

# BTI 2012 | Latvia Country Report

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scale: 1 (lowest) to 10 (highest)    score    rank    trend

This report is part of the Bertelsmann Stiftung's Transformation Index (BTI) 2012. The BTI is a global assessment of transition processes in which the state of democracy and market economy as well as the quality of political management in 128 transformation and developing countries are evaluated.

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### Key Indicators

Population	mn.	2.2	HDI	0.805	GDP p.c.	\$	16312
Pop. growth <sup>1</sup>	% p.a.	-0.5	HDI rank of 187	43	Gini Index		35.7
Life expectancy	years	73	UN Education Index	0.873	Poverty <sup>3</sup>	%	<2
Urban population	%	68.2	Gender inequality <sup>2</sup>	0.216	Aid per capita	\$	-

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

## Executive Summary

For Latvia, the mid-2000s represented a brief era of unparalleled economic growth, increasing political stability and foreign policy success as the country joined the European Union and the North Atlantic Treaty Organization (NATO). In contrast, in 2009–2011 Latvia experienced a sharp economic contraction (with the biggest fall in GDP of any country anywhere in the world at the time), mass unemployment and the threat of social disorder, as well as witnessed the continuing flight of many Latvians to other European Union countries, particularly Ireland and the United Kingdom.

At the same time, however, Latvian political institutions proved to be remarkably firm in the face of disastrous economic collapse. Following the fall of the Ivars Godmanis government in early 2009, the two government coalitions led by Prime Minister Valdis Dombrovskis (March 2009–November 2010, and November 2010 onwards) enacted a series of increasingly larger budgetary cuts, resulting in severe salary decreases in the public sector as well as cuts in public spending on healthcare, education and other welfare sectors. Unemployment rose to over 20%, the highest in the European Union. Nevertheless, Dombrovskis' technocratic approach to government and his successful public communication of the inescapable economic reality and the necessity for radical reforms resulted in a surprising victory for his Unity political alliance in the October 2010 parliamentary election. Indeed, there was surprisingly little public opposition to draconian budgetary cuts. Many Latvians were shocked by the violence during a 10,000-strong anti-government protest in January 2009, as participants attacked the Latvian Parliament building, government ministries and private banks. Thus while the large public sector trade unions organized peaceful demonstrations against the proposed cuts, and a small number of individuals camped out in the street opposite the Cabinet of Ministers during the winter of 2009–2010, opposition was generally muted and was expressed in accordance with the laws and norms of a democratic state.

## History and Characteristics of Transformation

The territory that makes up modern Latvia was a part of the former Swedish, Polish and Russian empires. Throughout these different eras of empire, the effective governors of Latvia remained the Baltic Germans, who first conquered Latvian territory in crusades against the pagans of Northern Europe in the early 13th century. The Latvian nation emerged in the mid-19th 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 World War I, 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 stability and 13 different government coalitions were formed by 1934. This political instability, accompanied by an economic crash in the early 1930s, led to a peaceful coup in 1934 and the benign dictatorship of Karlis Ulmanis, the dominant figure of inter-war Latvia, who 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 World War II, and Latvia's subsequent forced annexation into the Soviet Union.

Soviet occupation saw the collectivization of agriculture, an increased pace of industrialization and a sharp demographic change. The large German and Jewish minorities virtually disappeared as a result of the Holocaust and the forced dislocations of World War II. Many Latvians fled west or were deported to Siberia. The post-1945 era saw a large influx of Russian speakers to Latvia. The Soviet regime floundered in the 1980s as falling energy prices threatened economic stability, and the democratic reforms of the Soviet Union's 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, as well as 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.

Latvia was faced with a radical political and economic transition. The political transition to a multiparty democracy began with the re-adoption of the country's 1922 constitution and the first post-Soviet parliamentary elections in 1993. Since then Latvia has had six parliamentary elections, all of which have been judged as free and fair by international observers. However,

Latvia's extreme multipartyism has meant that government stability has been hard to achieve, with governments staying in power, on average, for little over a year. Other major political challenges were an agreement on the withdrawal of Russian forces from Latvian territory (reached in 1994), internationally acceptable 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 van producer RAF, went bankrupt, while others were privatized or returned to previous owners. Unemployment levels were 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, in the mid-2000s Latvia experienced rapid economic growth, albeit primarily as a result of a construction and consumer-spending boom funded by cheap credit. However, the Latvian economy fell again in late 2008, and the government turned to an IMF-led international consortium for financial assistance. A dramatic recession – at the time one of the most severe in the world – followed, with Latvia experiencing a GDP decline of more than 25% in 2008 and 2009. Modest growth was achieved after the stabilization of the economy in 2010, and in October 2010 the Latvian electorate surprisingly returned the Valdis Dombrovskis government, the same ruling group that had pushed sharp cuts in spending that transformed Latvia in 2009, 2010 and 2011, to power.

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

## Transformation Status

### I. Political Transformation

#### 1 | Stateness

The state has a monopoly on the use of force. Latvia has not experienced any major domestic or external challenges to the existing regime.

The 1994 Latvian citizenship law was based on the principle of “jus sanguinis,” where nationality is acquired through citizen parents. Thus citizenship was granted to individuals who were citizens before the Soviet occupation of 17 July 1940 as well as to their direct descendants. This meant that the one-third of the Latvian population that had moved to Latvia during the Soviet era (approximately 700,000 people) was denied automatic citizenship.

External pressure from the European Union, NATO, the 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 the Latvian language knowledge criteria could be naturalized. There was a sharp increase in naturalization after Latvia’s accession to the European Union. Some 16,064 people were naturalized in 2004; 19,169 in 2005; and 16,439 in 2006. However, this figure decreased to just 2,008 individuals in 2009. As of July 2010, Latvia still had 336,000 resident non-citizens amid a population of 2,245,000. These non-citizens cannot vote in national, local or European elections, and are barred from holding certain public posts, but otherwise enjoy full economic and social rights and protections.

Latvians and Russian speakers occupy different information zones. There are distinct newspapers, TV and radio channels, as well as Internet portals for each group. Political parties are also aligned along an ethnic cleavage. The result is two distinct ethnic communities with radically opposing positions on domestic issues of language policy, but also on international issues, such as the Russia-Georgia war of 2008.

Question  
Score

Monopoly on the  
use of force

10

State identity

8

Latvia is a secular state and church attendance is among the lowest in Europe (7% of the population attended church services on a weekly basis according to a 2004 Eurobarometer poll). The First Party of Latvia rose to prominence on a conservative-religious platform in the early 2000s. The party recruited a number of priests and ensured a steady flow of government funding toward church renovations. However, the economic crisis of 2008–2010 and the radical budget cuts that accompanied it put an end to such state support. Moreover, the First Party of Latvia fared poorly in the 2010 parliamentary election, winning just eight seats in an electoral alliance (For a Good Latvia) with the conservative People's Party.

No interference of religious dogmas  
10

The basic civil functions of a state apparatus are fulfilled in terms of regulation, administration and implementation. Institutions of jurisdiction, tax authorities and law enforcement are functioning. The state and local government apparatus is responsible for the administration of communications, transport and basic infrastructure, while services are provided by the state and private operators. The severe budget cuts of 2008–2010 led to the reduction of staff and pay in controlling and regulating state institutions, the closure of many smaller regional public schools and medical facilities as well as cuts in social benefits. However, the state has continued to provide a minimal level of public services.

Basic administration  
10

## 2 | Political Participation

The October 2010 parliamentary election was observed by the OSCE and other election monitoring organizations. There were 13 contenders – seven parties and six electoral alliances – significantly less than the 19 to 23 candidate lists that competed in the previous five post-communist era elections. This was primarily due to a series of electoral alliances struck in the run-up to the election. As with all previous elections since independence from the Soviet Union, the contest was declared to be both free and fair. The only major concern was media access. Multiple changes in media ownership, particularly with Diena, Latvia's newspaper of record, have led to unclear ownership and resulting claims of political bias. The Latvian constitution gives politicians four weeks after the election to conduct negotiations and build coalitions before the president is obliged to name a candidate for the post of prime minister. The new government was formed by the winner of the election (Unity Alliance) and the third-placed Union of Latvian Greens and Farmers Party, which together hold a joint parliament majority of 55 seats out of 100.

Free and fair elections  
9

Democratically elected officials do have the power to effectively govern. However, Latvia is one of the few remaining European Union states with political parties that are entirely privately financed. This has left political parties open to influence from wealthy patrons (oligarchs), resulting in a lack of transparency in policy-making and largely contributing to a dramatic loss of trust by the electorate in political institutions, particularly with the parties themselves. However, this situation has

Effective power to govern  
10

been addressed with new party financing regulations which will see Latvia switch to a publically funded party financing regime in 2012.

There are no formal restrictions on association or assembly. However, in recent years both gay activists and Latvian far-right nationalists have had to turn to the courts in order to receive permission to organize demonstrations, following initial rejections from the Riga local authorities.

Association /  
assembly rights  
10

The constitution guarantees freedom of expression, and Latvian courts have a modern history of defending these rights. There was one case where government authorities had been harassing a Latvian public television news journalist and illegally tapping her phone. However, the case ended with a court ruling and compensation in favor of the journalist. Both the private and state-run media are largely free from direct government influence, although the National Radio and Television Council, which supervises electronic media, is composed of representatives from political parties (elected by the Latvian parliament). Moreover, ownership of much of private media, particularly the daily newspapers, has become increasingly opaque. Indeed, ownership changes have frequently resulted in the mass dismissal of “old-guard” journalists and the recruitment of newer and less experienced writers. *Diena*, Latvia’s leading daily newspaper, changed its editor four times in two months in the run-up to the October 2010 parliamentary election. Media observers have argued that younger journalists are less independent and more open to owner influence.

Freedom of  
expression  
9

### 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 the summer of 2010, President Valdis Zatlers called for an expansion of presidential powers, including the ability of the president to dissolve parliament without the need for a referendum. Zatlers also called for constitutional reforms that would see the president elected in a national rather than a parliamentary vote. The executive branch has grown stronger in recent years as political parties have created more effective party organizations and tightened internal discipline. However, the 2010 parliamentary election saw six political alliances, rather than parties, elected to parliament. The government formed after the election was made up of two political alliances (the Union of Latvian Greens and Farmers Party and the Unity Alliance). As a result, six parties effectively make up the government. This will make it more difficult for the executive to maintain effective control over the legislature.

Separation of  
powers  
10

The judiciary is a distinct profession in Latvia. However, the formal independence of the judiciary is compromised by the widespread perception of judicial corruption, which has seen high-profile cases ending with the imprisonment of judges. Moreover, in May 2010 the Latvian parliament elected parliamentary deputy Vineta Muizniece to Latvia's Constitutional Court. While Muizniece has a legal education, she had never previously worked as a judge or a legal scholar (she was in parliament from 1998–2010), the two traditional sources for Constitutional Court judges. This appointment suggests the politicization of Latvia's highest court.

Independent  
judiciary  
8

Latvia created a Bureau for the Prevention of Corruption (KNAB) in 2003. It has uncovered and successfully prosecuted a series of corruption cases that have led to the imprisonment of local politicians, public officials and businessmen. At the same time, however, the effectiveness of the institution has been significantly weakened by a succession of feuds and confrontations between the KNAB director (who is elected by a simple majority in parliament) and the prime minister. This led to the dismissal of the previous KNAB director in 2008. A similar confrontation between the new KNAB Director Normunds Vilnitis and Prime Minister Valdis Dombrovskis began brewing in mid-2010. Vilnitis attempted to make his mark on KNAB by drawing up a new organizational model that included a greater concentration of investigative powers into his own hands. This plan was heavily criticized by Vilnitis' two deputy directors and other senior staff. The prime minister called for a review of the plans, and then asked a senior prosecutor to investigate the case. The prosecutors' draft report led Dombrovskis to call for Vilnitis' resignation. Vilnitis, who however can only be removed by a parliamentary vote, has refused to resign. This type of political conflict has distracted the anti-corruption agency from its key tasks.

Prosecution of  
office abuse  
7

Latvia has a national ombudsman, and as an EU member state, also has recourse to the office of the European Ombudsman. The Latvian Constitutional Court also protects the rights of Latvian citizens with regard to the constitution. There are no restrictions on the civil rights of women, religious groups or ethnic groups in Latvia. A large anti-gay movement (NoPride) has been mobilized by far-right political groups and Latvian mainstream churches (which are virulently anti-gay), resulting in violent protests during gay-rights marches. In 2005, the Latvian parliament passed a constitutional amendment to ban gay marriage.

Civil rights  
9

#### 4 | Stability of Democratic Institutions

Latvia's democratic institutions were severely challenged by the unprecedented economic crisis of 2008–2010, which saw GDP fall by over 25% and unemployment rise to over 20%. This led to large cuts in public spending, particularly cuts in public sector jobs, salaries and capital investments. These were difficult decisions that were, nevertheless, prepared, implemented and reviewed by

Performance of  
democratic  
institutions  
9



the appropriate authorities. Indeed, some of the political decisions were reversed in the Latvian Constitutional Court. For example, in December 2009 the Constitutional Court ruled that the decision to reduce by 70% the pensions of pensioners still in paid employment (and all other pensions by 10%) was unconstitutional.

All major political actors have accepted the legitimacy of Latvia's democratic institutions.

Commitment to  
democratic  
institutions  
10

## 5 | Political and Social Integration

The first post-Soviet parliamentary elections were marked by volatility and party system fragmentation. Indeed, the first four post-Soviet parliamentary elections (1993, 1995, 1998 and 2002) were each won by parties that were formed less than 12 months before the poll, and typically centered around charismatic personalities rather than political ideologies or policies. This was then followed by further fragmentation and political realignment. However, the last two parliamentary elections (2006 and 2010) have produced a far more consolidated party system, albeit as a result of party fusion and amalgamation. No genuinely new parties have been elected to parliament in these two elections.

Party system  
7

However, the party system continues to be weakened by the institutional failings of the parties themselves. Only 200 individuals are needed to form a party, resulting in small political parties that are over-dependant on wealthy sponsors. This weakness has been partially addressed by the switch to state financing of parties in 2012. However, other weaknesses, such as small memberships, concentration of power at the top of the party as well as a lack of institutional linkages with civil society and think tanks or other policy-making institutions, have yet to be addressed.

The 2010 parliamentary election confirmed that the Latvian party system continues to split along the core ethnic cleavage. Russian-speaking parties continue to form a permanent opposition in parliament (holding roughly one-quarter of parliamentary seats). Government coalitions have been exclusively composed of center-right and ethnic Latvian parties. This has contributed to a weakness in political ideology, which prevents real policy debate in the Latvian party system.

Ongoing party weakness and resulting public disillusionment has led to increased calls for an expansion in the powers and role of the presidency. The last 20 years have seen several (failed) citizens' initiatives attempt to gather a quorum of signatures needed to have a referendum on a popularly elected president. President Zatlers has also put forward several legislative initiatives aimed at strengthening the

powers of the presidency. However, these initiatives have been vigorously opposed by parliament.

The deep economic recession of 2008–2010 confirmed the lack of effective associations and interest groups in Latvia. There were several large and peaceful demonstrations, organized by the sector trade unions, for example doctors, teachers (and students) and farmers, to protest budget cuts. However, these protests were typically single-day marches that failed to influence government policies. Trade unions representing private sector workers are small and have been particularly ineffective. Informal economic and business interests, with close financial ties to political parties, remain far more influential.

Although the National Tripartite Consultation Council meets regularly and was, for example, involved in the discussions on fiscal consolidation in 2009 and 2010, its recommendations are typically ignored.

There are no recent polls on public support for democracy. However, the 2009 Eurobarometer (72) revealed drastically high levels of distrust in Latvian political institutions. A remarkably high number of Latvians distrust the national government (88%), the parliament (92%) and political parties (95%). In terms of trusting institutions, the poll showed that just 9% trusted the government, 6% the parliament and just 2% political parties. These were the highest levels of distrust and lowest levels of trust regarding these institutions among EU member states.

There is little sense of solidarity among the Latvian population. First, there is the core divide between Russian-speakers and Latvians. Each ethnic group has its own media, schools and even social gathering places. Thus there is very little solidarity between these groups, as evidenced by the ethnic vote in parliamentary and municipal elections. There are many cultural associations in Latvia, particularly choirs and folk dancing groups, as well as sports associations. However there are fewer social or political (such as environmental) groups. Indeed, a culture of volunteerism, as well as social pressures to donate time or money to good causes, is weakly developed.

Interest groups  
6

Approval of  
democracy  
8

Social capital  
7

## II. Economic Transformation

### 6 | Level of Socioeconomic Development

Latvia has witnessed high levels of both poverty and income inequality since the fall of the Soviet regime in 1991. The economic recession of 2008–2010 further exacerbated this situation. Latvia fell to a rank of 48 in the United Nations Human

Question  
Score

Socioeconomic  
barriers  
7

Development Index (44 in 2008), behind neighboring Estonia (34) and also Lithuania (44). At the same time, Latvia trailed only Bulgaria and Romania in the European Union in terms of the country's highest absolute poverty rate and extreme absolute poverty rate. Latvia also had the second-highest Gini coefficient in the European Union (behind Portugal), meaning that the distribution of income among households is extremely unequal. The number of individuals officially living in poverty doubled from 100,000 to 200,000 in 2010 (despite a fall in unemployment). Moreover, the country's rate of individuals that are at risk of poverty, at 26%, is the highest in the European Union. There is also a distinct regional bias to poverty levels, with the highest levels of poverty in the eastern region of Latvia (which neighbors Russia), and the lowest levels in the capital city Riga and surrounding region. However, poverty is partly offset by own-consumption agricultural production in poorer rural regions, as well as income underreporting due to Latvia's relatively large shadow economy. The groups most at risk of poverty are pensioners, those of pre-pension age, the unemployed, single-person households (where there is no income pooling), single parents and families with more than one child.

Economic indicators		2007	2008	2009	2010
GDP	\$ mn.	28765.7	33669.4	25875.8	<b>24009.7</b>
GDP growth	%	10.0	-4.2	-18.0	<b>-0.3</b>
Inflation (CPI)	%	10.1	15.4	3.5	<b>-1.1</b>
Unemployment	%	6.0	7.5	17.1	-
Foreign direct investment	% of GDP	8.0	4.0	0.4	<b>1.5</b>
Export growth	%	10.0	2.0	-14.1	<b>10.3</b>
Import growth	%	14.7	-11.2	-33.5	<b>8.6</b>
Current account balance	\$ mn.	-6424.5	-4492.0	2283.7	<b>731.2</b>
Public debt	% of GDP	7.8	17.1	32.8	<b>39.9</b>
External debt	\$ mn.	39040.1	41847.4	41822.3	<b>39555.3</b>
Total debt service	\$ mn.	4582.9	6120.2	7573.6	<b>10546.4</b>

Economic indicators		2007	2008	2009	2010
Cash surplus or deficit	% of GDP	0.8	-2.6	-6.4	-
Tax revenue	% of GDP	15.6	15.0	12.7	-
Government consumption	% of GDP	17.4	19.6	19.6	<b>17.2</b>
Public expnd. on edu.	% of GDP	5.0	-	-	-
Public expnd. on health	% of GDP	6.2	6.6	6.5	-
R&D expenditure	% of GDP	0.59	0.61	-	-
Military expenditure	% of GDP	1.7	1.7	1.4	-

Sources: The World Bank, World Development Indicators 2011 | International Monetary Fund (IMF), World Economic Outlook 2011 | Stockholm International Peace Research Institute (SIPRI), Military Expenditure Database 2011.

## 7 | Organization of the Market and Competition

Latvia's Western-oriented foreign policy and the conditionality of accession to the European Union meant that the foundations of the market economy were already in place by the mid-1990s. However, market competition continues to be undermined by three factors. First, structural corruption undermines true competition for state procurement contracts as well as privatization of large state enterprises and the dispersal of EU structural and cohesion funds. Second, Latvia has a large shadow economy, which, according to the Latvian Employers' Confederation, amounts to almost 40% of GDP, the highest in the European Union. However, this figure was challenged by the State Revenue Service which claimed the shadow economy was no more than 16% of GDP. In any case, tax evasion is widespread and successive governments have tried to address this, without much success. Third, the honesty of courts and the judiciary, which rule on disputes in the private sector, has been questioned in light of a number of scandals over the past decade; the scandals resulted in the imprisonment of judges as well as the disbarment of a number of attorneys.

This overall situation has been exacerbated by a deep recession that began in late 2008. Businesses have circumvented collective agreements and increasingly have been pushed into the shadow economy, particularly to avoid payroll taxes.

Latvia maintains a Competition Council and the country is now subject to stringent EU as well as national competition laws. The number of resolutions adopted by the council rose sharply after EU accession, from 68 in 2005 to 110 in 2008, although the numbers fell to 41 in 2009. The council also in 2009 issued fines totaling over LVL 7 million (€10 million). The council has vigorously investigated the grocery,

Market-based  
competition  
9

Anti-monopoly  
policy  
10

agriculture and food production sectors in recent years, partly because of public concerns over rising prices.

As a member state of the European Union since 2004, Latvia's trade policy has been fully liberalized and is now subject to EU law.

Liberalization of  
foreign trade

10

Latvia's first commercial bank began operating in 1987. This same bank, Parex, however was the catalyst for the near collapse of the Latvian banking sector in 2008. Indeed, the banking sector has a long history of being a source of economic trouble in Latvia. Several banks, including Latvia's then biggest, Banka Baltija, collapsed in 1995 and hundreds of thousands of Latvians lost their savings. Since that time, the Bank of Latvia (the country's Central Bank) has radically improved its supervisory and regulatory approach. At the same time, most of the largest Latvian banks have been taken over by Nordic banks such as Swedbank, SEB, Danske Bank and so on. As the only major domestically owned bank (and the second biggest in Latvia in terms of assets), Parex suffered from a severe liquidity crisis in late 2008 as a result of poor investments and the global credit crunch. The bank was subsequently nationalized, with the European Bank for Reconstruction and Development (EBRD) stepping in to assume a 25% stake in the bank. Parex was subsequently divided, with non-performing assets kept in the original Parex Bank, and non-core assets and liabilities (about two-thirds of assets) placed into a "good" bank, which was named Citadele Bank.

Banking system

8

The Latvian banking sector suffered significant losses in 2008–2010. The percentage of non-performing loans in 2008 was 2.8%, but this level rose in 2009 and in 2010. An IMF report stated that in October 2010, 15% of bank loans were more than 90 days overdue. However, parent banks in Nordic countries were able to absorb the losses and remained confident about the long-term outlook in Latvia, with a view to return to modest profitability in 2010.

## 8 | Currency and Price Stability

The Latvian lat is pegged at LVL 0.702804 (+/- 1%) to €1. Recent years have seen persistent calls for a devaluation of the lat as an instrument to assist Latvia's economic recovery. However, Latvian Prime Minister Valdis Dombrovskis (a former Bank of Latvia employee) and Finance Minister Einars Repse (a former president of the Bank of Latvia) have maintained a consistent no-devaluation message (with the strong support of Repse's successor as bank governor, Ilmars Rimsevics), and have negotiated this policy as a key part of an IMF-led financial rescue package in late 2008. Over 90% of loans are denominated in foreign currencies (primarily the euro, although there are also loans in U.S. dollars and Swiss francs), and there were well-founded fears that devaluation would lead to a mass loan default and the subsequent collapse of the banking sector. Inflation in

Anti-inflation /  
forex policy

8

Latvia was the highest in the European Union during a property bubble in the mid-2000s, but recent years have seen inflation decrease to the extent that Latvia recorded deflation of -1.2% in 2010 (inflation was 3.3% in 2009 and 15.3% in 2008). This radical fall in inflation was largely the result of the government's internal devaluation policy, which saw radical cuts in government spending, including public sector salaries and spending on infrastructure projects, opposed to a currency devaluation.

Having emerged from the Soviet Union with no public debt, it is unsurprising that Latvia has long maintained low levels of public debt. At the same time, however, government fiscal discipline has been weak, with budget deficits maintained even in the mid-2000s with sharp GDP growth. Nevertheless, overall public debt remained low until the beginning of the economic crisis in late 2008. Latvia accepted an IMF-led bailout emergency loan of €7.5 billion. Latvia's public debt rose sharply from 9% of GDP in 2007 to 19.7% of GDP in 2008 and then 36.7% of GDP in 2009. A strict condition of the bailout deal was a reduction of public spending, and thus a de facto budget reduction to less than 3% of GDP in 2012, thus opening the door for euro adoption in 2014. As a result, the budget deficit has steadily declined since a high of 7.1% in 2009. An agreement over a 5.4% budget deficit for 2011 was reached with international lenders in December 2010.

Macrostability  
7

## 9 | Private Property

Private property rights are adequately protected for both Latvian citizens and foreign investors.

Property rights  
10

The Latvian private sector employs over 75% of the workforce, and accounts for a similar amount of Latvian GDP. Privatization was largely completed by the end of the 1990s. However, privatization was a highly contentious and politicized process, and many large enterprises have still not been privatized. A successful citizens' initiative process in 2000 led parliament to adopt a law that bans the privatization of the national electricity company, Latvenergo. Political divisions in the governing coalition blocked the proposed 2007 management-employee privatization of the hugely profitable domestic telecom giant, Lattelecom. The state also holds a majority stake in the fast-growing national airline AirBaltic.

Private enterprise  
9

Utilities and public sector services (railway, electricity, communal services, education, research, health care and social services) have been liberalized, but in many of these industries competition is not fair regarding the private sector. For instance, state and private education and research institutions are not equally eligible to participate in state programs that promote and support innovation.

## 10 | Welfare Regime

Latvia has a comprehensive, albeit poorly funded, welfare system. The state provides pensions, child and maternity support and other standard benefits, although the financial level of benefits is quite low. 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 pension reform introduced a capital-funded pension scheme for current employees. The medical system is maintained by a mix of state and private financing. Certain types of visits to family doctors or specialists and certain procedures require co-financing. Co-financing often takes the form of informal cash payments (Latvian President Valdis Zatlers has admitted to accepting such payments while he worked as an orthopedic surgeon). Primary and secondary education is free, although there is a shortage of places in nursery schools. Tertiary education is offered at a mix of public and private institutions.

The 2008–2010 economic crisis led the government to make major cuts in public spending. Many of the austerity provisions, such as cuts in pension payouts to working pensioners and cuts to maternity benefits, were successfully challenged in the Latvian Constitutional Court. Other cuts, such as the closure of small but expensive rural schools and medical centers inherited from the Soviet era, have generally been welcomed. However, the extent of “consolidation” has varied considerably. Cuts to higher education and research funding and the medical system in general have seriously affected the quality of services provided, while pensions have remained untouched.

Women and ethnic minorities have equal access to higher education, public services and employment opportunities. Latvia is ranked 18th in the 2010 Global Gender Gap Index (although this represented a fall from its 10th position held in 2008). More than two-thirds of students in higher education are funded through private means. Many private students are Russian speakers who choose to study in their native language (as public higher education is only available in the Latvian language). Students do have access to inexpensive student loans to finance their education, and the higher education system also allows students to maintain part-time and, in some cases, even full-time employment, while enrolled in tertiary programs. Individuals have recourse to the state ombudsman’s office in the event of discrimination. Nevertheless, growing poverty increasingly constrains access to education.

## 11 | Economic Performance

Latvia experienced extremely high rates of GDP growth following the country’s accession to the European Union in 2004. Latvia experienced a personal

Social safety nets

7

Equal opportunity

8

Output strength

6

consumption- and property-led boom that saw double-digit growth between 2005 and 2007. However, this boom was accompanied by extremely high rates of inflation, particularly wage inflation (real wages grew by 10% in 2005 alone), but few gains in productivity. This domestic economic bubble was eventually popped by the global economic crisis of 2008.

Indeed, Latvia experienced the biggest economic contraction of any country in the world between 2008 and 2009, when GDP contracted by over 25% (although there was modest growth in 2010). Inevitably, unemployment rose rapidly, peaking at 23% in the first quarter of 2010 (the highest in the European Union). FDI flows remained high; however, this was largely a result of capital injections from Nordic banks to their subsidiaries in Latvia.

## 12 | Sustainability

The environmental movement in Latvia is weak, with few associations (and those that do exist have low membership and poor funding) and little public interest. The “green” part of the Union of Latvian Greens and Farmers Party (which has been in every government coalition since 2003) is subordinated to the party’s much stronger farming and business interests. Indeed, there is a general tendency in Latvia to stress the greater importance of economic development over environmental concerns. Nevertheless, Latvia’s service-driven economy and low population density makes it a relatively environmentally healthy country. Indeed, the Latvian state has made a tidy profit from trading its emission quotas. Accession to the European Union has led to stronger environmental legislation.

Environmental  
policy  
8

Government investment in research and development remains among the lowest in the European Union at 0.6% of GDP, well below the targeted 2% level as articulated in the Lisbon Agenda. Moreover, cuts in government spending that began in 2009 and will continue through 2012 have particularly affected education and R&D spending. Increases in spending in these sectors are unlikely in the near future. This will hit universities particularly hard, as the number of new students continues to decrease as a result of falling demographics (Latvians have had fewer children since independence) and increased foreign competition, with students often choosing to study abroad. This means that universities are likely to remain at the bottom of global rankings. Although education spending remains at 5% of GDP, far more needs to be spent on infrastructure development and teacher training, as few new teachers having entered the profession since the early 1990s, due to both the low prestige of the post and low salaries.

Education policy /  
R&D  
8



## Transformation Management

### I. Level of Difficulty

There are very few structural constraints on governance. While Latvia is among the poorest states in the European Union (only Bulgaria and Romania are poorer), it does fund all three levels of education and provide a basic transport and communication infrastructure. Moreover, Latvia is geographically located on the Baltic Sea, and has close links with the wealthy Nordic states, and is attempting to improve relations with neighboring Russia.

Structural  
constraints

2

Latvian civil society remains both small and weak. Organizations suffer from a lack of popular legitimacy and low levels of financing. Low legitimacy is a historical legacy of the forced voluntarism of the Soviet era, as well as the aggressive anti-civil society tone often adopted by two of the three major Latvian language daily newspapers (The Independent Morning Newspaper and Latvia's Newspaper). This anti-civil society rhetoric is usually directed at the Soros Foundation, which is presented as being a vehicle for foreign influence in Latvia's internal affairs. However, this typically feeds into a criticism of civil society as a whole, as the Soros Foundation has been the major financial supporter of grassroots civil society since the early 1990s. Indeed, there are few other financial resources available to civil society groups. There is no tradition of wealthy individuals donating to charitable organizations, and the general level of economic development is so low that most citizens are simply not able to contribute financially to civil society organizations. EU funding is typically tied to concrete projects rather than financing the general operations of civil society organizations.

Civil society  
traditions

4

Social capital thus is also low. Latvians have the highest levels of distrust in political institutions in the European Union and also have low levels of mutual trust. Mobilization remains low. A November 2010 protest against large public spending cuts, which was supported by all of Latvia's major trade unions, attracted just 200 protesters.

The major divide in Latvia is ethnic. Russian speakers (encompassing ethnic Russians and other eastern Slavs) and Latvians have their own newspapers, radio and TV stations, book publishing houses and even bookshops. The Latvian party system is also structured around this ethnic cleavage. Each ethnic group also has its

Conflict intensity

3

own national days of celebration. Latvians celebrate 18 November (national independence day) while Russians celebrate victory in World War II on 9 May. Latvians see 9 May, however, as the beginning of Soviet occupation. Nevertheless, this ethnic polarization does not result in major interethnic violent incidents; rather, both groups live peacefully side by side and cooperate in the private sphere.

## II. Management Performance

### 14 | Steering Capability

In broad terms, Latvia has maintained an extremely consistent policy direction since 1991. Foreign policy has focused on institutional integration with Western Europe, primarily through accession to the North Atlantic Treaty Organization (NATO) and the European Union (achieved in 2004). Economic policy has focused on building a market economy (primarily to meet the demands of EU membership), with regressive taxation and relatively low regulation. Social policy has targeted the maintenance of a very basic level of universal social service provisions. Political reforms have largely focused on improving the quality of democracy, for example introducing a human rights section to the Latvian constitution in the 1990s and the creation of a Latvian Constitutional Court. This remarkable level of long-term policy consistency can be explained by the conditional demands of international actors, such as the European Union as well as the center-right ethnic Latvian political parties' monopoly on power. Political conflicts have centered on particular issues, such as how major state enterprises should be privatized (not whether they should be privatized). Thus only policy details, rather than the broad direction of policy, have been open to challenge. The economic crisis of 2008–2010 did not alter the fundamental direction of Latvia's development.

Ideological continuity has ensured that successive Latvian governments have been able to implement their policies despite frequent changes of government. Latvia has seen 15 governments between 1993 and 2011, with the longest lived in office for 30 months, and the shortest for just nine months. Most recently, the two government coalitions led by Valdis Dombrovskis (2009–2010 and 2010 onwards) have managed to successfully agree on and execute radical cuts in government spending.

The greatest weakness of Latvian government involves policy learning. There is no tradition of utilizing academic or external experts in policy formulation (an exception includes externally imposed influence, for example pre-EU accession or following the 2008 IMF-led bailout). Political parties have no links with think tanks or policy experts, largely because of the cost this entails (party financing is directed

Question  
Score

Prioritization  
9

Implementation  
9

Policy learning  
8

at funding election campaigns). Governments have relied on the bureaucracy for policy formation. However, low salaries and a resulting high turnover of staff have weakened bureaucratic capacity. This lack of policy expertise was illustrated in early 2010, as the finance minister publically waffled over taxation policy, arguing in different venues on the same day that Latvia should either cut or maintain income tax rates, before eventually presenting a package of tax increases.

## 15 | Resource Efficiency

The country's rapid economic growth in the mid-2000s resulted in the rapid rise in the size of the Latvian bureaucracy, as well as sizeable increases in salary levels (partially fuelling the double-digit inflation of that era). The economic crisis of 2008–2010 led to a sharp downsizing in the size and benefits of the bureaucracy. This era of budget cuts gave the public access to information on the bloated salaries and benefits that some public sector areas received. These have now been cut, and a centralized salary system has been introduced. Moreover, there is now greater transparency with monthly salaries of all staff being publicized on public institutions' Internet sites. However, the government has yet to undertake a more systematic restructuring of the public sector, although several audits have been ordered in recent years. Although such a restructuring is one condition of Latvia's international bail-out, there appears to be a lack of political will to undertake such all-encompassing reform. This is largely because of the nature of Latvian government, as ministries are divided between political parties, which become fierce protectors of their own sectors, turning fundamental reforms into a zero-sum game.

Efficient use of  
assets

7

Coordination between different ministries and government institutions has been relatively weak because of the multiparty nature of Latvian government coalitions. The result of this fragmentation was clearly seen in the multiple budget cutting exercises in 2008–2010, which were mechanical (for example, 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 exact role of government.

Policy  
coordination

7

The Latvian Bureau for the Prevention of Corruption (KNAB) has proven to be a deeply polarizing institution. Its work has been limited by two major confrontations between the KNAB director (who is elected to the position by a parliamentary vote and can only be dismissed by a parliamentary vote of no-confidence) and the prime minister, who oversees the KNAB. The first confrontation ended with the dismissal of the KNAB director.

Anti-corruption  
policy

6

These incidents illustrate the problems in investigating and fighting corruption in Latvia. While administrative corruption (such as policemen accepting bribes) can be effectively fought, efforts to fight political corruption are hampered by the

influence of private money in political party financing. Indeed, the leader of the Union of Latvian Greens and Farmers Party and mayor of Ventspils, Aivars Lembergs has faced longstanding charges of corruption, but no trial has to date taken place. Meanwhile, his party has been a key member of every government coalition in the same period.

## 16 | Consensus-Building

All the major parties and political actors agree on Latvia's broad strategic domestic goals, which are building democracy and a market economy. However, Latvian and Russian-speaking political parties disagree somewhat over foreign policy (Russian speakers support EU membership but oppose NATO membership, arguing that it results in a confrontational position with Russia, with whom they favor much closer economic and political ties).

Consensus on goals  
10

The military (with 4,000 soldiers) is under the control of the civilian authorities. There exists no major organized group that opposes Latvian democracy or the market economy. One party that was elected to parliament in 2010, All for Latvia!, supports a populist anti-liberal agenda, particularly favoring a more hard-line approach to the country's Russian minority. Latvia has seen a rise in far-right group activity in recent years, primarily by skinhead gangs such as the virulently anti-gay NoPride movement as well as local branches of extreme Russian nationalist movements. Yet this growth has not been accompanied by extremist party success in elections.

Anti-democratic  
actors  
9

Ethnicity remains the major cleavage in modern Latvia. The 2010 parliamentary election confirmed that the party system is structured around a linguistic Latvian-Russian divide. Although a Russian-speaking party came second in the 2010 election, it was not taken seriously as a potential coalition partner. Yet there are few ideological differences between the parties, aside from general attitudes toward the Russian minority and the extent to which the state should support the Russian-speaking community (how many classes should be taught in Latvian in Russian-language state schools, whether Russian should be given official status, and so on).

Cleavage /  
conflict  
management  
7

A Special Assignment Ministry for Social Integration was created after the 2002 parliamentary election. Ethnic relations expert Nils Muiznieks, a fluent Russian speaker and of American-Latvian descent, was appointed to the post. The ministry experienced some limited success but was closed amid the 2008–2010 budget cuts. As a result, there is now no institution and no clear policy to govern ethnic relations in Latvia.

Accession to the European Union promoted the formal role of civil society in decision-making in Latvia. Parliamentary committees, ministries and other political institutions now routinely ask civil society organizations to offer expert opinions. However, the institutional weakness of civil society organizations as well as the influence of background economic actors or political party sponsors means that their involvement is often of a symbolic rather than substantive nature.

Civil society  
participation  
6

Formal cooperation takes place through the National Tripartite Council, which was created in 1998. However, it meets only intermittently. The economic crisis of 2008–2010 and the resulting harsh cuts to public spending gave new life to the council. Regular meetings took place in the weeks leading up to the budget announcements, although the extent of the council's influence on shaping the content of the budgets is open to question.

Governments have been responsive to the influence of mass protests, largely because protests have been rare in post-Soviet Latvia. The November 2007 “umbrella revolution” led to the resignation of Prime Minister Aigars Kalvitis, and the anti-government protests on 13 January 2009 led to the collapse of the Ivars Godmanis government.

Latvians and Russian speakers have starkly contrasting interpretations of 20th Century history. Latvians see their state's incorporation into the Soviet Union at the end of World War II and the near half-century of communist economic and social policies and Russification that followed as an historic injustice. Russian speakers tend to hold a more positive opinion of this era, and consider the end of World War II as a victory against fascism rather than considering the events as an occupation of Latvia. Rapprochement with Latvia's Russian-speaking minority has been slow, with restrictive citizenship and language laws being seen by many Russian speakers as a punishment for past history. Moreover, Latvians are deeply offended by the celebration of the Soviet Union that accompanies the annual 9 May celebrations (victory in World War II) at the Soviet-era Victory Monument in Riga. At the same time, Russian speakers are offended by the annual 16 March procession to the Latvian Freedom Monument in commemoration of Latvian Legionnaires, whom Russian speakers identify as the fascists that Russia fought against. These competing interpretations of history are quite deeply rooted in society and show little sign of abating. However, there have been signs of reconciliation with the Russian Federation, after President Valdis Zatlers' state visit in December 2010, the first by a Latvian head of state since 1995.

Reconciliation  
8

## 17 | International Cooperation

Latvia has traditionally relied on international assistance for its long-term development strategy. Thus accession to the European Union has shaped much of Latvia's domestic policy, while post-accession years have been marked by the country coming to terms with the use of EU structural and cohesion funds and rules within the Common Agricultural Policy. From 2007–2013, Latvia will receive over €4.5 billion in structural and cohesion funds.

Effective use of  
support  
9

Following the IMF-led international bailout of 2008, the IMF and the European Commission now assist Latvia with budget planning and fiscal advice, as well as assistance in major structural reforms of the public sector.

Latvia generally has a high level of international credibility. It has proven itself a reliable EU member state and has provided troops for NATO missions in Afghanistan and the Balkans, as well as participating in the U.S.-led war in Iraq. Finally, it has impressed the IMF, the European Commission and private ratings agencies with the consistency with which it has cut budget spending since 2008, and the fiscal discipline it has shown in realizing its internal devaluation policy.

Credibility  
10

Regional cooperation is a key dimension of Latvia's foreign policy. As a small country, Latvia has benefited from regional cooperation with wealthier states bordering the Baltic Sea (Sweden, Finland and Denmark, as well as the Nordic countries of Norway and Iceland. The former were particularly eager political supporters of the Baltic states' EU integration). However, cooperation with Lithuania and Estonia has been far weaker. Institutions of cooperation do exist (such as the Baltic Council of Ministers), but they are rarely utilized. In 2010, the European Union initiated its first "macro-region" in the Baltic Sea Region. The Baltic Sea Strategy (BSS) aims to further governmental and regional cooperation among the EU states that border the Baltic Sea, in areas that are of concern to all, such as environmental issues. The BSS is thus likely to be the vehicle for more integrated regional cooperation.

Regional  
cooperation  
10

Latvia has also increasingly lent its expertise to the European Union eastern neighborhood policy, by promoting democratization and the development of markets in Georgia as well as support for Moldova and Ukraine, countries which the Latvian government feels could benefit from its transitional experience to a market democracy. However, major cuts in government spending during 2008–2010 have led to a virtual end in bilateral cooperation, although such work does continue through EU financed projects.

To improve Latvia's relations with Russia, Latvian President Valdis Zatlers made a state visit to Russia in 2010, and Russian President Dmitri Medvedev accepted his

invitation for a return visit to Latvia. This opens up the opportunity for Latvia to fully utilize its knowledge of the Russian market, language and culture, and truly operate as a transport, communication and business hub between Russian and Western markets.

## Strategic Outlook

Latvia successfully weathered the 2008–2010 economic recessions and returned to modest growth in late 2010. However, the state still faces three major challenges. First, the state must find a model of socioeconomic development that is capable of driving stable growth. Second, the political system needs to reconnect with Latvian voters and earn their trust. Third, the fight against both administrative and political corruption must be renewed.

Latvia's socioeconomic policy since 1991 has been consistent, if not entirely successful. Consecutive governments have attempted to reconcile a low-tax regressive regime with the provision of an ever wider range of public goods, ranging from universal health care and generous maternity benefits (to promote demographic growth) to free higher education. However, the result has been a mediocre level of services. Health care outcomes, in terms of life expectancy and child mortality, are among the worst in the European Union. Hospitals are outdated and dilapidated, and medical staff is underpaid and thus open to "gratuity" payments (i.e., bribes) in exchange for services. Universities are grotesquely underfunded and uncompetitive. Latvian policymakers must make a decision between continuing with the low-tax regime and reducing the number of funded public goods (e.g., privatizing higher education and increasing co-payments in the health sector) or raising taxes in order to provide better services.

Latvians continue to distrust their politicians and political institutions. The most recent Eurobarometer report reveals that Latvia is the country that most distrusts its political parties and its parliament. The move to a state-funded party financing regime in 2012 is a big step toward minimizing the influence of wealthy individuals (known as "oligarchs" in Latvia). However, parties (and thus ultimately parliament) can also be legitimized by increasing the role of rank-and-file members. This can be achieved by raising the minimum membership number from the current 200 to at least 1,000. A full or partial ban on TV advertising would also force parties to organize more voter-focused election campaigns.

Finally, Latvia continues to be blighted by corruption. The anti-corruption bureau (KNAB) has been successful in fighting administrative corruption but has failed to deliver on the fight against political corruption largely because it has itself become a battleground for political skirmishes. As a result, the institution has lost much of its popular legitimacy. The only short-term solution to free the institution from political control is to either appoint a respected foreign national as director or to hand over the governance of the KNAB to an international organization. However, either of these moves would be challenged by both Latvian nationalists (because of the challenge to national sovereignty) and the parties that wish to maintain political influence over the institution. The judicial system also needs major reform. Aivars Lembergs, the mayor of Ventspils (the oil-transport port hub on the western coast of Latvia), was charged with bribery, fraud, money laundering and corruption in 2006, yet the case had not yet come to trial during the



period under review. Radical reforms would not only support the fight against corruption but also build public trust in the political system.