no longer, entitled to insurance benefits.

In 2012, disability benefit recipients outnumbered unemployment beneficiaries by a factor of three. At 6.5% of the working age population, the rate of receipt in 2012 was lower than in Estonia (10.7%) and similar to several other comparator countries (Slovak Republic: 6.1%; Slovenia:

6.4%). The steady upwards trend since before the crisis is also related to the ageing of the workforce, and increasing legal retirement ages. But receipt rates rose much faster than in most OECD countries (+19% since 2007, compared with a country average of 6%), suggesting that some of the increase is related to difficulties accessing unemployment benefits. The resulting rise in disability benefit receipt may have been one contributing factor to the substantial growth of labour market inactivity among individuals aged 55 or older (see Figure 1.9).

A number of safety net provisions may provide transfer payments of “last resort”, including to jobseekers who are not (or no longer) entitled to receive insurance benefits. The coverage of these last-resort benefits is limited too, however, leaving a large coverage “gap” among the poorest: strikingly, the majority of income-poor or materially deprived individuals do not receive support from any of the main income replacement benefits (Table 4.1).

Table 4.1. The majority of poor or socially excluded receive no significant income support

Share of people in “working age” households not covered by income-replacement benefits, by group

	All Individuals (thousands)		Share not receiving income replacement benefits (%)	
	2008	2011	2008	2011
“At risk of poverty or social exclusion”	698	651	72	59
“At risk of poverty” before transfers	553	481	70	54
Severe material deprivation	432	456	68	55
In “low work intensity” household	118	178	59	41

Note: Headcounts relate to all individuals in the respective households; individuals “not covered” are those living in household where no one receives an income-replacement benefit. Eurostat classifies individuals as “at risk of poverty or social exclusion” if they are “at risk of poverty” (income below 60% of the national median) or severely materially deprived or living in households with very low work intensity. Income replacement benefits are those recorded in the following EU-SILC variables are included: “unemployment”, “housing”, “incapacity, sickness” and “other social”. Family benefits are excluded. With the exception of severe material deprivation, social exclusion measures reported in EU-SILC generally capture the situation of families in the year before the interview.

Source: OECD calculations using the 2012 wave of EU-SILC.

The municipality-administered GMI programme was very small in 2007 but subsequently scaled up with support from the central government’s budget to provide crucial income support during the crisis. However, financing responsibilities have now fully reverted back to local governments and recipient numbers are falling in spite of still-elevated income poverty. Both the GMI programme and cash housing benefits are administered and fully

financed by municipalities. The national government sets minimum standards for benefit levels but municipalities can set higher levels and determine benefit eligibility in practice. Housing benefits are entirely regulated by municipalities without national requirements for minimum benefit levels. As both benefits employ strict means-testing, they are very important income sources for those who receive them. But benefit levels can be extremely low and are set in set relation to available budgets rather than by following objectively justified standards of families' material needs (Figure 4.7).

The continuing lack of a detailed national policy framework and comprehensive implementation guidelines, combined with large regional differences between municipalities' social budgets, make access to crucial income support highly unequal and potentially unpredictable. The Ministry of Welfare's lead in initiating a national debate on the design and functions of minimum-income protection is therefore welcome. A number of studies commissioned and undertaken since 2012 provide concise diagnostics and several policy options, including increasing GMI benefit levels nation-wide to 40% of median incomes (Ministry of Welfare, 2014). Moreover, to support monitoring and evaluating the effectiveness of safety net policies, the government has developed a powerful database linking information from municipalities' benefit registries with State Employment Agency (SEA) data on job search activity and participation in active labour market programmes, and with benefit claimant's career histories from social insurance data.

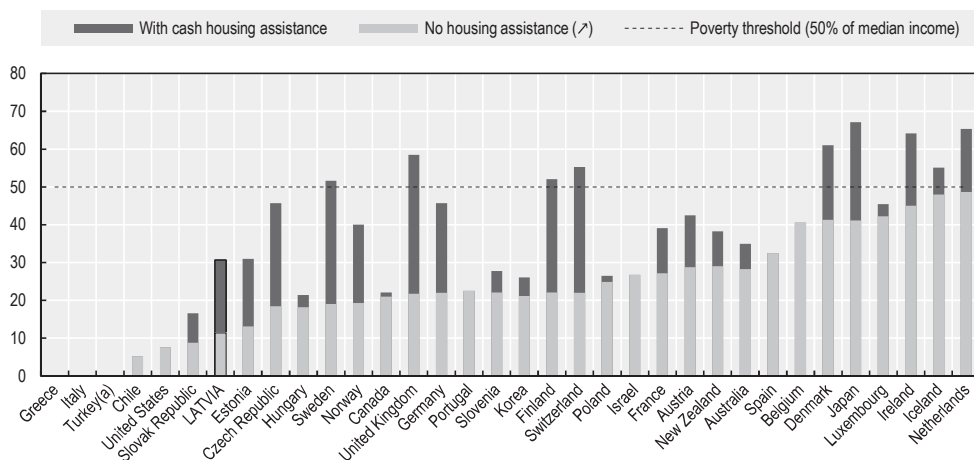
However, the current proposals focus mainly on benefit levels, and less on the more difficult but crucial issues of ensuring equality of access, financing the proposed benefit increases, further integrating income support with employment and rehabilitation services, and improving governance and co-ordination between state and local institutions (State Audit Office, 2014).¹¹ There is currently still no agreed-upon reform package and implementation is not foreseen before 2017. In part, the disappointingly slow progress reflects the difficulties in building consensus among all stakeholders in national and local governments. But it may also reflect a lack of priority attached to safety net programmes in the government's overall reform agenda. In particular, the budgetary envelope of reform measures, and the division of financing responsibilities between central and local governments remain unclear. The crisis experience has shown that clear and reliable co-financing arrangements between different levels of government are needed for equitable social safety nets which respond to changing economic need.

In the Latvian context of high regional disparities, exclusive local financing of safety nets puts pressure on weaker municipalities to effectively restrict access to welfare benefits. In addition, local governments have cut down on discretionary support or locally provided social services, such as

the development of day-care centres, to finance GMI benefits. Some types of support, such as discretionary welfare payments, may in fact be more efficiently provided as part of a nationally co-ordinated GMI programme, but this is not always the case. The government should therefore base safety net reforms, and associated financing arrangements, on a detailed inventory of locally provided cash support and services in order to avoid diverting resources away from well-functioning social protection measures. A lack of co-funding can also hamper functional links and co-operation between local-level welfare offices and the nationally funded SEA, and it may be a missed opportunity for bringing institutional incentives in line with the objective of fostering self-sufficiency.¹² While there are examples of well-functioning locally financed last-resort benefits in OECD countries (e.g., in Nordic countries, see Angelin et al., 2014), their success hinges on an adequate resource base and accessible first-tier out-of-work benefits.

Figure 4.7. Safety net benefits are far lower than commonly used poverty thresholds

Net incomes provided by GMI benefits, single-person household, in percentage of median incomes



Note: Income levels account for all cash benefit entitlements of a family with a working age head, no other income sources and no entitlements to primary benefits such as unemployment insurance. They are net of any income taxes and social contributions. Where benefit rules are not determined on a national level but vary by region or municipality, results refer to a “typical” case (often, including in Latvia, the capital city). The “cash housing assistance” indicates the range of benefit levels in countries where they depend on actual housing expenditure. The bottom end shows the situation where no housing costs are claimed while the top end represents cash benefits for someone in privately-rented accommodation with rent plus other charges amounting to 20% of average gross full-time wages.

a) Average wage (AW) value is not available. Calculations are based on average production worker (APW).

Source: OECD Tax-benefit Models (<http://www.oecd.org/social/benefits-and-wages.htm>).

Balancing incentives and public support

Spending on active labour market programmes and social services is very low by OECD standards (see Figure 4.2 and Chapter 3). Those not covered by income support are difficult to reach for service providers and may, in effect, be excluded from accessing high-quality reemployment and reintegration services. A weak resource base for services relative to benefit spending suggests that existing ALMPs and social integration services may be limited even for those receiving income support payments.

Latvia has traditionally emphasised work incentives through keeping benefit levels modest. Financial incentives indeed need to be considered carefully as informality and income underreporting can potentially lower targeting efficiency, with some “leakage” of support payments to groups whose incomes may be higher than reported. But without access to adequate income support, many Latvians may have little choice but to explore all available earnings opportunities – including informal or only partly registered employment. With a carefully balanced rights and responsibilities framework for benefit claimants, more accessible income support would reduce both the need and the opportunities for undeclared work, complementing the government’s ongoing efforts to tighten the enforcement of wage reporting.

In view of the modest generosity of support for the poorest in society (Figure 4.7), issues of work disincentives may have been overemphasised in the public debate (Figure 4.6). While incentives built into current tax-benefit provisions could still be improved, the main issue is not benefit generosity but the integration of benefit payments into a mutual obligations framework geared towards re-establishing self-sufficiency among benefit claimants:

- At up to 80% for those with employment records of 30 years or more, net replacement rates for recipients of ***unemployment benefits*** can be relatively high initially. But benefits are significantly less generous for jobseekers with shorter contribution histories, and they decline markedly for unemployment spells lasting longer than three months. While declining benefits can provide suitable job search incentives for job losers who are job ready, it may be counter-productive for jobseekers whose main employment barriers are obsolete or insufficient skills. For these groups, falling benefits and short benefit duration leaves relatively little room for achieving a good match between jobseekers and vacancies. Benefit cuts of 25% after three months, and 50% after six months are steeper than in any OECD country, and steeper than may be required for maintaining incentives.¹³ Combined with the prospect of very low and difficult-to-access GMI benefits once unemployment support expires, the current policy configuration may

distract benefit claimants from effective job search as they seek to manage the short-term consequences of falling incomes.

- The nationally binding minimum level of the **GMI benefit** amounts to less than EUR 50 per month and family member, well below the poverty line and subsistence levels. At this level, the GMI benefit as such does not have a big impact on the financial incentives for formal employment.¹⁴ Any incentive problems are, instead, mainly due to the availability of informal earnings opportunities, which may lead people to combine benefit receipt with unreported or underreported income. These are best addressed through stronger enforcement along with credible requirements to work or participate in employment or rehabilitation measures. As in other countries, incentive problems for formal work may also arise when families are entitled to both GMI transfers and means-tested housing assistance. In these cases, formal employment may produce no or little income gain as benefits are withdrawn at a rate of 100% without any earnings disregard. Reducing the benefit taper, as proposed in the Ministry of Welfare's GMI concept paper, is essential to make work pay, especially when GMI benefit levels are increased. However, benefit tapers, earnings disregards and other make-work-pay measures will only work if income information is timely and reliable and the extent of underreporting is reduced.
- At currently EUR 64 per month, **disability benefits** for the lowest category of disability are also very low. Benefits are not designed to replace earnings in this case, but to compensate part of additional costs related to the disability. Recipients who are able to work can be assumed to supplement benefits with income from work as far as possible, and financial incentives for formal work do not appear to be a problem for them (as in the case of GMI benefits, incentives for informal work can be an issue and those expecting receipt of low disability benefits for longer periods of time may in fact apply for GMI as well). But approximately 88% of all recipients receive more than EUR 64 minimum. Benefits for the two higher categories of disability can be significantly more generous if the disabled person is entitled to an earnings-related benefit. A careful assessment and continued monitoring of remaining work capacity are therefore essential for this group in particular. The government has recently reviewed assessment practices and enacted a number of reforms to shift from a near-exclusive medical focus towards assessing functional restrictions and, in a second phase, plans to elaborate assessment criteria building on clear professional restrictions. In view of these changing criteria, considering ways to re-certify existing disability benefit claimants would be a logical next step that could draw on recent experience of

OECD countries, such as the Netherlands or the United Kingdom (OECD, 2010). Preventing longer-term or permanent withdrawal from the labour market also requires pairing benefit provision with necessary medical assistance and, crucially, employment support.¹⁵

3. Old-age pensions: Bold reforms but significant risks for social sustainability

Low fertility, ageing and emigration trends were the principal drivers of pension reforms in Latvia and other Baltic countries since the 1990s. Latvia enacted far-reaching reforms to maintain the financial sustainability of pension promises. In 1996, it was one of the first countries in Europe to start introducing a multi-pillar system consisting of a mandatory notional defined contribution (NDC) public “1st pillar” that is financed on a pay-as-you-go (PAYG) basis, a mandatory defined contribution (DC) “2nd pillar”, and a voluntary private-pension “3rd pillar” (see Box 4.2).

In the new system, there is a direct link between contributions and subsequent pension pay-outs; the reform transferred longevity, labour market and capital market risks from social insurance and state budgets to individual members. Based on current policy parameters, future public pension expenditures are projected to fall from 7.7% of GDP in 2013 to 4.6% in 2060 (Figure 4.8, Panel A). But the reforms also diminished redistribution mechanisms in the pension system. A flat-rate minimum pension remains part of the system, providing a safety net for those with small entitlements or insufficient contributions to qualify for the earnings-related scheme.¹⁶ But it is currently very low (ranging from around EUR 70 to 109 per month) and not effective at preventing poverty during old age.

Although the system is fiscally sound on a technical level, the risks of significant income gaps for future retirees create uncertainty about its social sustainability. In the medium term, this uncertainty also translates into potential risks for fiscal sustainability, as increasing numbers of pensioners can add to political pressures for ad-hoc changes and for additional expenditures beyond those currently projected. To reduce these risks, a comprehensive review should systematically assess the effectiveness and adequacy of current pension provisions in the context of Latvia's expected demographic trends and labour market developments.

Box 4.2. Fundamental pension reform in Latvia

Latvia’s fundamental reforms started in the mid-1990s and sought to address sustainability challenges of the Soviet era unfunded defined-benefit system in the context of the major demographic, income and employment changes that accompanied the country’s transition to a market economy:¹ prior to the reforms, standard retirement ages were 55 for women and 60 for men, but benefits could be claimed from age 40 for a range of occupations and categories of workers. Revenues fell due to low tax compliance and shrinking contribution bases and incentives for early retirement pushed up the ratio of beneficiaries to contributors further. Pension expenditures soared from 5.5% of GDP in 1985 to 10.4% in 1994, while the number of contributors declined by almost 50% between 1991 and 1995. At the same time, pensions were often still too low to provide adequate social protection (Fox and Palmer, 1999).

The context for large-scale pension reforms in transition countries was arguably much more difficult than in higher-income OECD countries. Constraints included fragile public finances, major competing expenditure needs, a lack of developed financial markets, and a “social contract” that required protecting pensioners who may not live to enjoy the future benefits of transition (de Castello Branco, 1998).

Latvia was the first country in the world to adopt a PAYG 1st pillar with notional individual accounts that determine notional “rates of return” on contributed amounts based on wage growth and capital saving. The reform followed a gradual approach that aimed at establishing a multi-pillar system in the longer term, closely following the Swedish reform guidelines of 1995 (arguably Latvia introduced a “Swedish system” before Sweden did). But initially, the focus was on strengthening the contribution link, as well as compliance and coverage, in the PAYG system:

- The NDC pillar was introduced in 1996, featuring individual notional accounts, supplemented by a modest minimum guaranteed pension benefit that also depends on the contribution record (around EUR 70 for those with up to 20 years, to EUR 109 for those with 41 years or more).
- The regulatory framework for a voluntary private-pension 3rd pillar was adopted in 1997. Private pension funds started operating in 1998 and are open for contributions from employees, employers and self-employed.
- A DC 2nd pillar was introduced in 2001, with mandatory membership for cohorts born after 1971, and voluntary contributions for those born from 1953. It is expected to be fully mandatory by 2035 as the size of older cohorts will gradually diminish. Until 2003, all 2nd pillar assets were managed by the treasury. From January 2003, 2nd-pillar members could choose between state or private asset managers (and change them up to once a year).

Initially (in 2001), the total contribution rate of 20% was directed to the 1st and 2nd pillars using a 18%/2% split. With the planned gradual strengthening of the funded 2nd pillar, this changed to 8%/12% in 2008 and it was envisaged to move to an equal 10%/10% split by 2010. However, the rapidly shrinking contribution base during the crisis led to a reversal back to 18%/2% during 2009-12, up to 16%/4% in 2013, 15%/5% in 2015, and a planned increase to 14%/6% by 2016. Capital accumulation during the crisis was thus very volatile not only because of financial market conditions and a sharp contraction in the contribution base, but also due to large changes in capital inflows among active contributors. Over the period as a whole, capital growth in the 2nd pillar was, and remains, markedly slower than expected at the time of the reform.

Box 4.2. Fundamental pension reform in Latvia (*cont.*)

In 2015, the retirement age is 62.5 years, increasing by three months every year until it reaches 65 by 2025. No further increases are currently planned beyond 2025. The early retirement age is 60.5 years increasing to 63 by 2025. Other than the consequences of the shorter contribution period, there is no penalty for early retirement. The minimum contribution period to secure a full pension was recently increased from 10 to 15 years and is expected to reach 20 years by 2025. Pensions from the voluntary private 3rd pillar pensions can be received from age 55.

The NDC system functions according to actuarial principles and the annuity calculated at the time of retirement accounts for life expectancy at the time of retirement (using unisex tables, implying some redistribution from men to women on average). There is no automatic link between statutory retirement age and life expectancy, although as people live longer, the system creates incentives to delay retirement in order to counter the reduced annuities resulting from longer life expectancy at the point of retirement. Those continuing work after the statutory retirement age have the option to receive their pension at the same time; they continue to contribute and accumulate additional notional pension capital, with their pension entitlement being recalculated once a year. Pensionable earnings are determined using all earnings of a person's working life, and valorisation is done using an index based on the contribution wage and contributors (i.e., wage increases beyond the upper contribution ceiling are not considered). Pensions in payment are indexed using a mix of prices (75%) and the real value of the sum of contribution wages in the country (25%, only for lower pensions up to half the average wage).² Up until 2013, indexation was suspended as a crisis-related measure.

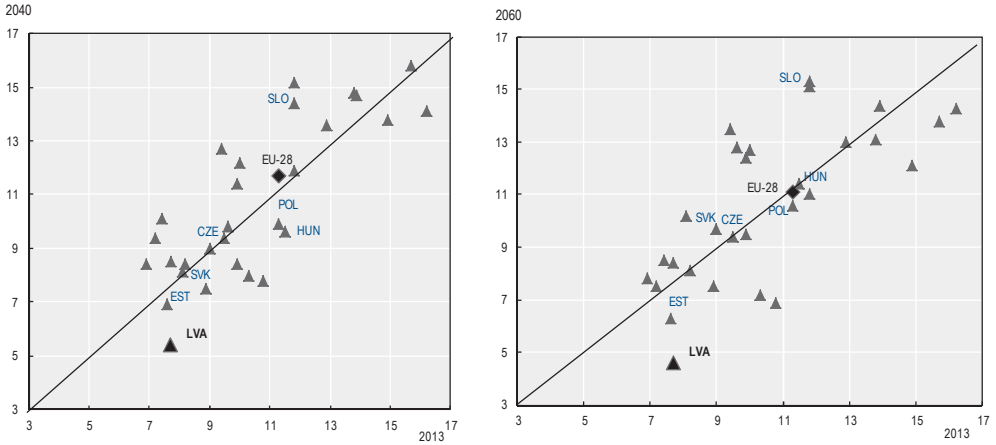
Non-contributory periods credited or taken into consideration through transfers from the state budget to the 1st and 2nd pillar funds include the following: childcare periods for a child under 1.5 years of age, period of receipt of maternity benefit, paternity benefit, unemployment benefit, sickness benefit, periods of inactivity of individuals with a recognised disability (including all disability benefit recipients), periods spent in a public works programme. As receipt of GMI safety net benefits does not give rise to contribution credits, low unemployment benefit coverage translates into patchy contribution records for many unemployed.

1. The pre-reform PAYG system dated back to a 1990 Soviet Union law, which instituted a contributory system with universal coverage. Pensions only depended on years of service, not on the level of contributions. The weak link between contributions and benefits translated into strong incentives for employer-employee agreements to underreport wages.

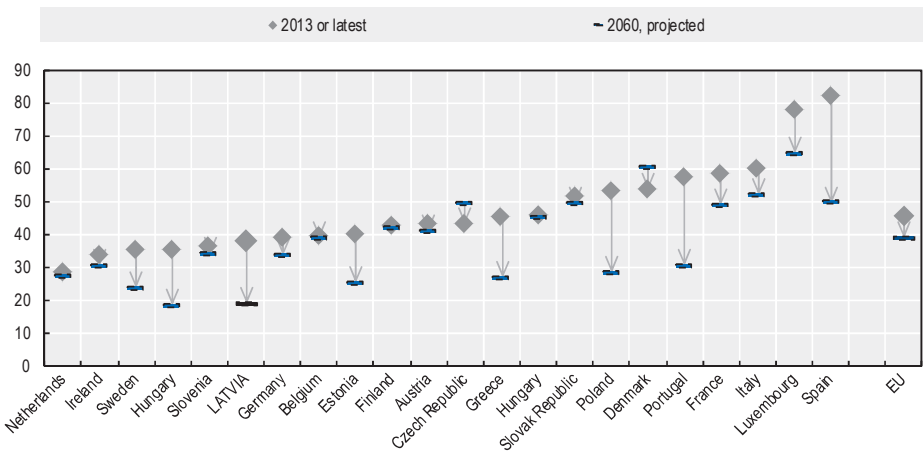
2. Indexing to the *sum* of wages leads to significantly different outcomes than indexing to *average* wages. In the Latvian context, a successful strategy to increase formal employment would mean that the wage bill grows more strongly than individual wages, whereas a continued decline in the labour force and continued negative net migration would have the opposite effect. Generally, sum-of-wages indexing makes pension spending more pro-cyclical.

Figure 4.8. Current legislation implies very large falls in future public pension levels and spending

Panel A. Projected public spending on old-age pensions 2040 and 2060, in percentage of GDP



Panel B. Replacement rate in the public earnings-related old-age pension, 2013 and projections for 2060



Note: Spending figures in Panel A do not include spending on survivor pensions (2060 levels projected to remain as in 2013) and disability pensions (projected to fall by 0.3% of GDP). The replacement ratio in Panel B is the average first pension as a percentage of the economy-wide average wage at retirement.

Source: European Commission (2015), 2015 Ageing Report. Economic and Budgetary Projections for the 28 EU Member States (2013-2060), Tables I and II.1.25.

Closing the pension gap

All cohorts born after July 1971 are part of the mandatory funded (DC) system, and voluntary membership among older cohorts has grown strongly during the pre-crisis boom years. The incomes of current pensioners are, however, still largely driven by the more redistributive pre-reform pension rules. As the new systems is progressively phased in, the strong contributions link will become the dominant determining factor of future pensions, and differences between entitlements will widen as a result: essentially, the NDC and DC systems will carry the substantial disparities of earnings in the current working age population (see Chapter 3) forward into retirement. As the elderly account for a growing share of the total population, these trends will also tend to push up overall inequality.

A particularly worrying aspect of widening inequalities in old age is the growing poverty risk among pensioners. The share of elderly classified by the European Commission as “at risk of poverty or social exclusion” already stood at 39% in 2014. Future public pension entitlements will be markedly lower than today, with average (gross) replacement rates in the earnings-related public pension projected to halve from 38% in 2015 to 19% by 2060 (Figure 4.8, Panel B).¹⁷ The drop is in part a result of the increasing life expectancy at retirement, which will result in lower annuities for future retirees.¹⁸ According to OECD calculations, future replacement rates in the PAYG system will be low even for those retiring on a full career (36% by 2059, against an OECD average of 53%).

Low projected replacement rates in the 1st-pillar NDC scheme affect future retirees at all earnings levels and, by the logic of a three-pillar system, leave a sizeable income gap to be filled by the 2nd and 3rd pillars.¹⁹ Membership in the mandatory 2nd-pillar DC scheme has indeed expanded, from 200 000 in 2002 to 1.2 million in 2014, and pay-outs are currently projected to reach 2.2% of GDP in 2060 (European Commission, 2015a). These projections are subject to considerable uncertainty, however, and they fall well short of the 4.5% of GDP spending reductions that result from lower 1st-pillar pension benefits over the same period.²⁰ With unchanged policies, any remaining gaps would have to be primarily filled by substantial expansions of the voluntary 3rd pillar private pension, or through very significant additional public expenditures outside the state social insurance system (notably safety net benefits for the elderly). In 2013, 21% of 15-74 year-olds were enrolled in voluntary private pension schemes (OECD, 2014b). Projections of voluntary private pensions in Latvia are not available, but recent economic and policy developments since the onset of the financial crisis suggest that closing the pension gap will remain a significant challenge:

- Job losses and the legacy of the crisis led to lower mandatory contributions towards NDC and DC schemes and reduced households' ability to save for retirement.
- The need to finance ongoing pension benefits in the PAYG/NDC scheme with a much smaller number of contributors triggered numerous departures from the government's earlier plans of channelling increasing shares of mandatory contributions away from the NDC and into the DC scheme.
- The reduction of DC contributions from 8% of gross wages in 2008 to 2% from 2009 to 2012 meant that retirement capital of workers accrued at a much lower rate than initially planned. The mandatory DC contribution rate currently stands at 5% and a further increase to 6% is planned for 2016. However, under current legal provisions, contribution rates remain well below pre-crisis levels and it is not clear whether or when the originally-envisioned rates of 2nd-pillar capital accumulation will be re-established. Moreover, a continuation of pro-cyclical adjustments of payments into the DC system could depress long-term returns on members' capital as plan investments are reduced during downturns (when asset prices are typically low) and expanded during upswings (when they are high).
- The volatility of contribution rates made it more difficult for members to anticipate future retirement savings and may have contributed to the erosion of confidence in the overall pension system. In addition, returns on 3rd pillar funds have been volatile and negative in real terms in the 2nd pillar DC scheme during most years since its inception in 2001.²¹ Latvians' overall assessment of their pension system has deteriorated sharply since before the crisis when DC scheme membership grew strongly; it is now among the least favourable in Europe (Figure 4.9).
- Operational costs in both mandatory and voluntary pension schemes are high, fiscal incentives for investing in voluntary private pensions are weaker than in many OECD countries, and options for converting pension capital into inflation-protected annuities remain limited for members of voluntary private plans (OECD, 2014b).
- Financial literacy related to pension issues is relatively low, and the scope for misjudged investment decisions high.²² Individual pension expectations are still unrealistic, with responses to a 2013 survey implying that anticipated replacement rates far exceed actual ones (Rajevska et al., 2014).

The government recognises the need to bolster income provisions for the lowest-income pensioners in particular. As part of the review of minimum-income levels that is currently underway (see Section 2), one of the options discussed is raise minimum-pension levels to 40% of median household incomes (approximately doubling their current value), and to implement a mechanism for adjusting them over time. But even with the very low current minimum pensions, minimum pensioners already accounted for 13.6% of new pension claims in 2014 (up from 4% in 1996; Ministry of Welfare, Fox and Palmer, 1999). A further large increase in the number of retirees qualifying for minimum pensions or broader means-tested safety nets would undermine the earnings link of the Latvian pension system, and possibly the incentives to contribute to it.²³ Introducing or strengthening redistributive elements that maintain incentives for building up pension capital would be more in line with the system's internal logic and could relieve pressures on minimum-pension claims. This could include measures to make the pension formula more progressive for those with entitlements above the minimum pension. Increasing minimum-pension provisions with age, say at age 70 or 75, could be another option for alleviating old-age poverty while maintaining incentives to contribute during working age.

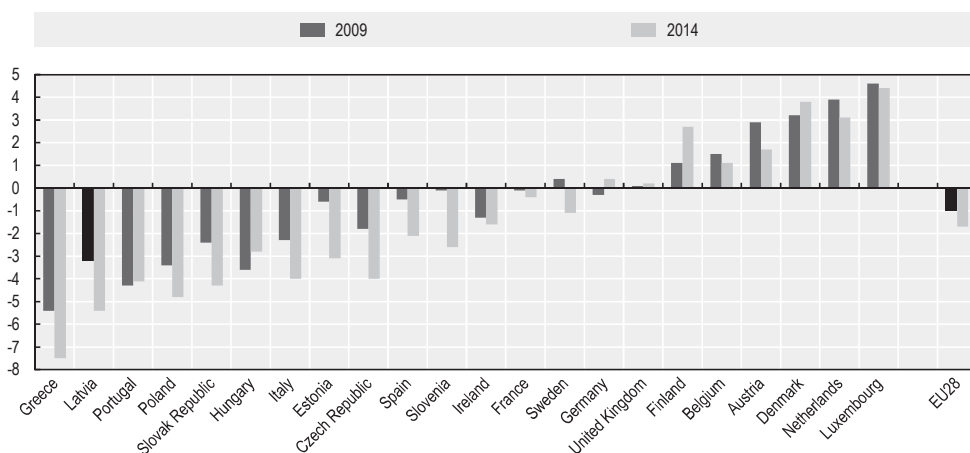
In addition, minimum-contribution periods should be reviewed. The contribution requirement under the public system has been tightened as part of an overall objective to stimulate social contribution payments; the minimum has increased from ten years prior to 2014 to the current minimum of 15 years, with plans to increase it to 20 years from 2025 (Ministry of Finance, 2015). Retirees with fewer contribution years do not have any entitlement under the NDC (1st) pillar. These thresholds are high by international standards (OECD, 2015c). Rather than strengthening incentives, strict contribution thresholds might, instead, be perceived as a significant *disincentive* to contribute, notably among individuals who consider that their likelihood of accumulating sufficient contributions during their lifetime career is low, and those who can otherwise avoid mandatory contributions. This includes workers with short or unstable formal employment histories, those considering spending some time working abroad, as well as earlier emigrants thinking about returning to Latvia. Opportunities for avoiding mandatory contributions exist through wage underreporting, but also for the self-employed.²⁴ Limiting or abolishing “threshold” effects in the NDC system would significantly strengthen both the links between contributions and future entitlements, and the incentives to contribute.

The current calculation of minimum-pension entitlements also entails threshold effects which can erode contribution incentives: currently, minimum pensions increase in steps, resulting in unchanged entitlements

for, e.g., 5, 10 or 19 years of contributions (see Box 4.2). Smoothing entitlements by increasing them with each additional contribution would articulate work incentives more clearly for those with patchy working careers. The government could consider such a revision of the entitlement formula as part of the planned – and necessary – increase in minimum-pension benefit amounts.

Figure 4.9. Latvians have an unfavourable view of their pension system

Satisfaction with the current pension system, 2009 and 2014



Note: Results are based on an annual survey that asks respondents to evaluate “the current situation of the pension system in your country”. Responses are reported as index values on a scale from +10 (most satisfied) to -10 (most dissatisfied).

Source: European Commission (2015), “Special Eurobarometer 418 – ‘Social Climate’”, http://ec.europa.eu/public_opinion/archives/ebs/ebs_418_en.pdf.

Notes

1. During the crisis years, a large number of fathers exploited a loophole in the law enabling them to claim benefits, based on earnings that were typically higher than their spouse's, but without actually taking leave.
2. Estimates of net childcare costs for different family types and income situations across EU and OECD countries are reported in Richardson et al. (2015, forthcoming).
3. Data for 2012, OECD Social Expenditure (SOCX) database.
4. The Workplaces with Stipends, known in Latvia as the LVL 100 programme, provided a temporary (up to six months) safety net to those unemployed who did not qualify for unemployment benefits or whose entitlements expired. It was first implemented in 2009 and replaced an earlier public works scheme, had around 70 000 participants and paid wages of initially LVL 100 per month (equivalent to 56% of the full-time minimum wage). Relative to emergency public works programmes in other parts of the world, overall spending was relatively modest (EUR 77 million) but it nonetheless amounted to around 2.5 times of Latvia's spending on poverty-targeted income safety nets at the time (Subbarao et al., 2013). The duration of the placements offered through this programme was short, typically limited to three months. Nevertheless, there were significant waiting lists, with demand for work experience and associated income support outstripping the number of two. The WWS programme ended in 2011, and although a public works scheme still exists, its role in providing income support is now marginal.
5. ESSPROS (European System of Integrated Social Protection Statistics); data for 2012.
6. For instance, despite a high share of home ownership by international standards, the proportion of property taxes in overall taxation, at 2.6%, is around a half of the OECD average and revenues from the taxation of land and buildings amounting to only 0.8% of GDP in 2013 (OECD, 2015a). However, unlike other Eastern European countries, Latvia does not impose a tax on immovable property (buildings and land) and raising further revenues from this source would need to account for households' ability to pay.

7. There is strong evidence that spells of poverty and unemployment give rise to longer-term scars that lead to lower future employment and earnings and negatively impact a range of other important outcomes, including health. Key results are summarised in OECD (2014a). Findings of substantial scarring of low-income and out-of-work spells are consistent with historical income trends for several OECD countries discussed in the same study: low-income groups fell significantly further behind the rest of the population during recessions, opening up gaps that subsequent upswings often failed to close.
8. This includes the progressive tax-free allowance and income-related family benefits mentioned above, the government's planned improvements to the GMI benefit means-test (see Section 2), and also any future plans for income-related in-work benefits or earned-income tax credits (see also Immervoll et al., 2013).
9. In addition, 2.2% of the working age population have given up looking for work, a higher share of "discouraged" jobseekers than in any OECD country but Hungary.
10. OECD (2015a) summarise some recent estimates of informal employment. Evidence of the extent of wage underreporting includes survey estimates reported in European Commission (2014a).
11. For a single-person household, a benefit amounting to 40% of median household incomes would approximately triple the currently applicable minimum benefit.
12. For instance, central-government financing of an earnings disregard (that would enable some people to combine benefit receipt with some employment income) would strengthen local offices' incentives to support beneficiaries into jobs. More generally, central-government funding could be made conditional on certain performance criteria of local welfare offices.
13. International evaluation studies generally find that threats of relatively minor benefit reductions are effective at maintaining work and job search incentives (see e.g. Boockmann et al., 2014; Lalive et al., 2005; and Van den Berg et al., 2004).
14. Although municipalities may decide to increase benefits, fewer than 10% of the 119 municipalities in Latvia use this option (Ministry of Welfare, 2014). For most recipient families, even part-time work at the minimum wage (EUR 360 per month for a full-time job) results in substantial income gains relative to GMI benefit levels. Indeed, a majority of GMI benefit spells last no longer than two to three months, indicating that uninterrupted long-term benefit dependence is unlikely (Immervoll et al.,

- 2014) and that people frequently draw on GMI benefits as a temporary “stop-gap” measure (World Bank, 2013).
15. The rising number of disability support payments illustrates that work impairments cannot be addressed through the health system alone but need to be part of an overall activation agenda. As in other countries, non-severe forms of disability represent a large majority of recipients, for whom psychological issues are frequently a principal employment barrier. OECD reviews of disability and mental health policies have shown that re-integration into work can be part of the solution to these problems (OECD, 2015d).
 16. Those with contribution periods below the 15-year minimum can currently only start receiving the minimum pension five years after reaching the retirement age (i.e., they are expected to try to build up further contributions for five additional years). From 2017 they will be entitled starting at retirement age.
 17. The replacement ratio is the average first pension as a percentage of the economy-wide average wage at retirement.
 18. Retirement durations for men (women) are projected to go up by 6.5 (4.9 years) between 2014 and 2060, the largest (third-largest) increase in the EU countries (European Commission, 2015a).
 19. Replacement-rate profiles in the NDC system are flat, with similar replacement rates at different earnings levels.
 20. A decomposition of projected spending changes over the 2013-60 shows that the decline in the benefit ratio accounts for a 4.5% of GDP drop in public spending (European Commission, 2015a, Table II.1.18).
 21. Schwartz et al. (2013), Figure 4.8.
 22. In a 2013 survey conducted by the Financial and Capital Market Commission, 57% of respondents were classified as having a basic or poor understanding of financial services and 39% had limited knowledge about the main components of the existing pension system.
 23. OECD calculations show that the elderly over 64 account for only 3% of GMI recipients, but for 40% of households receiving means-tested cash housing benefits (based on administrative data covering five sizeable cities: Riga, Liepaja, and Rezekne, Valmiera, Ventspils).
 24. The self-employed are not required to contribute as long as self-employment income remains below EUR 3 840 per year, approximately 90% of the income in a full-time minimum-wage job.

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