

## Chapter



# Human Development, the Economy and the Transition in Latvia

## Introduction

Over the last year, Latvia has achieved considerable success in consolidating reforms and improving the general economic environment. The banking system has not only stabilized, but also regained the public's trust after the crisis of 1995. The government's financial situation has improved, interest rates and inflation continue to fall, investment is growing and the securities market is developing rapidly. Gross domestic product (GDP) has begun to grow and, as of the end of 1996, so have real wages. 1996 saw significant progress in privatization, including the privatization of large state monopolies, and the expansion of the real estate market. The government has also enacted significant measures to improve the climate for small and medium sized businesses and to encourage exports. Consistent efforts have been made towards integration with European political and economic structures and the World Trade Organization (WTO).

However, up to now Latvia's economic recovery has had little effect on the public's level of material well-being. For many, living standards are still quite low and the macroeconomic transformation has not yet led to a perceptible increase in incomes. This drives home the point that balanced, people-centred economic and social development is not easy to achieve and success is directly linked to the pace, sequence and quality of reforms during transition. Nevertheless, Latvia has made great progress in establishing a stable environment for sustainable economic growth.

## The Economic Situation — An Overall Picture

Notwithstanding the scope of the tasks still ahead, 1996 should be viewed as a turning point in Latvia's economic development. Following the significant fall in registered output in 1991 and 1992 (GDP in 1993 was only 42 percent of that in 1990), the macroeconomic situation has clearly improved.

In 1996 GDP rose by almost 3 percent, there was a minimal fiscal deficit (1.9 percent of GDP), inflation fell significantly to the lowest rate in the Baltics and the volume of exports rose. The rise in economic activity over the past year and a half certainly gives rise to optimism.

International financial institutions such as the International Monetary Fund and the World Bank and regional organizations such as the European Bank for Reconstruction and Development (EBRD) have reacted positively to macroeconomic stabilization and the recent changes in the Latvian economy. In addition to the onset of economic growth, these organizations have also noted the stability of the Lat exchange rate, the surmounting of difficulties caused by the banking crisis, the fall in interest rates for loans, the development of a securities market and the onset of large state enterprise privatization.

A very important economic achievement this past year has been the high credit rating ("A" for long term debt in local currency and "BBB" for overseas currencies) awarded by Standard & Poor's, one of the world's most influential credit rating agencies. Among the indicators used in making this assessment were the level of external debt, the balance of payments, overall fiscal policy and price stability. Latvia's rating is one of the highest among the Central and East European countries.

However, comparing Latvia's economic development with that of other countries in transition, GDP growth in 1996 was still relatively modest. Table 1.1 shows that the majority of countries in transition in Central and Eastern Europe have had higher growth rates than Latvia. It should be noted that these countries have now been in recovery longer than the Baltic states. With economic growth for Latvia estimated to increase to 4-5 percent in 1997 and inflation to decrease to around 8-9 percent, it is anticipated that Latvia's economic performance will show similar continued expansion. Indeed, the rate of GDP growth through the first six months of 1997 was 4.6 percent over the same period in 1996.

Similarly, the indices of industrial output (see Table 1.2) still remained low compared to other

countries in Central and Eastern Europe. Thus, industrial output in Latvia grew by only 1.4 percent in 1996, after being negative in both 1994 and 1995. In contrast, industrial output grew by 9.1 percent in Poland, 9.8 percent in Romania and 6.8 percent in the Czech Republic. However, Latvia did witness noticeable growth in the construction (5.3 percent) and service (4.7 percent) sectors. On the other hand, the decline in the agricultural sector continued over the past year, resulting in adverse effects on rural living standards and national indicators overall. GDP growth rates by sector are examined in greater detail below.

Although Latvia and the other Baltic states are clearly catching up with other Central and Eastern European economies, per capita GDP in Latvia is still one of the lowest in Eastern Europe (see Table 1.3). Per capita GDP (expressed in Purchasing Power Parity dollars) in Latvia in 1995 was only US\$ 3273. For the same period it was US\$ 4051 in Estonia, US\$ 4000 in Lithuania, US\$ 6604 in Hungary and US\$ 4852 in Bulgaria. Per capita GDP in Latvia is five to ten times lower than in countries of the European Union. It should be noted, however, that the reliability of statistics on GDP per capita in transition countries is problematic. Not only has data collection been difficult for all transition countries, but the peculiarities of each country's path and pace of reform make cross-country comparisons especially difficult.

## Taking a Closer Look — Distribution of the Gross Domestic Product

While officially GDP increased by 2.8 percent in 1996, unofficial estimates that include the informal market or shadow economy place the level of growth higher — at 3 to 5 percent. Growth was achieved in almost all sectors in 1996 except agriculture (see Table 1.4). Latvia's successful operations in the transit business in 1996 secured a 13.5 percent growth in transport and communications. Moreover, in the first months of 1997, the volume of goods transferred at the ports and the number of railway transit shipments continued to increase.

To a large extent, the economic recovery in Latvia over the last year was led by the transport sector, especially the growth in transit services. Transit and port services account for a quarter of all exports. Although Latvia may currently be in an advantageous position, competition is steadily increasing in the transit business. In the future, more must be done to improve the competitive-

**Table 1.1**

### Growth of Gross Domestic Product (GDP) in Eastern Europe and the Baltic States, 1994-1996 (percentage change on previous year)

Country	1994	1995	1996	Percentage change on 1993*
Bulgaria	1.8	2.1	-10.0	-6.5
Czech Republic	2.6	4.8	4.4	12.3
Croatia	0.6	1.7	4.4	6.8
Estonia	-2.7	2.9	3.4	3.5
Russia	-12.7	-4.2	-6.0	-21.4
LATVIA	0.6	-0.8	2.8	2.6
Lithuania	1.0	3.0	4.0	8.2
Poland	5.2	7.0	6.0	19.3
Rumania	3.9	7.1	4.1	15.8
Slovakia	4.9	6.8	6.9	19.8
Slovenia	5.3	3.9	3.5	13.2
Hungary	2.9	1.5	0.5	5.0

\* estimate from growth rates 1994-1996

ness of Latvia's major ports (Riga, Ventspils, Liepaja). As transit services are subject to the often unpredictable political and economic processes in Russia and the other CIS countries, from the point of view of balanced and sustainable economic growth, it is necessary to pay more attention to other economic sectors, especially in manufacturing and services.

1996 saw the first increase in industrial output since the introduction of reforms. This was particularly evident in the food, wood processing, paper, building materials, textiles and metal-working industries. Food processing is the leading branch of industry in Latvia, both in terms of value added (44 percent of total industrial output) and employment. This branch has been successfully restructured and the main increase in output has been in dairy and fish processing. The quality of production complies with local market requirements, but exports are mainly to the CIS (90 percent).

Wood processing is the highest foreign currency earner in Latvian industry. It provides a quarter of all exports and 85 percent of output is exported to the advanced industrial countries. Lately, a positive trend has emerged — the share of processed wood and furniture in exports has increased. The wood processing industry is the leading sector in terms of employment growth.

Textiles and clothing manufacture is another dynamic sector. Successful restructuring after privatization has contributed to a rapid growth in

exports (39 percent in 1996), of which 50 percent is to the EU and 30 percent to the CIS. Many new and successful businesses have sprung up in this area. The expansion in construction is largely due to repairs of the Latvian road network and cement exports to the West.

However, many branches that were formerly deeply integrated with the Soviet economy have not managed to escape stagnation. It has not been possible to halt the fall in output in the manufacture of electrical machines, automobiles and trailers. Even now large state enterprises dominate these branches. The main braking factors are delayed privatization, tax debts, obsolete technology and a limited market.

Agriculture is still a significant sector of the economy, employing 18.3 percent of the work force in 1996 and providing 9 percent of GDP. In the course of privatization and agrarian reform, some 200,000 individual, mostly small-scale businesses have been created. The agricultural sector, however, is in decline. Several studies have shown that only 5-8 percent of rural enterprises engaged in agricultural production are operating on a commercially viable basis. Structural changes in the national economy, restitution issues, the lack of investment capital, outdated technology and buildings, a small market, low incomes and inefficient management have caused significant disruptions in the rural economy resulting in increased unemployment in the agricultural sector. The social consequences and policy implications of the decline in living standards in rural areas are discussed in greater detail in Chapter 4.

Due to all of these reasons, the fall in production has still not been halted and Latvia has become a net agricultural importer. Furthermore, the trade balance with the EU is worsening because foodstuff imports are increasing. The rise in prices for produce of successful farming enterprises does not compensate for the continuing rise in production costs, making farming increasingly unprofitable.

The overall trend for Latvia's economy is for the continued growth of industrial output to be concentrated in labour-intensive branches with low added value (foodstuffs, forestry and wood processing, construction and clothing manufacture). From a human development perspective, this trend is positive in the short term, as it creates jobs. In the long term, however, Latvia's interests lie in the development of high technology branches with high added value and great export potential.

**Table 1.2**

**Growth of Industrial Production in Eastern Europe and the Baltic States, 1994-1996**  
(percentage change on previous year)

Country	1994	1995	1996
Bulgaria	108.5	105.4	99.0
Czech Republic	102.1	109.2	106.8
Croatia	97.3	100.3	103.1
Estonia	97.0	101.9	101.1
Russia	79.1	97.0	94.0
LATVIA	90.5	93.7	101.4
Lithuania	73.4	105.3	102.8
Poland	112.1	110.2	109.1
Rumania	103.3	109.4	109.8
Slovakia	106.4	108.3	102.5
Slovenia	106.4	102.0	101.0
Hungary	109.5	106.5	103.3

## Inflation and Unemployment

Inflation has been an economic as well as social problem in Latvia from the early 1990s. For most people, inflation has essentially been a cruel way of taxing their financial wealth. Moreover, it has contributed to the emergence of income inequality and, for some, a rapid descent into poverty. 26 percent of the Latvian population are pensioners whose pensions are indexed at a rate less than the inflation rate, making even moderate inflation a most painful experience (see also Chapter 2 below).

Compared to other countries in transition, Latvia has a rather low rate of inflation (see Table 1.5), largely due to the anti-inflationary measures (tight monetary and fiscal policies) taken by the government and the Bank of Latvia. Inflation in Latvia declined rapidly from an annual rate of 950 percent in 1992 to just over 100 percent in 1993 and further to 36 percent in 1994. Inflation proved to be relatively stubborn during 1995-1996, and by the end of 1996 was close to 18 percent. In 1996 inflation fell more than was forecast mainly because of lower price rises for foodstuffs and services. More recently, inflation has declined sharply, reaching a 12-month rate of 8.6 percent by August 1997.

The main causes of inflation in 1994-1996 were: 1) an initial undervaluation of the currency relative to its equilibrium value; 2) the adjustment of administered prices to reflect international price levels; 3) an adjustment in excise

taxes to European levels; 4) differential rates of productivity growth between the traded and non-traded goods sectors; and 5) the creation of a quasi-fiscal deficit caused by ineffectual banking operations, later reflected in the commercial banking crisis.

Price stability and the reduction of inflation to single digit levels have become the main objectives — and achievements — of Latvia's economic and monetary policy. Inflation is forecast to fall to approximately 8-9 percent in 1997 and still further to 5 percent by 2002. For a country in Latvia's circumstances, this is a very positive element in an overall reform programme. However, the process of price transformation is still continuing as previously regulated prices rise for certain goods and services. Only a few administered prices remain, relating to transportation, energy, and housing rents.

A key anti-inflationary element has been the slow rise in incomes linked to restrictive fiscal policy. In the last two years, wages have not kept pace with consumer price increases. This means that the purchasing power of wage earners has fallen. After a sharp rise in 1994-1995, nominal wage levels have stabilized, but they are still low compared to those in other Central and Eastern European countries. The average gross monthly wage in the state sector and state-owned enterprises rose by 10.3 percent compared to the previous year and was about Ls 100 in 1996. In 1996 the purchasing power of the employed fell by 8.8 percent. This affected consumption rates not only in individual sectors, but in the entire economy as well. The average pension in 1996 increased by 18 percent compared to 1995, but real incomes rose by only 0.3 percent.

Official unemployment in Latvia in 1996 totaled 90,800 workers, or 7.2 percent of the economically active population. One must also take into account hidden unemployment (underemployment during working hours, compulsory unpaid leave and other forms), for which there are no precise calculations. Although unemployment continued to rise slowly in the first half of 1997, it is still lower than in many other countries in transition (see Table 1.6) as well as in many EU and Nordic countries. Nevertheless, the structural changes in Latvia's economy have placed certain social groups at greater risk of unemployment than others. Chapter 2 addresses the social implications of unemployment through an analysis by gender, age and education level.

## Investment, Consumption and Continued Economic Growth

The **Latvia Human Development Report 1996** emphasized that future economic growth is very much dependent upon investment, of which the current level overall is rather low. Important factors in promoting investment are a favourable business climate for foreign investors and the availability of affordable capital for domestic investors.

The aggregate stock of fixed capital, the most essential component of domestic investment, was 15 percent of GDP in 1996. However, this is too small to promote significant economic growth. In comparison, the figure for both Lithuania and Estonia is over 20 percent of GDP. One must bear in mind, however, that the banking crisis in 1995 severely decreased the level of domestic capital available for investment, thus making cross-country comparisons of capital stock levels in 1996 problematic.

Since 1994 the volume of the aggregate stock of fixed capital has grown every year. Even in 1995, when there were problems in the banking sector, the volume rose by approximately 5 per cent. The most rapid modernization of fixed capital occurred in the transport and communications sector which, as noted above, enjoyed impressive growth over the past year. Of the total capital investment in the sector in 1995, 56 percent was in communications. Latvia's relatively successful processing industries also attracted capital investments, although the distribution of those investments was uneven. In some branches investment has been negligible, while in others — the food processing, wood processing and chemicals industries — it has been quite high.

The difference between the volume of finan-

**Table 1.3**

### Real GDP Per Capita in Eastern Europe and the Baltic States, 1994-1995 (PPP US\$)

Country	1994	1995
Bulgaria	4372	4852
Estonia	3784	4051
LATVIA	3178	3273
Lithuania	3803	4000
Poland	5001	5479
Romania	3926	4307
Slovakia	6716	...
Slovenia	9894	10,521
Hungary	6303	6604

cial assets and investment growth rates is still increasing. Thus, in 1996, foreign assets in Latvia's banks increased by 76 percent (December 1996 compared to December 1995), but the credit issued to local companies rose by only 10 percent (according to the 1996 accounts of credit institutions). At the end of 1996, the sum owed by foreign banks was twice the amount owed by companies.

Typically, the greatest aggregate capital investment is in sectors with the greatest direct foreign investment. Net direct foreign investment in Latvia has grown in the last year. In Central and Eastern Europe, only Hungary, Slovenia and the Czech Republic attracted greater direct foreign investment per capita than Latvia in 1996. According to the Central Statistical Bureau, the total amount of foreign investment from the beginning of the 1990s to the end of 1996 was 369.2 million Lats (over US\$ 700 million). In per capita terms, the level of direct foreign investment in Latvia is average for Central and Eastern Europe during this period.

Foreign investment has mainly come to Latvia through privatization. The bulk of foreign investment has been in the service sector: transport, communications, finance. There has been relatively little foreign investment in industry. Obstacles to greater foreign investment today are the troubled financial situation of many local companies, poor management, the low capitalization of the securities market, frequent changes in legislation, the

slow pace of land reform, as well as the unresolved border issue with Latvia's largest neighbor, Russia. As privatization continues and the economic environment improves, the volume of direct foreign investment is expected to increase.

Direct foreign investment is important not only as a source of capital, but also as a source of foreign expertise, technology and management skills. It is particularly important to attract foreign investment in those sectors with high added value so as to maximize the utilization of Latvia's skilled labour. A special effort should be made to entice companies with a world-wide reputation, as the entry of such companies into the Latvian market would bring immediate technological and management benefits and encourage other investors. Although companies with foreign capital tend to perform more effectively, on the whole, the return on foreign investment has still been modest and has had little noticeable impact on living standards or human development in Latvia.

The role of public investment in financing infrastructure development is also increasing. In 1997, public investment might reach approximately 2 percent of GDP (up considerably from 0.9 percent in 1996). The government plans to increase public investment in infrastructure by at least 70 percent in the 1998 budget.

Of course, an increase in capital investment does not always mean an increase in production.

Table 1.4

**Growth of Gross Domestic Product (GDP) by Sector, 1993-1996 (percentage change on previous period)**

	1993	1994	1995	1996
Gross Domestic Product, including:	-14.9	0.6	-0.8	2.8
Gross value added at basic prices:	-14.3	0.8	-0.8	2.8
Agriculture, hunting and forestry	-19.4	-15.6	3.2	-10.1
Fishing	-20.2	-5.3	12.4	7.7
Raw materials	-32.9	41.0	-47.6	53.6
Processing	-32.4	-10.6	-0.5	3.0
Electricity, gas and water supply	-19.8	-2.0	10.0	2.2
Construction	-49.5	11.5	-9.4	5.3
Services, including	6.6	8.7	-3.3	4.7
wholesale and retail trade, vehicle repair, repair of personal and household goods	19.7	15.3	25.5	-3.4
Hotels and restaurants	-33.8	34.2	-36.3	8.3
Transport and communications	7.6	13.7	-15.2	13.5
Finance	4.2	5.6	7.1	-8.0
Real estate; rents and trading	4.4	-11.3	-16.7	6.8
Public administration and defence, obligatory social insurance	17.4	7.7	-0.2	8.0
Education	-6.5	1.6	3.9	1.5
Health care and social care	17.7	-7.4	-1.3	3.2
Other community, social and individual services	-4.6	-4.5	10.8	9.9
Taxes on food products (less subsidies)	-20.0	-0.6	-0.8	2.9

An important impediment to increasing outputs at this time is the limited size and purchasing power of the domestic market. In a survey of market conditions in the construction industry, 73 percent of all respondents considered this to be the main factor inhibiting growth. On the other hand, only 20 percent of those questioned mentioned financial problems (such as high interest rates).

One of the main indicators of the development of the internal market is the volume of private consumption. The Ministry of Economy estimates that private consumption in 1996 was 96 percent of the 1995 level in real terms. Real incomes continued to fall in 1996, as wages increased less than the rate of inflation. A strict fiscal policy and monetary austerity slowed increases in income for those dependent on government budgetary expenditures — approximately 60 percent of all those with a regular income. As mentioned above, official unemployment rose over the last year as well. Both these factors, in turn, affected wage levels in the private sector. As a result, aggregate demand fell, thereby keeping a powerful check on inflation. Low incomes are often one of the costs for relatively low inflation during the transition period.

## The Structure of Ownership and Privatization

Privatization is one of the most important economic processes during transition, as it reduces the role of the state in the economy and places economic resources in the hands of private owners, thereby enhancing both capabilities and opportunities for entrepreneurship and the generation of new wealth.

Many factors caused the delay in privatization in Latvia in the first half of the 1990s: the indecisiveness of the political elite, bureaucratic inefficiency, heavy economic dependence on the CIS, and the political decision to give priority to restitution instead of privatization. For several years, privatization was sporadic and even as late as the end of 1993, about 68 percent of total industrial output came from state enterprises.

There was a rapid acceleration of privatization in February 1996, when state enterprises came under the control of the Latvian Privatization Agency (LPA) and one institution became responsible for privatization. To encourage the participation of foreign investors, restrictions on the foreign ownership of land were lifted in January 1997.

By mid-1997, the LPA had privatized two-thirds of the property of state industrial enterprises.

**Table 1.5**

### Inflation in Eastern Europe and the Baltic States, 1994-1996 (percentage change on previous year)

Country	1994	1995	1996
Bulgaria	...	...	123.1
Czech Republic	10.0	9.1	8.9
Croatia	...	...	3.6
Estonia	47.7	29.0	23.1
Russia	215.0	198.0	47.8
LATVIA	35.9	25.0	17.6
Lithuania	72.2	39.6	24.7
Poland	32.2	27.8	19.8
Rumania	...	...	38.8
Slovakia	13.6	9.9	6.0
Slovenia	...	...	9.7
Hungary	18.8	28.3	23.6

The privatization of small enterprises is virtually complete and now, the focus is the large energy, transport and industrial concerns (including *Latvian Gas*, the Latvian Electricity Company *Latvenergo*, the *Latvian Shipping Company* and others). The government plans to complete privatization by mid-1998.

At the beginning of 1997, the private sector accounted for about 55 percent of GDP and 64 percent of those employed. Specialists estimate that by the end of 1998, private enterprise will account for some 90 percent of the commercial sector.

Rapid privatization in 1996-1997 highlights the price paid by society for delayed privatization; this has mainly been the protracted difficulties of restructuring enterprises and factories and the poor management of state property. It is expected that poor financial prospects and the lack of strategic investors will leave many state enterprises without buyers. The 1996 regulations on enterprise bankruptcy ought to encourage restructuring, but bankruptcies will unavoidably lead to a rise in unemployment. In some cases, as the large state energy monopolies come into private hands, rates will rise, as was the case with the privatization of *Latt Telekom* (the Latvian Telephone Company).

The main methods of privatization are international tenders, attracting strategic investors and public offers. Such methods undoubtedly encourage the involvement of foreign and domestic investors and the faster restructuring of enterprises, although the government's requirement that employees are retained by the new owners has thus far delayed some enterprise restructuring. However, this strategy may potentially lead to the con-

centration of ownership and capital among the wealthier members of society and to the growth of economic and social inequality.

In order to involve wider sections of society in privatization and to guarantee greater social justice, the government launched public privatization by certificates or vouchers in 1996. However, certificates are usually used only for privatizing a minority share of assets. By 1 April 1997, under the public offer programme the shares of 37 enterprises were offered and about 10,000 people are now shareholders. To redeem these certificates, with a total nominal value of over 700 million Lats, and to activate the Riga Stock Exchange, the LPA has decided to offer the shares of a further 30 middle to large scale enterprises to the public. The estimated number of potential shareholders in the population is 4 percent, a negligible amount considering that certificates were allocated to everyone.

As privatization certificates may be used to privatize not only state enterprises, but land and housing as well, it is reasonable to assume that the low level of public participation in the privatization process is due to individuals' preference to utilize certificates to obtain land and housing. However, the process has been slow because of a lack of interest on the part of local governments. The government has planned to privatize only 20 percent of all apartments by the end of 1997.

From the perspective of human development, the idea of privatization certificates has only been partly successful and has not encouraged widespread ownership. For a long time, there was nowhere to invest certificates and many people,

mainly the less well off, sold their certificates at a fraction of the nominal value (certificates are transferable and may be bought and sold like securities). There is insufficient interest from the population in the public share offers. From an economic perspective, the use of certificates for the privatization of state enterprises has not increased investment, as new shareholders tend to have a greater interest in allocating profits to dividends instead of development.

## The Development of Small and Medium Sized Business

Small and medium sized businesses are a bridge between economic and social development. They guarantee the stable functioning of the market and make it more receptive to innovation, creating jobs and new owners. Indeed, small and medium sized businesses are a core element of quality growth insofar as the sector relies on personal initiative and responsibility and expands consumer choices.

The number of families involved in small and medium sized businesses is growing. This sector attracts families and individuals who hope to improve their material circumstances. Therefore it is important to create favourable preconditions for the development of this type of business by encouraging a spirit of enterprise, improving the credit market and strengthening institutions that train and support entrepreneurs.

**Table 1.6**

### Unemployment in Eastern Europe and the Baltic States, 1994-1996 (percentage of economically active residents)

Country	Total			Women			Long-term unemployed (more than 12 months)	
	1994	1995	1996	1993	1995	1996	1995 3rd Q	1996 3rd Q
Bulgaria	12.8	11.1	12.5	...	...	...	65.8	60.0
Czech Republic	3.2	2.9	3.5	4.6	3.9	4.1	31.1	30.6
Croatia	17.3	17.6	15.9	...	...	...	53.8	51.3
Estonia	5.1	5.0	5.6	2.1	...	...	29.0	31.0
Russia	7.1	8.2	9.3	1.1	3.8	4.6	30.3	32.9
LATVIA	6.5	6.6	7.2	6.4	6.6	7.7	24.6	29.5
Lithuania	4.5	7.3	6.2	3.3	7.1	7.0	24.0	32.0
Poland	16.6	14.9	13.6	17.9	17.0	15.9	42.2	40.4
Rumania	10.9	9.5	6.3	12.6	10.9	7.4	47.0	51.7
Slovakia	14.8	13.1	12.8	11.7	14.9	14.2	54.4	51.7
Slovenia	14.2	14.5	14.4	...	14.0	14.0	52.9	52.1
Hungary	10.4	10.4	10.5	10.1	9.1	10.3	51.3	49.7

**Box 1.1****The Family Business of Ludmila and Andris Ozols**

Ludmila and Andris Ozols are a married couple aged about thirty. They own and run a shop selling motoring goods, alcohol and groceries in Riga. The company was founded in 1995. Before that Andris worked as a salesman, but Ludmila was unemployed although she has an education in accounting. The decision of both young people to start their own business was driven by the desire to improve their standard of living.

The company was set up as a subsidiary of an international retail firm developing a network in Latvia. The foreign company provided the necessary start-up capital, financed renovations and provided consulting services. The contract with the parent company gives the Ozols responsibility for the range of goods stocked, staff, accounting and dealings with government institutions. The parent company is responsible for cash flow, quality and strategy. The profits are shared between the Ozols and the parent company. In short, successful co-operation between a foreign investor and local entrepreneur ensures the company's stability. This is reflected in the increase in turnover, which reached 300,000 Lats in the first three months of 1997.

Ludmila and Andris are satisfied with the results so far and they have had no problems with finances or the subsidiary arrangement. However, they have encountered staff problems. The shop has another 10 employees — eight men and two women

whose average monthly salary is Ls 215. Since not all people are trustworthy, there are frequent staff changes.

Low purchasing power is a problem for the retail trade; therefore the company tries to keep prices down, runs promotional campaigns and tries to attract new customers.

The business has not faced extortion or organized crime. The owners explain this by the fact that they are running a legal business and pay all their taxes.

Ludmila and Andris have no love for civil servants whom they perceive to be unhelpful and corrupt, although could not give a specific example of a bribe being demanded. They have, however, met with delays and bureaucratic obstacles when registering as tax payers, in dealings with the fire service and the architectural board. The entrepreneurs are dissatisfied with the frequent amendments to the law and trading regulations which create uncertainty and permit civil servants to manipulate with legal ambiguities. They did mention one positive example of the local government representative who regularly takes an interest in how the business is doing.

The Ozols also complained about employment law which they see as being too favourable to employees and unsuited to the new conditions. They proposed increasing the working week from 40 to 50 hours and shortening annual leave from 4 to 3 weeks.

Small and medium sized businesses up to 250 employees employed 58.6 percent of the workforce in 1995. Small and medium sized businesses are concentrated mainly in trade, services, industry and construction. Latvia has a sound legislative and institutional base for the operation of this type of enterprise and a network of PHARE business support centres. However, a survey conducted by the Central Statistical Bureau revealed that 83 percent of entrepreneurs cited as their primary problem difficulties in selling their goods caused by low purchasing power. The main barrier to business development was said to be the lack of finance (87 percent) and limited credit (38 percent). Other negative factors were insufficient knowledge of the market, unfair competition, the low level of technology and the lack of qualified personnel. Other surveys confirm these findings and point to another problem — frequent changes in legislation and inconsistent implementation.

The government has produced a national programme for small and medium sized business development that includes a series of measures for 1997-1998 — an improvement in business regulations (e.g. tax changes, simplification of licensing), the introduction of a credit guarantee system, co-

ordination of foreign technical and financial assistance, promotion of technological development, encouragement of contact and co-operation between small businesses and the development of business training. These government initiatives together with the efforts of business organizations and federations should stimulate growth and competitiveness in the sector.

## The Balance of Payments and External Trade

Despite continued growth in exports, a very liberal trade policy has contributed to a significant current account deficit, which reached 8 percent of GDP in 1996. In 1996, imports were 1.6 times more than exports and grew in nominal terms by 33.2 percent, while exports increased by 15.5 percent. The rise in imports was primarily caused by energy demand, modernization needs as well as consumer demand for quality and durability. In part, this reflects one-time increases in fuel imports in advance of pre-announced excise tax increases and adverse external conditions for wood exports.

However, large capital inflows resulted in a balance of payments surplus in 1996.

In the first quarter of 1997, some positive trends in the balance of trade were observed. Although the trade balance is still negative, exports in 1997 have grown faster than imports (during January-May 1997 exports rose by 22.1 percent while imports grew by 17.9 percent). As a result, the difference between the value of exports and imports has decreased. Also, the share of investment goods in total imports continues to increase. Imports of machinery and electrical equipment have increased by 47.6 percent during January-May 1997 compared to the same time period in 1996 and accounted for 18.6 percent of all imports compared to 14.8 percent during January-May 1996.

Currently, the main problems are insufficient innovation, passivity in the search for new markets, insufficient foreign language skills, inadequate responsiveness in foreign customer relations, insufficient information about Latvian exports abroad and the high cost of bank loans for export promotion. Exports to the CIS are hampered by customs barriers and the still disorganized payment and guarantee system. However, the fundamental cause for slow export growth is delayed privatization, which hampered the badly needed modernization of many enterprises and improvements in the quality and competitiveness of locally manufactured goods.

Recently, the government has become more active in export promotion by expanding technical and information support for exporters, supporting the creation of overseas chambers of commerce and developing a mechanism for export credit guarantees. In the first five months of 1997, there was a significant increase in the export of timber, metal products, furniture and, to a smaller degree, foodstuffs, textiles and light industry production. This has led to forecasts of an 18 to 20 percent increase in exports for 1997. However, imports rose by 16-

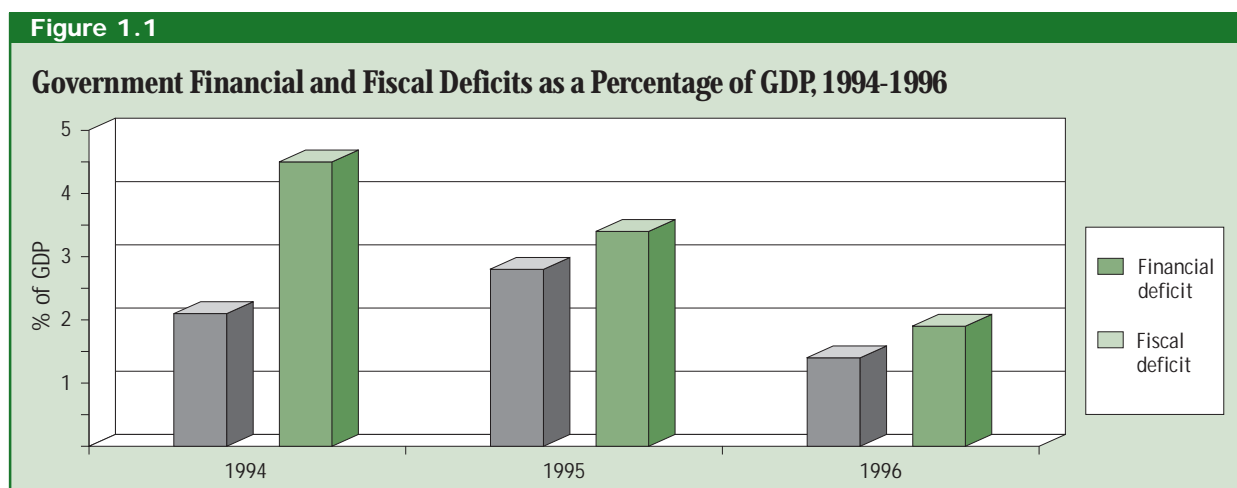
17 percent for the same period and the external trade deficit has persisted.

The structure of Latvia's foreign trade has changed in recent years, with the EU share increasing and the CIS share diminishing. In 1996, the EU share of total turnover was 47.5 percent, while that of the CIS was 29.5 percent. In terms of trading partners, in 1996 the largest turnover was with Russia (21.2 percent), followed by Germany (13.8 percent), Sweden (7.4 percent), Lithuania (6.7 percent), Finland (6.6 percent) and Great Britain (6.0 percent).

Increasing exports is critical, as the internal market is currently too limited to foster economic growth. Increased exports would heighten the interest of domestic and foreign investors, which should contribute to infrastructure development. This, in turn, would lead to income growth, resulting in more resources for human development priorities — health and education.

## Fiscal Policy

The essential precondition for macroeconomic stabilization is adherence to tight fiscal policy. Ideally, the budget of a transition economy should promote economic recovery and favourable conditions for the development of private enterprise, while providing adequate social security. These tasks are difficult to accomplish in practice because of the need to maintain a low fiscal deficit to ensure a stable economic environment. The implementation of tax reform in Latvia has taken place under very difficult circumstances, as tax revenue has decreased with the decline in production. At the same time, there have been urgent needs in the realm of social benefits and rebuilding the infrastructure. Still, Latvia has moved quite rapidly in transforming its fiscal system.



The general government fiscal balance recorded a surplus of 0.6 percent of GDP in 1993. Fiscal policy was expansionary in 1994 and moved to a deficit of 4 percent of GDP, reflecting increases in net lending. In 1995, fiscal problems were exacerbated by the banking crisis, which had both a direct and indirect effect on revenue collection. Total revenue fell by about 1 percentage point of GDP in 1995. Nevertheless, as a result of a major compression of net lending, the overall fiscal deficit was reduced to 3.4 percent of GDP in 1995.

Fiscal policy was tighter than predicted in 1996. The fiscal deficit was reduced to 1.9 percent of GDP (See Figure 1.1) and the financial deficit was reduced to 39.9 million Lats or 1.4 percent of GDP. This was achieved through a major revenue mobilization effort combined with restraints on expenditures. Tax revenues in 1996 increased by 21 percent compared to 1995. Revenues rose by 70 percent from the excise tax and by 23.8 percent from personal income tax. The increased growth in revenues was a result of changes in tax rates (on the excise tax) and improvements in administration.

Continued commitment to fiscal discipline is reflected in the 1997 budget which was approved as balanced, while the overall fiscal deficit is expected to be about 1.2 percent of GDP. Through the first eight months of 1997 the total state budget maintained a surplus.

Latvia has made good progress in establishing the institutions needed for fiscal management in a market economy. There is a well-functioning treasury geared for central government operations and a tax system suited to the needs of a market-based economy. Over the last few years several changes were introduced in the tax system aimed at adjusting legislation to EU requirements. The standard rate of the value-added tax (VAT) is 18 percent and corporate and personal income tax is 25 percent. The social tax rate is 37 percent, but this is to be lowered to 33 percent by 2001.

Because tax rates are already sufficiently high, the main task of the revenue service is to ensure tax collection. Poor administration during fiscal reform gave rise to two types of violations — tax evasion and non-payment of tax debts. The sharp fall in corporate tax receipts and customs revenues despite the increase in imports suggests that tax evasion is still a serious problem. Improving administration is critical to securing the necessary resources for the state to fund human development priorities.

The main economic aim of the ruling centre-right coalition is to achieve a low fiscal deficit with

macroeconomic equilibrium and to leave the rest to market forces. Within the confines of a tight budget, the government has limited room for maneuver in economic and social policy. The public still harbours skepticism of unregulated market forces and expects more active government social policy. To a certain extent, the Latvian public has a *welfare state mentality* and believes that the state should provide a wider range of social services than is currently possible within budgetary constraints.

At the same time, conditions must be created such that tax payments are unavoidable and perceived as an expression of civic responsibility. The current state tax “philosophy” is based on a person’s ability to pay, regardless of what the state gives in return. Latvia has not yet reached the stage in which the government offers various benefits (education, health care etc.) and taxpayers’ money covers the costs. In such circumstances, it is incumbent upon the state to provide accurate information regarding the availability and quality of services (such as education and health care) it intends to provide, the revenue source which will finance the services and the progress made in collection of those revenues. Should the revenues fall short of expected levels, the government has three policy options: 1) decrease the services provided to match revenues; 2) redirect money from other parts of the budget; or 3) borrow money to ensure the provision of services. Regardless of the option chosen, the policy must be clearly communicated to the public to reinforce the linkage between budget revenues and services provided.

## The Budget and Human Development

As stated in the introduction to this Report, the quality of economic growth is just as important as the quantity. The state budget is the mechanism through which the government can translate quantity into quality, focusing on human development priorities. For the time being, achieving macroeconomic stability has taken precedence over addressing social problems, with serious consequences for human development, particularly in the realms of health and education. Fiscal policy remains primarily geared towards macroeconomic stabilization.

The analysis of the state budget in **Latvia Human Development Report 1996** concluded that the distribution of budget resources by sector was not as great a problem as the relatively small aggregate size of Latvia’s budget and registered output. A low GDP means that budget revenues in absolute terms are relatively small and

remain insufficient for addressing the complex social problems of the transition. When one considers that total government spending according to the 1997 budget amounts to only 564 Lats per capita, it is clear that the *capabilities* of the government are limited, and the *choices* available to policy makers in terms of adding quality to growth are severely constrained. However, this situation only highlights the need for government to continually improve the effectiveness of spending from a human development perspective. If one has little to spend, it is especially important that the money be well spent.

The structure of planned expenditures in 1996 differed little from that in 1995. The sharpest rise in expenditures was for general government services at both the state and local levels. Overall, such expenditures increased by 25 percent compared to 1995. However, after adjusting for inflation, spending on education, health care and social security was no greater than in 1995 and in some cases (e.g. for education) even lower.

Real budget expenditures on education are decreasing annually, as increases are not keeping pace with inflation. In 1996, expenditures were 96 percent of those in 1995. Inadequate funding has generated serious problems, as resources have not been sufficient to maintain the education infrastructure. During the transition, teachers' salaries have not reflected the importance of their work. The average monthly salary of those in education is only 80 percent of those in commerce. Teachers' salaries are below the average in the public sector, leading many to seek supplementary employment or leave the profession altogether. This has typically meant that teachers are overworked and encounter difficulties in maintaining adequate standards (see also Chapter 2 below).

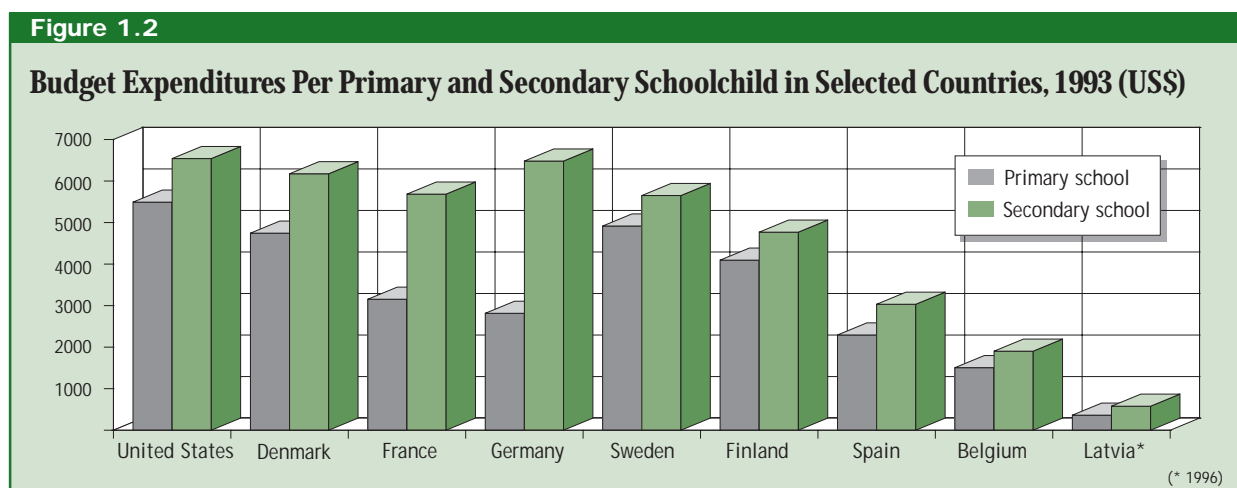
Spending on education comes from the state budget, the budgets of local authorities, the re-

sources of private individuals and legal persons, as well as from foreign assistance for particular institutions and projects. Budget resources cover slightly more than 90 percent of the total expenditure on education. Although these make up 6.5 percent of GDP, which corresponds to the world average, in absolute terms the sums are very small (see Figure 1.2).

Expenditures on education are to rise by 16 percent in 1997, but this increase is insufficient for addressing the accumulated problems in this realm. The greatest increase in spending in recent years has been for running expenses, maintenance, heating and lighting, repairs etc. If the average expenditure in 1995 on heating, lighting and hot water was 10 percent of planned spending on education, in 1997 this figure could rise to as much as 20 percent. Because the total allocation for education is not being adequately increased, running costs are paid for at the expense of more qualitative reforms including training, development and improving the education system.

The funding of the health care system has been changed for 1997 with the creation of a new, special national health care budget (one of the central government special budgets). In 1997, 53.6 million Lats will be allocated to this budget. This total includes personal income tax revenues (28.4 percent of total personal income tax revenues go towards this budget), the state budget and local government funds. The latter are voluntary, because local authorities themselves may increase planned expenditures on health care above the amount foreseen by the national health care budget.

This funding arrangement complies with the recently introduced payment system for medical services, whereby part is paid by the state and part by health insurance funds. Funds from the state budget go towards state health programmes, such as the treatment of tuberculosis, cancer and men-



tal illness, and mass immunization. The basic health care programme is similarly funded, including the treatment and diagnosis of aggravated chronic and acute illnesses, emergency treatment, prenatal observation and midwifery, preventative medicine for infectious diseases, prevention and treatment of contagious and skin diseases and others. Planned budget expenditures on health in 1997 will not increase in real terms because they do not exceed the expected inflation rate.

Since the budget allocation for health care has been minimal for several years in succession, there are only sufficient resources for regular medical services and none for investment. Although the number of hospital beds and doctors has fallen (see Figure 1.3), the Health Department of the Ministry of Welfare still believes there are too many doctors. The demand for doctors, especially in outpatient clinics and hospitals, is on the decline, suggesting that many health care professionals will be forced to undergo retraining.

According to Government forecasts, the increase in revenue from the social tax could be 17 percent more than in 1996. State pensions in real terms (adjusted for inflation) could increase by about 8 percent in 1997. However, it should be noted that this increase will not apply to all pensioners. The rise in pension payments for those who retired before 1996 will not be above the inflation rate.

In the first six months of 1997, the basic budget of local government was slightly in surplus. Of course, this does not necessarily mean that local government services have been provided at adequate levels; as noted before, the aggregate size of local government budgets is small and will continue to be so for the foreseeable future. Thus, municipal budgets will continue to be tight, which could affect the provision of support to the needy.

As pointed out before, enhanced revenue collection is essential to securing resources to address human development priorities. Given the small size of the budget, money which isn't collected is as important as that which is collected. The 1996 **Report** included the results of a survey conducted by the Central Statistics Bureau which estimated that the shadow economy accounts for approximately 14 percent of GDP. The persistence of a sizable shadow economy deprives the budget of badly needed revenues. Information on unregulated or unreported economic activity is critical to rectifying the situation and minimizing revenue loss. However, no follow-up studies on the shadow economy have been conducted.

One positive development with regard to Latvia's budgeting practices is the shift toward a form of programme-based budgeting beginning

with the 1997 state budget. This may help the government to use the budget more effectively as a means of focusing on the achievement of certain objectives, rather than merely keeping track of expenditures for various public spending categories. However, a programme-based budgeting system should also be supplemented by an effective system of monitoring programme implementation so as to better determine future budget allocations for individual programmes.

## Conclusions and Recommendations

1996 saw a major turn for the better in Latvia's macroeconomic indicators, though reforms need to be maintained and accelerated. In the near future, Latvia's industrial growth will most likely be concentrated in areas that rely on domestic resources and produce goods with modest added value primarily for the domestic market (including the food industry). More dynamic growth will require industries to employ raw materials (e.g. timber) from the other Baltic states and the CIS to produce high-quality goods for the world market. However, investment capital must be made more easily and cheaply available to facilitate factory modernization.

Fiscal policy should support investment, which in turn encourages economic growth. Tax receipts could be increased by expanding the tax base and reducing various tax allowances. As tax collection continues to improve, the tax rates must be rationalized. Tax administration could be improved by more efficiently organized audits, registration, information dissemination to tax payers and declaration processing. Tax payers must recognize that non-compliance with the tax laws means punishment. Tax discipline could be improved by public debate on the significance of paying one's taxes and the basis of the tax system. Regular monitoring of the size and dynamics of the informal or shadow economy should be carried out.

As noted before, the relatively small aggregate size of Latvia's state budget creates difficulties for the government to adequately address human development priorities while maintaining a balanced budget. Although running a budget deficit (for example, no more than 3 percent of GDP as per the Maastricht Treaty requirements) to address health, education and other problems exacerbated by the transition remains an option, more important from a human development aspect is improving the *efficiency* of government spending. The structure of government spending should continually be reviewed to identify areas of excess or

duplication. Where the government remains involved (developing regulatory frameworks, ensuring the supply of public goods, like education and health, providing social welfare), it needs to become more effective. Education spending should be geared toward teacher training, curriculum development and modernization of Latvia's education infrastructure. Investments in health care should increasingly be focused on primary health care and preventive measures such as public information and health education programmes in schools; there is also a need to deliver health services more efficiently. Increasing efficiency of spending will not only further human development priorities, but it will also increase the government's *legitimacy* as the keeper of the public's money and help create the critical link between taxes and tangible benefits.

With government expenditure representing almost 40 percent of total GDP, it is clear that public sector reform and the realignment of the role of the state continue to be very important public policy priorities. As indicated above, public sector salaries remain low, while the number of employees remains high; it is clear that a more rational balance is required. It is also clear that the underlying problems associated with the sector — low credibility with the public at large and especially the private sector, low productivity, poor responsiveness — need to be addressed. In Latvia's overall reform agenda, top priority and long-term commitment need to be accorded to strategic public sector reform.

As the economy grows and wages rise, adequate attention must be paid to encouraging private savings to promote investment. Continued effective regulation of the banking system is essential to securing public trust in the banking system so that savings will be deposited within that system.

Public trust in the government's regulation of financial institutions is also important for the future development of Latvia's private pension system.

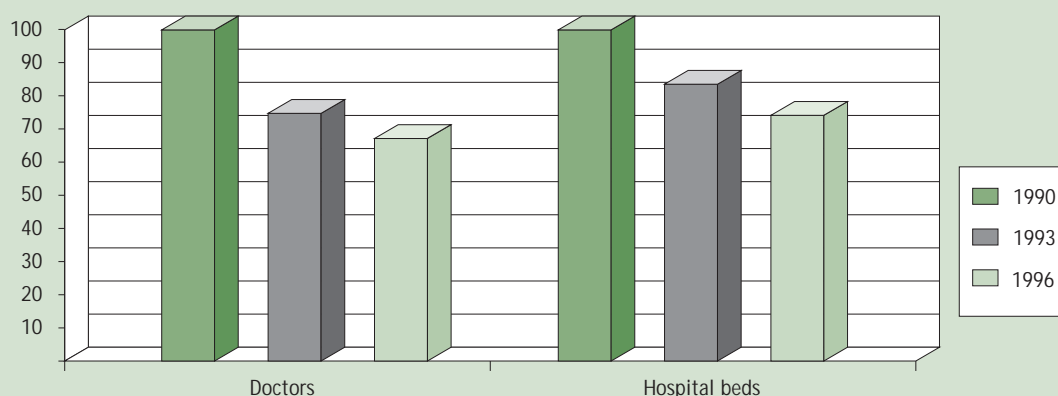
Latvia has made good progress in establishing the institutions required for fiscal management in a market economy, including a well-functioning treasury and a tax system geared towards the needs of a market economy. Similar attention needs to not only be given to non-bank financial institutions, but also to further reform and development of the judiciary and the overall legal system. An important element of establishing the rule of law (as well as in overall public sector reforms) is limiting corruption. While this issue is discussed in greater detail in the next chapter, in the context of trying to restore the general public's trust in state structures, it is important here to highlight that unchecked corruption, or the perception of widespread corruption, can deter much-needed investment coming to Latvia. From a human development perspective, beyond its negative impact on economic growth, corruption can also lead to what are very limited public budgetary resources being diverted away from human development priorities such as education and health.

Privatization of land and housing by certificates must be accelerated. As a result, there would be increased liquidity in the housing and real estate markets which would not only increase the capabilities of property owners, but also allow for greater mobility of labour. In addition, a more rapid shift from public to private ownership of housing could free up resources which could be redirected toward wages or invested in human development priorities.

Significantly more attention must be paid to supporting small and medium sized businesses, especially new businesses. To be effective, entry for new businesses should be cheap and adminis-

Figure 1.3

Doctors and Hospital Beds in Latvia, 1990-1996 (1990=100)



tratively easy. In this context, work should continue on a credit guarantee scheme for small loans, on expanding and improving the support network for enterprise support so that it becomes a one-stop information and consulting agency. The work of enterprise support organizations should be brought closer to businesses in the smaller towns and rural areas. Further, to operate efficiently new businesses should also have broad access to markets for their products.

In this context, it is also important that priority be placed on further developing and reforming Latvia's trade policy. Latvia's goal of joining the World Trade Organization (WTO) by the end of 1997 or early 1998 is very important, as it would both enhance market access and provide some security against the arbitrary imposition of trade barriers. Most importantly, accession would signal to the international community that Latvia has made real progress in its economic reforms and is open to trade and investment. However, with membership come a number of responsibilities and obligations which the government should be prepared to meet.

A deeper understanding of the integrated nature of development of the urban and rural econo-

mies is needed. Capital, intellectual resources and investment tend to be concentrated in the cities, mainly Riga, while rural development is lagging behind. The obstacles to resources flowing to the countryside need to be identified and removed. Specific attention should be placed on improving infrastructure in support of regional development through the public investment programme.

The current system of subsistence farming serves as a social buffer because it provides for the livelihood and employment of some 600,000 members of rural households. Outside the home, employment in rural areas is hard to find. For many in rural areas, though, the social cost is low incomes, poverty and psychological depression. From the perspective of sustainable human development, it is important to encourage structural changes directed towards the strengthening of the commercial farming sector. At the same time, programmes should be introduced to provide financial and other resources that encourage rural enterprises, assist rural households start up new, non-traditional businesses and create employment for those who are unable to compete in the farming sector (see also Chapter 4 "Regional Development").