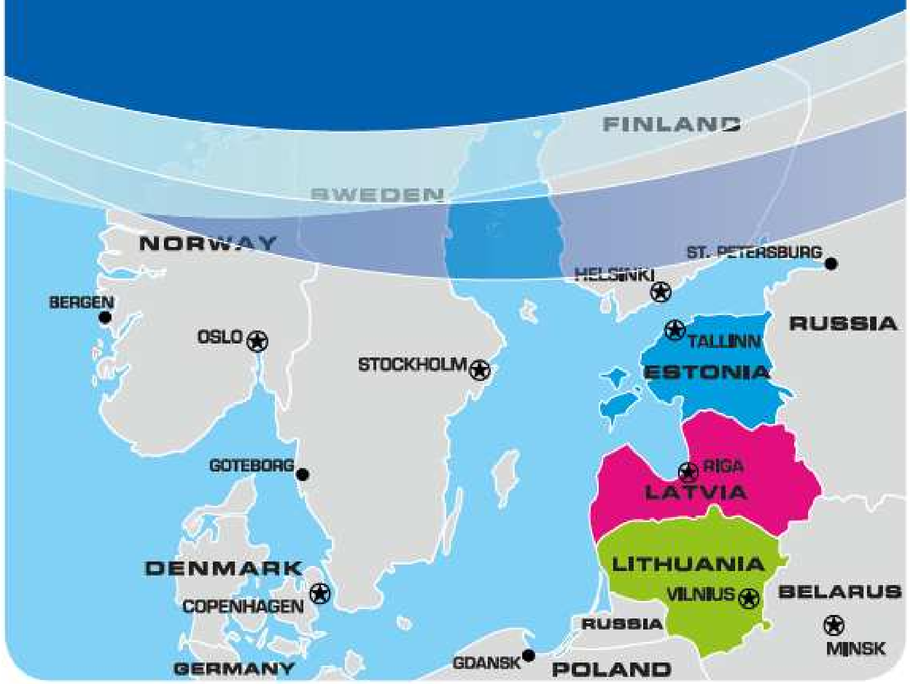
European Economic and Social Committee

ECONOMIC AND SOCIAL SITUATION IN THE BALTIC STATES

LATVIA



Study on the economic and social situation in the Baltic States
LATVIA

Jānis Kajaks[1]

Summary

After its accession to the EU, Latvia, like the other two Baltic States (Estonia and Lithuania) saw a sharp rise in its GDP (gross domestic product), justifying its rank as one of the "Baltic tigers." Between 2004 and 2007 Latvia's GDP rose by 33%, even reaching a growth rate of 12% in 2006. Many hoped that Latvia would maintain the same growth rate in the following years, which would have allowed it to catch up with the EU's average level of development without any problem in the near future. Unfortunately, its rapid development did not last long as its foundations were not solid. Foreign capital, which was freely available and cheap, was not invested in developing the economy but was mainly just used for consumption purposes (buying real estate, cars and various imports).

In 2007, three-quarters of the assets of all the commercial banks were in the hands of the four largest commercial banks in Latvia. Commercial banks with Scandinavian capital could obtain the resources they needed quickly and cheaply from their parent banks in Sweden and Finland. This is why, through competition and looking for an ever greater share of the market, these banks granted loans to Latvian citizens and businesses on very favourable terms and taking a very optimistic view of borrowers' creditworthiness. Latvia experienced an explosion of lending. The volume of credit granted in 2005-2006 was more than double the volume of that granted before. Easy access to credit also helped to boost the value of property. Between 2003 and 2007, property prices rose on average by 240%. The credit boom and rapid growth of the real estate market stimulated demand for all sorts of imports, which was previously non-existent. As a result, imports greatly exceeded exports and a big current account deficit became one of the main warning signs of an expected recession.

Although a slight deficit was provided for each year in the state budget, budget revenue estimates were always exceeded due to strong economic growth. Thinking that this would always be the case, the government allocated the extra revenue to new spending. As early as 2005, the International Monetary Fund (IMF) recommended that the Latvian government take measures to prevent the economy from overheating, but it was not until 2007 that the latter first turned its attention to the credit market, when high inflation was already really putting at risk the country's plans to introduce the euro in the near future. The measures taken by the government and the Bank of Latvia reduced the volume of credit but could not prevent the expected recession. The big commercial banks also became more and more careful and introduced tighter conditions of access to credit. The granting of credit was restricted even further, property prices began to fall, causing a chain reaction throughout the national economy. There was a sharp slowdown in consumption, trade and economic development in the country. The bankruptcy of the American company Lehman Brothers on 15 September 2008 led to foreign financial resources no longer being readily available and the main victim of this situation was the Parex banka, one of the most important commercial banks in Latvia in terms of local capital. The Parex banka was unable to refinance one of its syndicated loans and also in 2008, a quarter of the bank's deposits were withdrawn in the space of three months. The government felt that the Parex banka was too important a player in the Latvian economy, and so it decided to bail out the bank to the tune of around 1.2 billion lats. In view of the fall in revenue from the state budget and the problems in the banking sector, the Latvian government realised that it could not solve all the problems on its own. So, in late 2008 it turned to the only international financial institution which at that time could lend money to Latvia: the IMF. Another important partner in the negotiations on the international loan was the European Commission, which ultimately provided most of the financial support. The World Bank, the European Bank for Reconstruction and Development (EBRD) and several Member States also helped to put together the loan package. In the discussions on the loan terms and the economy measures required, the Latvian

1 Economics expert with the Latvian Confederation of Free Trades Unions.

government strongly defended the lats exchange rate against the euro and rejected any idea of devaluation. One of the main reasons given for keeping the exchange rate unchanged was Latvia's wish to join the eurozone in the near future. The discussions with donors were held *in camera*, preventing the participation of the government's social partners. Ultimately, out of the total loan amount of 7.5 billion euros, Latvia used only 4.5 billion euros during the recession, as the loan had been granted with certain strings attached, namely that the government should help out several Latvian commercial banks.

In 2009, the budget clean-up took place in two stages, as the situation continued to deteriorate during the year. In addition, at the beginning of 2009, there was a change of government in Latvia as a result of a loss of confidence in the government in power up to then, which had been unable to carry out the necessary reforms. The budget deficit for 2009 was brought down to 11% of GDP by cutting spending in almost all areas and raising taxes. In practice, this led to a big drop in public sector jobs and wages and a rise in VAT and excise duties. In the health and education sectors there were cuts in the number of hospitals, schools, doctors and teachers. The government also wanted to reduce pensions but was forced by a ruling of the Constitutional Court to pay all unpaid pensions.

When the 2010 budget was prepared, an attempt was made to maintain a minimum level of funding for education, health care, social protection, the maintenance of public order and national defence. The government felt that it was no longer possible to cut budget spending by as much as before, so budget consolidation was achieved largely by increasing taxes. From the beginning of 2010, the main Latvian economic indicators finally began to show signs of improvement. In the third quarter the first rise in GDP after nine quarters of decline was recorded (+2.9%). Between the second quarter of 2008 and the second quarter of 2010, GDP in Latvia fell by a total of 25%, with the biggest drop being recorded in 2009 (18%). The quickest recoveries were among exporting firms that were not dependent on domestic demand and had received extra support from the government. During the fourth quarter of 2010, GDP growth speeded up, so the overall drop in GDP for 2010 was only 0.3%. In 2011, public sector finances were also cleaned up, mainly by increasing taxation. Thanks to the continued steady growth of GDP in 2011, the budget for 2012 was significantly lower than in previous years and amounted to only 0.7% of GDP. By the end of 2011, Latvia had been able to successfully close the international loan programme. All the fiscal consolidation measures for the whole of the recession corresponded to 15% of GDP. Most of these measures were carried out at the beginning of the recession in 2009.

One of the most serious problems generated by the recession in Latvia was unemployment. It more or less tripled compared to its pre-recession level, reaching a record high of 20.5% in the first quarter of 2010. The sectors hardest hit were construction, trade, transportation and public services. As several occupations were no longer in demand on the labour market, the unemployed had to retrain or find a suitable job abroad. With support from the European Social Fund, the government took several active labour market measures during the recession to help the unemployed find work, retrain or even start their own business. The most popular measure was the temporary local public works programme in which some 120,000 of the unemployed took part between 2009 and 2011. A social safety net was put in place for the most disadvantaged citizens so that they could benefit from a guaranteed minimum income it they had no other income. Unfortunately, the state did not substantially increase the budget for welfare spending. The percentage of GDP spent by Latvia on welfare was about half the EU average. Because of the reckless budgetary policies of the previous government, the state lost a major part of the resources built up in the welfare budget, which are essential in a recession. The government therefore had to implement several measures to cut spending and boost revenues for the welfare budget. The taxes raised during the shakedown in public sector finances boosted growth in the underground economy and undeclared work, as the tax burden on workers had become excessive.

The social dialogue between government, employers and the unions took place in various councils and working groups. The tripartite social dialogue was held within the National Council for Tripartite Cooperation. In 2009 a steering group on reforms was established, which included the social partners and representatives of Latvian chambers of commerce and industry and the Latvian Association of Local Authorities. Unfortunately, the government often avoided discussing major issues with the social partners in good time and even if it did, their views were only rarely taken into account. During the recession the unions were faced with several attempts to violate labour law and refusals to comply with obligations under collective agreements signed previously. Working conditions in businesses operating or starting to operate in the underground economy worsened considerably. The recession also had a big impact on trade union membership, which fell by roughly a third during the recession.

For the first quarter of 2012, Latvia continued to post an excellent growth rate for GDP (+6.9%, the best result of all the EU Member States), based on exports and a gradual recovery in home consumption. In view of the good tax revenues and government forecasts for 2013, public spending cuts will no longer be necessary and it will even be possible to increase funding for economic sectors that have suffered most from the recession. However, Latvia still faces many urgent problems caused by the recession and the economic measures taken: high unemployment, huge income inequality, poverty, a fall in the number of inhabitants and workers, a big underground economy, a high tax burden for workers, etc. Sustainable economic development will not be possible while these serious problems remain unsolved.

Introduction

In order to get a better understanding of the current situation in Latvia, it is necessary to take a brief look at the country's history. Latvia only regained its independence from the Soviet Union (USSR) in 1991, which it had lost because of the Second World War. The Republic of Latvia was proclaimed on 18 November 1918 but it only existed as an independent state until the Soviet occupation and the setting-up of a communist regime in 1940. Because of Latvia's favourable geographical location, its well developed seaports, its high intellectual potential and the productivity of its workforce, several factories were set up under the Soviet regime which produced essential goods for the huge USSR market or its imposing military industry. All these factors helped to boost industrialisation in Latvia and produce a dazzling industrial boom. After independence in 1991, Latvia's economy went through very difficult times because of the collapse of the Soviet economy (of which Latvia had long been an integral part). GDP nosedived, the state budget deficit ballooned, the whole of the former USSR experienced hyperinflation, and demand for Latvian goods from the former USSR territories dried up. Despite this, the deficit in food and industrial products was still huge because prices had always been controlled and limited by the state. Latvia's GDP fell by around 49% between 1990 and 1993. The transition from a centrally planned to a market economy meant that a lot of systemic changes were necessary: the liberalisation of prices and trade, macroeconomic stabilisation and privatisation. It was necessary to create many new institutions and enact laws. To achieve monetary stability and independence and break its close financial ties with Moscow, Latvia introduced its own currency in 1992 which was initially the Latvian rouble and then the Latvian lats (LVL) from 1993 onwards. Privatisation of all sorts of goods was also started but this has been one of the most controversial processes in the history of Latvia after independence. On the one hand, privatisation was considered positive because it allowed many Latvians to recover their private property or that of their ancestors. On the other hand, many privatisations of business assets were considered unfair and utterly corrupt because it was possible to acquire many possessions of the state, including various types of businesses, for ridiculously low sums.

After the huge economic crash immediately following independence, the Latvian economy and GDP began to grow in 1994, but not for long because in 1995 the country experienced its first banking crisis. The main cause of this was the largest commercial bank at the time, Banka Baltija. Its fraudulent transactions and insolvency led to the bankruptcy of several other commercial banks, affecting almost 40% of commercial bank assets and 50% of customers' deposits. Because of this crisis, Latvia's GDP fell by 2.1%. In 1998, the recession in Russia left its mark on Latvia, but only caused a slowdown in growth. Most companies were able to quickly regroup, switch their activities to other markets and Latvian GDP continued to grow.

After EU accession in 2004, Latvia experienced an even higher rate of economic growth. Between 2004 and 2007, Latvia's GDP grew by around 33%. A similar growth rate could be observed in the other two Baltic States, which is why people started – quite rightly – to talk about the three "Baltic tigers" by analogy with the four East Asian tigers where growth was also very strong during this period: Hong Kong, Singapore, South Korea and Taiwan. It seemed then that Latvia would also maintain this growth rate in the years to come, which would allow it to easily catch up with the average level of development in the EU.

Main causes of the recession

Latvia's rapid development unfortunately did not last long since it was based primarily on a massive influx of cheap foreign capital that was used more for consumption (buying real estate, cars and various imports) than for developing the economy.

As labour was relatively cheap, this helped to boost company profits and growth. At the time of Latvia's accession, labour costs were about 20% of the EU average. At the same time, labour productivity was around 46% of the EU average. As wages rose, labour costs increased gradually but to only 30% of the EU average in 2007-2008.

After EU accession, economic development in Latvia speeded up considerably. Between 2005 and 2007, average GDP growth was 11% per year, even reaching 12% in 2006. At that time the national currencies of the three Baltic States were already closely linked to the euro, because this fostered macroeconomic stability and foreign investor confidence. Similarly, it was expected that, on average, three years after their accession to the EU, the three Baltic States would join the eurozone. The European Commission and the European Central Bank (ECB) also supported this idea, knowing that to be part of the eurozone, each Member State had to guarantee the stability of their national currency and meet all the other Maastricht criteria.

Although Latvia had regained its independence, established democracy and set up a market economy fairly recently, it had experienced an unexpected influx of foreign capital. All controls on capital flows by the state had already been removed before Latvia's accession to the EU, and the fixed exchange rate of the national currency (1 EUR = 0.702804 LVL) had destroyed the last possibility of limiting capital inflows. In 1998, the Russian recession favoured the merger of several small Latvian commercial banks, and some groups acquired Latvia's major commercial banks with Scandinavian capital. So, in 2007 three-quarters of all commercial bank assets were held by Latvia's four biggest commercial banks: Hansabanka (currently - Swedbank), Parex banka, SEB banka and the Latvian subsidiary of Nordea. Commercial banks with Scandinavian capital could obtain the funds they needed quickly and cheaply directly from their parent banks in Sweden and Finland. Given the low cost of the funds lent, the almost total lack of restrictions on the granting of loans and the high economic growth rate, Latvia experienced a credit boom. The volume of credit granted in 2005-2006 by the commercial banks was more than double the previous volume. Between 2004 and 2008, the value of banks' credit portfolios rose fourfold. The fastest growth was in mortgages, as there was a boom in the construction sector at the same time. As loans were easily accessible, property prices soared. In addition, at this time speculation on real estate (purchase and quick resale) was not taxed. The surge in the Latvian real estate market also caught the eye of Scandinavian banks, who saw some very good opportunities to make money, as the Scandinavian market then was not offering such promising revenue opportunities. The banks competed with each other in offering ever better and more advantageous loan terms of up to 100% of the value of a property and giving a very optimistic rating of borrowers' solvency. The volume of loans granted by the Latvian subsidiaries of Scandinavian banks accounted for only a small part of their overall loan portfolio and the income from these loans was much greater, so the banks were willing to take bigger risks than ever before to achieve greater market share and generate even more profits. The authorities supervising the national banks of Latvia and the Scandinavia countries were not worried about this and did nothing to rein in the rapid pace of lending.

After EU accession, Latvian inflation quickly gathered speed. In the first few years prices rose by 6 to 8% per year, but as early as 2007 the inflation rate was in double figures, reaching a peak of 17.9% in May 2008. The run-up in inflation at this time had several causes: the harmonisation or convergence of prices with those of other EU Member States, the sharp rise in the prices of oil and natural gas imported from Russia, the credit boom, the big jump in property values (between 2003 and 2007, property prices rose on average by 240%). Although the net average monthly wage more or less doubled between 2004 and 2008, for this same period Latvian wages only increased from 14% to 28% of the EU average and labour productivity reached 53% of the EU average. The credit boom and the rapid growth in the real estate market spurred demand for different types of goods which hitherto had been non-existent. As manufacturing companies in Latvia could not meet this demand in terms of product range or quality, most goods were imported. As a result, imports grew rapidly from 27% in 2004 to 31% in 2006, far outstripping exports, and the current account deficit peaked in 2006-2007 at 22.4% of GDP, becoming one of the main warning signals of a looming recession.

During this same period there was no problem with the state budget. Although each year the budget provided for a small budget deficit, budget revenue estimates were always exceeded due to strong economic growth, and in 2007 public sector debt was only 9% of GDP.

As early as 2005 the International Monetary Fund had warned Latvia that its growth was exceeding its real capacity to produce goods and services, wage and price inflation were too high, the current account deficit was rising and its chances of entering the eurozone were diminishing considerably. The IMF reported that lending by banks was stimulating consumption and pushing up property prices, which was not promoting sustainable development of the economy or generating added value. The IMF recommended that the Latvian government should take immediate steps to prevent the economy overheating, but because of the fixed exchange rate of the lats and the free movement of capital the possibilities were very limited. In fact, the country had only two tools with which it could exert its influence - budgetary policy and regulation of the banks. Unlike Estonia, which during the years of strong growth provided for a small surplus when preparing its budget, thus building up a safety net for a rainy day, the Latvian government had always prepared its budget with a slight deficit, thinking that the growth of the real economy would always be stronger than expected and earmarking all the extra money saved for new spending. When the economy started overheating several steps could have been taken but they were not applied to the banking sector because of the fear of too much state interference in the activities of the commercial banks or even the flight of some banks. However, the most surprising thing was that at that time there was no tax on real estate speculation; the tax on property was based only on the value of the land (there was no need to pay taxes for buildings), and investment income (securities transactions, deposits, dividends) was not taxed either. Any one of the taxes mentioned would have delayed the overheating of the economy or even prevented the bursting of the real estate bubble. It was not until 2007 that the Latvian government first turned its attention to the credit market, as inflation was starting its rapid rise which considerably exceeded the threshold allowed by the Maastricht criteria for adopting the euro. The government then began to try to curb inflation by every means possible. One of the first methods used was limiting the maximum volume of mortgage loans (compared to the value of the property) and applying stricter checks on a borrower's income, but unfortunately it was too late.

It could be said that the worldwide recession began in the second half of 2006 when property prices began to fall in the United States. Latvia's economy was then already "overheating", which is why it was one of the first to experience the recession. The recession took hold gradually. Its causes and extent were due to five key factors:

1) As the economy was overheating, prices rose sharply, and in order to continue along the path towards the euro the Latvian government drew up an anti-inflation plan focused on limiting commercial bank lending. At the same time, the Bank of Latvia (Latvijas Banka) took several steps to put the brake on lending (in particular, increasing the reserve requirement for commercial banks) The steps taken had a real impact and in mid-2007 the volume of loans began to fall.

2) Two of the biggest commercial banks in Latvia, Swedbank and SEB banka, brought in stricter lending terms in 2007 in response to the limits set by the government and at the request of their parent banks in Sweden, who had become much more cautious. The provision of credit was therefore sharply restricted and property prices fell by 35% in one year, which led to a big slowdown in demand, investment and economic development.

3) On 15 September 2008, when Lehman Brothers went bankrupt in the United States, the recession, which was already well established in Latvia, was made even worse because from that moment the country no longer had free access to foreign funds.

4) As the international financial market lost liquidity, the first and main victim in Latvia was the commercial bank Parex banka, which was the largest commercial bank in terms of Latvian capital and held 20% of the assets of all the commercial banks in the country. The Parex banka was no longer able to refinance one of its syndicated loans and, what is more, in 2008 a quarter of the bank's deposits were withdrawn within the space of three months. The government felt that the Parex banka was too big a player in the Latvian economy, so it decided to take it over by investing, as a starter, nearly 800 million lats or 4.9% of Latvia's GDP at the time. Without going into the details of how this bank was rescued, it should be noted that state support for

the restructuring of Parex banka came to a total of 1.2 billion lats. The state's support was mainly in the form of a cash injection and a stake in the bank's capital. At present, the state has recovered almost 37% of its what it put in.

5) Although Latvia was an EU Member State and thus a stakeholder in the ECB, it unfortunately did not have free access to European and international financial markets. It could not receive financial support from the ECB. It could then only turn to turn to international lenders, in this case the IMF.

Measures taken by the government to combat the recession and their impact

Although at the beginning of 2008 many local economic and financial experts issued warnings about the coming recession and Ivars Godmanis, who was prime minister at the time, was kept well informed, very little was actually done to try to avoid or alleviate the recession. The first serious steps to cut public spending were only taken at the end of 2008 when the prime minister announced the dismissal of 10% of staff working in public sector bodies and a wage freeze in 2009 in institutions funded by the state budget. The unions opposed this decision because it meant, in particular, freezing the salaries of teachers, doctors, the police and even other professions. In October 2008, more than 1000 health professionals took part in the strike organised by the trade unions to seek higher wages rather than having them frozen or cut. In October and November 2008, more bad news hit the Latvian economy: because of the recession and the general loss of solvency, production and retail sales also fell sharply, a number of small and medium-sized businesses went bankrupt and in November 2008 the unemployment rate was already 7.2%. To try and cope with the general shortage of money, the general public called first of all for big cuts in central government spending by reducing salaries and bonuses. Under the auspices of the prime minister, many of the measures mentioned were implemented. Amidst all this bad news, there were still some positive developments that occurred at that time in Latvia: after reaching its maximum in May 2008 (17%), inflation fell sharply by about 1% per month and exports began to catch up with imports, so the current account deficit declined significantly.

To reduce state budgetary expenditure, the prime minister proposed to cut spending in all sectors of the budget except for pensions and benefits for the worst-off. The government felt that all the planned economy measures would still not be sufficient to solve all the problems and ensure the solvency of the state, so an IMF technical mission was invited to Latvia in November 2008 in order to explore the possibilities of receiving an international loan. The IMF calculated that, to solve all its problems, Latvia would need about 7.5 billion euros, which it could receive gradually (by instalments) in the form of an international loan up to the beginning of 2011. In mid-November 2008, long and difficult negotiations were started between international lenders and representatives of the Latvian government. The Latvian government strongly defended the exchange rate of the lats against the euro (1 EUR = 0.702804 LVL) and rejected any idea of devaluation by pointing to the negative fallout suffered by states which had at some point chosen to devalue their currency. One of the main reasons for keeping the exchange rate was Latvia's wish to join the eurozone in the near future. The discussions and decisions on the scheduled economy measures and the terms of the international loan took place behind closed doors, thus preventing the involvement of the government's social partners. The Latvian Confederation of Free Trade Unions (LBAS) expressed its concern at the chaotic actions of the government and its inability to discuss the real state of the Latvian economy openly with society and the social partners and explain the need for the solution proposed. On 10 December 2008, the prime minister finally presented to the social partners the government's anti-recession plan, which included several tax changes as well as the wage cuts mentioned previously. The social partners rejected this plan, saying that the planned measures would further increase the number of unemployed, reduce domestic demand and make the recession worse. Despite all the objections and differences of ideas, the Latvian Parliament (Saeima) adopted the "programme for stabilising the economy and relaunching growth in Latvia" recommended by the IMF and the European Commission and was therefore able to sign an agreement on the international loan end at the end of December 2008. As a result, under the international loan programme, Latvia would receive financial aid from the European Commission, the IMF, the World Bank, the EBRD, several EU Member States (Denmark, Estonia, Finland, Sweden, Poland and the Czech Republic) and Norway. The amount of the planned budgetary shakeout in the programme for 2009 was extraordinarily high for Latvia: LVL 1 billion or 7% of GDP. Plans included a 15% cut in the public sector workforce, an average cut in wages of 15%, a 25% cut in the volume of public purchasing, a 3% increase in VAT (from 18 to 21 %) and an increase in the excise duties on fuel, coffee, alcohol and other beverages.

After receiving the first instalment of international aid (591 million euros from the IMF and €1 billion from the European Commission), Latvia had to immediately start bringing in the reforms provided for in the loan programme so as to first stabilise the economic situation and then improve it. Unfortunately, the Latvian government was unable to do so because, as a result of the recession and its slowness to react, it had lost the confidence and support of the general public, parliament and ultimately even the president of the republic. Social discontent at the situation in the country reached its climax on 13 January 2009, when civil society organisations and the trade unions organised a protest that turned into the biggest riot that Latvia had known since the restoration of independence, because of the aggressive behaviour of many young people who had no connection with the organisers. The parliament building, police vehicles and nearby shops were damaged. The coalition parties also gradually withdrew their support for the Latvian government and the prime minister, Ivars Godmanis, had no choice but to resign, which he did on 20 February 2009. The new government was headed by Valdis Dombrovskis, who had been Latvia's minister of finance from 2002 to 2004 and was recognised as an advocate of conservative financial policies. The economic situation continued to worsen and the IMF refused to pay the next instalment until Latvia had cut the state's budgetary expenditure by at least 20% from its 2009 figure. The new government undertook to do so, feeling that to save Latvia from bankruptcy, it would have to fully satisfy all the requirements of the lenders, despite their unpopularity and magnitude. The government's first goal was to cut spending so as to ensure the solvency of the state and its second was to implement key structural reforms. The previous government had adopted a budget for 2009 which provided for a cut in public spending equivalent to 7% of GDP. The new government proposed a further cut of 4%, bringing the total to 11% of GDP.

The most important structural reforms requested by the prime minister concerned the civil service, health care and education. The administrative machinery of the ministry of health was reduced by 44%, several hospitals were closed, the number of health professionals fell by 2700, a loss of 8% of the workforce. Following the reforms and economy measures, 115 schools were closed, 12% of the total number. The number of school staff was reduced in one year (2009) by 4000 units, or 14% of the workforce. No account was taken of the low population density in the rural regions of Latvia and since then people have had to travel a much greater distance to reach the nearest school or hospital. In the civil service 23,000 people (29% of staff) were laid off; in the second quarter of 2010, there were no more than 62,300 staff. There were also layoffs in the National Tax Service (VID), which lost 1,000 workers or 20% of its staff.

The most critical moment of the recession was in June 2009, when the European Commission had to pay most of its funding (€ 1.2 billion) and the IMF its next instalment (€ 200 million). As the economic situation in Latvia continued to worsen, international donors called for further cuts in public spending of around 500 million lats. The government drew up an amending budget that provided for cuts in almost all areas, except for social protection and financial obligations towards international organisations. The total cuts in budget expenditure were so big that before the adoption of the amending budget in parliament, the government proposed to all the coalition parties and the social partners and others that a specific agreement be signed on the state's amending budget for 2009. The social and other partners of the government (including the pensioners' federation) were faced with a very difficult choice: to approve the proposed amending budget and receive international aid or cause the insolvency and bankruptcy of the country. Given the situation, the social partners and others reluctantly signed this agreement. The economy measures were very severe: the number of key ministerial staff was cut by 30%, the number of public sector bodies fell by 50%, pensions and family allowances were cut by 10%, the pensions of retired people with a job were cut by 70%, the tax threshold for individuals went from 90 to 35 lats per month, excise duties were increased. Despite all these economy measures, it was expected that the budget deficit would be 10% of GDP in 2009 and 8.5% of GDP in 2010. In July 2009, Latvia received the funding promised by the European Commission and the IMF and the country remained solvent.

The 2010 budget projected a deficit of 7.5%. Among the major sectors, the government tried to maintain a decent minimum level of funding for education, health care, social protection, the maintenance of public order and national defence. Unfortunately, the government felt that it was no longer possible to cut budget expenditure to such an extent, so budget consolidation was achieved largely by increasing taxes, which provoked harsh criticism from the general public and the social partners. Personal income tax was increased by 3% (from 23 to 26%), a property tax on residential buildings and offices was introduced and the taxes on vehicle owners were also increased. The tax on capital gains and unearned income, which the LBAS had been calling for in recent years, was finally brought in. At the end of 2009, the Constitutional Court of Latvia upheld the complaint lodged by retired people concerning the cuts imposed on pensions by the government in June 2009. The Constitutional Court's irrevocable decision stated that the pensions cut was not consistent with the Latvian Constitution and all the sums withheld must be paid to the retired persons concerned. To do this, an extra 1% of GDP was needed. The government was lucky in this regard because the budget adopted for 2010 provided for a deficit reserve of 1%, and so extra budgetary restrictions were no longer necessary.

From early 2010 onwards, Latvia's main economic indicators finally began to show signs of improvement. The decline in GDP was significantly reduced at the beginning of the year and the first growth in GDP was recorded in the third quarter (+2.9%) after nine consecutive quarters of decline. Tax revenues began to exceed the volumes expected and the government promised the public that the budget cuts in 2011 would be less than originally planned. Exporting firms that were not dependent on domestic demand recovered the fastest. The government tried to help them in various ways. During the fourth quarter of 2010, GDP growth speeded up and so the decline in GDP for 2010 as a whole was only 0.3%. Exports were the engine of growth. In 2010, they rose by 30%, while thanks to them and a slight increase in domestic demand, production grew by 14%. The main exports were wood, wood and metal products and textiles. Between the second quarter of 2008 and that of 2010, Latvia's GDP fell by 25%, with the biggest drop being recorded in 2009 (-18%). No other EU Member State saw such a big fall in GDP.

In order to bring down the public sector deficit to 4.2% in 2011, the budget approved by the parliament provided for various rationalisation measures which, once again, were based largely on higher taxes. The standard VAT rate was raised from 21 to 22%, the reduced rate of VAT was increased from 10 to 12%, the property tax on residential buildings and apartments was doubled (to 0.6% of the rateable value) and the national social security contributions deducted from workers' wages were raised from 9 to 11%. To offset some of these tax increases, the government proposed to cut the tax on the income of individuals by one percentage point and raise the tax threshold. However, given that, in parallel with these measures, the price of electricity was raised and the reduced rate of VAT applied to it was suspended, the solvency of individuals and businesses was weakened even further. The government decided to raise the minimum wage to 200 lats per month before tax, hoping that this would boost tax revenue from the underground economy, where many workers were officially only paid the minimum wage.

Thanks to the continued steady growth of GDP in 2011 (+5.5% in a year), the budget consolidation measures adopted to achieve the aim of a public sector deficit of 2.5% of GDP in 2012 were much less than in previous years and represented only 0.7% of GDP. Most of these measures concerned cuts in public spending. Calculations show that during the recession, all the steps taken to clean up public sector finances corresponded to 15% of GDP. Most of these measures were completed in 2009. By the end of 2011, having fulfilled all the terms initially laid down, Latvia successfully terminated the international loan programme, and after several years, was no longer dependent on international lenders as regards its public sector budget decisions.

Despite events of increasing concern in the eurozone and various global challenges, Latvia continued to enjoy excellent GDP growth (6.9%) in the first quarter of 2012, the best of all the EU Member States. Total GDP growth for 2012 is estimated to be 2-3%. As export opportunities continue and home demand is rising, production in manufacturing is increasing. Most of the growth here is due to wood and metal processing. Growth is also visible in trade and construction, which shows that private consumption is still growing. In view of current trends and government forecasts for 2013, there will no longer be any need for budget consolidation measures and it may even be possible to think about boosting funding for those sectors that have suffered most from the recession: raise doctors' and teachers' pay, provide an envelope for highway maintenance, etc. In order to reduce the tax burden for workers a little, there are plans to cut personal income tax from 25 to 24% from 1 January 2013 and raise the tax threshold by mid-2013. At the same time, an increase in real estate costs is expected, since from 2013, local authorities will be allowed to set their own level of property tax at a rate ranging from 0.2-3% of a property's rateable value. The finance ministry has proposed not to apply a rate higher than 1.5% to buildings and apartments, but the government and parliament still have to take a decision on this matter.

Jobs and unemployment

Between 2001 and the start of the recession, the increase in economic activity in Latvia was accompanied by a rise in the number of jobs, while unemployment fell. The Latvian jobs market achieved its best performance in 2008: the overall employment rate reached 75.8% while the percentage of unemployed fell to 6.3%, one of the best figures in the EU at the time. But Latvia the recession had a much more devastating impact on the jobs market than in the other EU Member States, since the employment rate fell almost as sharply as GDP growth. According to Eurostat, unemployment in Latvia increased from 6.3% to 20.5% between the second quarter of 2008 and the first quarter of 2010; since then it has gradually improved. The layoffs affected primarily the young and low-skilled but also, unfortunately, older workers. The hardest hit sectors were construction, manufacturing, trade, transport and the public sector. The social repercussions of a high level of unemployment during a recession could not have been greater. The first reaction of the government was to alleviate the harmful effects: irrespective of the time they had worked, the unemployed could receive unemployment benefit for nine months, with the amount being gradually reduced, and this measure was maintained until the end of 2011. The percentage of registered unemployed who no longer received unemployment benefits rose from 43% in 2008 to 66% in 2010 and 76% in 2011. The number of unemployed persons not receiving benefit and the number of long-term unemployed only began to fall in mid-2011. For the unemployed, the chances of finding a job in Latvia remain low for two main reasons: 1) there are very few job vacancies, and 2) many of the unemployed lack the skills required for the jobs which are available. Age-wise, unemployment is at its highest among those aged 15 to 24 (28.1% in March 2012) and those approaching early retirement (15.7% of those aged 50 to 59).

During the recession the employment rate fell sharply in the 15-64 age group from 68.6% in 2008 to 61.8% in 2011. During the same period the number of self-employed increased slightly from 5.5% to 6.6%. The percentage of part-time workers also increased, from 6.3% to 9.2%, the main reason being that it was impossible to find a full time job. The largest number of workers was in the 25 to 54 age group, while youth employment (15-24 age group) fell unfortunately, possibly due to emigration in particular. In the first quarter of 2012, the main source of jobs was the trade, hotel and restaurant services sector, which employed 155,600 people, or 18% of the entire workforce. The figures for men and women in the 15 to 64 age group were very similar: in the first quarter of 2012, 62.1% of men and 60.3% of women had a job. The men worked mainly in industry (19.7%) and transport (16.5%) and the women in trade (23.3%) and education (16.5%). The sector where the recession had the greatest impact was construction, which provided work for a fifth of the male workforce in 2008 and only 12.7% in 2011. In other sectors there were no major changes during the years in question and it can be assumed that most of the interested parties chose to look for a job abroad. At the beginning of 2011, the gap between the wages of men women in Latvia was 16.6% on average, with its peak in the financial sector and its lowest in government and construction.

The latest available information on unemployment indicates that, according to Eurostat, the rate was 16.3% in the first quarter of 2012, but when measured by the National Employment Agency (NVA) it stood at 12.3% in May 2012, 0.6% less than in April 2012. There were fairly wide variations between the unemployment rates in the different regions of Latvia: in May 2012, unemployment reached 23.4% in Latgale, while it was only 8.5% in the Riga region, 13.2% in Kurzeme, 13.6% in Zemgale and 14.4% in Vidzeme. At the end of March 2012, the long-term unemployed accounted for 42.6% of the total number of registered unemployed. The unemployed registered with the NVA were looking mainly for a job in the most common occupations (assistance, retailing, cleaning), while according to the number of vacancies identified by the NVA, the demand for labour in March 2012 was concentrated in manufacturing industry, wholesaling and retailing, transport and storage, agriculture, forestry and fishing, accommodation and catering services. On 31 March 2012, 42.6% of all registered unemployed had been out of work for over a year and 8.3% for more than three years. Graduates of higher education made up 11.9% of the total number of unemployed, of whom 15.5% were economists, 14.3% engineers and 11% teachers. The number of registered unemployed continues to be significantly higher than the number of jobs: in March 2012, there were 44 applications from the unemployed for each vacancy. At the end of that month, the NVA had identified only 2900 vacancies. Most of the vacancies at the beginning of 2012 were for skilled workers in the processing industries.

In Latvia, one of the most painful consequences of the recession was to push a large number of economically active young people into leaving the country to find better working and living conditions abroad. As the government had opted for the route of so-called internal devaluation, which was to reduce wages, the number of workers and public spending, many Latvians found themselves without work or income and set off looking for new horizons outside their country, especially in Western Europe, where labour markets had already been opened up to migrant workers, except in Germany, where they were opened up later. Unfortunately no source is able to provide precise figures on the number of emigrants, as people leaving the country often fail to inform the government of their departure for a long time. From investigations conducted by local experts it appears that a total of 200,000 individuals could have left the country. The census conducted in 2011 corroborates these studies to some extent, since in 2011 Latvia had no more than 2 million inhabitants, although it had counted around 2.4 million in 2000, even if this drop is also due to a negative demographic trend.

Apart from unemployment, one of the other major problems affecting the Latvian labour market is a relatively high level of taxation. In addition to the taxation on employment, Latvia adds a tax on personal income (IIN), currently set at 25%, and compulsory contributions to the national social insurance scheme (VSAOI); these represent 35.09% of a worker's pay, of which 11% comes from the worker's pay packet and the remaining 24.09% is paid by the employer. If one compares the percentage of tax on personal income in Latvia (25%) to the progressive rates of this tax in other EU countries, one may have the impression that the tax burden is low. However, the situation is quite different if one considers that in more developed countries, the low-paid benefit from advantages of various kinds and also a reduced rate of tax adapted to their income. If one compares the tax burden on the low-paid in the various Member States as calculated by Eurostat, it emerges that in 2010 Latvia came sixth in the rankings, ahead even of Sweden, which is considered to be a country where taxes are high. As regards the taxation of labour, Latvia also came out ahead of the other two Baltic States. As this state of affairs represented a major threat to the country's international competitiveness, the government finally took notice and developed a plan to gradually bring down the tax rate on personal income to 20% by 2015, while raising the exemption threshold. Once all their taxes are paid, workers who only receive the minimum wage set by the state of 200 lats per month do not have enough to pay for even the basic necessities of life. The Central Statistical Office of Latvia (CSP) calculated that in May 2012 the minimum subsistence income per capita came to LVL 176.26 per month. But the CSP uses an outdated method to calculate this minimum subsistence income, so that the actual amount is even higher.

During the recession years, the underground economy swelled to unprecedented proportions: some experts think it might even have amounted to 40% of GDP. In a study published in May 2012, experts from the Higher School of Economics in Riga showed that in 2011 the underground economy's share had fallen to 30% of GDP but this level is still huge, even when compared with those of neighbouring states such as Lithuania (17%) or Estonia (19%). According to this research, only 36.5% of private companies in Latvia formally declare all their workers and only 14.6% inform the National Tax Service (VID) about what they pay all their staff. In the cases of fraud detected, roughly a third of the wages was hidden from the said service, so that the taxes on them were lower and workers received more pay. When a company operates in the underground economy, hiding its workers and their income and hiring staff without a contract, there can be no question of there being a normal business environment, where job security and other provisions of labour law are respected. In Latvia it is the job of the National Labour Inspectorate (VDI) to check compliance with the rules, but unfortunately its capabilities are very limited, since during the recession it too suffered cuts in resources and staff. The information it has collected shows that the situation in this area continues to deteriorate: during the first five months of 2012, it was found that the number of illegally employed workers increased by 10% compared to the same period in 2011. There were also more companies employing people without an employment contract.

One should exercise the utmost caution when analysing the statistics on pay cuts in Latvia in both the public and private sectors during the recession, and take into account the huge size of the country's underground economy, which has grown even more because of the recession. These statistics certainly show a bigger drop in pay in the public sector than in the private sector (26% compared with 10%), on the understanding that average pay is lower in the second than in the first, but the size of the drop has in fact been similar, as wages in the private sector are paid partially under the counter, thus evading tax, and a drop in this pay component does not appear in any statistics.

The social security system

The government faced major problems during the recession because of the special budget for social insurance, which was funded by the compulsory contributions from the national social insurance scheme (VSAOI), whose resources are used to pay pensions and social benefits. When the recession began, social budget revenues fell sharply, while the payments it was required to make rose significantly. As a result, the budget reserves that the social insurance scheme had accumulated during the years of rapid growth began to melt away faster than expected, so that the state had to think about what to do next. Even before the recession, much of the social security budget surplus was used to cover the general budget deficit of the state through deposits with the treasury. When social budget revenues suddenly fell it was impossible to recover this surplus which had been "lent out" in this way. Another source of problems was that in the years of vigorous growth, when contributions exceeded the levels expected, the government introduced extra welfare benefits for parents (parents' allowance), the cost of which was not actually covered by these levies. The first measure which increased the burden on the social budget was the cut in the state's contributions to the pension scheme (second pillar pensions) from 8% to 2%, which led to an increase in those from the first pillar, i.e. the social budget. Secondly, to reduce social budget spending, the government tried in June 2009 to cut pensions by 10% but the negative opinion by the Constitutional Court put an end to the initiative. The third measure was to cap benefits of any kind, including unemployment benefits, during the period 2010-2014, regardless of the income of the person concerned before seeking such assistance. In a fourth step concerning the social budget, workers' compulsory contributions to the national social insurance scheme were put up from 9 to 11% from 1 January 2011. A fifth measure worth mentioning is the decision, which has already been adopted, to gradually raise the retirement age from 62 to 65 by a quarter of a year from 2014 up to 2025. To justify this postponement of the retirement age the government is basically arguing that, if this is not done, in a few years from now the country will no longer have the money needed to pay for current pensions and new ones, because the number of jobs will not increase, especially since, due to the ageing population, the proportion of pensioners in the population will continue to rise (at the beginning of 2012, the ratio of taxpayers to pensioners was 1.59).

By exploiting the resources of the European Social Fund (ESF) and providing the corresponding national co-funding, the government has created a "social security net" to protect the most vulnerable sections of the population. One of the first steps taken was to increase the guaranteed minimum income (GMI) for people who were no longer entitled to unemployment benefit and had no other means of subsistence to 40 lats per month for adults and 45 lats for children. The state budget provides 50% of the funding for the benefits granted as guaranteed minimum income and 20% of the aid for housing, with the balance coming from local authorities. The right to receive a guaranteed minimum income is granted to anyone recognised as being in need, i.e. when their average income or that of any member of their family during the previous three months is less than 90 lats per month, with account also being taken of their overall financial situation and the fact that their monthly income has been below the legal minimum. For those with a retirement or disability pension, local authorities have the possibility of fixing another guaranteed minimum income per month which cannot be less than 40 lats or more than 90 lats. For a family, the allowance granted as guaranteed minimum income is equal to its theoretically estimated level, i.e. its specific value multiplied by the number of people in the family minus the total of all of their previous earnings. This is the scheme which is still in force today. According to data published by the ministry of social welfare, assistance under the guaranteed minimum income scheme was granted to 25,000 families in 2009, while in 2010 no fewer than 49,000 benefited. Housing allowances were granted to 87,000 families in 2009 and 98,000 in 2010.

Although it tried to increase public spending on social protection during the recession, the Latvian government had little success here, since in 2009 the country only allocated 17% of GDP for this purpose, when the EU average was 30%. In 2010, the figure rose only slightly, to 18% of GDP. Unemployment benefit was paid for only nine months and the amount gradually reduced to 45 lats per month during the last quarter. Since the beginning of 2012, the period during which such benefits are granted, ranging from 4 to 9 months, depends on the duration of the previous period of work, and in the last few months an unemployed person can claim only 50% of the allowance initially granted. The temporary public works programme that the ministry for social welfare launched with the assistance of the World Bank and the ESF has become very popular among the unemployed. Participation in this programme has given them the opportunity to earn a monthly allowance of 100 lats, a fairly modest sum but a welcome addition in such a recession. This programme was put into effect from September 2009 to December 2011 by the local authorities in cooperation with the National Employment Agency (NVA), but the entitlement was cut to 80 lats per month in the third quarter of 2011. A total of 120,000 people took part, filling approximately 80,000 temporary jobs in the municipalities. From 2012 to 2013, the long-term unemployed will have the opportunity to take part in a new programme funded by the ESF for "temporary paid workers": they will be able to sign up under similar conditions and receive a monthly wage of 100 lats. So, thanks to the funding of 14 million lats provided by the ESF, it is expected that around thirty thousand unemployed will be covered over the two years.

The government completed the programme of temporary work in the general interest that has just been mentioned by launching several initiatives as part of the active labour market policy, with the help of funding from the ESF and the World Bank. These were divided into four broad categories: 1) training for the unemployed, 2) training for people at risk of redundancy, 3) employment initiatives, and 4) career guidance. These measures basically consisted of the following:

- vocational training, retraining and skills development, giving the unemployed the chance to take a course in first or second level higher vocational education, with the costs being covered with training coupons issued by the NVA;
- initiatives to boost competitiveness, aimed at making the unemployed, job seekers and those at risk of redundancy more competitive in the labour market;
- measures for specific groups of people, ensuring that the unemployed were hired in jobs co-funded by the state;
- schemes to help people set up their own business or become self-employed;
- workplace apprenticeships designed to train the specialists needed by employers;
- combined aid measures.

In the first quarter of 2012, 57,600 unemployed persons took part in active employment measures organised by the NVA, each being able to take part in several initiatives. The most successful so far are the measures to boost competitiveness, the paid temporary work of general interest and non-formal training. The following statistics give some idea of the effectiveness of these measures:

- 33.5% of the unemployed who followed a vocational training, retraining or skills development scheme during the period 1 October 2010 to 30 September 2011, i.e. 6,925 people, found a job within six months of completing their course;
- 30.7% of the unemployed who took part in non-formal training between 1 October 2010 and 30 September 2011, or 24,650 people, found a job within six months of completing their course;
- 19.8% of the 6,141 unemployed who followed the non-formal training programme "mastery of the national language" during this same period, from 1 October 2010 to 30 September 2011, were recruited within six months of completing their course.

Social dialogue

At the time of the recession, the main forum in Latvia for hosting tripartite social dialogue at national level between the government, employers and workers (the Latvian Confederation of Free Trades Unions, or LBAS) was the National Council for Tripartite Cooperation (NTSP), which continues its work today. It contains eight internal sub-councils covering (i) tripartite cooperation on labour issues, (ii) social security, (iii) tripartite cooperation on vocational training and employment, (iv) the health care sector, (v) tripartite cooperation on transport and communications, (vi) tripartite cooperation on environmental protection, (vii) tripartite cooperation for regional development and (viii) public safety. Despite official recognition of the importance of the NTSP, the government has often avoided discussing major issues with it in good time and even when a particular issue has been discussed and a compromise position adopted, neither the government nor parliament is bound by it. The LBAS would like such deficiencies to be prevented as soon as possible. To ensure a better social dialogue and guarantee that the social partners are involved in national decision-making in times of crisis, prime minister Valdis Dombrovskis decided in July 2009 to set up a steering committee for reforms, which had been non-existent until then, including the LBAS, the Latvian Employers' Confederation (LDDK), the Latvian Chambers of Commerce and Industry (LTRK), the Latvian Association of Local Authorities (LPS) and representatives of the government. The committee's main task was to prepare the draft national budget for 2010 but also, in the long term, the budget for 2012, whose deficit was not to exceed 3% of GDP. In this way the prime minister tried to win the support of the social partners for the austerity measures proposed by the government and calm public opinion by showing that discussions and consultations had taken place. In order to accomplish the tasks assigned to the working group, the decision was taken to start work on real structural reforms to help cut the budget deficit and reduce the effects of the recession. But more often than not the working group instead discussed how to strengthen the national budget and put the issue of structural reforms on the back burner. The steering committee for reforms continues its work: this year, it is discussing and examining various issues, such as the outlook for the Latvian economy, the principles and directions of the structural reforms, employment, fiscal policy, social protection, civil service reforms or the principles for managing equity capital held by the state, to name but a few.

On numerous occasions during the recession, employers have urged the LBAS, as a social partner, to waive section 110 of the Latvian Labour Code, which provides protection for unionised workers by guaranteeing that they cannot be dismissed without the prior consent of their union except in special circumstances, such as the consumption of alcohol during working hours. The Labour Code states that the dismissal of an employee without the approval of their union is allowed only by court order. On the employers' side, several attempts have been made to violate social guarantees provided for in collective agreements concluded previously, e.g. regarding employers' contributions to workers' private pension funds. Even in the ranks of government, there have been calls for non-compliance with the obligations laid down in collective agreements. For workers in state institutions and local authorities, the government drew up a special law in 2009 "on the remuneration of officials and other staff of the institutions of the state and local authorities", in which it introduces severe restrictions concerning their wages, benefits and welfare guarantees, ignoring from the outset the obligations laid down in collective agreements (if there were any). It was only after incessant applications and tireless work that the LBAS succeeded in establishing that, despite the recession, businesses whose capital is controlled by the state or local authorities are also obliged to respect workers' rights as laid down in collective agreements: in April 2010, in fact, the government adopted a "Regulation on the list of corporations" which lists the corporations owned by the state and local authorities, i.e. private companies with capital from the public sector, which, in accordance with well-defined criteria, are entitled to pay bonuses, cash bonuses and allowances, and to take initiatives to encourage other types of payments in kind.

Trade union power was unfortunately hard hit during the recession, and membership fell sharply in parallel with the number of workers. At present, the LBAS represents around a hundred thousand employees, or about 12% of all workers, whereas before the recession, membership was approximately 1.5 times higher. The coverage rate of collective agreements also fell, to around 20%. Latvia imposes restrictions on the possibilities of taking strike action; if a strike is challenged in court, it has to be suspended until the court has delivered its judgment. Some professions that provide important services nationally, such as judges, prosecutors, police officers and firefighters, to name but a few, are not allowed to strike. Strikes in sympathy are also prohibited, unless they are related to non-compliance with conditions laid down in general agreements. All these factors meant that during the recession, Latvia did not have such wide-ranging protests as those in other EU countries, where the austerity measures were not as severe.

Trade union proposals for combating the effects of the recession

As the main advocate of the interests of unionised staff and workers in Latvia, the LBAS not only took part in the discussions on the proposals for budgetary discipline which were presented by the government but also made various suggestions to the latter for improving the country’s economic situation, as well as the working conditions and welfare of its workers. On several occasions since 2009, it has stressed that medium-term planning is necessary when drawing up the national budget. In order to ensure that the country's development is sustainable, the state budget should be calculated with an eye on not just the year ahead but on the next three to four years. In its statement, the present government has planned to introduce medium-term budget planning from 2014.

The LBAS has hardly ever stopped telling the government that the underground economy could be a source of extra revenue for the state budget. Finally, in 2010, following pressure from the social partners, a plan was drawn up with the real intention of combating the underground economy and stimulating legal businesses. Under the plan, 15 million lats were included in the amount for straightening out the 2011 budget as extra revenue produced by the efforts to combat informal economic activity.

Among the successes achieved by the LBAS in the negotiations with the government, mention must be made of the maintenance of national family allowances. In order to ensure that all Latvian children continue to benefit from these, the LBAS suggested several alternative sources of funding to consolidate the national budget, either by managing the state's funds more effectively, increasing the financial stability tax imposed on the commercial banks, or by centralising support functions in the ministries (accounting, the vehicle fleet, including maintenance, staff services, etc.).

At its seventh congress, held at the end of 2011, the LBAS adopted its strategic guidelines for action for the years 2012-2016 and the resolutions which it had discussed. In line with these, the LBAS urged the government to reduce the tax burden on labour and grant tax breaks to businesses that had collective agreements in order to offset some of the expenses incurred in providing the social benefits in them and promote socially responsible entrepreneurial activity.

Main conclusions and recommendations for the future

While Latvia had one of the world's fastest growth rates before the recession, it has lost about a quarter of its GDP since the recession hit. Although the economy is now growing at a good pace, the projections of the ministry for economic affairs suggest that, at best, it will not be able to reach its pre-recession level before 2015. The basic reason for this is that the country's development was based not on industrial production but on an influx of cheap and readily available foreign capital, which was invested in consumption in the form of loans granted by the commercial banks, thus creating an illusion of growing and sustainable prosperity. A boom in construction and real estate transactions boosted trade and imports of goods, and led to a surge in inflation and a rise in wages in a general trend that continued until capital stopped flowing into the country because of the worldwide recession. When construction activity and domestic trade suddenly dried up, the other sectors of the economy were not strong enough to provide the country with sufficient revenue, which is why the recession was so severe and painful. While Latvia, as an EU Member State, was not allowed to restrict the free movement of foreign capital, at least its central bank was able to restrict the volume of loans granted by the commercial banks. It actually took this initiative but unfortunately too late. It is hoped that through this experience and the improved level of the monitoring of commercial banks throughout the EU, the repetition of such errors can be avoided.

The manner in which the country overcame the recession and its after effects is mainly due to the refusal of the Latvian government to devalue the national currency and its insistence on keeping to the exchange rate which had been set with the euro. The shock arguments put forward in support of this decision were that it was necessary to preserve the stability of the banking system and avoid the occurrence of a regional crisis in the Baltic and neighbouring region, and that Latvia also wished to join the eurozone as soon as possible, which meant that the exchange rate of its currency is fixed and that the deficit of the national budget should be less than 3 % of GDP. It should, however, be pointed out that Latvian public opinion has never been much in favour of joining the eurozone and has become even less so recently because of the debt problems of the states using the currency. Several domestic and foreign economic experts have questioned the government's decision to depress the economy rather than devalue the currency, pointing out that the experience of other countries has shown that devaluation would help the country to recover more quickly by boosting exports and, in addition, the fall in GDP would not be as sharp and it would be possible to use international loans to preserve the solvency of the banks rather than the state. What would have been the results if this option had been chosen? We shall never know and can only hazard a guess on this point.

Fortunately, out of the 7.5 billion euros placed at its disposal in the form of international loans, Latvia only actually needed to use 4.5 billion, the main reason being that when the worldwide recession was at its height, the Latvian state only had to help out one of the country's largest commercial banks. It was also possible to save resources through administrative reforms: staff numbers in the ministries and civil service were cut, thereby making the system more efficient and less expensive. The social partners feel that the performance of the country's administrative apparatus can be improved even further, so work along these lines needs to continue. During the recession, Latvia increased the productivity of its workforce: compared to the average level in the 27 EU Member States, it was barely 51.6% in 2008, while in 2010 it had risen to 54.6%. Some may consider this trend very positive, but it must be noted that it was achieved mainly by cutting the number of workers, since businesses did not have the funds needed to invest in technological innovation and renewing equipment. If Latvia wants to continue to improve productivity, it must increase investment in technology and production line equipment.

Recently, one question has repeatedly been heard both in Latvia and throughout the EU: can the manner in which the country got out of the recession be described as a success and can it be transposed to other recession-hit Member States? It is possible to answer the first part of this question by comparing the main economic indicators before, during and after the recession. The only obvious improvements are the almost perfect current account balance (-1.2% of GDP) and the low level of inflation. If one compares the current situation with that during the worst period of the recession, it is clear that GDP has risen, unemployment has fallen, the average wage is slightly higher and the budget deficit is smaller, all of which should be considered as positive, but the fact remains that these indicators are still below their pre-recession levels. The main concern, however, is that several others have deteriorated and continue to do so, such as the tax burden on the employment of labour, the percentage of the population that risks suffering from poverty and social exclusion (40.1% in 2011) or the total number of inhabitants. If the government keeps its promises and reduces the tax burden on labour a little in 2013, the number of people at risk of suffering from poverty and of social exclusion could fall too. However, the approach chosen is unlikely to increase either the total population or the total number of people in work. And basically it is here that Latvia seems to have suffered during the recession: the number of inhabitants, particularly those of working age on whom the country depends for its continued development. By cutting its budget during the recession, the state has at the same time reduced its population.

The second part of the question can be answered briefly by saying that in theory it is certainly possible to apply the Latvian approach to other countries, but it is doubtful whether this will lead to a positive result. When deciding whether to use one or the other option, account should be taken in any case of the specific situation and features of the country, most – if not all – of which depend on both the decisions taken by the government of the country concerned and its population. One of the objective parameters that marks out Latvia from other states hit by the recession, especially those in southern Europe, is that the general government debt was low before the recession. Despite the high volume of international loans made available to the country, it only rose from 9% in 2007 to 44.7% in 2010, whereas now it is around 43% and was at 38.3% in the first half of 2012. The Latvian government, led by Valdis Dombrovskis, has said that during the recession most of the population approved its policy and the austerity measures that were taken, since there were no protests, demonstrations or collective disorder of any size. The prime minister felt that his victory in the 2010 parliamentary elections was also an endorsement of his policies. However, in reality social protest has taken a more unusual, somewhat hidden, route in the form of emigration for economic reasons and the underground economy. As the unemployed in Latvia have emigrated to other countries, the Latvian state has been able to stop worrying about them, official statistics have shown a fall in unemployment, savings have been made in the welfare budget and the state has even benefited as a result. When only a few members of any given family had left the country, leaving the others in Latvia, these migrants were able to send back some of the money they earned, and thus both support their family members and at the same time boost domestic consumption.

Exporting firms have helped the country to get out of the recession, since the demand for goods produced in Latvia has remained strong in its major trading partners, while the international competitiveness of its firms has improved because of the reduction of labour costs, carried out mainly at the expense of wages. However, at present there are not enough exporting companies, and their level of production is not high enough for the country to rely on them for its further development. New business and market niches need to be developed and domestic consumption encouraged. The Latvian economy cannot look forward to sustainable growth unless it is based on industrial production, manufacturing high added value products which can be marketed both at home and abroad.

If the government wants to cut back the underground economy to a "normal" manageable size, its only option is to regain the lost confidence of businesses and the general public by explaining and giving concrete examples of what taxes are used for, while reducing the overall tax burden. In the field of labour taxation, the most important initiative would be to increase the amount exempted from personal income tax (IIN), as this exemption threshold is at present the only fiscal policy instrument through which it may be possible to introduce an element of graduation, albeit at a modest pace, and social fairness. To help families with children, consideration could be given to raising the minimum threshold for exemption, in line with the number of dependants. The government's plan to transfer the tax burden from labour to consumption and property may not produce the desired effect, because people are concerned above all about the total amount of tax they pay rather than the relative significance of different types of taxes. This is also the conclusion revealed by the survey on the public’s views on national tax policy conducted on behalf of the LBAS by the Centre for Public Opinion and Market Studies (SKDS) in May 2012: 58% of those workers who replied said that they were not interested in the tax burden being transferred from labour to other areas, but they did want its overall level reduced.

The future development of the Latvian economy, at least in the short term, will remain heavily dependent on export opportunities, so its growth potential will be closely linked to growth prospects in its major EU trading partners. In any event, the success or failure of the development path chosen by Latvia will be decided primarily by the country’s ability to meet all the prior conditions required, such as a well-trained and skilled workforce, new jobs which can provide high added value products and services, and a tax policy that promotes growth.

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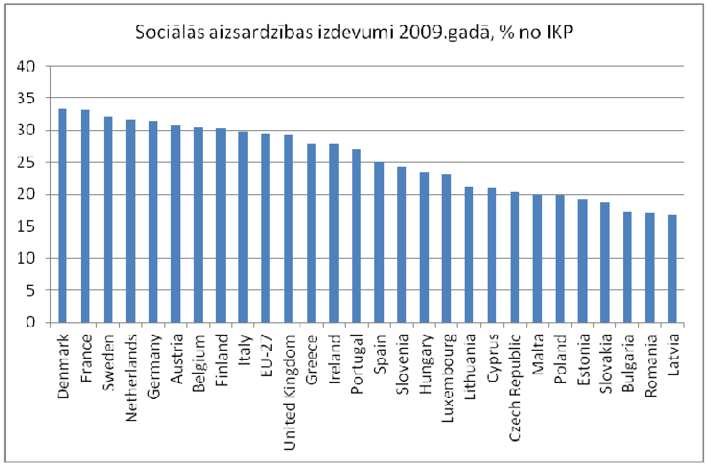
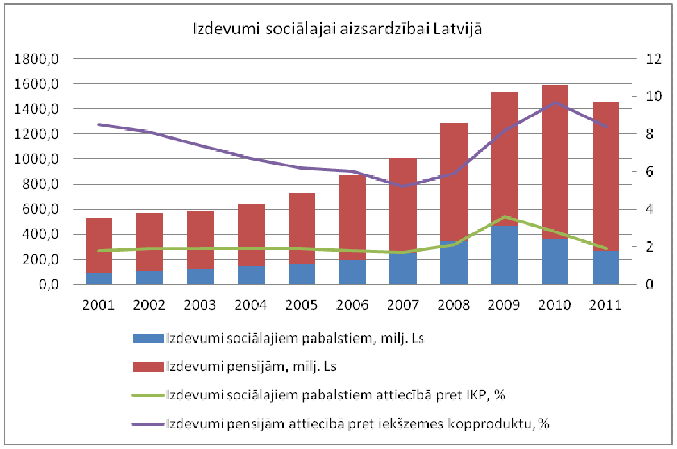
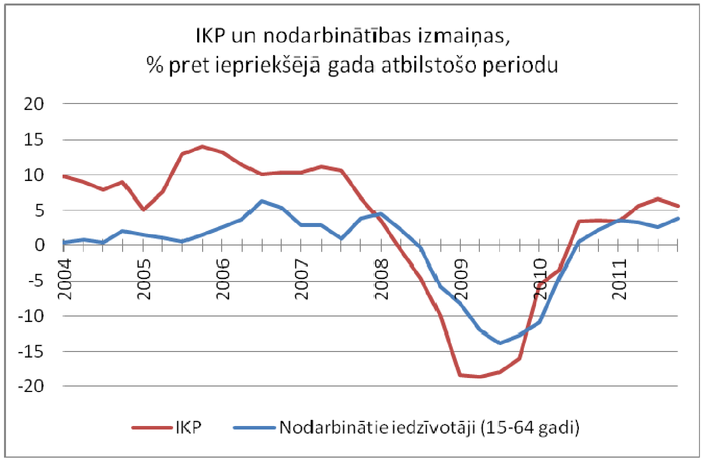
Tables and graphs



Graph 1: Social welfare spending in 2009 as % of GDP
Source: Eurostat



Graph 2: Social welfare spending in Latvia
Source: Latvian Central Statistical Bureau (CSP)
Blue columns: Spending on welfare assistance in millions of lats
Red columns: Spending on pensions in millions of lats
Green line: Spending on welfare assistance as % of GDP
Mauve line: Spending on pensions as % of GDP

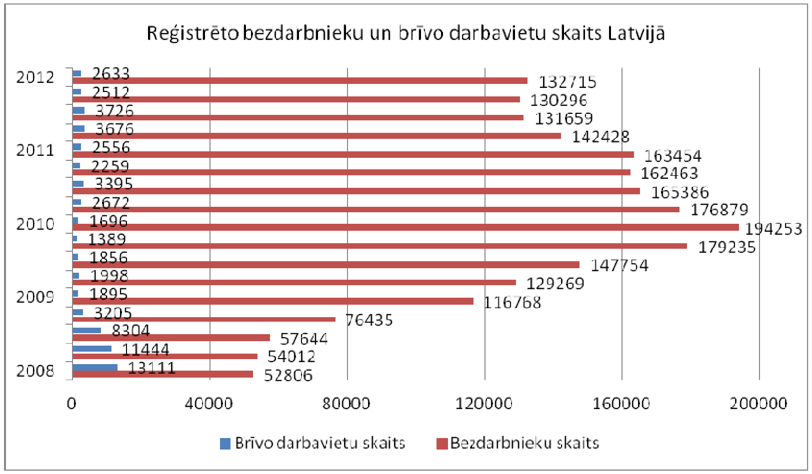


Graph 3: Variations in GDP and jobs, in % compared with the same period in the previous year

Source: Latvian Central Statistical Bureau (CSP)

Red line: GDP

Blue line: People in active employment (15-64 years)



Graph 4: Number of registered unemployed and vacancies in Latvia

Source: National Employment Agency (NVA)

Blue lines: Number of vacancies

Red lines: Number of unemployed

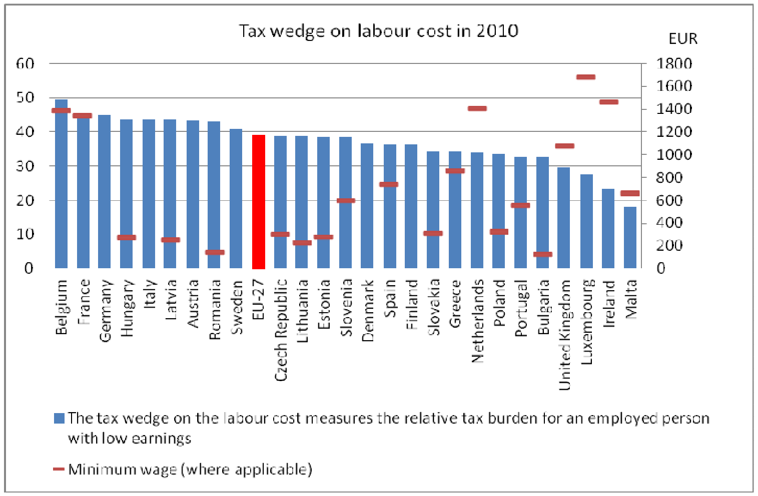
Table 1: Employed population, by sector of activity (in thousands)

Year	Quarter	Total	Agriculture, forestry and fisheries	Industry and energy	Construction	Trade, hotels and catering services	Transport, storage, information and communication services	Financial services, insurance, science and real estate management	Civil service and defence, compulsory social security	Teaching	Health and welfare aid	Other types of economic activity
2008	1st quarter	1137.8	80.9	206.0	130.3	208.1	126.3	94.6	88.3	90.1	53.7	59.1
	2nd quarter	1142.1	93.7	198.4	139.4	220.0	115.8	85.4	87.7	93.8	54.7	53.1
	3rd quarter	1132.5	96.6	195.8	131.6	219.8	122.9	86.8	87.5	90.8	52.8	48.0
	4th quarter	1085.6	83.0	191.7	113.6	202.1	129.6	86.4	83.4	94.1	48.8	52.1
2009	1st quarter	1046.7	82.8	178.5	96.2	195.3	123.6	94.9	74.6	95.8	48.3	56.5
	2nd quarter	999.3	89.4	175.3	89.0	188.3	99.6	95.6	70.4	92.5	48.8	49.9
	3rd quarter	953.9	90.6	149.4	70.0	190.4	111.5	83.2	67.6	89.5	46.7	54.7
	4th quarter	932.6	78.7	160.0	65.0	180.2	109.8	89.3	64.6	91.9	41.6	51.3
2010	1st quarter	916.1	74.6	160.5	58.5	174.4	112.4	89.9	63.4	92.3	45.6	44.2
	2nd quarter	936.0	85.0	156.4	63.8	179.1	111.0	92.4	62.3	94.2	48.0	43.1
	3rd quarter	960.3	85.0	157.0	70.1	185.8	112.3	95.3	62.2	97.4	48.2	46.8
	4th quarter	951.0	85.4	163.0	73.1	176.8	108.6	93.7	62.0	98.2	48.1	42.3
2011 *	1st quarter	835.9	76.7	134.1	57.9	157.2	93.8	87.3	58.8	84.3	52.0	33.1
	2nd quarter	858.5	78.5	136.5	60.1	161.0	104.1	89.4	60.1	86.8	48.5	33.5
	3rd quarter	875.1	77.9	137.7	62.2	167.5	98.3	93.2	59.5	89.7	50.9	38.2
	4th quarter	876.7	73.4	137.5	63.3	160.0	97.8	94.7	59.0	94.4	54.9	41.6
2012	1st quarter	857.6	75.6	132.6	56.1	155.6	98.3	94.9	58.5	92.1	55.3	37.6

Source: Latvian Central Statistical Bureau (CSP).

* According to the results of the population census of 2011.

The total includes those who did not specify a sector of activity in their reply. In the second half of 2013, it will be possible to access a version of the survey's findings on the active population that have been recalculated in the light of the data from the population census for each quarter of the years 2008-2010.



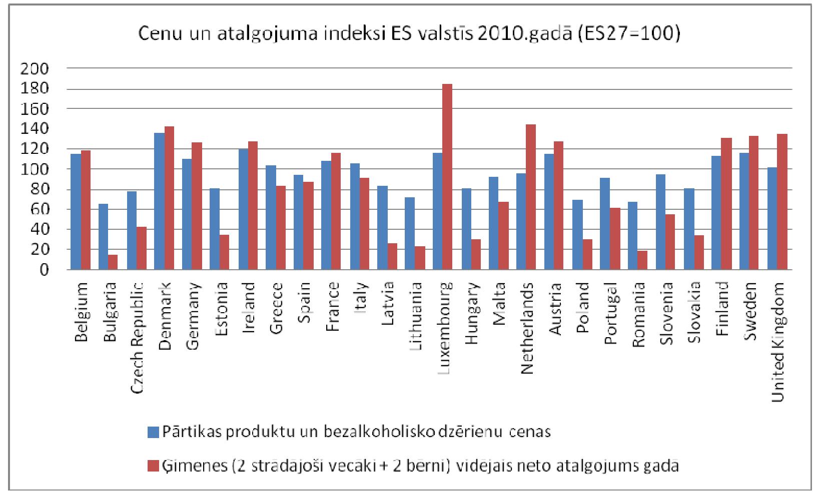
Graph 5: Tax pressure and minimum wages in the EU Member States in 2010

Source: Eurostat

Tax wedge on labour costs

Columns: The "tax wedge on the labour cost" table measures the relative tax burden for an employed person with low earnings.

Red line: Minimum wage (where applicable)



Graph 6: Index of prices and wages in the EU Member States in 2010 (EU-27 = 100)

Source: Eurostat

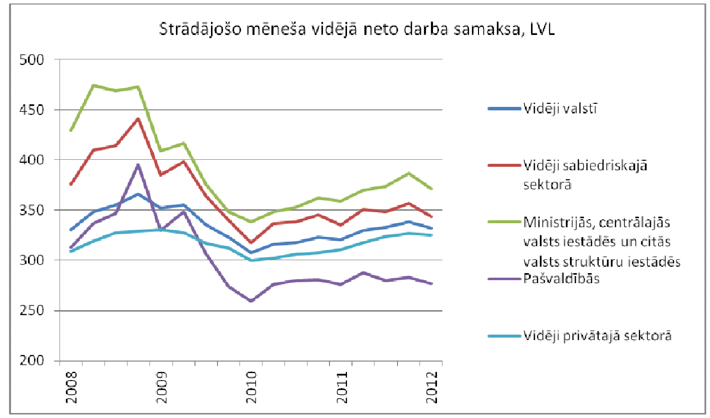
Blue columns: Prices of food and non-alcoholic drinks

Red columns: Net average annual income per family (two working parents and two children)

Table 2 Proportion (in %) of households financially unable to meet certain expenses

Year	Paying bills for municipal services, rent or loans	Heating their home	Meeting unforeseen expenses	Spending a week's holiday away from home	Eating meat, poultry or fish one day in two
2005	22.5	32.4	73.7	77.5	41.2
2006	13.8	27.3	72.4	70.4	35.5
2007	10.3	24.7	66.4	66.6	33.2
2008	13.0	19.1	61.0	56.7	27.4
2009	20.0	17.9	73.4	59.8	25.2
2010	23.8	21.4	79.0	61.8	28.5
2011	24.0	24.0	81.4	63.3	32.9

Source: Latvian Central Statistical Bureau (CSP)



Graph 7: Net monthly pay, in lats

Source: Latvian Central Statistical Bureau (CSP)

Dark blue line: national average

Red line: public sector average

Green line: ministries, central government and other state bodies

Mauve line: local authorities

Turquoise line: private sector average

Members of the Workers' Group representing Latvia

Abeltina Ariadna
Coordinator for external relations for the Free Trade Federation of Latvia (LBAS)
ECO - REX - SOC

Krigers Peteris
President, Free Trade Union Confederation of Latvia (LBAS)
NAT – REX - TEN

European Economic and Social Committee

Workers' Group
Rue Belliard 99
B – 1040 BRUXELLES

Workers' Group secretariat
Telephone : +32 2 546 99 32
Fax: +32 2 546 97 55
E-mail: gr2@eesc.europa.eu
Internet: http://www.eesc.europa.eu/gr2

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