

2007 2012 2011
 2005 2009 2004
 2008 2006 2010 2013

Latvia: maintaining a reform state of mind

- For Latvia, accession to the European Union has been among the main motivations for improving business regulation.
- Latvia's reform agenda has benefited from strong public support for economic integration.
- Since 2004 the country has made positive changes across all areas measured by *Doing Business*.
- Despite being substantially affected by the financial crisis starting in 2008, Latvia continued its reform agenda, adapting it to the new challenges the country was facing.

Latvia has made substantial economic progress since its transition to a liberal market economy in the 1990s. Income per capita has more than tripled over the past 15 years despite a deep recession following the global financial crisis.¹ Exports grew by almost 7% a year in the 2000s, and the share of the population living on less than \$4 a day fell from 25.8% in 1998 to 3.4% in 2008, the latest year for which this information is available.²

Economic reforms have been a central part of this process. Structural reforms have increased competitiveness and facilitated integration with the world economy. Reforms to business laws and regulations have substantially improved the investment climate. Since the late 1990s successive governments have held a regular dialogue with the private sector and international organizations to identify and implement ways to streamline business registration, improve the tax system and increase the efficiency of international trade, among many other such reforms.³

These reform efforts have been sustained through changing domestic and international conditions. They began as part of a process to join the European Union (EU). They continued during a period of rapid growth in the mid-2000s. And they have persisted during the significant economic downturn following the financial crisis. Throughout this transition there were many changes in political leadership—but the commitment to legislative and regulatory reform endured.

What enabled this continued commitment to reform? How has Latvia made such

significant improvements to its regulatory environment—advancing further toward the frontier in regulatory practice than almost all other EU member economies (figure 4.1)? And what lessons can be learned about this “reform state of mind” demonstrated by Latvia?

REFORMING FOR THE EUROPEAN UNION

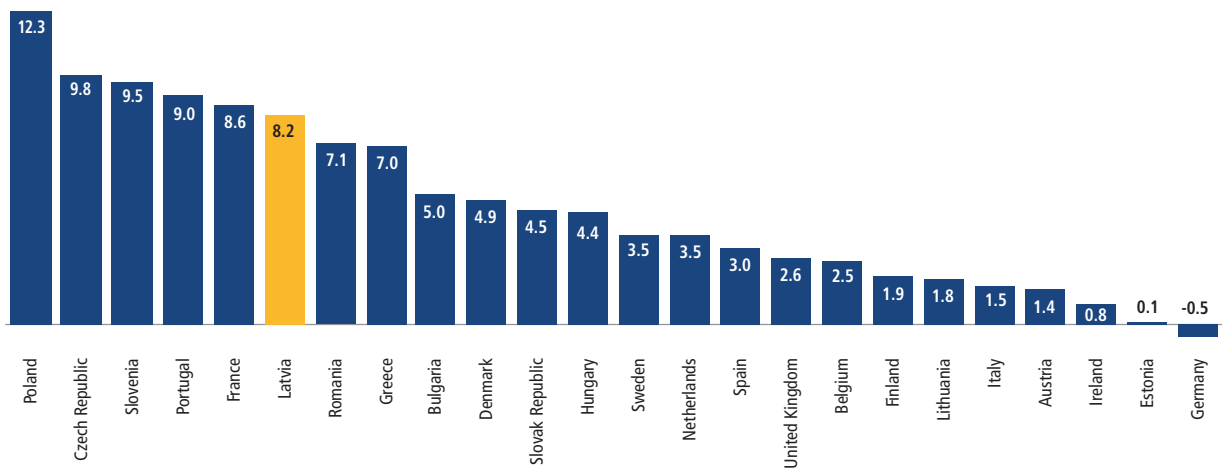
Broad consensus for reform emerged in Latvia in the late 1990s, as the country transitioned to a liberal market economy after regaining independence in 1991. Integration into the world economy was a commonly held goal, and the Latvian government and business community began a dialogue on how to achieve it. Latvia joined the World Trade Organization in 1999, then targeted membership in the European Union.

The goal of EU accession provided a structure for an array of legislative and regulatory reforms. The EU membership requirements, known as the Copenhagen criteria, provided a series of general directives for reforms centered on democratic governance, human rights, a market economy and commitment to European integration. Latvia also began harmonizing its laws with the body of EU legislation, the *acquis communautaire*, including in ways to reduce administrative barriers to investment. In 1999 the Latvian Cabinet of Ministers adopted an action plan to improve the business environment and welcomed support from international financial institutions to implement the reforms.⁴

These reform efforts proved very successful: by 2003, 91 of 106 reforms

FIGURE 4.1 Latvia has made big advances toward the frontier in regulatory practice

Progress in narrowing distance to frontier since 2005 (percentage points)



Note: The distance to frontier measure shows how far on average an economy is from the best performance achieved by any economy on each *Doing Business* indicator since 2005. The measure is normalized to range between 0 and 100, with 100 representing the best performance (the frontier). The figure shows the absolute difference for each economy between its distance to frontier in 2005 and that in 2012. It shows data for all current EU members except Cyprus, Luxembourg and Malta, which were added to the *Doing Business* sample after 2005.

Source: *Doing Business* database.

initially identified in 1999 had been implemented.⁵ During this initial reform phase the government focused on improving aspects of the investment climate that had been raised as issues by the Latvian business community.

One focus was streamlining business registration. The government simplified the procedures required, such as by combining company and tax registration. By 2004 starting a business in Latvia took only 5 procedures and 16 days—less time than in all but 21 economies covered by *Doing Business 2005*. The change was dramatic: in 1999 opening a business in Latvia had required 17 procedures and 114 days.

The government also improved business inspections. Most business inspectorates in Latvia were perceived as obstructing rather than enabling legitimate business in their enforcement of government regulations. The government requested that inspectorate reform be included as a conditionality of financing from the World Bank.⁶ Later efforts provided new instruction on the rights and responsibilities

of government inspectors and private firms, introduced a requirement for written reports after all inspections and developed performance indicators for inspectorates.⁷

Construction permitting was another target of regulatory reform. In 2001 it took Latvian businesses 2 years to obtain all the licenses and inspections required to build a warehouse. By 2004 the government had reduced the time required to obtain a building permit by 2 months, simply by preparing a flowchart showing what offices to visit and which documents to take.⁸ Further improvements followed, including amendments to the construction code and the establishment of a public register for construction companies.

The government improved tax administration by amending the laws on value added and corporate income tax to resolve specific issues identified by businesses. Draft tax legislation was posted online for public comment, and an appeals body was established in the State Revenue Service.⁹

Latvia enjoyed significant growth during this initial reform period. From 2000 to 2004 GDP growth averaged 7.5%, and unemployment fell from 14.2% to 9.9%.¹⁰ In May 2004 Latvia achieved its goal of joining the European Union.

CONTINUING THE AGENDA

Latvia's strong economic performance continued after the country became an EU member. From 2005 to 2007 economic growth averaged nearly 11% a year. The number of newly registered firms rose from around 7,000 a year to 12,000. And exports of goods and services grew by more than 5% a year, with a peak in growth of 20% in 2005.¹¹

Business regulation reforms continued as well. Rather than relaxing the reform agenda after becoming an EU member, Latvia continued working to enhance its competitiveness by bringing its economic laws, regulations and institutions further into line with those of Western European countries.¹² The action plan initially established in 1999 was regularly amended to identify new areas to target with regulatory reforms. *Doing Business* has tracked

the success of many of these reforms over time.

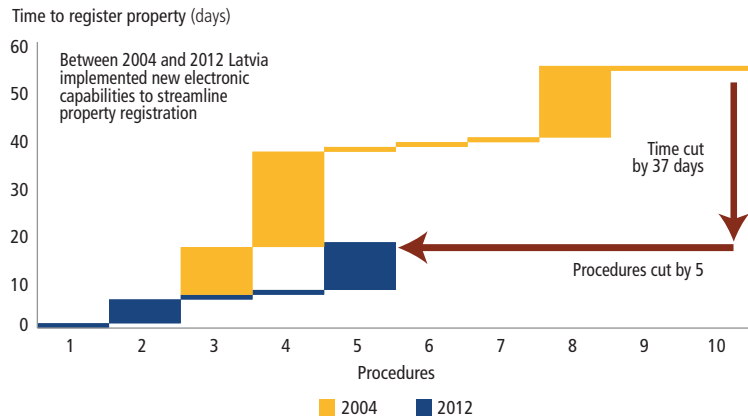
One set of improvements made property registration faster and easier. Businesses trying to expand were being hindered by complex administrative procedures to access land, leading to long delays and considerable uncertainty. The government responded by installing electronic terminals at the land registry, enabling businesses to pay fees and stamp duties at the same time that they registered property. It also granted the land registry electronic access to municipal tax databases, eliminating the requirement to obtain the property tax status in paper format. As a result, the time required to transfer property fell from 55 days in 2004 to 18 in 2012 (figure 4.2).

Construction permitting, a focus of earlier efforts, received renewed attention in response to investors' complaints that unclear fee schedules were a burden to construction activity. The government established a more transparent set of construction fees and duties, reducing the cost associated with completing the procedures to legally build a warehouse from 43.5% of income per capita in 2006 to 18.6% in 2012.

Even after Latvia's accession to the European Union, some regulatory reforms were still driven by the integration process. One was the adoption of an electronic customs system, triggered by the implementation of EU regulations in 2009. Entry and exit declaration forms can now be submitted electronically, and a requirement to submit customs information in advance allows the system to perform computerized risk analysis before goods are presented to customs.

Continuing its improvements in tax administration, Latvia introduced a process for electronic submission and acceptance of tax declarations in 2005 and 2006. This reduced the number of tax payments as measured by *Doing Business* from 29 a year to 7 in 2006.

FIGURE 4.2 Latvia made transferring property simpler and faster



Source: *Doing Business* database.

More recently, Latvia made getting electricity easier by streamlining the approval process for connection designs for straightforward projects. Before 2011 an entrepreneur in Riga had to wait more than 6 months to connect a warehouse to the electricity network. Reducing the number of approvals that were required shortened the wait by almost 3 months—a change that earned Latvia recognition in *Doing Business 2012* as having made the biggest improvement in the ease of getting electricity in the year covered by the report.

CONFRONTING THE CRISIS WITH REFORMS

The global financial crisis brought Latvia's strong economic growth to a halt. Much of the growth had been driven by increased domestic demand enabled by substantial inflows of foreign capital, and when the capital inflows ceased, the economy went into a deep recession starting in 2008.¹³ Latvia responded by undertaking significant structural reforms, including reductions in public spending and wage moderation in the public sector. The public broadly supported the main thrust of the authorities' response to the crisis, and election results in October 2010 endorsed the government's reform efforts.¹⁴

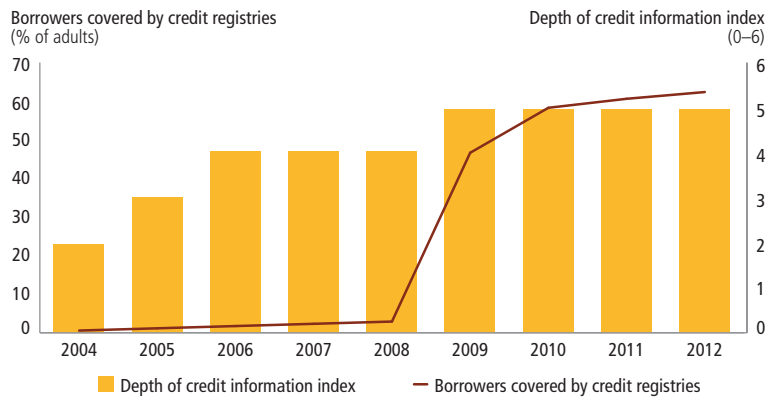
Despite the economic turmoil associated with the financial crisis—or perhaps because of it—Latvia also implemented

a series of new business regulation reforms. The crisis highlighted the need for greater resilience to such shocks in the future and for greater access to finance. It also underscored the need to reduce administrative barriers to investment. The Latvian authorities responded with reforms targeting the insolvency regime, the credit information system and corporate governance.

The insolvency law was amended in 2008 to ensure a better balance between the interests of debtors and creditors and to facilitate the recovery of companies experiencing financial problems. The changes included allowing easier access to insolvency and restructuring procedures, introducing faster procedures for selling a debtor's assets and implementing stricter qualification standards for insolvency administrators. In 2009 further amendments to the insolvency law introduced a mechanism for settling insolvencies out of court to ease pressure on the judiciary. As a result of these reforms, the recovery rate for creditors rose from 32 cents on the dollar to 56 between 2010 and 2011, leading to the biggest improvement in the ease of resolving insolvency worldwide according to *Doing Business 2012*.

Another focus was expanding the credit information system. In 2008 the Bank of Latvia's registry of debtors was transformed into a full-fledged credit registry.

FIGURE 4.3 More and better credit information in Latvia



Source: *Doing Business* database.

It now collects both positive and negative information on borrowers, borrower guarantors and their obligations. The registry is also able to record more precise information, such as the type of settlement of the borrower's obligations and the date on which settlement of a delayed payment is registered. And the registry expanded its coverage from 3.5% of adults in 2008 to 63.8% in 2012 (figure 4.3).

With the goal of increasing investors' confidence in the market, Latvia also introduced more robust corporate governance measures. The government amended the company law to harmonize with the EU *acquis communautaire*, including by improving disclosure mechanisms and increasing transparency.¹⁵ And in 2010 the Riga Stock Exchange issued corporate governance principles and recommendations related to disclosure requirements, remuneration policy and conflicts of interest, further strengthening corporate governance rules for listed companies.

WHAT ARE THE LESSONS?

Latvia has sustained a clear commitment to business regulation reform over more than a decade, under changing political leadership and through economic booms and downturns. What factors have enabled this impressive commitment?

One is the structural incentive provided by economic integration. The

EU requirements of committing to democratic institutions and processes, strengthening the institutional underpinnings of a free market and harmonizing laws with EU legislation provided an actionable roadmap. Results are reflected in Latvia's improvement on the Worldwide Governance Indicators between 2000 and 2005, including on the Regulatory Quality Index.¹⁶ In addition, the potential economic benefits of joining the European Union created strong public support for the reform agenda. This combination of EU requirements and potential economic benefits made it possible to sustain the implementation of both broad structural reforms and specific business regulation reforms.

Similar support for economic reform after the crisis can be linked to a desire for further integration with the European Union, including as a future full member of the euro zone. Devaluation of the Latvian currency against the euro was a policy option for mitigating the effects of the crisis, and it might arguably have implied lower short-term economic costs than cuts in public spending. But the government opted instead to intensify the pace of structural reforms; it viewed maintaining the currency peg less in terms of the purely macroeconomic effects and more as part of its long-term strategy for strengthening links with the European Union, particularly the members of the euro zone.¹⁷ This approach was broadly

endorsed by the business community and the population.

That economic integration can provide useful incentives is not a new lesson: *Doing Business 2012* identified a similar association between successful reforms in FYR Macedonia and its preparations ahead of eventual EU entry. But the case of Latvia provides another example of how economic integration can serve as a powerful stimulus for economic and institutional reforms—and how integration and reform together can create a virtuous circle of development.

The case of Latvia also shows that local circumstances matter as well. Latvia has benefited from a high-quality technocratic bureaucracy through which pro-reform civil servants were able to provide competent support to the reform process over time. The presence of a stable cadre of well-qualified civil servants, maintained through changes in political leadership, almost certainly aided the development and implementation of what has been a largely successful reform agenda. In addition, the ability to establish an ongoing dialogue between the government and the business community may have helped build and sustain the broad political consensus for the reform process.

Whatever the combination of causes, Latvia has maintained a state of mind focused on reform of the business environment and the broader economy. *Doing Business* measures just one component of the reforms that Latvia has implemented. But the results are clear: in the areas tracked by *Doing Business* indicators, the quality of the business environment has improved substantially over the past decade and a half.

CONCLUSION

Latvia's reform process is likely to continue. The authorities have signaled their determination to continue to implement cautious macroeconomic policies that will support continued investments in infrastructure, education and training, seen as key elements of an ambitious

competitiveness agenda.¹⁸ Further business regulatory reforms are planned as well, as part of Latvia's program to implement the "Europe 2020" strategy.¹⁹ The objectives include, among others, the reduction of administrative barriers and the strengthening of access to finance as well as support for access to external markets and encouragement of greater inflows of foreign direct investment to export-oriented sectors. These reforms should enable Latvia to fully overcome the economic effects of the financial crisis and allow it to continue on its path toward successful long-term development.

NOTES

This case study was written by Caroline Frontigny and Betina Tirelli Hennig.

1. World Bank, World Development Indicators database, <http://data.worldbank.org/>. The income measure is gross national income (GNI) per capita at purchasing power parity.
2. Export growth data are from the World Bank's World Development Indicators database (<http://data.worldbank.org/>). Poverty data are based on the poverty headcount ratio at purchasing power parity and are from PovcalNet, the online tool for poverty measurement developed by the World Bank's Development Research Group (<http://iresearch.worldbank.org/PovcalNet>).
3. See, for example, Coolidge, Grava and Putnina (2003).
4. Liepina, Coolidge and Grava 2008.
5. Liepina, Coolidge and Grava 2008.
6. World Bank 2001.
7. Coolidge, Grava and Putnina 2003.
8. World Bank 2007.
9. Liepina, Coolidge and Grava 2008.
10. World Bank, World Development Indicators database, <http://data.worldbank.org/>.
11. World Bank, World Development Indicators database, <http://data.worldbank.org/>.
12. Liepina, Coolidge and Grava 2008.
13. Latvia, Ministry of Economics 2011.
14. EBRD 2011.
15. EBRD 2011.
16. The Regulatory Quality Index captures perceptions of the government's ability to formulate and implement sound policies and regulations that permit and promote private sector development. It ranges from -2.5 (weak government performance) to 2.5 (strong government performance). Latvia's score rose from 0.74 in 2000 to 0.94 in 2005, then rose to 0.98 in 2010.
17. See, for example, Åslund (2009). Another consideration in the government's policy choice may have been a desire to protect the significant share of the population with debt in euros and other foreign currencies from the consequences of a devaluation.
18. EBRD 2011.
19. Latvia, Ministry of Economics 2011.