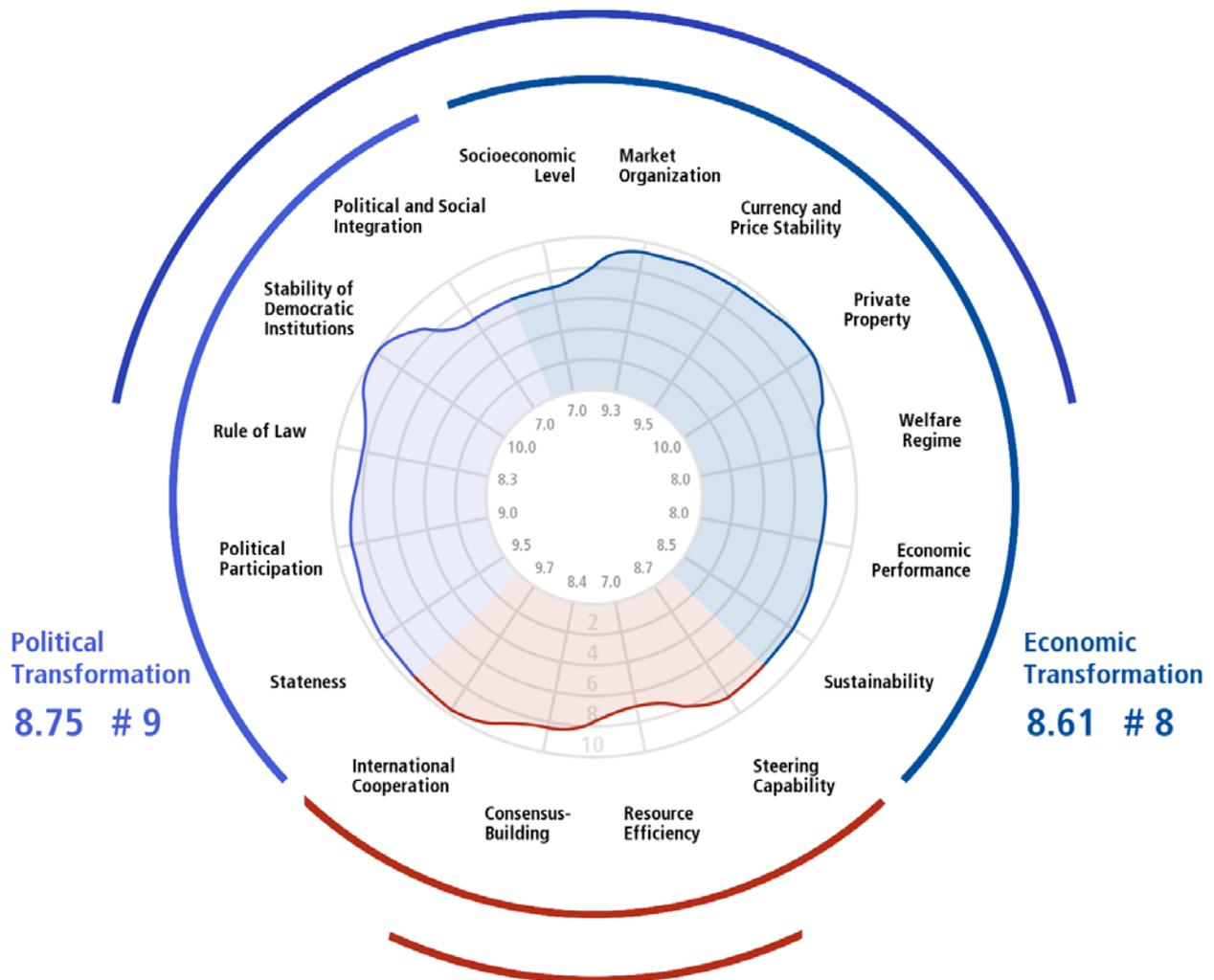


# Latvia

## Status Index

**8.68 # 8**

on 1-10 scale out of 129



**Political Transformation**  
**8.75 # 9**

**Economic Transformation**  
**8.61 # 8**

## Governance Index

**7.00 # 8**

on 1-10 scale out of 129

This report is part of the Bertelsmann Stiftung's Transformation Index (BTI) 2018. It covers the period from February 1, 2015 to January 31, 2017. The BTI assesses the transformation toward democracy and a market economy as well as the quality of political management in 129 countries. More on the BTI at <http://www.bti-project.org>.

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## Key Indicators

Population	M	2.0	HDI	0.830	GDP p.c., PPP \$	26031
Pop. growth <sup>1</sup>	% p.a.	-0.9	HDI rank of 188	44	Gini Index	35.1
Life expectancy	years	74.1	UN Education Index	0.858	Poverty <sup>3</sup>	% 0.9
Urban population	%	67.4	Gender inequality <sup>2</sup>	0.191	Aid per capita	\$ -

Sources (as of October 2017): The World Bank, World Development Indicators 2017 | UNDP, Human Development Report 2016. Footnotes: (1) Average annual growth rate. (2) Gender Inequality Index (GII). (3) Percentage of population living on less than \$3.20 a day at 2011 international prices.

## Executive Summary

Latvia made great international strides between 2015 and 2017, culminating in the country's accession to the OECD in 2016. Consequently, Latvia has joined every major western international organization. This was seen as a necessary security development due to the external threat posed by Russia following Russian's occupation of Crimea. The number of NATO troops hosted by Latvia has also increased, including a battalion of 1,000 Canadian soldiers that arrived in 2017. Meanwhile, the government has committed to gradually raising defense spending with the aim of eventually reaching 2% of GDP in 2018. At the same time, after a heated political debate concerning the country's response to Europe's refugee crisis, Latvia eventually accepted a small quota of refugees. However, poor living conditions and job prospects have led many refugees to leave Latvia for Germany and other western European countries, although the terms of their refugee status do not allow them to claim benefits or work outside Latvia.

During the period under review, Latvia's economy grew more sluggishly than in the previous years. This was partially caused by a delay in EU structural spending, demonstrating Latvia's dependence on EU funds for economic growth. Despite slow economic growth, the budget remained balanced as it has been since the harsh austerity measures introduced between 2008 and 2010, which saw taxes rise and public spending cut, and led to a relatively balanced budget, booming exports and the return of FDI. At a conference in Riga in mid-2012, Christine Lagarde hailed Latvia's "remarkable" achievements, attributing them to the government's "political will and ownership," and readiness to "bite the bullet" and frontload reforms so as not to delay the pain. The government is now focusing on economic reforms to stimulate competitiveness, with major reforms to the tax system, health care financing and the school system planned for 2017. Public pressure on government to address social inequality has also increased, including pressure to introduce progressive taxes and target benefits at those most in need.

Despite a change of government in February 2016, the political system has remained stable. The same three parties - the center-right Unity, radical-right National Alliance, and conservative Union

of Greens and Farmers - have been in a governing coalition since the October 2014 election. The coalition was initially led by Prime Minister Laimdota Straujuma (Unity), who successfully led Latvia through its presidency of the Council of the European Union in the first half of 2015. However, instability within the Unity party led to a failed coup to oust Straujuma, which resulted in the Union of Greens and Farmers seizing the political initiative and nominating their own leader, Māris Kučinskis, to head the government. He was elected to the post in February 2016.

The key long-term challenge for Latvia remains the demographic crisis. The Latvian population has fallen from 2.6 million in 1989 to less than 2 million in 2016. Eurostat projects that (if current trends continue) Latvia will have a population of just 1.4 million in 2050. Low fertility rates and continuing migration to wealthier EU member states has led to a rapid decline in the dependency ratio (i.e., the number of working age people to pensioners). However, successive governments have been unable to introduce any policies to reverse these trends and the Kučinskis government, which has not prioritized this issue, is unlikely to break this pattern.

## History and Characteristics of Transformation

The Latvian territories have been a part of the Swedish, Polish and Russian empires. However, throughout these different eras of empire the effective governors of Latvia remained the Baltic Germans, who had first conquered Latvian territory in crusades against the pagans of northern Europe in the early thirteenth century.

The modern Latvian nation emerged in the mid-nineteenth century as a result of Tsarist peasant emancipation, urban industrialization and the subsequent emergence of an educated Latvian middle-class. Independent Latvia emerged in the aftermath of the First World War, as the Russian empire collapsed, and new countries formed all across east and central Europe. The new Latvian state adopted a parliamentary constitution in 1922, although this failed to provide solidity given the formation of 13 government coalitions by 1934. This political instability, accompanied by an economic downturn in the early 1930s, led to a peaceful coup in 1934, and the benign dictatorship of Karlis Ulmanis. He had been the dominant figure of inter-war Latvia, having served as Latvia's first prime minister and as the head of the committee that declared Latvia's independence in 1918. These years of dictatorship are remembered with great popular affection largely because of the brutality and violence of the following Soviet and German occupations during the Second World War, and Latvia's subsequent forced annexation into the Soviet Union.

Soviet occupation after 1945 saw the collectivization of agriculture, an increased pace of industrialization and sharp demographic change. The large German and Jewish minorities had virtually disappeared as a result of the holocaust and the dislocations of the Second World War, while many Latvians (largely the middle-class elite) fled west or were deported to Siberia. The post-1945 era saw a large influx of Russian-speakers. The Soviet regime floundered in the 1980s as falling energy prices threatened economic stability, and the democratic reforms of Mikhail Gorbachev allowed the forces of Latvian nationalism to organize and compete in free elections.

Three major factions emerged in the late 1980s: The radical nationalists of the Latvian National Independence Movement, the more moderate and inclusive Latvian Popular Front (LPF), and the anti-reform Interfront movement, an amalgamation of pro-Soviet forces primarily composed of ethnic Russian Latvian Communist Party members and Soviet officers who had settled in Latvia after their retirement. The contemporary Latvian party system still largely reflects this order, with radical Latvian nationalist, moderate centrist nationalist and left-leaning pro-Russian-speaker parties in the Latvian parliament. The LPF won a majority in the 1989 elections to the USSR Congress of People's Deputies, and again in the 1990 elections to the Latvian Supreme Soviet, which then voted to restore independence in May 1990, leading to the establishment of parallel Latvian and Soviet government structures. De facto independence was achieved following the failed August 1991 anti-Gorbachev coup in Moscow.

At this point Latvia faced a radical political and economic transition. The political transition to a multiparty democracy began with the re-adoption of the 1922 constitution and the first post-Soviet parliamentary elections in 1993. Since then Latvia has had eight parliamentary elections, all of which have been judged as free and fair by international observers. However, Latvia's extreme multi-party system has meant that government stability has been hard to come by, with governments lasting, on average, little over a year. The other major political challenges included an agreement on the withdrawal of Russian forces from Latvian territory (reached in 1994), internationally accepted rules on the naturalization of Russian-speaking Soviet-era immigrants and accession to the major Euro-Atlantic organizations (Latvia joined the European Union and NATO in 2004).

Reforms to the economy were equally challenging. Many of Latvia's largest industrial enterprises, such as the electronics manufacturer VEF and the minibus producer RAF, went bankrupt, while others were privatized or returned to previous owners. Unemployment was high in the early 1990s, and the quality of public services fell as government receipts collapsed. Two currency reforms (first instituting the Latvian ruble, then the Latvian lat) and rampant inflation in the early 1990s, as well as the collapse of several commercial banks in the mid-1990s, wiped out people's savings. However, the mid-2000s saw Latvia experience rapid economic growth, albeit primarily as a result of a construction and consumer-spending boom funded by cheap credit. The Latvian economy fell back to earth in late 2008, and the government turned to an International Monetary Fund (IMF) led international consortium for a financial bailout. A dramatic recession (the deepest in the world) followed, with Latvia experiencing a cumulative GDP decline of 23.9%. Modest growth followed stabilization of the economy in 2010, and in October of that year the Latvian electorate surprisingly returned the Valdis Dombrovskis government to power. The Dombrovskis government introduced sharp cuts in public spending in 2009, 2010 and 2011. Dombrovskis returned to power after the early election of September 2011, called after the then president Valdis Zatlers complained that parliament was controlled by a number of oligarchs that threatened the very basis of democracy in Latvia. The subsequent election saw the vote for two of the three oligarchs collapse, while the party of the third oligarch (the Union of Greens and Farmers) was pushed into parliamentary opposition with a reduced number of parliamentary deputies.

However, the parliamentary election of 2014 saw the Union of Greens and Farmers increase their share of the vote. A Union of Greens and Farmers' politician, Raimonds Vējonis, was elected state president the following summer and in February 2016 the Union of Greens and Farmers seized the opportunity presented by the fall of Laimdota Straujuma's Unity-led government to take the prime minister's office for its own candidate, Māris Kučinskis. Hence, the Zatlers referendum had failed to break the pattern of Latvian politics.

The BTI combines text analysis and numerical assessments. The score for each question is provided below its respective title. The scale ranges from 1 (worst) to 10 (best).

## Transformation Status

### I. Political Transformation

#### 1 | Stateness

The Latvian state has a complete monopoly on the use of force and there are no serious domestic challenges to the current democratic regime.

Question  
Score

Monopoly on the  
use of force

10



The Latvian territories have had a multi-ethnic make-up since at least the arrival of the Teutonic Knights in the early 13th century. However, the dislocations of the Second World War and the russification policies of the Soviet era, which saw some 700,000 Russian-speakers (approximately one-third of Latvia's population) settle in Latvia, fundamentally changed Latvia's demographics. The 1989 Soviet census of the Latvian SSR revealed that Latvians made up just 52% of the republic's population.

State identity

8



Partly as a reaction to this, Latvia's 1994 citizenship law granted citizenship to individuals, and their direct descendants, who were citizens before the Soviet occupation of July 17, 1940. This effectively denied automatic citizenship to those 700,000 Russian-speakers that had moved to Latvia during the Soviet era.

External pressure from the EU, NATO, Council of Europe and other western international organizations led to a loosening of the citizenship law, and by the late 1990s anyone meeting the residency and Latvian language knowledge criteria could be naturalized. There was a sharp increase in naturalization after accession to the European Union. In 2004, 16,064 people were naturalized in 2004, with a further 19,169 in 2005 and 16,439 in 2006 naturalized. However, this figure fell to 2,080 in 2012 and just 987 in 2016. At the end of 2016, Latvia had 247,000 resident non-citizens in a population of 2.1 million people. These non-citizens cannot vote in

national, local or EU elections, and are barred from holding certain public posts, but otherwise enjoy full economic and social rights and protections.

Little progress has been made in integrating Russian-speakers. Latvians and Russian-speakers live in two distinct communities, with different newspapers, TV shows, radio channels and social media. Political parties are also aligned along ethnic lines.

This ethnic division has been increasingly politicized. A process that culminated in February 2012 when a failed referendum on Russian as a second language further polarized Latvians and Russian-speakers along ethnic lines. Since the referendum, there have been attempts to depolarize politics by implementing a more systematic policy of integration, a minimize the risks to internal and external security that come with this division, especially after Russia's annexation of Crimea and the use of fake news by Russian state-controlled media.

Religious leaders of the major denominations in Latvia (Lutheran, Catholic and Orthodox) have frequently criticized the encroachment of “western liberal” ideas - primarily the growing social and legislative acceptance of same-sex relationships as well as rights for women - and in recent years have also begun to speak out against economic inequality. However, in 2016 there were no political parties in parliament with explicit links to any church and religious representatives have little influence over a society that has the second lowest level of weekly religious attendance (7%) in Europe.

The Latvian state has recovered from the severe economic recession of 2008 to 2010 which saw successive governments adopt severe austerity measures that affected education, health care and law enforcement. The state continues to deliver all basic services, although spending on health care as a percentage of GDP, in particular, lags well behind the EU average.

The EU structural and cohesion funds have ensured that Latvia's communication, transport and basic infrastructure has continued to be upgraded, regardless of budget constraints elsewhere.

## 2 | Political Participation

Parliamentary and local elections in Latvia are both free and fair. The last parliamentary election was held in October 2014, which was the eighth election since independence in 1991. Thirteen parties participated in the election with six passing the 5% threshold needed to win seats in parliament. There were accusations of minor vote-buying in a small rural region of Latgale and a court found several people guilty of buying votes in exchange for €10. Latvia's highest administrative court had earlier ruled that the vote-buying had taken place on such a small scale that it had not affected the result of the election and that there was no need for a re-run.

No interference of religious dogmas

10



1

Basic administration

10



1

Free and fair elections

9



1

Latvia's elections feature parties that represent both Russian-speakers and ethnic Latvians, although ideological differences between parties can be harder to discern. Parties tend to campaign on personalities rather than programs or policies. The largest share of votes in 2014 were won by the pro-Russian-speakers Social Democratic Party Concord. However, as with previous elections, the party was excluded from the subsequent government coalition for being too close to the Kremlin.

The Central Election Commission, which organizes and oversees elections in Latvia, is an independent organization with sufficient resources to organize elections across Latvia.

However, media access remains a concern. The ownership of the majority of both the Russian-speaking and Latvian printed press and the increasingly important internet news portals is opaque, leading to concerns of biased reporting, "hidden political advertising" and occasional accusations of "fake news." Legislative changes that limit party access to paid-for TV and radio advertising in the month before a parliamentary election have increased the relevance of the printed and internet media, which had previously been waning.

Democratically elected political representatives have the effective power to govern. There has long been concern that three powerful oligarchs have an undue influence over the Latvian political system. In 2011, the then president of Latvia, Valdis Zatlers, called a referendum on the recall of parliament because of concerns that the three oligarchs had gained a dangerously disproportionate influence over political parties and government. The resulting September 2011 election saw support collapse for the political parties of two of the three oligarchs (and these two parties subsequently folded). Although the third party (the Union of Greens and Farmers, a political vehicle for the Mayor of Ventspils Aivars Lembergs) was re-elected, it was excluded from the government coalition and went into opposition. However, this opposition was short-lived, with the party returning to government a few years later and, since February 2016, the prime minister's post has been held by the party. This follows the election of another representative of the Union of Greens and Farmers, Raimonds Vējonis, as president of Latvia in June 2015.

Nevertheless, while Lembergs continues to play a role in politics, the other two oligarchs (Skele and Slesers) have been pushed out of the political system. Further reforms to both party financing (which saw reduced limits on party private income and expenditure, and the introduction of public party financing from 2012) and election advertising have further limited the political influence of wealthy benefactors. Though private money continues to play a crucial role in party financing,

Effective power to govern

9



1

There are no formal restrictions on association or assembly. Individuals can form and join independent political or civil society groups. However, Latvia sees few political demonstrations or trade union protests. Even the radical austerity measures, characterized by large cuts to benefits and public sector salaries, introduced between 2008 and 2011 prompted only minor, largely peaceful protests. The Riga local authority has regularly attempted to ban gay pride and far-right nationalist parades, but the courts have consistently overturned these bans and the marches have gone ahead.

The constitution guarantees freedom of expression and the Latvian court system, particularly the Constitutional Court, has actively defended these rights.

However, oversight of the media has long been deeply politicized. The National Electronic Mass Media Council (NEPLP) which supervises radio, TV, the printed press and internet media, is elected by parliament and composed of political-party representatives from political parties. Members of the council have been regularly criticized by parliamentarians and the media, and work in a highly politicized climate. Moreover, the chairman of NEPLP, Ainārs Dimants, was fired by the parliament in a highly politicized environment in July 2015, but later returned to office after the administrative court overruled parliament's decision in December 2015. Ownership of much of the private media is opaque.

The public media remains under-financed and, whenever elections approach, the management finds itself under political pressure from both government and opposition. Nevertheless, public media journalism remains among the highest quality in Latvia, with journalists producing independent coverage of the political system, investigating corruption and incompetence, and acting as a check on political power.

### 3 | Rule of Law

The Latvian parliament elects the state president. Despite the key role that political parties have in selecting, nominating and voting for the head of state, all Latvia's post-Soviet-era presidents have acted independently and occasionally returned laws to parliament or otherwise challenged, within Latvia's framework of laws, the parliament. Indeed, in May 2011, the then president, Valdis Zatlers, triggered a referendum on the recall of parliament. Zatlers was up for re-election a few weeks later. However, parliament rejected re-electing Zatlers, choosing to replace him with Andris Berzins, a little-known back-bench deputy from the Union of Greens and Farmers party who had formerly been president of a commercial bank. Berzins served for four years before deciding not to run for re-election. Raimonds Vējonis (also from the Union of Greens and Farmers) was elected to the presidency in 2015.

The political executive (the Cabinet of Ministers) has continued to grow in strength as political parties have created more effective party organizations, and tightened

Association /  
assembly rights

10



1

Freedom of  
expression

8



1

Separation of  
powers

9



1

internal discipline, leading to more harmonious cooperation between ministers from the same parties. However, the prime minister in Latvia is a much weaker institution than in other European democracies, effectively controlling only his own party's ministerial portfolios, while other coalition parties maintain effective control over their own ministerial fiefdoms.

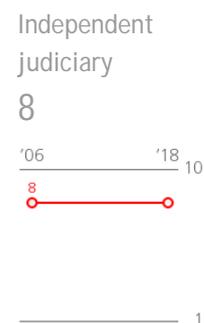
The Constitutional Court remains an important check on both the executive and legislature, regularly returning laws when it adjudges them to be unconstitutional.

The judiciary in Latvia is formally independent and is certainly a distinct profession and differentiated organization. However, the de-facto independence of the judiciary is compromised by widespread perceptions of judicial corruption, and regular arrests and dismissals of judges. In January 2017, the Supreme Court became the only cassation instance for civil, criminal and administrative cases. This was the result of a judicial reform aimed at streamlining the judicial system by establishing a unified hierarchy of three instances. In a report published in 2017, the European Commission noted that Latvia's parliament had not yet adopted an amendment to the law on judicial power, which aimed to strengthen the Council for the Judiciary.

The Latvian legal and security authorities continue to have major problems prosecuting political corruption. This is best illustrated by the ongoing case of Aivars Lembergs, the long-standing Mayor of Ventspils, a wealthy port and transport hub city. Lembergs is one of Latvia's wealthy three oligarchs. Lembergs was indicted with large-scale money laundering and corruption in 2000, and briefly detained before being placed under house arrest later that year. Though the prosecutor alleged that Lembergs had been interfering and hindering the investigation of the case. Since 2000, there have been a number of breaks due to illness (of the accused, his lawyers, the judges) and other technical issues. This has revealed the ease with which the Latvian judicial system can be delayed and manipulated. As of early 2017, there is still no sign of the case reaching a conclusion. Indeed, many legal disputes involving international actors are now being resolved in British or other courts, due to the skepticism of international actors that their cases would be heard fairly in Latvia.

This and other similar cases contribute to a widespread populist anti-political elite attitude in Latvia. There is a widespread perception that politicians, leading civil servants and successful businessmen are corrupt, and that every law or business deal has been carried out in some underhand way. This has resulted in low levels of mutual trust and social capital, and open distrust of the judicial system. Regular arrests of judges and low to mid-level public servants (policemen, customs officials, bureaucrats) strengthens this opinion.

Partially as a reaction to this state of affairs, a new party - Who Owns the State? - was founded in spring 2016, and will campaign on an anti-corruption and pro-tax payer platform, led by the popular former-actor turned politician Artuss Kaimins (currently an independent deputy in the Latvian parliament). The New Conservative



Party, including a former minister of justice, Janis Bordans, and former high-ranking official of the Corruption Prevention and Combating Bureau (KNAB), Juris Jurass, also campaign under a similar flag in the upcoming municipality elections (June 2017).

Latvia has a national Ombudsman's office and as an EU member state also has recourse to the office of the European Ombudsman.

The Latvian Ombudsman's office has regularly and consistently defended both individual and group (e.g., Roma or low earners) rights, and challenged government institutions. In January 2016, the Ombudsman even challenged the anti-corruption bureau, claiming that it was failing to fulfill its anti-corruption mandate and that politicians should debate closing the institution.

The Latvian Constitutional Court ensures that laws and administrative practices do not conflict with the constitution, and has overturned several major laws passed by parliament (e.g., a law to cut pensions as part of the 2009 austerity program). Latvia has no formal restrictions on the civil rights of women, religious groups or ethnic groups. However, both refugees and LGBT issues can mobilize radical movements, including far-right activists, and even mainstream churches (both Catholic and Protestant).

In 2005, the Latvian parliament passed a constitutional amendment banning same-sex marriage. This amendment has strong political support and is unlikely to be reversed in the immediate future.

#### 4 | Stability of Democratic Institutions

Latvia's democratic institutions have withstood the extreme strains of the uncertain economic and social transition of the 1990s, as well as the severe austerity measures introduced between 2008 and 2011.

Parliament, the executive, national and municipal bureaucracies, and judicial institutions take decisions and then see them implemented. While many of the more rushed decisions (such as the pension reforms) were subsequently rescinded, this provides evidence that checks and balances work in the Latvian system.

In recent years, the lack of research capacity to support policy formulation has been recognized as a major deficit in the working of the democratic institutions. As a result, in early 2017, the Latvian parliament created a new Parliamentary Research Unit while the Economics Ministry plans to establish an institution to study Latvia's competitiveness and productivity. These developments will improve the functioning of government institutions.

Civil rights



1

Performance of democratic institutions



1

All democratic institutions are accepted as legitimate by most relevant actors. Wealthy business tycoons (so-called oligarchs) have lost influence compared to 2011 (prior to the 2011 referendum on oligarch-sponsored parties). Though the party of one of the oligarchs, Aivars Lembergs, has led the governing coalition since February 2016, the parties of the other two oligarchs (Skele and Slesers) have been marginalized.

There are several active NGOs supported by Russian government funded foundations such as “Russky Mir.” However, these organizations (e.g., the Latvian branch of World Against Nazism) are small in terms of membership and support in the Russian-speaking community. As a result, very few extremist political actors have emerged out of the Russophone community.

## 5 | Political and Social Integration

The first four post-Soviet parliamentary elections saw both voter volatility and party system fragmentation. Indeed, all of these elections (1993, 1995, 1998 and 2002) were won by parties formed less than 12 months before the respective election and typically centered around charismatic personalities rather than political ideologies or policies. Further fragmentation and political realignment continued over the course of the parliamentary terms. At first glance, the last four parliamentary elections (2006, 2010, 2011 and 2014) produced a far more consolidated party system. However, this is largely as a result of party fusion and amalgamation. Ethnic Latvian voters have low party identification and continue to float from supporting one party or party coalition (from the constellation of ethnic Latvian parties) to another. In contrast, Russian-speaking voters have rallied around the Social Democratic Party Concord (previously known as Harmony Center), which has dominated the Russian-speaking vote since 2010. The party has attempted to reach out to the ethnic Latvian electorate in order to expand its share of the vote, but this has hitherto only worked in municipal rather than national elections. Indeed, the only salient political cleavage remains ethnicity (Russian-speakers versus ethnic Latvians). Ethnic Latvian parties differentiate themselves via charismatic leaders rather than competing policy offers or ideology. The lack of ideas in politics (no party has its own think-tank or a tradition of using research centers to generate ideas) remains a fundamental weakness of the Latvian system.

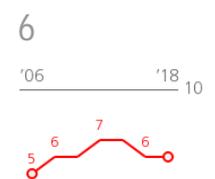
The weakness of the parties can be largely explained by the fact that the party registration requirement, which requires a group to have just 200 individuals to register as a political party. (The threshold was raised to 500 in 2015 for parties participating in parliamentary elections). The low threshold enables the creation of many small political parties, which are overly-dependent on wealthy sponsors. Differences of opinion in parties result in break-away and new parties being formed. However, the last two parliaments have attempted to deal with these issues by

Commitment to democratic institutions



1

Party system



1

limiting party campaign expenditures, and cutting access to TV and radio advertising, thus increasing the importance of campaigning by the party membership. The introduction of public financing in 2012 (wherein parties receive a fixed sum of money proportional to the percentage of votes they secured in the previous parliamentary election) also aimed to reduce the importance of private money in politics.

The most influential interest groups in Latvia are business and sectoral associations. There is a National Tripartite Council, which regularly discusses major changes to taxation or other cross-cutting issues. However, the Latvian Employers' Confederation as well as the Latvian Free Trade Union Confederation (the two partners in the tripartite council) complain that their comments and suggestions are frequently ignored.

Informal economic and business interests retain great influence, although the political marginalization of the oligarchs, and changes to the party campaigning and financing regime, has slightly weakened the influence of these informal interests.

Although the mechanisms for the formal political participation of interest groups, trade unions and other civil society organizations do exist, the majority of organizations have few members and small operating budgets. The exceptions are the sectoral associations (e.g., the wood processing or pharmaceuticals sectors), and business associations that represent small and medium-sized businesses and large businesses.

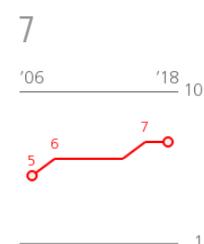
The economic downturn of 2008 to 2010 severely affected support for democracy in Latvia. According to a 2016 report by the European Bank for Reconstruction and Development (EBRD), only 41% of Latvians supported democracy. Around 30% of respondents said that they would favor under certain circumstances an authoritarian regime, while 34% would prefer a planned economy and approximately one-third did not declare a marked preference for a specific economic or political system.

However, trust in national political institutions has gradually increased with the economic upswing, and Eurobarometer revealed in spring 2016 that trust in the government was equal to the EU average (27%) up from 13% in 2010, while trust in parliament had grown from 6% in 2010, to 12% in 2012 to 17% in 2016 (compared to a EU average of 28% for 2016).

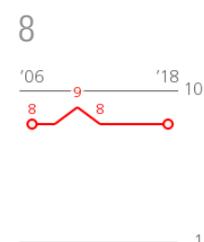
Latvia's society remains fragmented and lacking in social capital. The core division is between ethnic Latvians and Russian-speakers and this is likely to continue well into the future due to the presence of an ethnically divided education system and media. The ethnic political cleavage exacerbates this divide.

At the same time, Latvia has a strong tradition of public participation in various different cultural associations such as choirs, folk-dance groups and sporting clubs. However, there are far fewer politically oriented interest groups, largely because there

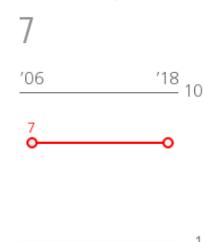
Interest groups



Approval of democracy



Social capital



is no established tradition of donating financial or temporal resources to good causes. Indeed, a 2011 survey revealed that more Latvians distrusted NGOs more than trust them (20.1% to 32.4% respectively).

A promising development has been the establishment of an entrepreneurial social initiative platform that gives citizens the opportunity to formulate and then circulate legislative initiatives online ([www.manabalss.lv](http://www.manabalss.lv)). A number of internal checks and balances ensure that the initiatives are well-formulated and non-trivial. If an initiative collects 10,000 authenticated electronic signatures it is submitted for parliamentary debate. In its first few years of operation, two initiatives submitted by the platform were passed into law by the parliament.

Another recent initiative has been the creation of a “democracy festival” on the Scandinavian model. The Lampa festivals held in 2015 and 2016 gathered thousands of participants to the small Latvian town of Cesis to listen and participate in hundreds of discussions about a wide range of themes.

## II. Economic Transformation

### 6 | Level of Socioeconomic Development

The economic crisis of 2008 to 2010, and the accompanying politics of austerity, led to a rapid rise in inequality and poverty. Latvia slipped from 44 (2010) in the UNDP HDI rankings to 48 (2012) although by 2015 Latvia had risen up to 46 out of 188 countries. Moreover, while economic growth returned in 2010, and Latvia had one of the highest rates of GDP growth in the European Union from 2011 onwards, rates of socioeconomic inequality have remained among the highest in the European Union, ahead of Bulgaria and Lithuania.

In January 2013, both the International Monetary Fund (IMF) and the European Commission argued that the Latvian government had gone too far with its austerity measures after the government cut benefits, including the guaranteed minimum income level (which supports poor families) in the 2013 budget. Latvian political parties initially showed little interest in tackling poverty and inequality, preferring to focus on balancing the budget and, after the Russian occupation of Crimea in 2014, raising spending on defense to 2% of GDP, leading to socioeconomic inequality becoming increasingly structurally engrained.

Those at greatest risk of poverty in Latvia include rural communities (especially those in the eastern region of Latgale that borders Russia and Belarus), pensioners, families with a high number of children and low-skilled workers (who were most likely to be made unemployed following the 2008 downturn). Poor employment prospects and

Question  
Score

Socioeconomic  
barriers

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relatively low benefits led many Latvians to emigrate to western Europe, particularly Ireland and the United Kingdom. While estimates vary, the Foreign Ministry claims that some 370,000 Latvian citizens and non-citizens live outside Latvia.

Latvia's Gender Inequality Index was 0.167 in 2014, an improvement compared to 2013 (0.222). The Gini index was 35.5 in 2012 (according to World Bank data), higher than in most East Central and Southeast European countries. The share of the population living on less than \$3.10 a day at 2011 international prices adjusted for purchasing power parity was 2.6% in 2012, higher than in many other countries in the region (World Bank data).

Economic indicators		2013	2014	2015	2016
GDP	\$ M	30254.6	31352.2	27026.0	<b>27677.4</b>
GDP growth	%	2.6	2.1	2.7	<b>2.0</b>
Inflation (CPI)	%	0.0	0.6	0.2	<b>0.1</b>
Unemployment	%	11.9	10.8	9.9	<b>9.9</b>
Foreign direct investment	% of GDP	3.3	3.5	2.8	<b>0.6</b>
Export growth	%	1.1	3.9	2.6	<b>2.8</b>
Import growth	%	-0.2	0.5	2.1	<b>4.6</b>
Current account balance	\$ M	-822.5	-624.1	-211.3	<b>403.1</b>
Public debt	% of GDP	35.8	38.5	34.8	<b>37.2</b>
External debt	\$ M	-	-	-	-
Total debt service	\$ M	-	-	-	-
Net lending/borrowing	% of GDP	-0.7	-1.9	-2.3	-
Tax revenue	% of GDP	20.7	21.1	21.4	-
Government consumption	% of GDP	17.6	17.5	18.0	<b>17.5</b>
Public education spending	% of GDP	7.0	5.3	-	-
Public health spending	% of GDP	3.5	3.7	-	-
R&D expenditure	% of GDP	0.6	0.7	0.6	-
Military expenditure	% of GDP	0.9	0.9	1.0	<b>1.5</b>

Sources (as of October 2017): The World Bank, World Development Indicators | International Monetary Fund (IMF), World Economic Outlook | Stockholm International Peace Research Institute (SIPRI), Military Expenditure Database.

## 7 | Organization of the Market and Competition

Latvia's membership of the European Union and the World Trade Organization ensures the regulation and enforcement of market competition. EU competition rules and policies are applied. Latvia uses the euro. Prices are fully liberalized. In 2016, Latvia also joined the Organisation for Economic Cooperation and Development (OECD), which is expected to help fill the research and policy advice gap in domestic politics. However, corruption and allegations of judicial bribery distort competition in areas such as state procurement, enforcement of contracts and bankruptcy administration. The shadow economy (which is estimated to be between 20% and 40% of GDP, although this is decreasing) and the widespread use of so-called envelope salaries (i.e., non-taxed cash salaries) also creates an unequal playing field between enterprises.

As an EU member state, Latvia complies with both EU and domestic anti-monopoly legislation. The Latvian Competition Council issued 97 resolutions in 2012 a marked increase on the 60 issued in 2011. In 2015, the council received and evaluated 135 applications and issued over €1 million in fines. In 2016, the parliament amended the energy law in order to liberalize Latvia's gas market, including the unbundling of services provided by Latvijas Gaze, the only national gas company.

Latvia is an EU member state, and its foreign trade is now regulated and overseen by the European Commission. As a small, open and liberal state, Latvia's governments have traditionally been strongly pro-trade. According to government data, exports to EU member states accounted for 74% of the total volume of Latvian exports in 2016.

Post-1991, Latvia has seen a string of spectacular banking failures. The first collapse came in the mid-1990s when Banka Baltija, Latvia's largest commercial bank, folded owing some \$400 million to more than 200,000 creditors (30% of all Latvian deposits were held in Banka Baltija). A further 15 banks had collapsed by the end of 1995. Banking regulations and supervision were tightened, and a financial regulator (the Financial and Capital Market Commission) created to oversee the sector in 2000. The banking sector was further consolidated as the largest Latvian banks were taken over by a succession of mostly Nordic banks. However, bank failures continued. The massive recession of 2008 to 2010 was triggered by the collapse and subsequent government bailout of Parex, Latvia's oldest commercial bank. The Russian-owned Latvijas Krajbanka was declared bankrupt in December 2011. These failures led to

Market-based competition

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Anti-monopoly policy

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Liberalization of foreign trade

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Banking system

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the resignation of the head of the Financial and Capital Market Commission, and a reorganization of the institution.

Since 2015, the Latvian government has focused on increasing regulation of the large non-resident banking sector that has emerged over the last quarter of a century. In line with Latvia's commitments with regard to its membership of OECD, the Financial and Capital Market Commission (the industry regulator) has enacted new anti-money laundering laws and increased oversight of the sector. Several banks (e.g., the Latvian branch of Swedbank) received fines for insufficient internal control systems to tackle money laundering. Nevertheless, these controls have served to significantly strengthen the Latvian banking system and visibly reduced the proportion of non-resident funds held by Latvian banks.

The Riga Stock Exchange (RSE) is part of the NASDAQ OMX chain of bourses. The volume of trading is very small and very few Latvian enterprises are publicly listed. In 2015, Latvia's capital to assets ratio was 10.1% and the share of non-performing loans was 4.6%.

## 8 | Currency and Price Stability

Latvia joined the euro zone on January 1, 2014. The previous years had been spent preparing for accession, with a focus on currency stability and maintaining low inflation. This had been particularly challenging during the economic downswing of 2008 to 2010, when many politicians and a minority of economists called for a devaluation of the Latvian lat in order to allow the Latvian economy to recover. However, the Latvian prime minister, Valdis Dombrovskis (a former Bank of Latvia employee), successive finance ministers and the Governor of the Bank of Latvia, Ilmars Rimsevics, continued to promote a steady no-devaluation agenda and ensured that this was a key part of the IMF-led financial rescue package in late 2008. Over 90% of loans were in foreign currencies (primarily in euros, although there are also loans in U.S. dollars and Swiss francs), and there were fears that devaluation would lead to a mass loan default and the subsequent collapse of the banking sector.

Before the crash, the inflation rate in Latvia was the highest in the European Union, particularly during the mid-2000s property bubble. However, Latvia had an annual rate of inflation of less than 1% between 2013 and 2016.

Latvia's public debt burden grew rapidly after the IMF-led international bailout in late 2008. Previously Latvia had had low levels of public debt, largely because it had emerged from the Soviet Union with no public debt. However, until recently, Latvian governments have lacked fiscal discipline, running budget deficits even in the years of unprecedented double-digit GDP growth in the mid-2000s. Nevertheless, overall public debt remained low until the beginning of the economic crisis in late 2008. Latvia accepted an IMF-led bailout facility amounting to €7.5 billion. This raised

Anti-inflation /  
forex policy

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Macrostability

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Latvia's public debt from 9% of GDP in 2007 to 19.7% of GDP in 2008 and has remained steady at around 36% since 2009. In order to balance the economy, Latvia's government introduced radical cuts to public spending. As a result, the budget deficit has steadily declined since a high of 7.1% in 2009 to 1.4% in 2015.

A Fiscal Discipline Council was created in January 2014 to oversee government budget discipline.

## 9 | Private Property

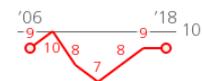
The private property rights of both Latvia's population and foreign investors are well regulated and adequately protected. However, the Foreign Investors Council in Latvia (FICIL) has been increasingly critical of bankruptcy procedures in Latvia, claiming that research carried out with Deloitte indicated that this had cost the Latvian economy around €65 million between 2008 and 2014.

The private sector now employs the majority of Latvia's working population (75%) and drives GDP growth. However, this is a change that has taken place over the last quarter of a century.

Following Latvia's break from the Soviet Union in 1991, the state began privatizing state-owned assets. The privatization of small enterprises was started quickly and was largely completed by 1995. However, the privatization of larger enterprises proved much more complicated and only began after the establishment of the Latvian Privatization Agency in 1994. Privatization was a political battlefield, with the most profitable state-owned companies (those involved in the transit business or a monopoly such as gas) enduring a complicated, politicized and often controversial privatization process. Indeed, the state still maintains a stake in some large enterprises. For example, the state holds a 51% share in the profitable telecommunications company, Lattelecom (efforts to privatize Lattelecom in the mid-2000s were thwarted by political interests) and owns the electricity monopoly Latvenergo which has a 90% share of the market.

## 10 | Welfare Regime

Despite adopting a liberal, open, flexible and low-taxation economic model, a combination of public pressure and political populism has seen Latvia maintain a comprehensive, yet underfunded, welfare system. The state provides a number of benefits (e.g., pension, child care, maternity leave and sick leave). Many benefits, such as maternity payments, were reduced during the austerity era, although others,



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Property rights

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Private enterprise

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Social safety nets

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such as pensions, were left largely untouched after government efforts to reduce them were successfully challenged in the Constitutional Court.

Latvia has a mixed pension system, with pensioners who worked during the Soviet era receiving small pensions based on receipts from current workers, while a 1990s's pension reform introduced a capital-funded pension scheme for current employees.

The medical system is a mixture of state and private financing. Certain visits to family doctors, specialists and procedures require co-financing. This co-financing often takes the form of informal cash payments. A former Latvian president, Valdis Zatlers, has admitted accepting these payments while he worked as an orthopedic surgeon. In 2016, the government began planning an overhaul of the health care system, planning to increase public funding. A final decision on a financing model is expected in 2017.

Primary and secondary education is free, although there is a national shortage of nursery school places. Tertiary education is a mix of both public and private, with state-funded university places being allocated according to grades rather than on a means-tested basis.

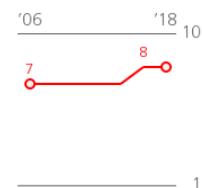
A public debate on Latvia's welfare system was initiated by the European Commission and the International Monetary Fund in January 2013, when both organizations criticized the Latvian government for cutting VAT and personal tax while simultaneously reducing social benefits for the state's poorest citizens. The biggest increase in welfare payments in recent years has been targeted at families with the aim of improving Latvia's demographic situation.

All citizens and permanent residents, irrespective of gender or ethnic origin, have equal access to the education system, public services and employment. Latvia ranked 18 out of 144 countries in the 2016 Global Gender Gap Index, and has typically ranked between 10 and 20 in recent years.

Approximately two-thirds of students in higher education are privately funded, and a great many of these are Russian-speakers who choose to study in their native language because free public higher education is only available in the Latvian language. Students do have access to cheap student loans in order to finance their education, and the higher education system also allows students to hold down part-time and, in some cases, even full-time employment, while enrolled in tertiary programs.

Individuals have recourse to the Ombudsman's office in the event of discrimination. Over the past few years the office has made rulings on the discrimination of Roma and sexual minorities in the labor market.

The ratio of female to male enrollment is 1.0 for secondary and primary education, and 1.4 for tertiary education (implying that women are more represented in



universities). In 2014, nearly 50% of the labor force were female workers (World Bank data).

## 11 | Economic Performance

Between 2008 and 2010, Latvia saw a 23.9% contraction of its GDP, a historic high for an industrialized state, second only to the great depression in the United States during the early 1930s. However, while the U.S. great depression lasted for four years, Latvia's contraction lasted just over seven financial quarters. Moreover, Latvia has since returned to economic growth, posting some of the highest GDP growth rates in the European Union from 2011 onward. In 2015, GDP growth was 2.7%, and the inflation rate was 0.2%. Growth has mainly been driven by private consumption. The inflows of foreign direct investment amounted to 2.3% of GDP in 2015 (EBRD data). Latvia's budget has been balanced within the Maastricht criteria since 2012, while unemployment has remained under 10% for several years.

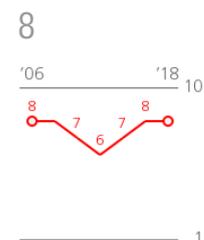
However, the economy has slowed in recent years and sluggish GDP growth has contributed to slow productivity growth.

## 12 | Sustainability

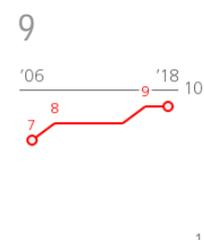
Latvia is an extremely environmentally friendly country and ranked second out of 132 countries in the 2012 Environmental Performance Index (EPI). In 2004, Indulis Emsis became Europe's first green party prime minister. (Though in 2007 Emsis exited politics in disgrace after misplacing a briefcase containing \$10,000 in cash in the Cabinet of Ministers building. He was unable to explain the origins or the purpose of the cash). Raimonds Vējonis, elected president in 2015, is also a Latvian Green Party politician who served as Latvia's minister for the environment and local government.

Paradoxically, the environmental movement is quite weak in Latvia. The Latvian Green Party has long been the junior partner to the Latvian Farmers' Union in the Union of Greens and Farmers party alliance. (The Union of Greens and Farmers is largely financed by the Latvian oil and transit lobby). Consequently, green issues are of little salience in Latvian politics. Latvia's high performance in the EPI can largely be attributed to a low (and still declining) population density, the de-industrialization of the last two decades and the methodology of EPI (which excluded the waste management sector in 2012 when Latvia ranked second. Waste separation is a serious problem in Latvia). Moreover, a comparatively low level of economic development also means that consumption levels are lower in Latvia than on average in the European Union.

### Output strength



### Environmental policy



Nevertheless, Latvia continues to improve its environment performance. In 2017, a large-scale electrification upgrade of the Latvian rail network will begin, while new car taxes will require higher polluting cars to pay higher road tax.

Successive Latvian governments have neglected investments in education and research. Spending on education has run between 5 and 6% of GDP, while just 0.4% of GDP goes toward research and development. This has resulted in sub-par performance (especially when compared to neighboring Estonia) in various international education indexes (e.g., the OECD's PISA report) as well as international rankings of universities and research centers. Research and education were particularly hard hit by the austerity cuts of recent years.

A new education minister assumed office in October 2011, following the early parliamentary election of September 2011. Roberts Kilis holds a doctorate degree in anthropology from the University of Cambridge, and was long employed as an associate professor at the Stockholm School of Economics in Riga. Kilis swiftly set about reforming the education system. He proposed restructuring the secondary school system, sweeping changes to higher education financing and accreditation, and a myriad of other reforms, both big and small. However, Kilis overwhelmed the education sector with his proposals, provoking a severe backlash from teachers, students and researchers (although public opinion largely remained on his side). As a result, in early 2013, Kilis toned down his rhetoric, and has attempted to engage more deeply with the research and education sector. However, having provoked such a reactionary response from the sector, his reforms were blunted and subsequent ministers have been far more timid in their proposed reforms.

Despite this lack of a concerted and harmonized strategy, Latvia has emerged as a major exporter of higher education, with 5,500 full-time international students seeking a degree in Latvia (primarily the capital city of Riga) in the 2015/2016 academic year. Early 2017 also saw the new conservative minister of education, Karlis Sadurskis, attempt to merge two major universities, start planning a new school curriculum and continue the reform on public spending in education (specifically wage reform for teachers) in line with the needed changes in school network (e.g., the need to cut the number of schools in regions due to depopulation).

Education policy /  
R&D



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## Governance

### I. Level of Difficulty

There are few structural constraints to governing Latvia. While Latvia is among the poorest states in the European Union (as of 2012, only Bulgaria and Romania were poorer), it is also a Baltic Sea state with growing economic and political links with the wealthy Nordic countries. Its border with Russia and Belarus, established transit infrastructure (including the biggest airport in the region and the largest national airline), and widespread knowledge of the Russian language and culture offers Latvia unique trade and economic opportunities. However, low investment in education and health care means that the Latvian labor force remains more unhealthy, less well-educated and less productive than western European countries.

Despite extensive financial support from the European Union and international NGOs (e.g., the Soros Foundation), Latvian civil society remains small, weak and fragmented. The biggest challenge it faces is financial. Latvia has no modern tradition of either association membership or charitable donations. As a result, civil society associations have few members and face a constant financial struggle. For example, Delna, the Latvian branch of Transparency International, relies heavily on just a few generous donors and has a membership of less than 50.

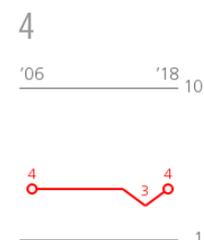
This situation was exacerbated by Latvia's accession to the European Union, which saw a number of the key financial civil society supporters (e.g., the Soros Foundation and the Nordic governments) retreat from Latvia and head toward the next countries in line for EU accession in the Balkan and the post-Soviet regions. However, EU financing (through the structural, cohesion, social and other funds) has not adequately replaced these lost funds, as the European Union offered only project-based financing, not the long-term "operation financing" that these other actors had provided. A few actors have managed to establish financially sustainable ways of operating by attracting public funding (largely EU) or private donations.

At the same time, civil society lacks popular legitimacy. The forced voluntarism of the Soviet era, has left the older generation skeptical of charitable and non-governmental activities. Moreover, all three major Latvian language daily newspapers (Diena, the Independent Morning Newspaper and Latvia's Newspaper) have adopted a language and tone that is skeptical of civil society, and particularly

Structural  
constraints



Civil society  
traditions



any organization or individual associated in some way with the Soros Foundation (the major supporter of civil society since the early 1990s).

Social capital is low. Latvians have the highest levels of distrust in their own political institutions in the European Union (particularly political parties and parliament), and low levels of mutual trust. Even the severe austerity measures of recent years failed to rouse society. Only a few, largely low-key, sectoral demonstrations took place. Indeed, there was little solidarity shown between, for example, the health care and education professions. However, civil society activism in the form of improving local neighborhoods or engaging in cultural activities (volunteering in choirs, folk dancing) is very pronounced, showing that certain activities do bring people together and decrease the barriers of trust.

Finally, there are few institutionalized links between civil society and government. Political parties remain isolated from civil society organizations. A positive recent development is the increased use of professionals representing various civil society organizations in parliamentary committees and ministerial working groups. However, their opinions are frequently marginalized making this more of a pro forma than substantial form of involvement in the political process.

The ethnic divide between Latvians and Russian speakers (ethnic Russians and other eastern Slavs) has remained salient, albeit largely at the political rather than the social level.

While Latvians and a large part of the Russian-speaking community united in opposing the Soviet regime in the late 1980s, this fragile coalition fell apart after Latvia gained independence and political forces began organizing in advance of the first post-Soviet parliamentary elections in 1993. Many ethnic Latvians harbored a deep-seated resentment of the russification of the Latvian state after 1945. While it rapidly became clear that any attempt to forcibly deport individuals would be unacceptable to the international community, mainstream nationalist thought settled on denying automatic citizenship to those that had settled in Latvia during the Soviet era. Thus, the 1990s were marked by the battle over citizenship rights, with no small involvement from the international community, while the 2000s has been marked by a battle over historical interpretations and language rights. The Russian-speaking community in Latvia has been assisted by the strong moral and financial support provided by the Russian Federation during the Putin era.

The battle of historical narratives centers on the Second World War. Latvians consider the entry of Soviet forces into Latvia an invasion and occupation, while Russian-speakers portray it as an essential battle against fascism. This conflict reaches its height every spring when Latvian nationalists march to the Freedom Monument on 16 March in honor of Latvian Waffen SS war veterans (freedom fighters to Latvians, fascists to Russian-speakers) and on 9 May when Russian-

Conflict intensity

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'06 '18 10

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speakers celebrate the end of the Second World War (victory to Russian speakers, the beginning of an illegal occupation to Latvians).

The language war culminated in a referendum in February 2012, when Latvia's citizens voted on the introduction of Russian as a second language in Latvia. This was defeated by a margin of 75-25 (which roughly reflects the ethnic distribution of Latvian citizens).

Ethnic tensions were raised by Russia's occupation of Crimea in 2014, with Latvians opposing the Russian action while many Russian-speakers adopted a more favorable view of the action. These differing attitudes are largely explained by Russian-speakers reading newspapers and watching television broadcasts originating from Russia, while Latvian media tends to be more western looking. Surveys indicate that these differing views are becoming more entrenched.

Thus, the Latvian population remains polarized along ethnic lines. However, this division does not translate into violence.

## II. Governance Performance

### 14 | Steering Capability

Since the 1990s, all Latvian governments have proven to be extremely capable in following international strategic priorities (conditionality). Integration with the West was a priority for all major political parties in Latvia, thus conditionality issues were largely out of the realm of party competition. However, the short political life of most governments (governments average less than one year before being changed) means that settling on domestic priorities has proven to be far more difficult.

As a result, there has been a great deal of unity in identifying foreign policy priorities and changes to those laws and institutions required for accession to the European Union or NATO. However, frequent changes of government have led to the neglect of policy areas (e.g., taxation and health care), which require long-term, detailed planning.

The prioritization of integration with the West allowed Latvia to join the European Union and NATO in 2004, the euro zone in 2014 and the OECD in 2016.

However, the Latvian government was guilty of both economic and political backsliding after the elation of EU accession in 2004. The unexpectedly swift economic growth that followed was not accompanied by balanced budgets or prudent macroeconomic policy, but by an uncontrolled public and private sector spending

Question  
Score

Prioritization

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binge that ended with the 2008 to 2010 recession. The re-imposition of international conditionality following the IMF-led international bailout allowed Latvia to return to a balanced budget, economic growth and accession to the euro zone.

Since 2010, Latvia has introduced more plans in order to join the euro zone and OECD. However, now that these goals have been achieved the government will have to rely more on its own resources to formulate strategic priorities. In 2016, new priorities were identified (e.g., reforms to the taxation system, health care and education) but it remains to be seen if the government can deliver on these reforms without the external constraint of international pressure.

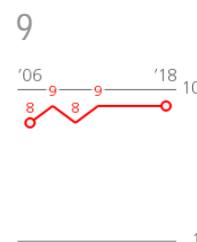
Latvia's government has established a Cross-Sectoral Coordination Center at the State Chancellery to develop strategies for public policy-making and to monitor the implementation of governmental policies. In addition, most ministries have some independent planning capacity that provides input during the preparation of policies, and the government consults with experts and NGOs. The government also assesses the impact of draft regulations by involving stakeholders and estimating costs of new policy measures.

Governments have shown that they have the capacity to deliver difficult and controversial policies. In 2009, Prime Minister Valdis Dombrovskis oversaw a fiscal adjustment of 9.5% of GDP. Taxes went up, public sector salaries (and other expenditure) went down. Public protests were muted. It should, however, be emphasized that these were policies were required by the international donors that had bailed out the economy. Reforms that need domestic agreement (e.g., cuts to the rural school network or a consolidation of publicly funded universities) tend to flounder when competing domestic interests come into play.

The government of Prime Minister Māris Kučinskis has promised to increase spending over the next few years and will spend the first half of 2017 exploring how to increase spending in health care by optimizing the existing network of hospitals. A more modest commitment has also been made to raise education spending by cutting the number of schools due to depopulation. In addition, the current government aims at reforming tax policy and plans to increase the efficiency of public service provision by returning to a more centralized division of functions. The government has proposed merging the existing 119 municipalities into a smaller number of regional cooperation areas.

However, the government is unlikely to implement all these reforms. A relatively small and sensible reform in the first part of 2016 - absorbing the Riga Teacher Training and Educational Management Academy into the larger and more prestigious University of Latvia - proved to be highly contentious and saw a sharp fall in the popularity of the minister of education. A parliamentary election is scheduled for October 2018, which will likely lead to the postponement of deep and controversial reforms of the health care and education sectors.

Implementation



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Latvian governments have shown little ability in terms of policy learning or innovation, especially when acting without the conditional support of international actors.

There are several reasons for this. First, Latvian political parties are not ideologically rooted, and thus lack a basic political compass or instinct. This was amply illustrated in 2010 when the then finance minister, Einars Repse (an experienced politician, having previously served as a prime minister), publicly hesitated over taxation reform. Repse initially contemplated a tax cut, then suggested keeping the tax rate the same, and eventually proposed a package of tax increases, all over the course of one day.

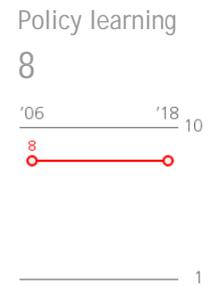
Second, political parties and the government have no autonomous research capacity or established links with think-tanks. Rather, politicians rely on civil servants for policy ideas. However, much of the civil service is young, inexperienced and underfunded.

Third, effective monitoring and evaluation was undermined by the harsh dislocations and funding cuts the public sector experienced from late 2008 onwards. Often the conclusions of monitoring and evaluation of policy reports funded by EU programs were left ignored due to the lack of an evidence-based policy-making culture.

However, recent events indicate that the government is aware of these challenges and is seeking to improve these skills. For example, a new Parliamentary Research Unit was set up in 2017. Furthermore, the Economics Ministry is creating a Productivity and Competitiveness Council (although this is a recommendation from the European Council and could be classified as an external conditionality). Also, there is a broader discussion of the importance of research in policy formulation. Nevertheless, the government recognizes ongoing weaknesses in domestic research capacity and has employed World Bank consultants to analyze and formulate recommendations for the taxation system, although domestic organizations were also asked to formulate competing visions.

## 15 | Resource Efficiency

Personnel management in the public sector remains a challenge. Latvia has no centralized recruiting procedure for hiring bureaucrats. Ministries and agencies manage these procedures individually, leading to highly opaque and dubious recruiting practices. Moreover, the most senior civil servants in a ministry (the highest position is state secretary) have often been hired and fired by ministers. In many cases state secretaries have not hidden their political allegiances and high-profile bureaucrats often leave the civil service in order to enter national politics. However, all monthly salaries in ministries and public agencies are now published on the internet, and public officials must submit annual financial declarations that are



also available to the public. The state sector does not really function as a cohesive whole due to the nature of Latvian government (i.e., ministries are divided between parties, which then become fierce protectors of their own sectors and substantial reforms are turned into a zero-sum game).

In an attempt to create a more cohesive public sector planning system, a planning and coordination institution located in the Cabinet of Ministers was created in December 2011. The institution currently employs 21 civil servants, and is charged with ensuring that the work of Latvia's different ministries is cohesive and joined up.

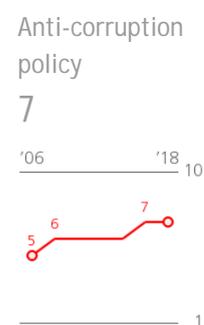
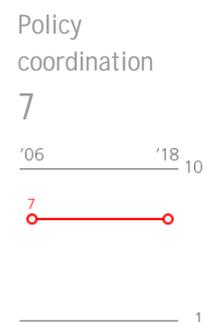
According to a European Commission report, government debt amounted to 40% of GDP at the end of 2016 and was expected to decline further. The European Commission also stated that expenditure plans beyond the annual budget would underrepresent spending needs.

Coordination between ministries and other state institutions remains problematic due to the de-centralized, party-based distribution of ministers. Moreover, the political parties that make-up government coalitions are often in dispute, and this feeds over into the effective management and coordination of government. The prime minister often has little control over ministries that are governed by other coalition parties. This was clearly seen in the multiple budget cutting exercises of 2008 to 2010 which were mechanical (e.g., each ministry cutting expenses by 20% across the board) rather than being based on a functional audit of government and a future vision of the role of government. In the same way, a return to growth has resulted in increased budgets for all ministries, with some sort of prioritization (e.g., prioritizing investments in external and internal security, health care or education).

Thus, while prime ministers may set priorities and form an agenda, the de-centralized nature of government ministries means that problems can arise in achieving these aims.

Latvia does not perform well in international corruption rankings. This shortcoming was addressed by the creation of the Corruption Prevention and Combating Bureau (KNAB) in 2002. The bureau was envisaged as an independent institution with the power to combat and prevent corruption at levels of the state system. It has partially succeeded in this ambition, although its work has been hampered by constant political interference and instability at the leadership level (not least because the director is elected by the parliament, thus making the position part of the political horse-trading process). In late 2016, a committee called to evaluate applications for the director's post decided that none of the applicants (including Jaroslavs Strelcenoks, who held the post at that time and had reapplied for another term) were qualified for the post. A new recruitment round was proposed for spring 2017.

KNAB has proved quite effective at fighting low-level corruption (e.g., bribes to police officers or low-level bureaucrats) but has found it far more challenging to fight



high-level political corruption, particularly when the oligarchs or other influential figures under investigation turn the power of their print and electronic media against the bureau. For example, while the Mayor of Ventspils, Aivars Lembergs, was first charged with corruption and money laundering in 2006, his case had still not reached a conclusion by early 2017.

Largely as a result of his frustration at this state of affairs, the then Latvian president, Valdis Zatlers, called a referendum on the recall of parliament in May 2011. He specifically stated his fear that Latvia's democracy was at threat of being "privatized" by three influential oligarchs. The subsequent referendum saw the public overwhelmingly vote to dissolve parliament (94.3% voted yes, although the turnout was just 44.7%, primarily because the result was never in doubt). The resulting election saw Latvian voters dismiss two of the three oligarch parties and grant a small parliamentary majority to the three primary anti-corruption parties. The subsequent government coalition that came to power in October 2011 declared itself to be the "law and justice" coalition, although it had little success in fighting political corruption. The current governing coalition (in place since the parliamentary elections of 2014) includes the Union of Greens and Farmers, which is linked to one of the oligarchs, Aivars Lembergs. Both the prime minister and the president of Latvia are currently from the Union of Greens and Farmers. Though, following tradition, the president has resigned from the party (and, in any case, was not considered to be close to Lembergs). Meanwhile, the prime minister has also stated his independence from Lembergs, insisting that he is beholden to no-one.

Party-financing regulations contain significant transparency requirements, limitations on donation sources and size, and campaign expenditure caps. In 2016, multiple parties were sanctioned for violations of public financing rules. One of the major parliamentary parties (Vienotība) has had its public funding withdrawn due to violations of campaign finance restrictions.

Latvia has a number of regulations promoting transparency in the decision-making process, requiring the government to make documents available to the public proactively. Regulations require that a wide range of documents must be published online for accountability purposes. This includes political-party donations, public officials' annual income and financial-disclosure statements, national-budget expenditures, conflict-of-interest statements, and data on public officials disciplined for conflict-of-interest violations. Latvia also has an independent and effective State Audit Office, which often publishes damning reports of spending and accounting in the state sector.

## 16 | Consensus-Building

All major political actors agree on democracy as the core element of the political system. There are no significant political parties advocating authoritarian rule or seeking to undermine the democratic apparatus of the state.

There is broad consensus among political parties that Latvia should be an open, liberal, pro-trade market economy. The opposition pro-Russian-speaker the Social Democratic Party Concord tends to emphasize a more redistributive agenda, but does not oppose the core elements of the market economy.

The Latvian military (5,000 professional military personnel and several thousand part-timers) is firmly under civilian control and has refrained from entering the political fray (bar one intensive period of public lobbying in 2008 when an unpopular defense minister proposed forming a horse guard at a time that Latvian soldiers were under-protected in Iraq and Afghanistan). There are no significant organized groups opposing either Latvian democracy or the market economy (the anti-globalist groups roused a dozen people to protest the euro in January 2013 and participate in an anti-refugee march in 2016), although there are several radical associations (both Latvian nationalist and pro-Russian) active on the fringes of politics. However, these groups are closely supervised by the Security Police and Latvia's clandestine Constitutional Defense Bureau.

Latvia's only major cleavage is the ethnic Latvian versus Russian-speaker divide. Russia's occupation and annexation of Crimea in 2014 further polarized these two groups in Latvia. This was primarily caused by differing news sources used by the two groups and different attitudes to the annexation. In February 2012, a referendum on adopting Russian as an official state language had seen emotional speeches by politicians from both sides (Russian speakers wanted "respect" and "recognition," while Latvians believed their culture was under threat). Although this did not transmit into societal violence, it saw the two ethnic communities begin to drift further apart. The referendum had been motivated by exclusion from government of the major Russian-speaking party, Harmony Center (now renamed Social Democratic Party Concord), despite Harmony Center winning the largest share of seats in the September 2011 early parliamentary election. The Social Democratic Party Concord claimed that this was discrimination against Russian-speakers while the Latvian parties claimed ideological incompatibility. (Harmony Center had a much more left-wing program and rhetoric than the Latvian parties).

The political parties that represent the interests of Russian-speakers continue to be excluded from governing coalitions (although they are not excluded from power altogether - the pro-Russian speaker Social Democratic Party Concord has controlled the capital city of Riga's local government since spring 2009). However, this can be explained by incompatible socioeconomic programs (with the Social Democratic

Consensus on goals

10



1

Anti-democratic actors

9



1

Cleavage / conflict management

8



1

Party Concord offering a social-democratic policy agenda, while the ethnic Latvian parties tend to be center-right) as much as ethnic prejudice.

A secondary cleavage exists between liberals and social conservatives. Liberals advocate support for refugees, the LGBT community and are explicitly pro-European, while social conservatives (who come from the nationalist extremes of both the Latvian and Russian-speaking communities) are sharply anti-refugee, anti-minority and advocate traditional family policies. The European refugee crisis has exacerbated these differences.

Parliamentary committees, ministries and other political institutions have routinely asked civil society organizations to offer expert opinions in policy debates and the formulation of laws since accession to the European Union in 2004. However, the persistent institutional weaknesses of civil society organizations, as well as the background influence of economic actors and larger business associations, mean that civil society involvement is often symbolic rather than substantive.

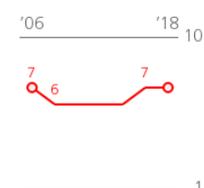
Formal cooperation at the highest levels of government takes place through the National Tripartite Council, which was created in 1998. However, the council has met only intermittently since then, although meetings have become more regular since the extraordinary decisions made during the 2008 to 2010 downturn. Throughout the autumn and winter of 2016 to 2017, the government engaged civil society in discussing reforms to Latvia's tax system. Employers' associations, chambers of commerce and trade unions participated in an open discourse with the Ministry of Finance and the prime minister. The resulting proposals reflect this wide consultation process, although the trade unions claim that they had less influence than the employers and business associations.

Governments have proved responsive to the rare large-scale public protests that have been organized over the last two decades. Public anger, as expressed in the November 2007 "umbrella revolution" gathering in Dom square, led to the resignation of Prime Minister Aigars Kalvitis, while the relatively small violent anti-government protests of January 13, 2009, led to the collapse of the Ivars Godmanis government.

There is little political appetite to bring about a reconciliation of the ethnic Latvian and Russian-speaking communities. Recent years have seen several political leaders attempt to reach across the ethnic divide. Ainārs Slesers, one of Latvia's three then-influential oligarchs, attempted to recruit both Latvians and Russians to his unusual Christian pro-technocrat party (named Latvia's First Party). In the 2009 Riga municipal election, his party adopted a "zipper" system in the ordinal ballot (i.e., Russian-Latvian-Russian-Latvian). His party subsequently formed a governing coalition in the city together with the Russian-speaking Harmony Center (since then renamed to the Social Democratic Party Concord). However, Latvia's First Party has since folded.

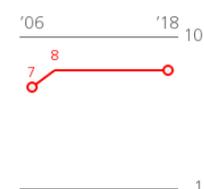
#### Civil society participation

7



#### Reconciliation

8



More significantly, Valdis Zatlers, the leader of the Zatlers Reform Party that came third in the 2011 early election, attempted to form a national government coalition with the Social Democratic Party Concord after the election. However, he could not cobble together a parliamentary majority as the other Latvian parties refused to participate a coalition with the Social Democratic Party Concord, and Zatlers also faced opposition from within his own party.

A political reconciliation between the two communities has subsequently come to be seen as the “third rail” of Latvian politics and no major political actors have demonstrated the political will to bridge the gap between the two communities.

## 17 | International Cooperation

Latvia’s membership of the European Union, with accompanying access to EU structural funds and support for the agricultural sector, is key to Latvia’s future development. The ambition of economic and political convergence drives policy-making in the absence of ideologically rooted political parties. Moreover, the available financial resources from the European Union are key to maintaining and developing the agricultural sector, and are an important source of funding for higher education, innovation and research, and for developing transport networks, and constructing a myriad of facilities in small towns and rural areas. Latvia received over €4.5 billion in structural and cohesion funds in the 2007 to 2013 financial perspective period with another €4.2 billion available in the 2014 to 2020 period.

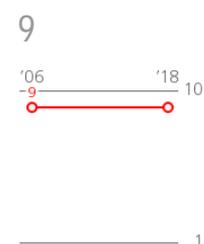
The only concern is that rather than focusing funds on key drivers of competitiveness (e.g., education and innovation or developing the transport infrastructure) the funds have been used in a more scattershot way, with a more or less even distribution across regions.

Having joined the OECD in 2016, the Latvian government is expected to make increasing use of the organization’s research and expertise in crafting policy.

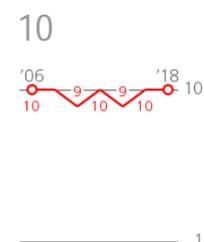
Latvia is seen as a credible and serious international partner. Militarily, Latvia has provided troops for NATO missions in Afghanistan and the Balkan region, and participated in the “coalition of the willing” in the U.S.-led war in Iraq. As the military threat from Russia has grown in recent years, the number of western soldiers Latvia has hosted has increased. For example, 1,000 Canadian troops arrived in spring 2017. Latvia is also among the few NATO countries that has clearly committed to increasing public spending on defense to 2% of GDP by 2018.

Latvia has also proven to be a reliable partner for international financial institutions. In 2012, Latvia successfully completed the IMF-led international lender program, which had been initiated in 2008. In a 2012 conference in Riga, IMF President Christine Lagarde lauded Latvia for its “collective determination and resilience”, and

Effective use of support



Credibility



cited the country as an inspiration for other European countries. At that time, the then Prime Minister Dombrovskis was regarded with some awe by his European contemporaries, having introduced a program of severe austerity measures and twice been re-elected on the back of the measures. After leaving the prime minister's office in 2014, Dombrovskis went on to assume a vice-president position (responsible for the euro and social dialog) in the European Commission.

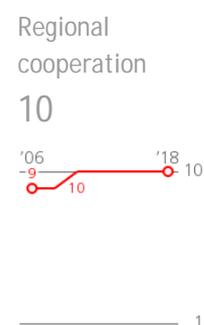
Indeed, Latvia has proven to be one of the more reliable EU member states. In 2013, Latvia was the EU member state that most rapidly transposed EU law into national law. However, a dispute within the government coalition regarding the relocation of refugees to Latvia as part of the EU relocation program caused some concern. Though, despite these internal disputes, Latvia did eventually agree to take in 500-plus refugees.

Latvia has long been an active participant in a number of regional organizations centered around the Baltic Sea (e.g., the Council of Baltic Sea States, the informal Nordic-Baltic 6 group in the European Union) as well as a number of regional initiatives such as the creation of the Baltic macro-region. The Baltic Sea Strategy (BSS) aims to further governmental and regional cooperation among EU member states that border the Baltic Sea. Latvia has long benefited from regional cooperation with the wealthier states bordering the Baltic Sea (Germany, Sweden, Finland, Denmark, Norway and Iceland).

However, despite a common past and closer geographic links, cooperation with Lithuania and Estonia has been far weaker. Institutions of cooperation do exist (such as the Baltic Council of Ministers and the Baltic Assembly which brings together parliamentarians), but they produce little substantive output. The closest links between the three Baltic states are in the sphere of defense. For example, a joint Baltic Defense Academy is located in Tartu, Estonia, and there is also a Baltic Battalion. New opportunities are created by the development of RailBaltica (the railway to link the Baltic states with western Europe) which is a public company established by the three Baltic states. In addition, closer cooperation between the Baltic states is also visible via the regular joint meetings of the prime ministers and governments of all three countries.

Latvia has also used the EU eastern neighborhood policy to promote democratization and marketization in other post-Soviet states, particularly Georgia, Moldova and Ukraine - countries which the Latvian government feels could benefit from the experience of Latvia's transition to a market democracy. Cooperation with these states remains a foreign policy priority.

However, relations with Latvia's eastern neighbor, Russia, continue to be politically difficult and the economic sanctions levered on Russia in 2014 have led to a further deterioration in bilateral economic relations.



Broadly speaking, Latvia is constantly building closer ties to the west, while simultaneously loosening political and social (but ideally not economic) links to Russia.

## Strategic Outlook

Over the last quarter century, Latvia has joined every major western international organization, culminating in membership of the OECD in 2016. With no major international organizations left to join, Latvian policymakers now need to focus on the three major challenges that will shape the Latvian state in the medium to long term, namely the looming demographic crunch, relations with Russia, and the long under-performing higher education and research sector.

The 2011 census found that Latvia's population had declined by 309,000 people (a fall of 13%) over the previous decade. This was caused by a combination of a negative birth rate and mass emigration following Latvia's 2004 accession to the European Union, which was accelerated by Latvia's deep recession from 2008 onwards. Moreover, there is an ongoing process of urbanization in Latvia, with young people relocating from Latvia's peripheral regions to urban centers, especially Riga and its surrounding suburbs. This has left some peripheral regions with populations one-third lower than a decade earlier, exacerbating challenges to public and private service provision. An increase in life expectancy coupled with the low birth rate means that Latvia's old-age dependency ratio has also been creeping up. Successive governments have attempted to promote demographic growth through increased family and maternity benefits, but with little success. The government has also found it difficult to attract migrants back from the United Kingdom, Ireland and Germany, especially those with school-age children. Research indicates that only rapid economic convergence with the European Union and rising salaries will attract people back to Latvia. With businesses requiring skilled and semi-skilled employees (especially IT programmers), Latvian politicians continue to avoid the controversial and painful but necessary debate on immigration. Painful, because the scars of a half century of russification still divide society, but necessary because the economy needs young workers to grow.

Second, Latvia faces the difficult task of managing relations with Russia in an era of heightened military tension. Trade with Russia has sharply declined since 2014 and Russia has also attempted to redirect the lucrative transit business (primarily rail cargo) to Russian ports. Military tensions have increased as the Russian military simulates invasions of the Baltic states, while NATO forces hosted in Latvia and the other Baltic states practice defensive exercises. Latvian leaders also complain that Russian media and Russian state-funded NGOs agitate against the Baltic states, attempting to promote dissatisfaction in the Russian-speaking communities. Latvian diplomats will have to step carefully in order to ensure that Russia receives some form of economic and political sanctions for the invasion of Ukraine while ensuring that economic relations, especially the lucrative transit trade, do not entirely dwindle away.

Finally, Latvia has long neglected the higher education, innovation and research sectors. The increased openness, transparency and comparative competition that membership of the European Union brought has proven these sectors to be largely unable to compete internationally. The most talented Latvian students continue to emigrate to study at other European universities. Though one promising sign is the rapid growth of international students (especially EU students studying

medicine) in recent years. There were 5,500 international degree students in Latvia (primarily Riga) in the 2015/2016 academic year. However, there are still more Latvians studying outside the country than international students in Latvia. Latvian research centers fare comparatively poorly in EU-funded research framework competitions and Latvia spends far less on innovation (perhaps because there are fewer places to spend public funds) on innovation. Higher education reforms are needed to drive economic growth, and convergence with other Baltic Sea states and EU member states. These reforms must include stricter evaluations, performance-based financing, and a restructuring of the higher education institutions and research institutions. (Latvia currently has well over 50 autonomous higher education institutions).