

Latvia

Status Index (Democracy: 8.30 / Market economy: 8.11)		8.20	Management Index		6.81
HDI	0.836		Population	2.3 mn	
GDP per capita (\$, PPP)	10.270		Population growth¹	- 0.2 %	
Unemployment rate	N/A		Women in Parliament	21.0 %	
UN Education Index	0.96		Poverty	N/A	
			Gini Index	33.6 (1998)	
Source: UNDP: Human Development Report 2005. Figures for 2003 unless otherwise indicated. ¹ Annual growth between 1975 and 2003.					

A. Executive Summary

In May 2004, Latvia became a member state of the European Union after the country's citizens voted in a referendum with a majority of 67% in favor of entry. After five years of negotiations with the EU Commission, Latvia's entry into the EU constituted a major success for the government of the relatively young Baltic nation. Subsequent elections to the European Parliament were deemed free and fair, as have all other national elections since 1990.

This report on the status of Latvia's transformation to democracy and a market economy covers the period from the end of 2002 to 2004. During this period, three different governments under Prime Ministers Einars Repše, Indulis Emsis and Aigars Kalvītis shaped the policies of Latvia, the latter coming into office only in December 2004. In these two years, Latvia has progressed further in certain areas of its political order and in formulating policies, particularly in the economic sphere. However, key shortcomings discussed in the 2003 BTI report continue. Full societal integration of the Russophone minority remains the most important challenge for Latvia becoming a sustainable liberal democracy. Secondly, widespread corruption continues to damage Latvian democracy and hampers further economic development. Although both problems are mentioned in the 2004 Declaration of the Cabinet of Ministers under Prime Minister Aigars Kalvītis, they do not constitute top priorities of its political agenda. How the current coalition of partners with governing responsibility in the last two years will effectively manage these challenges remains unclear.

B. History and characteristics of transformation

Latvia's transformation bears the hallmarks of contemporaneous political and socioeconomic transitions, particularly in terms of nation- and state-building. At the end of the 1980s, a strong movement for Latvian independence took shape against the backdrop of Mikhail Gorbachev's reform policy perestroika and the cautious liberalization of the Soviet regime. In October 1988, various reform movements joined forces to establish the Latvian Popular Front (LPF). In the 1989 elections to the USSR Congress of People's Deputies and again in the 1990 elections to the Latvian Supreme Soviet, the LPF won enough seats to force the communists from power in Latvia.

In May 1990, the Latvian Parliament voted to restore Latvia's national independence. The subsequent transition phase, which featured parallel Latvian and Soviet governance structures, ended in 1991 in the aftermath of the Soviet military's failed attempt to overthrow Gorbachev. The independent Republic of Latvia won international recognition on August 21, 1991. In 1993, Latvia set up its own state institutions by fully restoring the pre-war 1922 constitution, which since has been modernized via numerous amendments.

In addition to this transformation of political institutions, Latvia's transition from a centrally planned to a market economy required a complete overhaul of its key economic institutions. The primary goal of the new economic policy was to establish a market economy no longer dependent on Russia but oriented instead toward the EU. The establishment of an independent central bank and the currency reform of 1992 introduced a monetary and fiscal policy that succeeded in reducing the rate of inflation from 951% (1992) to 2.5% (2001).

During the first years of the young republic, the government flanked this stability-oriented monetary policy with a largely successful budgetary policy. In 1997, Latvia even achieved a budget surplus for the first time. "Small" privatization proceeded at a brisk pace and was largely completed by 1998. However, the privatization of key large enterprises in the communication, energy and transportation sectors has lagged behind. The fundamental framework for free competition was already in place before 2002. After a drop in economic performance in the first half of the 1990s, the tide turned. Latvia's GDP rose constantly from 3.3% (1996) to 8.0% (2001).

C. Assessment

1. Democracy

1.1. Stateness

During the period under review, Latvia remained on the democratic path, sustained its progress in transforming its political order and achieved integration into the European Union. Shortcomings remain only in the areas of stateness (citizenship for the Russian minority) and enforcement of the rule of law (political corruption).

The citizenship problem has not been fully resolved. The question of who qualifies as a citizen of the state is rooted in the history of transformation. Because the Republic of Latvia considers itself as successor to the first (interwar) republic, in 1992 automatic citizenship was granted only to those people who had lived within Latvia's borders before 1940, and to their descendants. This excluded approximately 40% of Latvia's population, primarily ethnic Russians, who were treated as foreigners. After repeated criticism from the Council of Europe, the European Court of Human Rights, the EU, and the Organization for Security and Cooperation in Europe (OSCE), the 1995 naturalization procedures were amended in 1998. This new law, including the right of automatic citizenship for children born in Latvia (*ius soli*), is still in place and has not been further amended. In December 2004, about 470,000 persons (mostly ethnic Russians) were still without Latvian citizenship. Considering this number, the increase in the annual rate of naturalization from 9,844 people (2002) to 16,064 (2004) is still only a modest and insufficient improvement.

Table 1: Naturalization data (2000–2004)

	2000	2001	2002	2003	2004
Number of applications for naturalization	10,692	8,672	8,370	11,268	21,297
Number of naturalizations approved	14,900	10,637	9,844	10,049	16,064

Source: Homepage of the Republic of Latvia - Naturalization Board: www.np.gov.lv

One of the main reasons for the slow naturalization process is the requirement of proficiency in Latvian. In order to improve integration, the Latvian parliament approved a reform measure converting Russian language schools into bilingual schools, in which 60% of all courses are taught in Latvian. This reform, which came into effect in September 2004, led to protests. It is seen as still

discriminatory against an ethnic minority and cannot be legitimated by the normative standards of liberal democracy.

1.2. Political participation

All Latvian citizens are granted both active and passive suffrage. During the period under review, national elections for Saeima, the Latvian Parliament, did not take place. According to international organizations, the last parliamentary election, in 2002, met the general standards of fair elections, apart from restrictions on citizenship. In the two European elections (the referendum and the election of the European Parliament) which were held during this period, the different governments continued to obey the principles of open, free, and competitive elections. However, the restrictions on citizenship effectively disenfranchised approximately 20% of Latvia's population in the referendum on EU membership in April 2003, as well as in the May 2004 election to the European Parliament. Apart from that, both elections can be generally considered as free and fair. Voter turnout for the European Parliament election was 41.3%, which was higher than the average of the ten new member states (26.4%), but considerably lower than the 72.5% turnout for the referendum on EU accession. From the standpoint of democracy and societal integration, however, the high proportion of non-citizen residents and their consequent exclusion from elections and referenda remains particularly problematic. This must be considered a defect of Latvia's democracy.

De jure and de facto, the media are independent. During the period under review, the pluralist media provided for open and pluralistic political reporting and proved to be a watchdog on politics. Two decisions of the Constitutional Court further improved the situation of the media. In 2003, the Constitutional Court ruled to strike the language quota requiring at least 75% of broadcast programming to be in Latvian. Additionally, investigative journalism was empowered through a decision by the Constitutional Court to nullify an article in the criminal code that set heavy penalties for conscious falsification of information against politicians.

The right of association and the right to form political parties have constitutional status and both are accorded de facto respect. However, in reality, party membership, as well as confidence in Latvia's political parties, is low. The latter further decreased during the period under review.

1.3. Rule of law

The separation of executive, legislative, and judicial powers is anchored in the Latvian constitution. During the period under review, the executive branch

continued to respect the independence of the other two branches. The Constitutional Court continues to issue rulings that do not reflect views of the different governments.

Positive developments can be observed in the legal system. By establishing the 12-person Judicial Affairs Council in May 2004, which is responsible for screening candidates for the office of judge, the Court Department became more independent of the Ministry of Justice. In addition, the Ministry of Justice strengthened the judiciary by investing in court infrastructure. However, the legal system still lacks efficiency due to a scarcity of resources. According to Eurobarometer surveys, the population's confidence in the judiciary and the legal system, after an increase in 2003, remains low at 29%.

The Latvian Anti-corruption Bureau (KNAB), established in 2002, was fully active for the first time in 2004. In December 2004, the KNAB submitted its first report to the government in line with the National Program for Combating and Preventing Corruption for the next four years. According to this report, fairly good progress has been made: 290 in-depth examinations have been carried out in 207 institutions. In 63 cases, charges against public officials resulted in fines. Regarding political parties' finances, the KNAB forwarded claims against 16 political parties to the Court in 2004. However, since KNAB is relatively new, it depends on greater cooperation within the administration, and since most institutions still lack internal regulations addressing anti-corruption matters, corruption remains an urgent problem. Latvia's score of perceived corruption calculated by Transparency International - is 4.0 in 2004 (3.8 in 2003). In the 2004 Corruption Perception Index (CPI), Latvia ties with Slovakia for 57th place - the lowest ranking among EU nations. According to the most recent Eurobarometer, general public trust in the authorities is low.

The basic rights guaranteed in the constitution are not systematically violated either by the state or by private actors. Access to the courts is legally open to everybody. De facto, however, poor people's access is limited, since a legal aid system is only partly established. During the period under review, there was no evidence of discrimination against the Russian minority or other minorities in the court system. However, the population continues to consider the courts extremely corrupt.

1.4. Stability of democratic institutions

Although Latvia has not yet attained full institutional and democratic stability, the democratic system itself has not been threatened during the period under review. Latvia's democratic institutions remain limited in their ability to perform effectively and efficiently. As a rule, political decisions are prepared, made,

implemented and reviewed in legitimate procedures by the appropriate authorities. However, Latvia's political institutions cannot be considered fully stable because of the frequent turnovers of government. Additionally, organizational problems in the public administration hinder full enforcement of the rule of law.

During the period under review, Latvia was governed by three different prime ministers within a single legislative term. The elected government of Einars Repše (2002-2004) resigned after one of the coalition partners, Latvia's First Party, withdrew its support. His successor, Indulis Emsis, the first Green prime minister in a European country, formed a minority government. He resigned in October 2004 after failing to gain a majority for the 2005 state budget. In December 2004, Aigars Kalvitis, head of the People's Party, became the new prime minister and began to lead a somewhat heterogeneous governing coalition with "New Era," the Green and Farmers Union, and Latvia's First Party. Despite this frequent turnover of governments, all relevant political actors accept democratic institutions as the only legitimate means for the "rules of the game."

1.5. Political and social integration

Problems of political representation continue to burden Latvia's political system. Extensive fragmentation has kept the party system unstable. Of the 43 political parties officially registered with the Ministry of Justice, six were elected into the current Eighth Saeima in 2002: (1) New Era, (2) For Human Rights in a United Latvia, (3) the People's Party, (4) Latvia's First Party, (5) the Union of Greens and Farmers People's Party and (6) the For Fatherland and Freedom/Latvian National Conservative Party (TB/LNNK). In February 2003, however, the party alliance For Human Rights in Latvia split and a new independent faction of the National Harmony Party was created. A positive feature of the party system is its moderate ideological polarization. No party that opposes democracy is represented in parliament. Political parties remain only weakly anchored in society. Trust in political parties has further decreased. Non-citizens remain restricted in their options for political participation. They can join political parties, but they are not allowed to found a new (or "Russian") party.

Like political parties, interest groups have yet to set firm roots in Latvian society. In March 2004, 137 trade unions were officially registered. The Free Trade Union Confederation of Latvia (LBAS), an alliance of 25 individual unions, is the most important organization representing 170,248 members (2003). Through social dialogue, LBAS participates in the preparation of laws and other labor (market) regulations.

A solid network of non-governmental organizations (NGO) exists in Latvia. The total number of organizations registered with the Ministry of the Interior rose above 7,000 in 2003. In April 2004, a new Law on Associations and Foundations

came into effect, improving the legal environment of NGOs. According to recent surveys, however, the number of people actively involved with NGOs remains low, although confidence is rising. Approval for democracy generally has

strengthened but remains considerably below the level seen in Western Europe. According to the most recent Central European Eurobarometer, only 35% of the Latvian population was satisfied or very satisfied with democracy.

2. Market economy

2.1. Level of socioeconomic development

According to U.N. indicators, social exclusion in Latvia is quantitatively and qualitatively minor: In 2002, the UNDP Global Development Report ranked Latvia 50th, three places higher than it was in the last Human Development Index (HDI). Latvia's moderate level of socioeconomic inequality, which helps sustain democracy, is a typical legacy of the communist period. However, as the increase of the Gini coefficient from 0.327 (2000) to 0.358 (2002) indicates, inequality is rising. The UNDP Gender Development Index (GDI) does not indicate particular gender-specific exclusion in Latvia. Although there are no signs that ethnic Russians are generally excluded in the economic arena, studies suggest a correlation between higher unemployment and lower competence in the Latvian language. The still-exclusive citizenship and language policy of the Latvian governments obviously leads to some economic and social exclusion as well.

2.2. Organization of the market and competition

Latvia has established institutions for a competitive market economy, and the Latvian governments have continued to guarantee compliance with the economic rules of the European Union. There are no significant restrictions on access to the market. Administrative barriers were further dismantled during the period under review. Prices are generally deregulated, apart from price controls applied by public service regulators. Legislation on the Competition Council, established in 1993, was improved through the "Regulations of the Competition Council," passed by the Cabinet of Ministers in October 2004. In 2004, foreign trade was further liberalized, bringing restrictions on agricultural products in accordance with EU law. As monetary indicators show, the Latvian banking system has stabilized since the banking crisis of the mid-1990s. In 2003, about 70% of the total share of capital of Latvian banks belonged to foreign investors. By international standards and banking supervision, it complies in almost all respects with the Basel Accords.

2.3. Currency and price stability

The central bank of Latvia is institutionally independent and pursues consistent anti-inflation and foreign exchange policies. However, after keeping the rate of inflation below 3% in 2002 and 2003, the rate rose to 6.9% in 2004 due to a combination of different factors. These included: (1) the rise of administratively regulated prices; (2) harmonization of indirect tax rates; (3) high oil prices; and (4) inflation expectations related to Latvia's accession to the EU. In its foreign exchange policy, Latvia reconsidered the decision to peg its currency, the lat, to the SDR currency basket. Since January 1, 2005, the lat has been pegged to the euro.

The Latvian governments continued to pursue a stability-oriented fiscal policy. Although both domestic and foreign debt rose slightly, new debt remained considerably below the Maastricht Criteria of 3% of GDP with 1.6% (2003) and 1.8% (2004). Latvia's total national debt was expected to be only 15% of its GDP for 2004. Continued close cooperation with the IMF also indicated that a stability-oriented budgetary policy was maintained.

2.4. Private property

The Latvian Constitution protects the right to private property. The role of private enterprise as the institutional backbone of the national economy is not questioned. During the period observed, the percentage of GDP produced in the private sector rose further from 69% (2001) to 75% (2004). While the privatization of agricultural land was largely completed by 2001, the privatization of residential property is still in progress. In 2004, however, 80% of all housing in Latvia was in private hands. In as early as August 2003, a National Strategy for Privatization of state and local government properties was approved by the Cabinet of Ministers for the final stage of privatization. Although privatization of large enterprises continued, certain sectors are still excluded at present, such as communications, energy and transportation. The Latvian Privatization Agency did not sell further shares of the major telecommunications company Lattelekom. It still controls 51% of the shares. Latvenergo, the public energy company, remains completely state-owned, as do 38% of the shares of the oil company Ventspils Nafta. Currently, the railway company Latvi jas Dzelzcelš is not expected to be privatized.

2.5. Welfare regime

Latvia has a state-organized social security system to compensate for social risks. However, both protection and financing fall short. Although the health care system is organized to provide universal coverage, the benefits remain minimal. Public expenditures for health stagnated at a low level in 2003 (3.3% of GDP) and decreased dramatically in 2004. Compared to the rest of the EU, Latvia has the lowest funding for health care and sickness benefits. The institutional foundations of the welfare state are still weak. Social welfare offices are insufficient at the local level. Public welfare expenditures saw further cutbacks from 11.4% of GDP (2002) to 10.7% of GDP (2003). The newly established pension system provides an average old-age pension of only 65 lats (2003); the benefits are low and its growth was slower than the growth of employees' incomes. In July 2004, Latvia submitted its first National Action Plan against poverty and social exclusion in line with European Union obligations. Its impact cannot yet be evaluated.

Equal opportunity for Latvian citizens is provided by law and discrimination against ethnic Latvians in access to public services was not evident in the period under review. Latvia has incorporated some anti-discrimination provisions into its new labor law. However, the discriminatory practice of requiring citizenship for certain professions, which the majority of ethnic Russians still do not have, continues. Furthermore, state regulations limit the use of the Russian language. As a result, Russians who are not sufficiently proficient in Latvian are at a disadvantage, especially in administrative bodies and universities.

Discrimination against women in Latvia, as in all post-communist societies, is less pronounced than in most other third-wave democracies. Women's employment is higher than the EU average. Institutional structures, like the Gender Equality Council, have been established to eliminate gender-specific inequality. However, in 2004, Latvia was criticized by the United Nations for its lack of legislation protecting women from violence.

2.6. Economic performance

Most macroeconomic indicators reflect a positive development from 2002 through 2004. The economy grew steadily and surpassed EU averages between 2002 and 2004. Eventually, economic growth reduced unemployment. The rate of unemployment has decreased from an average of 13.9% (2002) to 8.9% (2003). Rising from 2.8% of GDP (2002) to an expected 4.5% of GDP (2004), the inflow of Latvia's foreign direct investments also developed positively. However, Latvia has not managed to keep inflation low, the Consumer Price Index rose to 6.2% in 2004.

2.7. Sustainability

Although ecological concerns are not at the center of Latvian policy, a considerable portion of the legislation has come in line with the high standards of the European Union after closing the accession negotiations. However, several transitional agreements have been made with 2010 deadlines. Environmental protection agencies are in place, but their efforts could be better coordinated. The Latvian government continues actively to support international environmental accords such as the Kyoto Protocol and Agenda 2000 for the Baltic Sea Region. On the 2005 Environmental Sustainability Index (ESI), Latvia is ranked 15th of 146 countries, showing the best performance of the ten new EU member states.

Latvia has an extensive network of primary and secondary schools as well as public and private universities. Its educational facilities have a solid infrastructure. In 2003, more than 66% of gainfully employed persons had finished secondary school and about 20% held a post-secondary degree. State expenditures for education, although still relatively high in international comparison, decreased from 6.9% of GDP (2001) to 6.1% (2003). However, the contribution of state and private sector in research and development remains low. The number of scientists and researchers is very low. There are only 1.1 research employees per 1000 employed persons compared to a EU average of 5.4. The significant brain drain of young scientists has not stopped.

3. Management

3.1. Level of difficulty

The level of development at the start of the period under review afforded good conditions for the successful continuation of Latvia's transformation. Favorable factors included: functioning market economy structures, a high level of education, low polarization of the conflict over income distribution, and the state's effective monopoly on the use of force. Even before 2002, the political elite shared a fundamental consensus on the goal of democracy and market economy. The greatest structural problem for the transformation process was and still is the existence of two parallel societies. The extensive segregation of the Latvian and the Russian communities hampers social integration. Apart from the ethnic situation, the level of difficulty of transformation in Latvia is rather low.

As Latvia continued its transformation, the global economic environment made economic development more difficult. On the other hand, Latvia's membership in the European Union has opened access to new funds stabilizing its reform path.

Profile of the Political System

Regime type:	<i>Democracy</i>
System of government:	<i>Parliamentary</i>
1. Head of Government:	<i>Einars Repse</i>
Type of government:	<i>coalition minority</i>
2. Head of Government:	<i>Indulis Emsis</i>
Type of government:	<i>coalition minority</i>
3. Head of Government:	<i>Aigars Kalvitis</i>
Type of government:	<i>oversized coalition</i>
<p>Source: BTI team, based upon information by country analysts, situation in July 2005. Constraints to executive authority (1-6 max.) measures the institutional constraints to executive authority; c_i is the share of parliamentary mandates controlled by party i. Effective number of parties denotes the number of parties represented in parliament.</p>	

3.2. Steering capability

The frequent change of governments indicates that the system of political representation is still not well-established. The successive Latvian governments identified themselves with the transformation process and pursued it constantly. Although medium- and long-term goals were kept in sight, they were sometimes set aside in favor of short-term political considerations. The governments' reform strategy aimed at further consolidating democracy and a market economy. It was based on a realistic assessment of scarce financial and human resources, and it proceeded without excessive fluctuations in public expenditures. Since 2002, the fundamental goals of democracy, rule of law and an effective market economy have not changed. Prime Minister and former president of the Bank of Latvia, Einars Repše, pursued a resolute transformation policy, as the charges of his "authoritarian style" from his coalition partners indicate. However, no government succeeded in raising the low level of popular trust in political authorities, which is related to corruption and party financing scandals.

3.3. Resource efficiency

The Latvian governments did not use all available resources efficiently. However, both public deficits and total public debts remained low. Deviations from expenditures planned in the state budget were in most cases minor and within the expected framework. Formally, Latvia's public administration is clearly organized, but de facto problems in coordination remain. Negotiations with the EU, which emphasized administrative reforms and the final accession, have brought further progress. The Latvian governments only partially succeeded in

implementing announced reforms, such as delaying the privatization of certain sectors. In the economic sphere, property rights and a largely functional market are guaranteed, but health care and education infrastructures are neglected. Widespread corruption continues to hamper the effective use of resources.

State expenditures are nominally subject to parliamentary review. Improvements in the oversight mechanisms of expenditures by subordinate agencies also improved the situation between 2003 and 2004. The new regulations of party financing are at least in part effectively controlled by the anti-corruption bureau KNAB. However, as political parties still do not receive state financing they remain dependent on private donors and hence are particularly susceptible to corruption. Resources are also wasted through corruption in the legal system, which is related to a combination of low wages for judges and long delays in proceedings.

The comparatively high level of education established during the communist era is a meaningful resource for the development and sustainability of democracy as well as for an independent media. However, Latvia's continued under-financing of research and education may weaken the latter. Historical experiences (e.g. losing independence to the USSR) can be considered as well-used resources in the context of the referendum on membership in the EU helping to mobilize the pro-European electorate.

3.4. Consensus-building

All major political actors agree on the reform goal of building a market-based democracy. A political pact between old and new elites does not exist nor was it necessary, as many former elites, who had cooperated with the USSR, had been discredited following the restoration of independence. They were replaced by a new elite.

Potential veto actors such as the military, large landowners, powerful opposition groups, or capital oligarchies either do not exist or are oriented toward democracy and a market economy. They are within the democratic consensus and integrated into Latvia's politico-economic system. The question of ethnicity as linked to citizenship remains a crucial point of conflict. Even if the issue seems unlikely to escalate at present, there can be no talk of a political community until all Russians living in Latvia are integrated as citizens. Despite the arguable historical grounds for this exclusionary behavior on the part of the elite, it is incompatible with the democratic principles of minority-sensitive citizenship rights. Attempts to come to terms with historical events clearly remain aimed at settling accounts from the autocratic past rather than shaping the democratic future.

3.5. International cooperation

During the period under review, Latvia's administration has slightly improved as legislation continued to be brought into line with EU laws and regulations during the accession process. Latvia achieved two major aims of its foreign policy: membership in NATO and membership in the European Union. The first will help to sustain independence, the second to enhance the quality of democracy and the efficiency of the economy. In March 2004, Latvia became a full member of NATO and since then has been regularly participating in NATO meetings. Its increases in defense spending and participation in international peace missions (Afghanistan and Iraq) reflect the will to fully participate in NATO. Cooperation during the accession negotiations and a successful referendum was rewarded with membership in the European Union in May 2004. Latvia is willing to participate in a deeper European integration, planning to introduce the euro and to support Common Foreign Security Policy. However, trouble surrounding Latvia's three nominees for the new European Commission in mid-2004 showed a lack of routine in recruiting apt personnel for international organization.

In general, Latvia is regarded as a reliable partner in the international arena. In the sensitive area of minority policy, Latvia received the blessing of the OSCE High Commissioner on National Minorities, Rolf Ekeus, for the school reform converting Russian-language classes into bilingual classes. Close cooperation with international financial institutions like the IMF and EBRD continued between 2002 and 2004, as international loans and joint projects indicate.

4. Trend of development

4.1. Democratic development

Before 2002, most of the indicators for evaluating democracy in Latvia showed satisfactory or good conditions. The state monopoly on the use of force and public safety and order were fully established. However, shortcomings were evident in two areas. Corruption and poor administration limited the effectiveness of the civil service, and the high proportion of ethnic Russians without citizenship posed particular problems in political participation. Aside from some activities of the anti-corruption agency KNAB, no noticeable progress has been made.

Concerning political participation, Latvia satisfied the criteria for the indicators of elections, the actual power to govern effectively, and freedom of opinion already in 2002. Its institutions also adequately supported the formation of civil society groups.

Aside from discrimination against the Russian minority, the greatest shortcomings were related to the rule of law. The criteria independence of the branches of government is already adequately met. In the areas where Latvia falls short, namely an independent judiciary and prosecution for abuse of office, further institutional improvements have been made.

The institutional stability of democracy was not threatened. Political institutions have been and continue to be supported by relevant actors. Both the administration and the judiciary further improved their ability to perform effectively. Nevertheless, corruption continues to plague political life, to obstruct the rule of law and to hamper Latvia's economy.

The shortcomings in political and social integration saw no remediation. On the contrary, the party system grew increasingly unstable. The results of the 2004 election to the European Parliament cannot be viewed as a consolidation. Although it remains weak, there are modest signs of much-needed improvement in functional representation by interest groups or in the accumulation of social capital. Intermediate organizations are weakly differentiated and not broadly embedded in civil society.

4.2. Market economy development

Socioeconomic indicators suggest further improvement. Latvia improved its standing by three places on the HDI and by one on the GDI, thus consolidating its position in the top third of the countries ranked and rated. The high increase in GDP per capita is the most striking and influential indicator. However, this development benefits only portions of the Latvian population. According to the Gini index, social inequality in international comparison remains low, though it has increased slightly further.

Between 2002 and 2004, the institutional setting for a market economy further improved. However, shortcomings remain because of bureaucratic inefficiency and a lack of coordination among various agencies.

Macroeconomic data definitely show a solid development during the review period. Higher FDI inflow and integration into the European market had a positive effect. In this and other respects, economic developments in Latvia have benefited from EU accession. Although unemployment remains a crucial problem, both

long-term unemployment and youth unemployment have decreased.

Table 2: Development of macroeconomic fundamentals (2000-2004)

	2000	2001	2002	2003	2004 ^a
Growth of GDP in %	6.8	8.0	6.4	7.5	8.5
Export growth in %	25.5	7.5	5.2	5.0	9.8
Import Growth in %	25.5	14.5	4.6	13.0	14.0
Inflation in % (CPI)	2.6	2.5	1.9	2.9	6.2
Foreign Direct Investment in % of GDP	1.6	2.8	2.7	4.5	4.5
Tax Revenue in % of GDP	29.3	28.1	28.1	28.2	n/a
Unemployment in %	14.6	13.3	12.1	10.7	n/a
Unemployment among persons under 25	21.4	22.9	23.9	17.9	19.0
Budget deficit as % of GDP	2.7	-2.0	-2.3	-1.6	-1.8
Current account balance in mill. LATS	-570.9	-712.9	756.1	846.3	n/a

^a All figures for 2004 as forecast.

Source: Republic of Latvia - Ministry of Economics (2004): Economic Development of Latvia.

D. Strategic perspective

Until 2002, Latvia's path to democracy and a market economy was largely a success story. However, only minimal progress has been made since 2002. Successful completion of democratic consolidation requires further improvements be made in both the political and economic spheres.

The *conditio sine qua non* for a sustainable democracy in Latvia remains the full integration of the Russophone minority. As evidenced by the experience of past years, migration to Russia for this part of Latvia's population is not an option. Full integration must therefore be a strategic mid-term priority for each Latvian government. The current government has declared several measures in the field of integration policy, including the implementation of ethnic policy principles that consider the interests of the entire society—Latvians as well as other nationalities; the improvement of regulations in ethnic policy; and the improvement of the prestige of Latvian citizenship, thus creating a more positive attitude toward acquiring citizenship. However, these measures seem insufficient to come to terms with the principal defect in Latvia's democracy.

Stabilizing democratic patterns of representation through cooperation among

political elites and reducing corruption are the two other major challenges in the political sphere to which Latvia's government should give priority. Although the current government will be more stable than the preceding minority government, tensions may emerge within the coalition as former Prime Minister Einars Repše receives the portfolio of defense minister. The next local elections in 2005 will be one of touchstones.

Strategic socioeconomic aims appear easier to achieve as national and international macroeconomic indicators currently suggest a sustainable and solid basis for the future. In general, Latvia should maintain its market-oriented policy and continue with the reform process. As the integration into the common European market deepens, Latvia should focus on the announced aim of becoming a member of the European Monetary Union and reduce the inflation rate.

Additionally, Latvia should improve social policy. According to the latest Eurobarometer, satisfaction with the current economic and social life environment is particularly low compared to other European countries. In addition to inflation and unemployment, Latvians are concerned most about the health care system. The current government should therefore ensure just and sustainable funding and restructure large sectors of the social safety net, particularly the health care system.