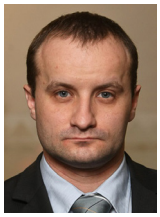
Allocation of resources in Latvia improved after the crisis



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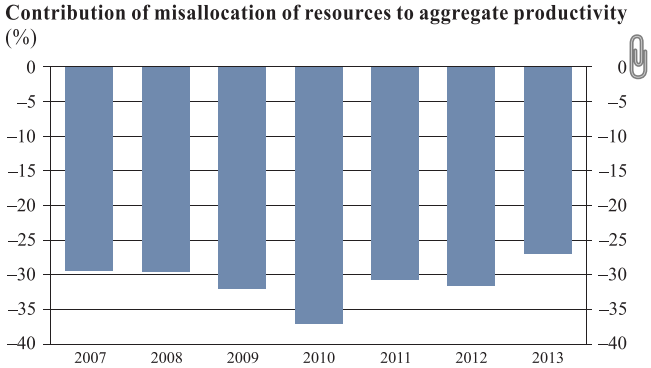
Aggregate productivity and income of a country can be boosted in two ways. One way is to increase the productivity of individual enterprises which is closely related to innovations and education reforms. Alternatively, redistribution of labour and capital from less productive to more productive firms improves the so-called allocation of resources. Productive firms will make better use of production factors and generate larger aggregate output.

What determines the allocation of resources? The economic theory states that it depends on productivity of individual firms: more productive enterprises will attract more labour and capital. However, "distortions" faced by individual firms matter a lot. If firms' access to labour resources (e.g. because of trade unions) and financial capital (e.g. due to credit supply conditions) differs, or legislation treats economic agents differently, the "distorted" firms are likely to underuse labour and capital and produce less output. Thus, the **removal of various "distortions" may improve the allocation efficiency and total output**.

Contribution of misallocation of resources to aggregate productivity



In my recent empirical study (see Benkovskis, 2015), I use anonymised firm-level data for 2007–2013 and apply the model of Hsieh and Klenow (2009) to the analysis of allocation of resources in Latvia. According to my estimates, the contribution of misallocation of resources to aggregate productivity losses was close to 27% in 2013 (see Figure). However, such **contribution of misallocation of resources in Latvia is relatively low by international standards**. Hsieh and Klenow (2009) argued that full liberalisation would boost aggregate manufacturing productivity by 86%–115% in China, 100%–128% in India, and 30%–43% in the US. García-Santana et al. (2015) reported an impressive rise in misallocation of resources in the Spanish economy, with potential gains from reallocation approaching 50% in 2007. Dias et al. (2014) showed that removing distortions would lead to a 30% gain in output in Portugal in 2011.

Specifically **in Latvia**, the **allocation of resources has improved since 2010**. The in-depth econometric analysis performed in the paper reveals that improved allocation of resources is to some extent related to growing competition in the domestic market. After the crisis, tighter competition in the Latvian market redistributed labour and capital to export-oriented firms that were on average more productive, thus contributing to an overall economic growth after 2010.

In general, the analysis led to the conclusion that labour "distortions" are minor in Latvia due to high flexibility of the labour market. However, there is still some room for improving allocation of resources by **stimulating further competition in the domestic market and ensuring better access to financial capital for export-oriented enterprises**.

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