



**MINISTRY OF ECONOMICS OF THE REPUBLIC OF  
LATVIA**

**Guidelines on National  
Industrial Policy of Latvia  
(Unofficial translation)**

# **Industrial Policy – the Basis for “Economic Breakthrough”**

## **Introduction**

Over the last 20 years the economy of Latvia as a small and open economy has been subjected to several economic shocks, out of which the last crisis has caused essential changes in the national economy of Latvia. While getting out of the crisis it was clear that the economic model in which the internal demand, being the main driving force of the growth, increased rapidly only due to the influx of external capital no longer existed. This model of economic development was not sustainable because it was characterized by marked macroeconomic disproportions – high inflation and a high deficit in the current account of the balance of payments.

Data analysis of the national economy shows a change of economic development paradigm– a transition to a model of sustainable development in which the main driving force are: export, the ability to compete in internal and external product markets, as well as the ability to compete in capital attraction to increase the productivity potential of Latvia.

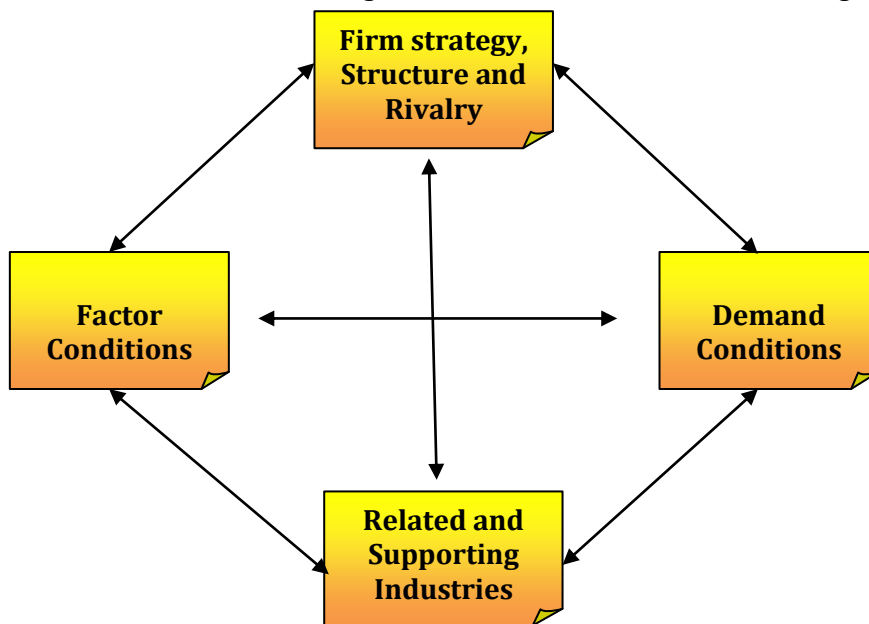
With the change of the common economic paradigm there is also a necessity to change the entire policies in the widest sense of the word so that these policies would comply with current scientific concepts that are modern, up-to-date and elaborated by economic theoreticians and already approbated in practice. Scientific literature of economy describes these concepts as “modern industrial policy” (synonyms “industrial policy 2.0”, “industrial policy of the 21<sup>st</sup> century”, etc. are also used), “competitiveness of nations” and “regional innovations strategies”.

The document of the guidelines on industrial policy provides an insight into the theoretical concepts of modern industrial policy, identifies the most essential activities to be performed and the main collaboration partners, as well as defines the trends for the implementation of the policy. Detailed modern industrial policy and a mechanism for its implementation will be elaborated by the Ministry of Economics till the end of 2012 by preparing and submitting a policy planning document to the Cabinet of Ministers for approval.

## 1. Competitiveness of Nations

The economic basis for the competitiveness of nations is elaborated by Mr M. Porter, professor of economics at Harvard University, and his colleagues. The theoretical model is used for evaluation of the competitiveness of the economy of several states. In practice, the theoretical model is developed and adjusted for the needs of each particular state. The competitiveness method elaborated by Mr M. Porter is based on totality of several factors (diamonds of comparative advantage of nations) defining the determinants of national advantage of each state. These factors characterize the environment created by each state for the development of sectors of national economy:

Figure 1 Diamond of National Advantage by Mr M. Porter



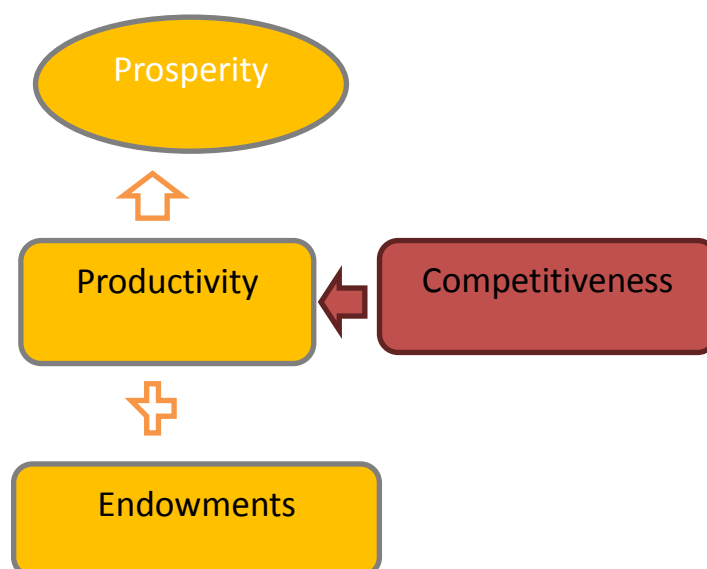
- factor conditions – access to skilled human resources, and capital, level of innovation, technological base. However, the entire factors within a particular period of time can be less important than the level of their development. The lack of certain factors in manufacturing promotes innovation, because the lack of labour force or raw materials creates conditions for the development of new methods that frequently become comparative advantage of the nation. If the global economy develops, also the factor conditions change, for example, currently the level of innovation and circumstances affecting it, is considered as one of the most essential factors;
- demand conditions – a strong local market leads to national advantage, because the local market, following global tendencies, promotes the ability of the local firms to anticipate global trends. At the same time, a strong local market (consumption) promotes the firms to devote more attention to the competitiveness of their product by developing product qualities. In accordance with the theory, such qualities create a comparative advantage when the product is offered in the global market;

- supporting industries – developed and innovative suppliers, supply chains and clusters promote occurrence of innovative raw materials and components that are more competitive and innovative in relation to price;
- firm strategy, structure and rivalry – firms strategy is defined by national characteristics. The research of these characteristics allows to define the competitiveness of the firms of the particular state in a particular business field.

***Mr M. Porter stresses that the role of the government is to develop such business environment which promotes the increase of firms' competitiveness, stimulates early demand for technologically high-quality products, focuses on specialized factor creation, and promotes domestic competition.***

The most current competitiveness reports are elaborated in several states and regions of the world, and Mr C. Ketels, professor at Harvard University, has actively participated in their elaboration. In accordance with the theoretical model of Mr M. Porter, an elaboration of Latvian Competitiveness Report was started up in 2011; this report is being developed by the Stockholm School of Economics in Riga, BICEPS and several other economic experts acknowledged in Latvia under the guidance of professor Mr C. Ketels. The report is based on an assumption that states with higher prosperity also have a higher level of competitiveness. In accordance with the theory the prosperity of states is affected by two essential factors – productivity and endowments (geographical location, raw materials, etc.). Competitiveness theory points out that it is almost impossible to affect the endowments with political instruments, for example, by promoting rational and sustainable usage of resources. The only element due to which the prosperity of the state increases is productivity, thereby we can conclude that the productivity is the main factor stating the competitiveness of the state.

Figure 2. Strategic Framework of the Latvian Competitiveness Report



## 2. Modern Industrial Policy

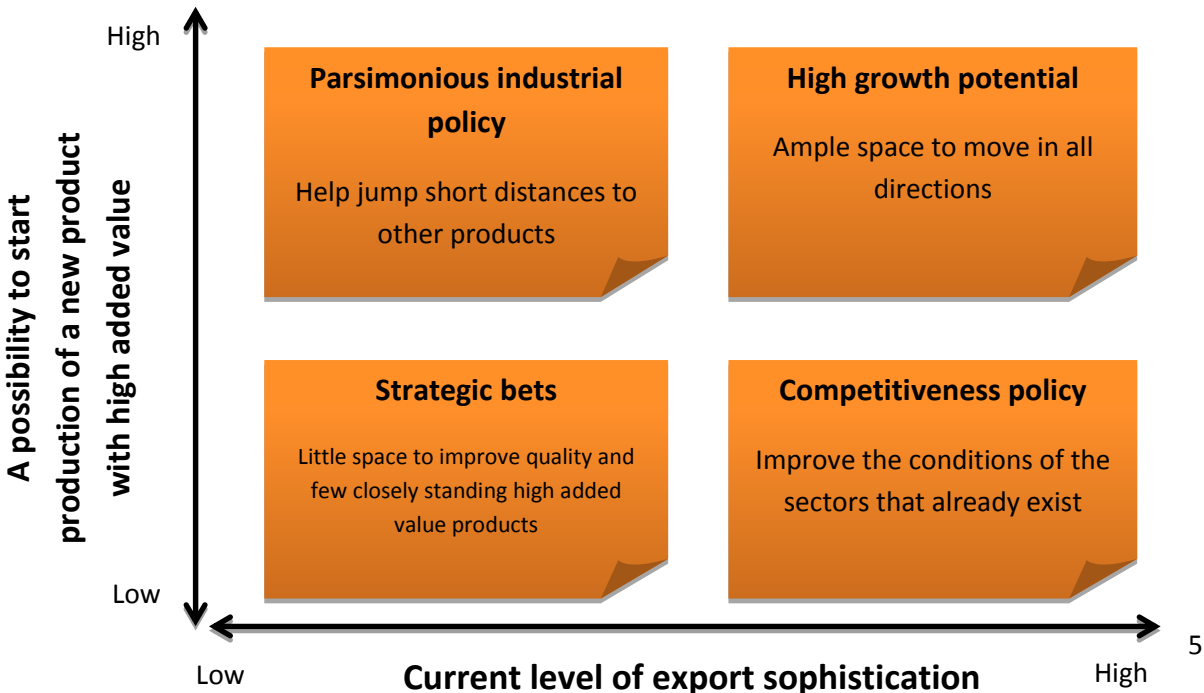
The industrial policy has developed quite a long time ago, it has a long history, for at least a century, and it originates both in theory and practice simultaneously with the beginning of capitalism. However, the definition and theoretical considerations of the industrial policy have changed due to changes in national economies and global economy, especially within the last 20 years.

*The modern industrial policy can be described as follows: the policy priorities of the central government is to work on the totality of support instruments by improving common competitiveness in all levels of national economy (macro and micro level), instead of deciding whether to “restrict or support individual firms”.*

Within the last years the industrial policy was profoundly analysed by Mr D. Rodrik, professor at Harvard University, and his colleagues. Mr D. Rodrik indicates that national economies developing in the 21<sup>st</sup> century global economy face new challenges, and the aim of the industrial policy is to support entrepreneurs in the search of successful specialization or niche. In accordance with the theory elaborated by Mr D. Rodrik the development of economy of modern states is defined by merging and using the characteristics of productivity in order to produce more goods in overall, as well as to produce goods which require more developed skills and knowledge or so called high added value goods. Taking into account the proposed provision, new challenges originate for states and their governments, for example, specialization of firms, segregation of society, setting of priorities, etc. The traditional industrial policy consisting of finance providing for enterprises or promotion of the initiatives of entrepreneurs with instruments of public loan or grants does not comply with the new challenges.

Therefore, state shall change the response to these new challenges in the national economy. Mr D. Rodrik offers a new strategic framework for industrial policy.

Figure 3. Strategic Framework for Industrial Policy by Mr D. Rodrik



The new framework offers to find responses to problems in the national economy by changing the accent of problem and solution. The researches have showed that it is impossible to compensate the lack of skills causing a corresponding market failure and inability to develop high added value products from government grants, therefore it is necessary to develop other instruments for improvement of existing skills and to create a friendly environment for the development of new niche products. The most successful way for the implementation of the previously mentioned is a society-wide dialogue in order to prevent unfavourable impact factors that may originate if this function is implemented exclusively by the state or private sector.

### 3. Modern Industrial Policy in Latvia

The basis for prosperity in Latvia and the determinant of future growth is the increase in productivity in the national economy. The economic theory stresses that the level of productivity and competitiveness of the manufactured production (not only in the relation to prices, but also to innovations and added value) are factors establishing the ability of the state to reach the level of states more developed than the respective state.

Theories of modern industrial policy developed by Mr D. Rodrik, Mr M. Porter, Mr R. Hausman and other theoreticians of economics, as well as the framework of national competitiveness and regional innovation model are adapted within the framework of modern industrial policy in Latvia. Also European Union priorities (EU industrial and competitiveness policy) and *acquis communautaire* will be taken into account when elaborating industrial policy.

**The modern industrial policy in Latvia is based on activity directed towards the elimination of market failures and the improvement of competitiveness (macro level national economy analysis), satisfaction of specific needs of separate sectors (micro level national economy analysis) and activation of regional advantages (micro level national economy analysis).**

At the same time the development of basic industrial policy (related to the development of infrastructure, improvement of tax and educational system and many other factors that Mr M. Porter described as “factor conditions”) will be ensured, as well as elaboration of advanced industrial policy (target oriented on the development of innovations, R&D, clusters and other factors that Mr M. Porter described as “related and supporting industries” and “firm strategy, structure and rivalry”).

Figure 4. Elements of Modern Industrial Policy



Modern industrial policy will be targeted both on industries historically developed in Latvia and having already achieved comparative advantage (traditional industries), as well as on future industries currently developing with a high export potential.

In the elaboration of industrial policy, Latvia's long-term planning documents are taken into account – long-term conceptual document "Latvia's Development Model: *People First*", Latvia's Sustainable Development Strategy 2030 (Latvia 2030) and National Reform Programme of Latvia for the Implementation of the "EU 2020" Strategy. It is planned that industrial policy will become an integral part of the National Development Plan.

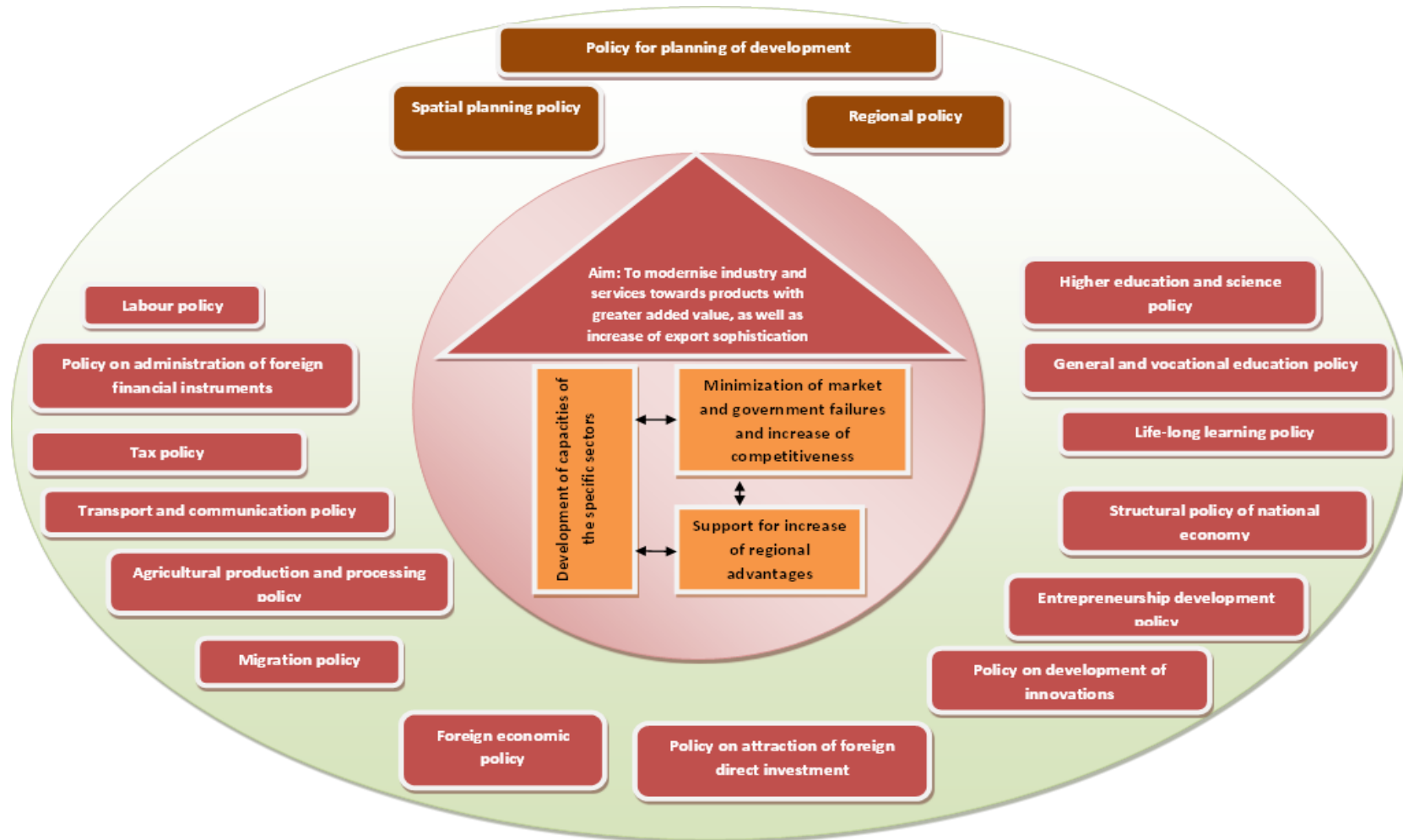
**The aim of industrial policy in Latvia is to promote structural changes in economy in favour of production of goods and services with higher added value, namely by increasing the role of industry, modernizing industry and services and export sophistication.**

**In order to reach the defined aim set within the framework of modern industrial policy the following results are determined:**

- **the proportion of manufacturing industry shall reach 20% of the gross domestic product in 2020;**
- **in 2020 the increase of the productivity of manufacturing industry shall reach 40% in comparison to 2011;**
- **in 2020 the increase of manufacturing industry shall reach 60% in comparison to 2011;**
- **investments in research and development shall reach 1.5% of the GDP.**



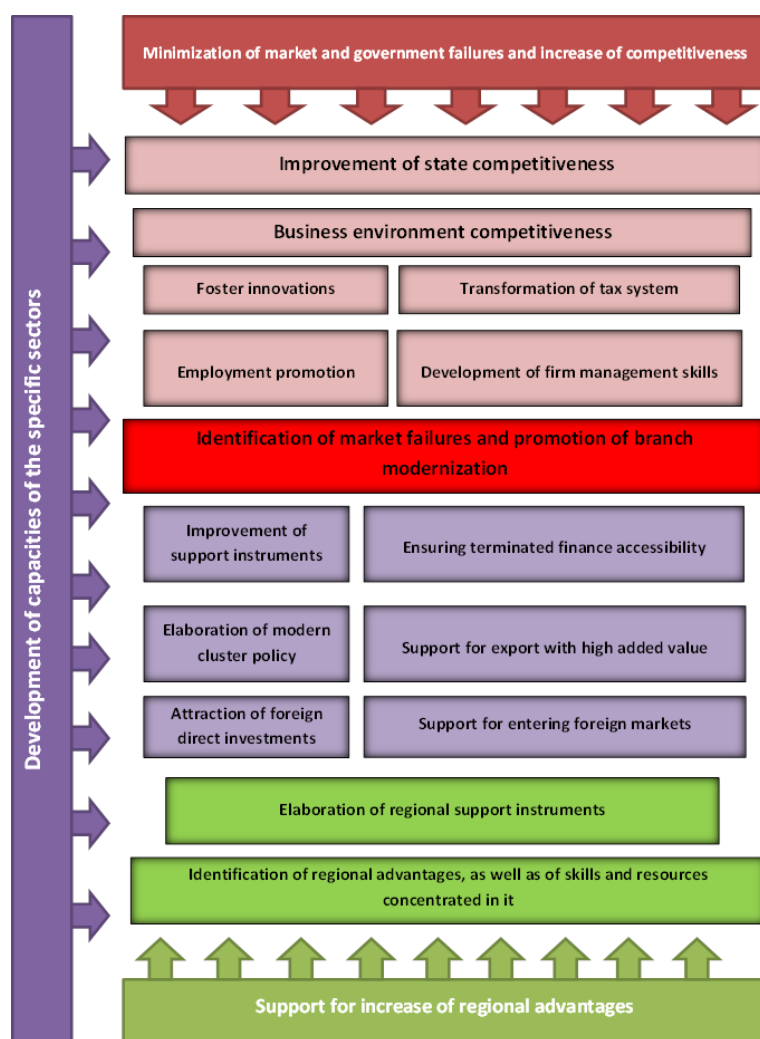
Figure 5. The Framework of Modern Industrial Policy in Latvian



The industrial policy is related to the fields of responsibility of many ministries, including, responsibility of the Ministry of Foreign Affairs, Ministry of Justice, Ministry of the Interior, Ministry of Finance, Ministry of Economics, Ministry of Education and Science, Ministry of Environmental Protection and Regional Development, Ministry of Transport, Ministry of Agriculture.

### 3.1. Directions of Activity of Modern Industrial Policy

Figure 6. Framework of Activity of Modern Industrial Policy



#### 3.1.1. Elimination of Market Failures and Improvement of Competitiveness

**Improvement of state's competitiveness** – parallel to the elaboration of the first Latvian Competitiveness Report also the analysis of indices affecting competitiveness and evaluation of strengths and weaknesses of competitiveness in Latvia was performed. It is important to eliminate the found weaknesses of competitiveness within the shortest possible time and at the same time maintaining the average term vision. The authors of the report have concluded that the most essential circumstances delaying competitiveness are as follows:

- a) comparatively large size of shadow economy;
- b) comparatively poor performance of industry;
- c) high social inequality.

It shall be noted that the level of competitiveness of the state is closely related to the competitiveness of firms and competitiveness of business environment developed by the state.

**Increasing competitiveness in business environment** – creation of outstanding business environment shall be continued, and it can be reached by reducing administrative burdens and increasing client-oriented state administration institutions.

**Promotion of innovation** by creating a framework for effective collaboration among scientists and entrepreneurs, promoting industrial researches, elaborating and manufacturing new products and technologies. An open, creative and innovative framework/environment promoting wide usage of innovation in various forms (innovations of process, services, products, technologies) is important for the increase of competitiveness and productivity.

**Employment promotion** should be actively initiated by the Ministry of Economics, the leading ministry in the promotion of development of national economy, by implementing measures related to the reconciliation of demand and supply of labour force and increase in labour force productivity.

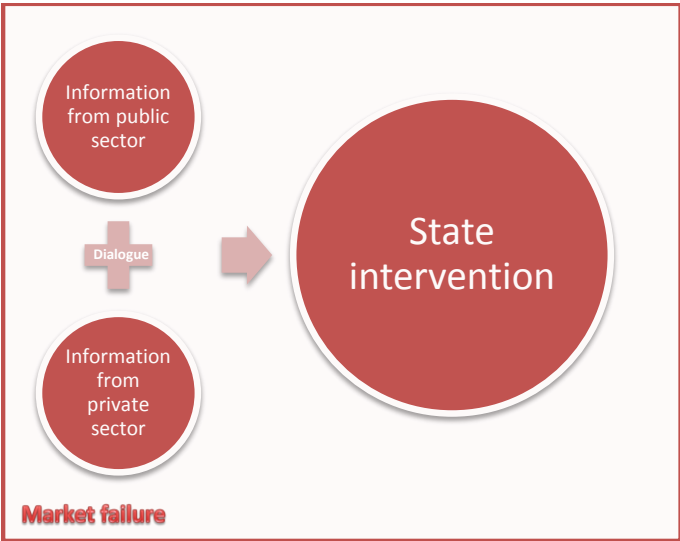
**Transformation of the tax system** with an aim to promote development and growth of industry, as well as the competitiveness of the national economy in total.

**Development of firm management skills**, especially in state enterprises.

**3.1.2. Development of Specific Potential of Particular Sectors**

The most essential element for industrial policy is the promotion of the modernization of sectors, in the result of which the activities mentioned in this section occur – in cooperation with the organisations represented in the National Economy Council a wide analysis of the abilities and skills of the sectors having to be concluded within the framework of new, improved dialogue (Dialogue 2.0), including analysis of government failures, for example, analysis of sectors set by the state as prior in the level of enterprises (micro) and national economy (macro), as well as inspection of the existing support instruments towards the identified market failures in order to promote the support for the increased sophistication of export products. Within the framework of the dialogue an agreement on supervision mechanism shall be settled. With the help of this mechanism an analysis on the efficiency of existing industrial support policy by evaluating gains, shortages and mistakes have to be performed on a regular basis.

Figure 7. Dialogue 2.0



**The improvement of the existing support instruments will be carried out** with an aim to eliminate the possibility of misuse of advantages developed by the state support, similar to advantages of monopolists.

**Ensuring terminated access to finance** to a wide group of entrepreneurs for which a necessity for financial solutions has originated due to the restrictions of classical financial sources and by taking into account the economic situation and analysis of skills available in Latvia.

**Elaboration of modern cluster policy** by promoting collaboration of firms acting in the industry, for example, promoting collaboration with scientific institutions and related industries.

**Support for export with higher added value** by promoting inclusion in supply chains and production of niche products. Regular monitoring of the support.

**Attraction of foreign direct investment** with an aim to ensure access to finance and markets, and transfer of knowledge, skills and technologies.

**Support for entering foreign markets** by reducing trade barriers in foreign markets and increasing export skills and knowledge of enterprises.

### 3.1.3. Activization of Regional Advantages

**Identification of regional advantages, as well as of the skills and resources concentrated in it** – includes analysis of particular territories or agglomerations where a totality of skills and informal networks exist with an aim to identify the comparative advantage thus supplementing evaluation of sectors with a regional component.

**Elaboration of regional support instruments** with an aim to promote the development of infrastructure and knowledge transfer within the region by increasing the common competitiveness of industries acting in the region.

## 3.2. Identification of Export-Oriented Niches and Elaboration of Support Instruments

One of the most important elements for the modern industrial policy in Latvia is the necessity to elaborate a state intervention policy. On the basis of international analytical researches the Ministry of Economics plans to elaborate the analysis of the most export-oriented niches and products of these niches. It is planned that within 2012 an analytical evaluation based on economic theories and global practice will be performed, for example, particularly on products space analysis method elaborated by Mr Hausman and his colleagues. This evaluation will include the identification of the most export-oriented niches of the national economy, the evaluation of export ability of niche products and the investigation of opinions of enterprises with an aim to identify current shortages and future vision promoting or delaying development of the corresponding enterprise or product and transition to production of products with higher added value.

On the basis of the performed analysis and conclusions the Ministry of Economics will elaborate state intervention instruments that will be financed by the EU Financial Perspectives 2014-2020. Indicative support instruments used in the state intervention shall be placed in the following categories:

**Indicative support instruments for the support of current and future industries:**

- support instruments based on product and field segments (clusters):
  - mezzanine, start-up, risk capital financing instruments to modify products and technologies;
  - co-financing for the development of new products by covering costs of product manufacturing and development;
  - implementation of new products and technologies in the manufacturing – support for the development of various skills;
  - wider access to technology incubation services/ development of incubators;
  - development of competence centres;
- promotion of wider access to financial instruments:
  - issue of state guarantees to exporters;
  - insurance of debtors' risk in case of export;
  - risk capital/ co-investments/ mezzanine.

**Indicative support instruments for base industrial policy:**

- support instruments directed towards the support of business and development of regional dimension:
  - promotion of business startup – business incubators, accelerators, micro credits, start-up capital, training for persons starting up business, micro and small enterprises;
  - development of infrastructure and industrial connection - support for infrastructure and performance of zero cycle, i.a. programmes for power connections;
  - development of human resources.

**Other indicative state intervention elements:**

- Intervention elements complying to the base industrial policy:
  - Employment policy:
    - Life-long learning,
    - Retraining.
  - Reduction of administrative burden
  - Education policy
    - Modernization of vocational education,
    - Promotion of collaboration between science and entrepreneurs.
- Intervention elements complying to target-oriented industrial policy:
  - Tax policy:
    - Tax discounts (R&D, investments in infrastructure, etc.).

- Regional development policy:
  - Identification of advantages of regional competitiveness,
- Revision of the innovation system

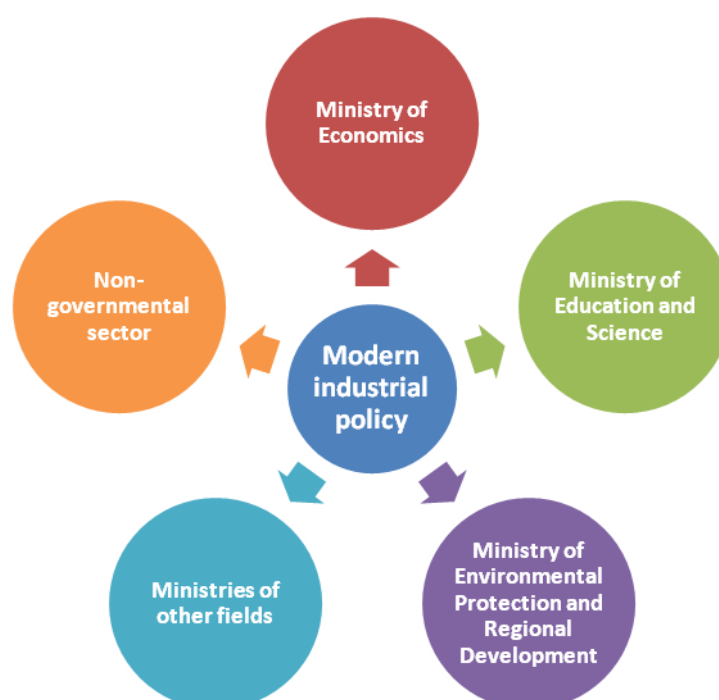
**In general, all indicative support instruments are planned on the basis of the following basic principles:**

- support both for traditional and future industries;
- orientation on products and product groups, not on wide support for industry – cluster approach (smart specialization);
- prerequisites for the implementation of programmes – market supplementing programmes;
- selection of professional partners (intermediary bodies) for the implementation of support programmes;
- more detailed discussion with the industry experts on support criteria, provisions and results to be reached;
- attention to the control of results achieved within the programmes (projects).

### 3.3. Institutional Model for the Implementation of Modern Industrial Policy and the Importance of Industrial Policy within the Development Planning System

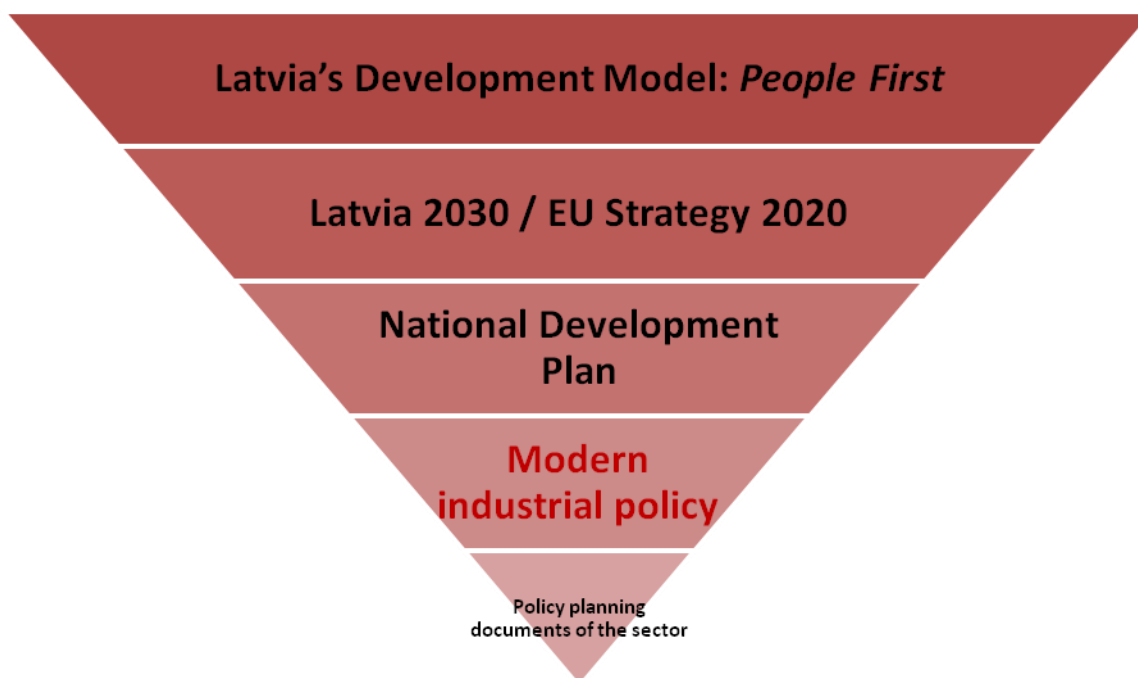
As previously mentioned, the modern industrial policy is closely related to many policies, however, the main collaboration partners to the MoE in the elaboration of policy will be the Ministry of Environmental Protection and Regional Development, the Ministry of Education and Science and non-governmental organizations representing entrepreneurs, as well as ministries and non-governmental organizations of other fields.

Figure 8.



The modern industrial policy is closely related to the long-term and medium-term planning documents of the state, and its aims correspond to the aims set in the long-term planning documents.

Figure 9



### 3.4. The Most Essential Future Activities of the Modern Industrial Policy

In accordance with task given in the Declaration of the Cabinet of Ministers and Government activity plan the Ministry of Economics in collaboration with line ministries will elaborate and submit to the Cabinet of Ministers for approval a detailed description of activities and planned measures until the end of 2012. However, the most important aspects for the implementation of modern industrial policy can already be observed – **6 step strategy**:

1. **Evaluation of the base of resources** – the evaluation of the base of results envisages the analysis of Latvia's national resources (human resources, production capacity, etc.) by determining base level for these resources in the territory of Latvia – Latvian Competitiveness Report and report "Development of Regions in Latvia". The evaluation of resources allows to identify not only the state support policies necessary in regional aspect, but also those policies that are oriented towards the reallocation and development of resources, for example, policy on the attraction of investments, infrastructure development policy, etc.
2. Determination of **the most export-oriented niches and corresponding niche products** with high added value potential (analysis performed by the Bank of Latvia in accordance with the methodology of Mr Hausman, Mr Klinger, Mr Rodrik and Mr Hwang) to promote competitiveness of products. The complexity level of currently produced products and the possibility to develop it are to be analysed in order to produce products with higher added value. Therefore it is planned to analyse the products space in order to identify niches and niche products that are

closest to products of the next development stage. Such factors as export-ability, productivity, employment and innovation, as well as future development tendencies of these factors will be analysed.

3. **Profound analysis of manufacturers** – analysis of enterprises manufacturing products will be performed with an aim to identify abilities, skills, capacity, possible strategies and shortages by taking into account analysis of niche and products mentioned above. It is planned that in the result of the analysis shortages (bottlenecks) of abilities and skills hindering the development of enterprises producing products with higher added value will be identified. This analysis will be used as a base for further dialogues on the steps of state intervention.
4. **Dialogue 2.0** – includes a change of paradigm in the discussion between the government and society. Within the framework of the new dialogue it is planned that discussions on previously mentioned export-oriented niches, their products, results of analysis of manufacturers, as well as on identified management failures will be carried out. Dialogue 2.0 foresees that vision and analysis regarding the aspects of above mentioned analysis is rendered not only by the government, but also by the society and non-governmental organizations representing entrepreneurs. Thereby, the result of modern dialogue is an acquisition of complete information by analysing the results of dialogue of both parties, as well as agreement on innovative state intervention mechanisms.
5. **Internal (self-appraisal) and external evaluation of current state support instruments**– to continue work on the elaboration of new European Union financial framework and implementation of modern industrial policy, it is necessary to perform evaluation of up to now state performed support instruments in order to identify instruments that comply with the guidelines on modern industrial policy, as well as to identify those instruments that have promoted rent seeking or have not been implemented in full amount, for example, performing analysis of causes and reasons of the failure.
6. **The elaboration of terminated support instruments** is performed in compliance with the EU *acquis communautaire* and aims set by the EU institutions. It is planned to elaborate terminated support instruments by using instrument of the previously mentioned dialogue in order to ensure increasing product sophistication and amount.

### 3.5. Timeline for the Elaboration of Industrial Policy

Although, six steps identified within the elaboration of industrial policy are not closely interrelated, they depend on results obtained in each step. Therefore, a potential timeline is identified for the implementation of these six steps and for the elaboration of policy planning document.



Figure 10. Timeline

