

BTI 2010 | Latvia Country Report

Status Index	1-10	8.51	# 13 of 128	
Democracy	1-10	8.85	# 13 of 128	➔
Market Economy	1-10	8.18	# 14 of 128	➔
Management Index	1-10	6.71	# 14 of 128	

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

This report is part of the Transformation Index (BTI) 2010. The BTI is a global ranking of transition processes in which the state of democracy and market economic systems as well as the quality of political management in 128 transformation and developing countries are evaluated.

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Key Indicators

Population	mn.	2.3	HDI	0.87	GDP p.c.	\$	17342
Pop. growth	% p.a.	-0.5	HDI rank of 182	48	Gini Index		35.7
Life expectancy	years	71	UN Education Index	0.96	Poverty ²	%	<2
Urban population	%	68.1	Gender equality ¹	-	Aid per capita	\$	-

Sources: UNDP, Human Development Report 2009 | The World Bank, World Development Indicators 2009.

Footnotes: (1) Gender Empowerment Measure (GEM). (2) Percentage of population living on less than \$2 a day.

Executive Summary

Latvia experienced sharp political and economic extremes during the review period from 2007 to 2009. Politically, the period began with the seeming stability of the Aigars Kalvitis government – an experienced and popularly re-elected government – and the first in Latvian history. Economically, Latvia was experiencing the highest GDP growth in the European Union, and a credit boom was fueling a sharp rise in personal consumption. Real income was rising quickly, and the quality of life for much of the population was rising rapidly. The construction industry was roaring ahead, with workers being recruited from Romania, Turkey and even Germany. Many Latvians entered the real estate market and quickly benefited from rising market values.

However, the picture was radically different by January 2009. The Aigars Kalvitis government that was re-elected in October 2006 quickly squandered its political capital in an ill-judged attempt to reform oversight of the security structures in Latvia. In November 2007, a gathering of some 10,000 people in Riga's old town called for Kalvitis' resignation, and expressed their support for Aleksejs Loskutovs, the head of the Anti-Corruption Bureau that Kalvitis had attempted to dismiss. Kalvitis left office one month later, and his successor, Ivars Godmanis, inherited a dire economic situation. Latvia's breakneck economic growth was coming to a halt, and by the end of 2008 Godmanis was forced to ask international donors, led by the IMF, for a humiliating financial rescue package. The government was also forced to nationalize Parex bank, Latvia's last major domestically owned bank. Finally, a second major anti-government protest of some 10,000 people, held again in Riga's old town on 13 January 2009, ended in violence between police and protesters, with attacks on the Latvian parliament building, government ministries and private banks.

History and Characteristics of Transformation

The territory that makes up modern Latvia has been, at different times, a part of the Swedish, Polish and Russian empires, although the Baltic Germans remained the effective governors of Latvia throughout these different eras. A politically aware Latvian nation emerged in the nineteenth century as a result of peasant emancipation and urban industrialization. A Latvian political state then emerged in the aftermath of 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, seeing the formation of thirteen government coalitions by 1934. This political instability, accompanied by an economic crash in the early 1930s, led to a peaceful coup in 1934, and the formation of a benign dictatorship under Karlis Ulmanis, who combined the offices of prime minister and president in 1936. The years of dictatorship did not lead to any significant economic growth, but they 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 by the Soviet Union.

The years of Soviet occupation entailed redirecting and integrating the Latvian economy into the Soviet Union. Agriculture was collectivized, and cities and towns rapidly industrialized. Latvia's demography was drastically changed as the German and Jewish minorities virtually disappeared, many Latvians fled to the west, or were deported to Siberia, and an extensive influx of Russian speakers took place. The Soviet regime floundered in the 1980s as falling energy prices threatened economic stability, and the democratic reforms of Mikhail Gorbachev allowed the forces of Latvian nationalism and independence 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 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. The Latvian Supreme Soviet voted to restore independence in May 1990, leading to the establishment of parallel Latvian and Soviet government structures. De facto independence was achieved following the failed August 1991 anti-Gorbachev coup in Moscow.

At this point Latvia faced a radical political and economic transition. The political transition to a multiparty democracy began with the re-adoption of the 1922 constitution and the first post-Soviet parliamentary elections in 1993. Since then, Latvia has had five 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 come by, with

governments lasting, on average, little over a year. The 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).

Economic reforms during this period 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 was high in the early 1990s, and the quality of public services fell as government receipts collapsed. Two currency reforms (first instituting the Latvian ruble, then the Latvian lat) and rampant inflation in the early 1990s, as well as the collapse of several commercial banks in the mid 1990s, wiped out people's savings. However, the 2000s saw Latvia experience rapid economic growth, albeit primarily as a result of a construction and consumer-spending boom funded by cheap credit. The Latvian economy fell back to earth in late 2008, and the government turned to the IMF, the European Union, and even neighboring Estonia for a financial bailout. This led to violent anti-government protests in January 2009, a confrontation between parliament and the president, and the threat of early elections being called in the spring. Indeed, an opinion poll in late January showed 64% of voters favoring early elections.

Transformation Status

I. Democracy

1 | Stateness

The state has a monopoly on the use of force. The spontaneous anti-government riot on 13 January 2009 in front of the Latvian parliament was small and easily dispersed by the authorities.

Monopoly on the use of force

Following the renewal of independence in 1991 there were two possible routes that Latvian policymakers could follow in defining the demos of the state. One option was to grant all Latvian residents citizenship, the other was to institute a more restrictive law based on ethnicity. Latvian policymakers chose the latter route, and citizenship was granted to those individuals that were citizens before the 1940 Soviet occupation as well as their direct descendants. Those people that moved to Latvia during the Soviet era (overwhelmingly Russian speakers), about a third of the population (700,000 people), were denied automatic citizenship. In the 1990s, the government made several changes to the law, gradually opening up citizenship to anyone meeting residency and language-proficiency requirements. Despite an increase in naturalization applications after accession to the European Union in 2004, as of mid-2008 some 360,000 people (16% of the population) remained non-citizens. Non-citizens cannot vote in national, local or European elections, and are barred from holding certain public sector positions, but otherwise enjoy full rights and protections.

State identity

A remaining concern is the de facto existence of two societies in Latvia. Russian speakers and Latvians occupy different information spaces, with language-specific newspapers, radio and TV channels, internet portals, and theaters for each community. Moreover, the higher production values of neighboring Russian television also attracts viewers. The impact of this was clearly seen in August 2008 following the Russian-Georgian conflict when the overwhelming majority of ethnic Latvians expressed sympathy for Georgians, while Russian speakers took the Russian side. This ethnic divide is also reflected in voting patterns – Russian speakers vote overwhelmingly for Russian-speaking parties, and Latvians for nationalist Latvian parties. This ethnic cleavage still dominates Latvian politics.

Latvia is a secular state, with low levels of church attendance. Latvia's First Party, which was formed in the run-up to the 2002 parliamentary election, was quickly nicknamed the "priests' party," due to the fact that it recruited clerics to run for office and adopted a conservative religious rhetoric. The party has ensured government funds for church construction and reconstruction, and vociferously opposed gay rights on religious grounds. However, the constraints of Latvia's membership of the Council of Europe and the European Union means that this has not been translated into constitutional amendments or legal initiatives.

No interference of religious dogmas

The state extracts and allocates resources at local and national administrative levels.

Basic administration

2 | Political Participation

There have been no elections during the period under review. International observers, such as the Organization for Security and Cooperation in Europe, and the European Union, have declared all Latvian national and local elections since 1991 to have been both free and fair. There have, however, been a few incidents of vote-buying in local elections, resulting in criminal trials and repeated elections.

Free and fair elections

While elected rulers have the effective power to govern across Latvia, the nature of the Latvian political party financing legislation (parties are entirely financed by private funds) leaves political parties under the control of wealthy patrons. This has led to a lack of transparency in policy-making, and contributed to political disenchantment with the political class.

Effective power to govern

There are no restrictions on association or assembly, although the Riga local authority and the government have decided to ban public gatherings in the old town area of Riga (where the Latvian parliament is based), following the January 2009 anti-government protest that turned into a riot.

Association / assembly rights

Both the private and state-run media are free from direct government influence. However, the National Radio and Television Council, which supervises these electronic media, is composed of representatives from political parties, which are elected by the Latvian parliament. Moreover, private media ownership is opaque, and specific private media outlets express vociferous support for certain political parties.

Freedom of expression

3 | Rule of Law

Although the Latvian parliament elects the president, all post-Soviet era presidents have proven to be sufficiently independent officeholders, able to act as an effective check on the parliament's powers. During the review period, the president has returned laws revising the structure of the state security apparatus, and, in January

Separation of powers

2009, threatened the parliament with dissolution if certain laws and constitutional amendments were not tackled in a three-month timeframe. The executive has grown stronger in recent years, as political parties have created more effective party organizations, and tightened internal discipline.

The judiciary is a distinct profession in Latvia. However, the formal independence of the judiciary is compromised by a widespread perception of judicial corruption, seemingly confirmed by the lengthy terms of imprisonment imposed on two judges in 2008. Moreover, in 2007 a best-selling book revealed corrupt, illegal, and off-the-record conversations between judges and lawyers, which led to the resignation of several judges and an investigation by the prosecutor's office. As a result, public trust in the judiciary is low – 59% of the Latvian public distrust the judiciary according to the January 2009 Eurobarometer report.

Independent
judiciary

The Bureau for the Prevention of Corruption (KNAB) was founded in 2003 to fight corruption in public institutions. However, in recent years it has become highly politicized, with government ministers questioning the professionalism and independence of its staff, leading to the controversial, and disputed, firing of its director in 2008 (he was first suspended, then reinstated in 2007, following an expression of public support that resulted in the resignation of the then Prime Minister Aigars Kalvitis). As of January 2009, the highly charged and politicized nature of appointing a new director means that this vacancy is yet to be filled. Despite this political pressure, KNAB has successfully investigated corrupt police officers, civil servants and local politicians. However, despite the arrest in 2007 of the mayor of the wealthy oil-transit town of Ventspils, a figure that the public has long suspected to have been guilty of corrupt practices, he has yet to come to trial. Indeed, despite the Latvian public's perception of high levels of political corruption in Latvia, no national politicians have yet been held to account in a court of law.

Prosecution of
office abuse

Latvia's first ombudsman, Romans Apsitis, was elected to office by the Latvian parliament on 1 March 2007. There are no restrictions on the civil rights of women, religious groups or ethnic groups in Latvia. A large anti-gay rights movement (NoPride) has been mobilized by extremist political groups and Latvian mainstream churches, resulting in violent protests against the annual gay rights march. However, this has not translated into restrictive anti-gay legislation.

Civil rights

4 | Stability of Democratic Institutions

Accession to the European Union and Latvia's rapid economic growth have enhanced the effectiveness of Latvia's democratic institutions in recent years. These two developments brought about increased investment in the public sector, which led to higher salaries and more internationally oriented work, which in turn made the public sector more attractive as a career path for higher caliber recruits.

Performance of
democratic
institutions

Accession to the European Union has also resulted in a more powerful executive branch, as the complicated and technical nature of European legislation places an increased load on ministries at the expense of the legislature.

Latvia's democratic institutions are seen as legitimate and, despite a tendency for informal, back-room dealing – as in the summer of 2007, when representatives of the ruling government coalition parties decided on their candidate for president in the Riga Zoo a few weeks before the parliamentary vote – there is a basic commitment to democracy among elites.

Commitment to democratic institutions

5 | Political and Social Integration

In the first decade and a half of post-Soviet politics, voter behavior was extremely volatile and the party system highly fragmented. The effective number of parties is 6.00, indicating a fragmented party system. Indeed, the first four post-Soviet parliamentary elections were each won by a party formed less than one year before the poll. Moreover, parties have regularly fragmented and collapsed, with new parties emerging in the wake of collapse. The major exception was the 2006 parliamentary election, which saw no new parties elected to parliament. However, one year after the election, the parliament contained two parties that had not been elected to parliament, but were formed through the fragmentation of other parties.

Party system

Parties tend to be weak because they over-rely on financing from wealthy business groups and sponsors, which alienates them from society and marginalizes the role of party members. Parties generally have few members (typically around 1,000), a top-down organizational structure, and few links to grass-roots organizations. The party system hinges on the core ethnic cleavage between the Latvian and Russian-speaking populations. Russian-speaking parties form a permanent opposition in parliament (holding roughly one-quarter of parliamentary seats), and government coalitions are composed of the predominantly center-right ethnic Latvian parties.

Interest groups in Latvia are rather weak. Trade union activity was extremely low in the years immediately after the collapse of the Soviet regime, although their role has been steadily growing in recent years. The most important trade unions represent public sector workers – teachers, doctors and nurses, and the police. Unions are almost invisible in private enterprises. Environmental, associational and sectoral interest groups do exist, but suffer from a paucity of funding. Employers' organizations – primarily the Latvian Employers' Confederation and the Latvian Chamber of Commerce and Industry – have risen to prominence in recent years, and have been active social partners in negotiations with the government on budget reform in 2009. Informal economic and business interests, with their close financial ties to political parties, are far more influential.

Interest groups

Although there is no recent opinion polling on public support for democracy, throughout the post-Soviet era a majority of the public have indicated their support for the democratic system. At the same time, however, there has also been significant support for a government led by a “strong leader” or a government of technocrats.

Consent to democratic norms

The low level of citizen interests and participation in civil society activities is indicative of the low levels of interpersonal trust and social capital in contemporary Latvia.

Associational activities

II. Market Economy

6 | Level of Socioeconomic Development

The transition from a Soviet to a more market-based economic model has resulted in increased poverty and greater income inequality. In 2008, Latvia was ranked 44th in the United Nations’ Human Development Index with a score of 0.863, directly behind neighboring Estonia and Lithuania. At the same time, Latvia has the highest absolute poverty rate and extreme absolute poverty rate in the European Union (excluding Bulgaria and Romania). One-third of the Latvian population can be defined as poor, a situation that is partly offset by the fact that many people in rural areas – which are generally prone to poverty – live off of their own agricultural production. In addition, given the large size of the shadow economy in Latvia, income underreporting must also be taken into consideration. The groups most at risk of poverty include pensioners, the unemployed, one-person households (i.e., where there is no income pooling), single parents, and families with more than one child. Latvia’s 2008 Gini coefficient of 37.7 is amongst the highest scores in the European Union, meaning that the distribution of income among households is rather unequal.

Socioeconomic barriers

Economic indicators		2004	2005	2006	2007
GDP	\$ mn.	13761.6	16041.8	19935.2	28765.9
Growth of GDP	%	8.7	10.6	12.2	10.0
Inflation (CPI)	%	6.2	6.8	6.6	10.1
Unemployment	%	10.3	8.7	6.8	6.0
Foreign direct investment	% of GDP	4.6	4.4	8.3	7.8
Export growth	%	9.4	20.3	5.3	12.5
Import growth	%	16.6	14.8	17.5	16.9
Current account balance	\$ mn.	-1761.8	-1992.3	-4521.6	-6484.9
Public debt	\$ mn.	1580.2	1318.2	1553.3	1808.7
External debt	\$ mn.	12708.5	14505.2	22793.0	39342.4
Total debt service	% of GNI	10.7	20.5	17.0	35.3
Cash surplus or deficit	% of GDP	-0.9	-0.9	-0.5	0.8
Tax Revenue	% of GDP	13.6	15.1	15.9	15.6
Government consumption	% of GDP	19.5	17.4	16.6	17.2
Public expnd. on edu.	% of GDP	5.1	-	5.1	-
Public expnd. on health	% of GDP	3.3	3.4	3.9	-
R&D expenditure	% of GDP	0.4	0.6	0.7	0.6
Military expenditure	% of GDP	1.7	1.7	1.8	1.7

Sources: The World Bank, World Development Indicators 2009 | UNESCO Institute for Statistics | International Labour Organization, Key Indicators of the Labour Market Database | Stockholm International Peace Research Institute (SIPRI), Yearbook: Armaments, Disarmament and International Security.

7 | Organization of the Market and Competition

The foundations of a market economy were established in the 1990s as Latvia prepared for accession to the European Union and NATO. However, there are three factors currently undermining true market competition. First, the private financing of political parties, as well as established corrupt practices, have undermined honest and transparent competition for state procurement contracts. Second, there is a large informal part of the economy in which income and other taxes are evaded. Third, the honesty of courts and the judiciary, which rule on disputes in the private sector,

Market-based
competition

has been questioned in the light of recent scandals, including the imprisonment of two judges and the disbarment of a leading lawyer taped discussing bribes to judges with his client.

Latvia has a Competition Council, and is now subject to stringent EU, as well as national, competition laws. The number of resolutions adopted by the council has risen sharply since EU accession, from 68 in 2005, to 110 in 2008. Indeed, the council issued a total of 573,000 Lats (over €800,000) in fines in the same year. The biggest recent dispute has been with the Riga airport and its practice of granting discounted landing fees to its biggest airlines. The railway and energy networks remain the only major spheres not to have been liberalized. Latvian antimonopoly policy includes price regulation for public services that are mostly provided by monopolists or monopolized sectors. Price regulation is the responsibility of the Public Utilities Commission. The commission sets the prices and tariffs of public services such as fixed telephone lines, gas and water supply, transport services, and electricity.

Anti-monopoly
policy

Foreign trade has been liberalized and integrated into EU trade policy.

Liberalization of
foreign trade
Banking system

The banking system first proved to be the Achilles heel of the financial system in 1995, when several banks, including Latvia's biggest, Banka Baltija, collapsed and hundreds of thousands of Latvians lost large amounts of money. This was largely due to weak levels of supervision conditioned by an inexperienced private banking sector. These weaknesses have been largely corrected through more than a decade of additional experience, which has seen most of the biggest Latvian banks bought out by foreign, largely Nordic, investors, as well as the creation in 2001 of the Financial and Capital Market Commission, an autonomous public institution that supervises Latvian banks and other financial institutions. However, foreign-owned Latvian banks, which dominate the domestic banking sector, have a large debt-to-asset ratio. A weak international banking sector, particularly its lack of liquidity, resulted in the near collapse, and subsequent nationalization of Latvia's oldest private bank, Parex, in late 2008.

8 | Currency and Price Stability

The domestic credit boom that followed EU accession fueled a sharp rise in inflation. Despite criticism from international financial institutions and the Bank of Latvia, the government did little to dampen inflation from 2007 to 2009, but rather continued to increase government spending and rapidly raise public sector salaries. In 2007 and 2008 the Bank of Latvia spent hundreds of millions of euro from its reserve to prop up the Latvian lat on the currency markets and maintain its peg of 0.702804 lats (+/- 1%) to 1 euro. The government also resisted calls for devaluation in late 2008 when negotiating a financial rescue package with the IMF and other

Anti-inflation /
forex policy

lenders. Approximately 80% of bank loans are in euro, and it was feared that devaluation would lead to a mass loan default and collapse of the banking sector.

Latvia has low levels of public debt, largely because of the fact that it inherited no debt from the Soviet Union in 1991, and the government budget has been balanced in recent years. However, despite rapidly rising government income in the 2000s, the government failed to save surplus income, which accounts in part for the government's appeal to international donors for financial help as tax receipts began to fall drastically in 2008. Latvia's current account deficit, which reached a high of 27.1% in the fourth quarter of 2006, then fell to 23% in 2007, before falling to 19.4% in the first quarter of 2008, is one of the widest in Europe.

Macrostability

9 | Private Property

There is adequate legislation safeguarding property rights of Latvian nationals as well as foreign investors.

Property rights

The private sector employs about 75% of the Latvian workforce, and accounts for a similar share of Latvia's GDP. Privatization is largely complete in Latvia. Most small enterprises were privatized by 1995, although privatization of the large enterprises only began in 1994 after the Latvian Privatization Agency began its work. Privatization has proved to be a highly contentious and politicized process that remains unfinished largely because of political disputes in the governing coalition. A prominent example of this is the failed privatization of the profitable Latvian telecom giant, Lattelecom, in 2007. The Latvian electricity monopoly, Latvenergo, is protected from privatization by a 2000 law adopted by parliament following a national petition that gathered over 300,000 signatures.

Private enterprise

10 | Welfare Regime

Latvia has a comprehensive state-funded welfare system, although it is severely underfunded. This has led to a situation in which both formal and informal mixed public-private financing regimes have been established. There is a universal healthcare system, although certain visits to family doctors, specialists and procedures require co-financing. Many employers, including state institutions, provide private health insurance to offset these costs, but pensioners, and others at risk of poverty, find it difficult to co-finance their health care costs. Doctors are also known to receive off-the-books "gratitude" payments from patients in exchange for treatment. Indeed, shortly before taking office, the current president of Latvia, Valdis Zatlers (an orthopedic surgeon) admitted to having accepted such payments and having failed to declare them to the tax authorities. Latvia also has a mixed pension system, with pensioners who worked during the Soviet era receiving small

Social safety nets

pensions that is based on receipts from current workers but is often below the official monthly subsistence level. However, a 1990s pension reform introduced a much lauded capital-funded pension scheme for current employees. Unemployment and maternity (and paternity) benefits are based on prior income and tax contributions.

Women and ethnic minorities have equal access to higher education, public services and employment. While more than two-thirds of students in higher education are privately funded, potential students have access to cheap student loans in order to finance their education, and the higher education system also allows students to hold down part-time and, in some cases, even full-time employment while enrolled in tertiary programs. However, women still suffer from wage discrimination, receiving smaller salaries than men in similar positions. Individuals have recourse to the ombudsman's office in the event of discrimination.

Equal opportunity

11 | Economic Performance

GDP growth was extremely high following accession to the European Union in 2004, reaching double digits from 2005 to 2007. This was primarily a cheap credit-fueled consumer, construction and real-estate led boom. It was accompanied by growth in tax revenue leading to balanced, but not surplus, budgets. However, high rates of inflation, particularly wage inflation that was not accompanied by gains in productivity, as well as a large current account deficit, led to fears that the Latvian economy was heading for a "hard landing." This duly happened in the fourth quarter of 2008 when the Latvian economy entered into a recession that is expected to last until the end of 2010. Tax receipts fell so rapidly that in November 2008 the government was forced to appeal to the IMF and other international lenders for a bailout package of around seven million euro.

Output strength

12 | Sustainability

Although an ostensibly green party (the Green / Farmers Union) has held government office in Latvia since 2003, environmental concerns are subordinated to economic development. Plans for a rapid expansion of the Riga airport over the next few years have not been accompanied by a public debate on the drastic and negative environmental impact that this will have on the capital city and surrounding territory. However, the nature of the service-driven Latvian economy, as well as a low population density, means that Latvia is not a great polluter. Moreover, accession to the European Union has led to the adoption of stringent environmental legislation.

Environmental policy

Latvia has one of the highest rates of higher education enrollment in the world, and spending on education accounts for about 5% of GDP. Latvia has a mixed higher education financing system, with public institutions benefiting from public funds as well as private fees in the much-demanded academic disciplines of law, economics and business administration, and social sciences. However, the quality of the education received is open to question, as no Latvian institutions feature in the numerous global rankings of universities and academic departments, and there are few Latvian publications in the science citation index and similar measures of scholarly excellence. Primary and secondary institutions have suffered from a lack of funding, particularly for teachers' salaries, since 1991. This has led to a severe shortage of teachers, particularly from the younger generation, which is particularly acute in rural regions.

Government investment in research and development is among the lowest in the European Union, amounting to 0.69% of GDP in 2007. Moreover, the radical cuts in government expenditure in 2009 caused by the sharply contracting economy have led to severe cuts in both education and R&D spending.

Education policy /
R&D

Transformation Management

I. Level of Difficulty

The structural constraints on governance are low. The relatively low, in EU terms, level of economic development means that government budgets are small. This has resulted in basic structural weaknesses at all three levels of education. One weakness, not unique to Latvia, is the low number of engineering and science students, compared to the high numbers of students in the social sciences. Another weakness is the low level of R&D investment. Both these factors result in a lack of innovation. Ongoing high levels of administrative, judicial and political corruption also affect the ability of the state to govern effectively and undermine the rule of law. Latvia's geography offers both constraints and advantages. The constraint comes from Latvia's dependence on Russia for energy. The advantage comes from Latvia's knowledge of the Russian market, language and culture, which means that Latvia can operate as a bridge between eastern and western markets. However, problematic diplomatic relations between Latvia and Russia means that it has only been able to partially capitalize on this advantage.

Structural
constraints

The half century of Soviet occupation has left Latvian civil society small and weak. The forced voluntarism of the Soviet era has left many people with a negative attitude towards civic activities and voluntary associations, while the strains of the economic transition have left people with scanty financial resources and little free time. Moreover, the Soviet system encouraged informal friendship networks in place of structured organizations. These networks still function today, and are unlikely to disappear bearing in mind Latvia's small population and elite concentration in Riga. Accession to the European Union actually had a negative effect on Latvian civil society, as many major donors, such as the UNDP, the Soros Fund and bilateral partners such as Denmark, reduced or even stopped financing programs in Latvia, and focused on the next round of accession applicants.

Civil society
traditions

Nevertheless, Latvian civil society has developed since 1991, and has begun to play an increasingly influential, albeit disputed, role in the Latvian polity. At the elite level, politicians continue to debate the nature and constitution of civil society. In August 2004, the then president of Latvia, Vaira Vike Freiberga – a retired Canadian-Latvian university professor, expressed her concern about the protests

organized by the Latvian branch of Transparency International, which opposed the appointment of the Latvian parliamentary speaker, Ingrida Udre, to the European Commission as the Latvian Commissioner. Freiberga argued that NGO's choosing to comment on the political process in Latvia should register as political parties, with all the financial declarations and other controls that this process imposes. One observer was prompted to compare Freiberga to the authoritarian Belarussian President Aleksandr Lukashenko. Indeed, the confrontation between state and civil society has been accelerating rather than softening over the last few years. In 2005, Transport Minister Ainars Slesers accused George Soros of attempting to organize a coup against the Latvian government, and then, in January 2006, proposed new legislation limiting the scope of operation for NGOs funded by foreign donors. This would have largely neutered civil society, particularly the primary anti-corruption vehicles Providus (a think tank off-shoot from the Soros Foundation-Latvia) and the Latvian branch of Transparency International who survive largely from foreign donations, particularly Soros. Thus Latvian civil society partially reflects the dissidence movement during the Soviet era in that it acts as a voice of opposition, rather than a partner, to the state.

Latvian society is split into two major groups – ethnic Latvians and Russian speakers. This societal faultline is reflected in ethnic-based media with differing editorial approaches. There is no major cross-cutting newspaper. In the 1990s Diena, Latvia's newspaper of record, briefly published a Russian-language translation of the daily paper, but it failed to make a profit. This cleavage is also reflected in political polarization, as no Russian-speaking party has been in a Latvian government coalition. However, the tendency has been for less fiery ethnic rhetoric in recent years, and the government coalition Latvia's First Party has made several attempts to recruit more Russian-speaking members. Combined with increasing knowledge of the Latvian language among Russian speakers, rising naturalization, and a steady decline in the number of non-citizens, this conflict is gradually declining in intensity.

Conflict intensity

II. Management Performance

14 | Steering Capability

All post-1991 Latvian governments have been committed to democratic instruments of government, a market economy, the maintenance of a social safety net, and integration with the Euro-Atlantic organizations. These broad strategic aims have

Prioritization

also guided Latvia's long-term development. While democracy has become entrenched, a functioning market economy created, and accession to the European Union and NATO secured, the weakest point in this chain has been the maintenance of a social safety net. The liberal economic model of relatively low income and other taxes has meant that successive governments have simply not had the financial resources to invest in health care, pensions and education, and the legacy of the Soviet infrastructure left behind means that many of these services are rather dilapidated and inadequate.

Despite the relatively short average lifespan of post-1991 Latvian governments (just over a year on average), ideological continuity has meant that the major reforms of the political and economic transition were implemented without any major problems. The only marginal exception is legislation of a contentious ethnic nature – the citizenship and language laws were disputed by both national and international actors, as was the more recent school reform law that introduced increased Latvian language classes in minority schools. Nevertheless, these laws have been implemented. The reorganization of local authority districts is another contentious piece of legislation that was only adopted at the end of 2008 after more than a decade of debate. In this case, opposition to the reform came from regional, rather than national or international actors.

Implementation

The high turnover of governments, parties and ministers means that Latvia has lacked the institutional memory and stability of West European political actors. Moreover, this turnover has also given governments the possibility of renouncing ownership of policies adopted by previous governments. However, despite the huge number of laws passed since 1991, very few policies could actually be deemed to be outright failures. Perhaps the ongoing political feuds that have led to the failure to privatize the last remaining large national enterprises indicate a failure to recognize the failure of the large-scale Latvian privatization model.

Policy learning

15 | Resource Efficiency

The rapid rise in government income after accession to the European Union has not been used efficiently. The swift increase in public sector salaries and spending fueled double-digit inflation and caused imbalances in the economy that led to the IMF-led financial bailout in late 2008. Successive governments' failure to create and save budget surpluses led to the near bankruptcy of the state. Moreover, the overt politicization of the upper levels of management and executive bodies of ministries, agencies and government owned enterprises has meant the creation of a class of managers appointed to positions of authority by dint of who they know, not what they know.

Efficient use of assets

The nature of Latvian multiparty coalition government has meant that successive governments have had to coordinate often conflicting objectives into coherent policy. However, these conflicts have been opaque in that they are disagreements between party financial sponsors and are of an economic nature, such as is the case with privatization. In terms of party programs, governments have been constituted by center-right ethnic Latvian parties that have agreed on the broad strategic aims of government outlined under “prioritization.” In coalition negotiations, specific ministries are distributed to concrete parties, which then assume responsibility for this sector. This has led to some coordination problems between ministries led by different parties when policy areas overlap, although this is quite rare.

Policy
coordination

The Bureau for the Prevention of Corruption (KNAB) is the major corruption-fighting organization in Latvia. However, it is weakened by the fact that it is under the direct control of the prime minister’s office, which can lead to a conflict in interests. For example, after the 2006 parliamentary election it became clear that the then Prime Minister Aigars Kalvitis’ People Party had radically broken election spending limits. Kalvitis then proceeded to suspend, and attempt to dismiss, the head of KNAB, Aleksejs Loskutovs. Mr. Loskutovs succeeded in keeping his job only because of a huge public show of support. Government spending is audited by the State Audit Office whose popular auditor general, Inguna Sudraba, was reappointed to the post in a parliamentary vote in January 2009. Sudraba has proven to be a fiercely independent and outspoken critic of public waste and efficiency, and has successfully drawn public attention to the payment of bonuses to civil servants, or semi-secret “management contracts” that often double the salary of top civil servants (the government barred this practice in late 2008).

Anti-corruption
policy

16 | Consensus-Building

Latvia’s major political actors agree on the strategic long-term aim of building a market economy while strengthening democracy. Despite the presence of opaque party sponsors and economic interest groups, all elections since 1993 have been free and fair, and Latvia has introduced and consolidated the framework of a market economy.

Consensus on goals

The military is firmly under the control of the civilian authorities and there are no major organized groups opposing Latvian democracy or the market economy. Latvia has seen a rise in far-right group activity in recent years – that is, skinheads, the anti-gay NoPride movement, local branches of extreme Russian nationalist movements. However, this has not been accompanied by success for extremists at the ballot box, largely because their rhetoric has been co-opted by some of the mainstream political parties, which have also siphoned off their potential voters. Moreover, these extremist groups do not challenge a market economy or democracy

Anti-democratic
veto actors

per se, but rather the liberal values associated with a modern European democracy.

Ethnicity is the only major cleavage in contemporary Latvia. The party system is structured around the Latvian-Russian speaker divide, with the majority Latvian parties refusing to countenance a government coalition with the Russian-speaking parties, even if there are ideological similarities between parties on different parts of the divide. This clearly does not promote societal integration and has led to a curious situation in which ethnic Latvians “think left, but vote right” – in other words, opinion polls clearly show that Latvians lean towards a social-democratic model of government, but vote for ideologically center-right parties because they associate left-wing parties with Russian-speaker interests.

Cleavage /
conflict
management

After the 2002 parliamentary elections, the new government created the post of Special Assignment Minister for Social Integration and appointed Nils Muiznieks, an American-Latvian (but fluent Russian speaker) non-partisan expert of ethnic relations as the first holder of this post. In recent years the ministry has had to address intolerance, particularly against gays, as a developing cleavage. Indeed, the anti-gay demonstrations in recent years have uniquely managed to bring together Russian and Latvian extremists in a common cause.

The formal role of civil society in decision making increased as Latvia moved closer to EU accession. Civil society organizations are now often asked to offer expert opinions in parliamentary committees, and participate in committee work in Latvian ministries. The farmers’ unions are particularly influential in the Ministry of Agriculture. However, the institutional weaknesses of the civil society organizations themselves, as well as the influence of background economic actors or party sponsors, means that civil society is only minimally involved in the political process, and then in a primarily critical capacity.

Civil society
participation

However, the government can be responsive to mass movements. The November 2007 “Umbrella Revolution” which called for a change of government, led to the resignation of Prime Minister Aigars Kalvitis. The anti-government protests of 13 January 2009 had a similar result, as several government coalition parties have called for early elections, and the governing coalition collapsed in February 2009.

Latvia’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 is viewed as an historic injustice by ethnic Latvians. Russian speakers, however, tend to have a more positive opinion of this era. Thus there are two objects of reconciliation for Latvians and the Latvian state – the Russian-speaking immigrants that entered Latvia during the Soviet occupation (and who still reside in Latvia), and the Russian Federation which, as the legal successor to the Soviet Union, is seen as responsible for Latvia’s half-century of subjugation. Rapprochement with Latvia’s Russian-speaking minority has been slow, with

Reconciliation

restrictive citizenship and language laws being seen by many as a punishment to the minority. Moreover, Latvians are deeply offended by the celebration of the Soviet Union that accompanies the annual 9 May victory in the World War II celebrations 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 the Russian speakers view as the fascists that Russia was fighting against in the war. These competing interpretations of history are quite deeply rooted in society, and show little sign of abating. Reconciliation with the Russian state has also proceeded quite slowly, with frequent bickering and trade disputes between the two sides. However, the signing of the much delayed Latvia-Russia border treaty on 27 March 2007 has laid the foundation for more moderate future relations.

17 | International Cooperation

Latvia's major international assistance since 2004 has come through the European Union's structural and cohesion funds, as well as the common agricultural policy. These funds are spent through planned, multi-year programs. In the period from 2007 to 2013, Latvia will receive over 4.5 billion euro in structural and cohesion funds. The major criticism of Latvia's spending of these funds in 2007 and 2008 was that far too much money was being spent in the Riga region, and too little in the poorer regions of Latvia, such as the Latgale region which borders Russia. However, the disbursement of funds is dependent on the quality of the applications, and it is inevitable that Riga, the capital of Latvia, would have the most competent project writers and project managers.

Effective use of support

Latvia has had a very consistent foreign policy aimed at first joining the major international organizations, particularly the European Union and NATO, and then proving itself as a reliable partner. In this context, Latvia joined the U.S.-led "coalition of the willing" in the 2003 war against Iraq, and currently has soldiers posted in Afghanistan. However, its international credibility has been severely dented by the recent financial turmoil that resulted in an IMF led financial bailout, and an expected dramatic fall in GDP in 2009.

Credibility

As a small country, Latvia has long focused on regional cooperation with its wealthier states bordering the Baltic Sea (i.e., Sweden, Finland, Denmark, as well as the Nordic countries of Norway and Iceland). However, this has resulted in a neglect of its relationship with Lithuania and Estonia. In more recent years, Latvia has begun to focus on the European Union's eastern neighborhood policy by promoting democratization and marketization in Georgia as well as support for Moldova and Ukraine – countries which the Latvian government feels could benefit from the experience of Latvia's transition to a market democracy.

Regional cooperation

Strategic Outlook

Latvia faces dramatic political, economic and social challenges. The remarkable economic collapse in the fourth quarter of 2008 led to a large public protest against the government and parliament on 13 January 2009. These protests ended in violent confrontations between police and demonstrators in front of the Latvian parliament building, the destruction and burning of police cars, attacks on ministry buildings and small-scale looting. More than 100 people were arrested.

Regaining the public's trust in the political system is the key political challenge - a challenge likely to be tested as the recession will inevitably exacerbate social problems as spending on education, health care, and benefits declines. Patient co-payments in the health care sector were already raised in January 2009. The mooted early parliamentary elections will not instantly renew trust in the political system. The lack of any credible alternative political parties, and the nature of the party financing system, which ensures that only those parties with wealthy donors can effectively compete in election campaigns, means that the same parties are likely to be elected, and a government coalition will, once again, be formed by center-right ethnic Latvian parties. The public will only begin to trust the political class when parties become member-oriented and responsive to society or social groups. This can be achieved by banning private financing for parties, and limiting television commercials in election campaigns, thus making the role of members in elections more important. Parties can also be forced to be more inclusive by raising the minimum membership criteria from the current 200 to 1,000 or more.

Of more immediate concern is the economic downturn. The Latvian government was forced to revise the 2009 budget downwards several times at the end of 2008, and held open the possibility of further downward revisions in 2009. Public sector spending has been cut by 25% across the board, and ministries were tasked with reducing salaries by 15% through either dismissals or salary reductions. At the same time, personal consumption has slowed as banks have tightened up lines of credit, and the construction boom has come to a shuddering halt. There is clearly no quick-fix to the recession, but the government could use this crisis to restructure the civil service, introducing a meritocratic recruitment system and a transparent pay structure (currently, every ministry and agency has its own pay structure, leading to huge institutional variations in salary). The military has used the cut in salaries as an excuse to dismiss more than 100 pre-pension age officers who were not granted NATO security clearance due to their Soviet era military service. The downturn can be used to make the public sector more efficient. Moreover, this is likely to be one of the IMF's demands in its bailout package.

The next two years will challenge the strength of Latvia's democracy and market economy. It is to be hoped that Latvia's institutions will emerge all the stronger for the tests they have faced.