



# *Economic Growth and Human Development*

## *Introduction*

As in previous **Reports**, the objective of the first chapter is to provide a summary of the main economic developments in Latvia and to examine the link between economic growth and human development. The growth of Latvia's gross domestic product (GDP) is analyzed by sector and compared with changes in the GDP of other Central European countries. Foreign trade, investments, and budget expenditures are analyzed from a human development perspective. Continuing the work of earlier **Reports**, the current implementation and future goals of the social insurance reform is analyzed. Echoing the theme of this year's **Global Report**, the structure of household consumption is also examined.

1997 was a successful year for the Latvian economy. GDP growth was significant – 6.5% – which is the largest increase since the beginning of economic reforms. As a result of fiscal policy, inflation and interest rates decreased. The state budget ended the year with a surplus. Inflation was 8.4%, one of the lowest inflation rates among the countries in transition. The unemployment rate declined. Foreign direct investment remained at a high level. On a per capita basis, Latvia ranked second among the Central European countries in attracting foreign direct investments.

In terms of macroeconomic indicators, Latvia can be said to have reached the final phase of the transition. The medium-term objectives of economic development have been defined, the efforts aimed at integration into the European Union continued, and Latvia became a member of the World Trade Organization. Great progress has been achieved in the liberalization of trade. In April 1998 the government approved the document “Medium-term Economic

Strategy in the Context of Accession to the European Union.” The EU's December 1998 Vienna summit evaluated Latvia's achievements positively and decided that Latvia could be invited to begin accession negotiations in 1999 if the present rate of reform is maintained.

Structural reforms are continuing, but the privatization of large state monopolies has slowed and was not completed by the end of 1998 as originally planned. Due to the Russian financial crisis 1998 has not been as successful economically as 1997. Nevertheless, GDP growth could be as much as 5%. Latvia's trade with Russia and the other CIS states is progressively decreasing. Because export growth is mainly to the West, the effects of the Russian crisis are smaller than they would have been in the past and Latvia's economy has remained stable. Since the 1995 banking crisis Latvia's financial system has become considerably stronger. Deposit insurance was introduced on 1 October 1998.

The role formerly played by the state in the command economy has decreased. However, as a growing number of economists admit, the very lack of regulatory activity by the state has been one of the main causes of the crises in East Asia and Russia. Economic liberalization requires the state to retain definite regulatory instruments, and the theory that everything can be regulated by the market has not been borne out.

The state must strive to play a balanced regulatory role in directing the economic and social processes that could promote more rapid human development. Although the trend toward economic growth has taken root in Latvia, this has not yet been adequately reflected in the growth of the general level of well-being. The standard of living of large segments of the population is still low, and macroeconomic growth and structural change have not created a sufficiently large, prosperous middle class.

## An Overview of Economic Growth

In terms of GDP growth, Latvia has significantly improved its position among the European Union candidate countries (see Table 1.1). In 1997, only Estonia and Poland had higher growth rates than Latvia.

Considering the low level of GDP per capita in Latvia, it is important to maintain high annual growth in order to steadily approach the level of EU member states. In 1997 per capita GDP, expressed in purchasing power parity dollars, was only 27% of the EU average (see Table 1.2). This is the second lowest figure among the candidate countries.

It should be noted that Latvia experienced a grave economic crisis at the opening stage of its reforms. Latvia's GDP in 1995 was only half of that in 1990. In comparison, in Estonia and Lithuania GDP in 1995 was 60%, in Hungary and Romania approximately 90%, and in Slovenia 97% of GDP in 1990. Thus, Latvia has recovered relatively more rapidly than these countries.

In 1997 employment increased, and the registered unemployment rate was 7%. At the beginning of 1998 employment continued to rise. However, the crisis in Russia halted this positive trend. If they do not find new markets, some of the companies whose sales are dependent on Russia and the other CIS states will have to lay off workers.

1997 saw marked growth in the service sector (7.4%) and industry (5.4%) (see Figure 1.1).

Trade has grown most rapidly, stimulated by the availability of new financial services such as leasing. The private sector's share reached 98% of the total value added of the trade sector. In 1997, Ls 88.8 million were invested in fixed assets in this sector, 54% more than the previous year. Foreign investors invested approximately Ls 9 million. Much of this money has been invested in the construction or reconstruction of large stores, gas stations, automobile dealerships, and repair shops.

Industrial production has also grown considerably. The processing industries have grown significantly, by 7%. The largest increase was in the area of food processing which is now the largest sector of the processing industry. Light industry also grew in 1997. For instance, clothing manufacture rose by 18.2%. A large percentage of the products of the textile industry are exported, mostly to the EU. During the last three years exports to the CIS have remained practically unchanged.

The development of the metalworking and engineering industries over the last few years should also be noted. In 1997 the production of electrical machines and equipment increased by 35.8%. Practically every sector of the machine-building industry grew except the production of transportation vehicles. 90% of the products of the metalworking sector are exported.

*Table 1.1*      **Annual GDP Growth Rates  
in EU Candidate States**  
(percentage change  
on previous year)

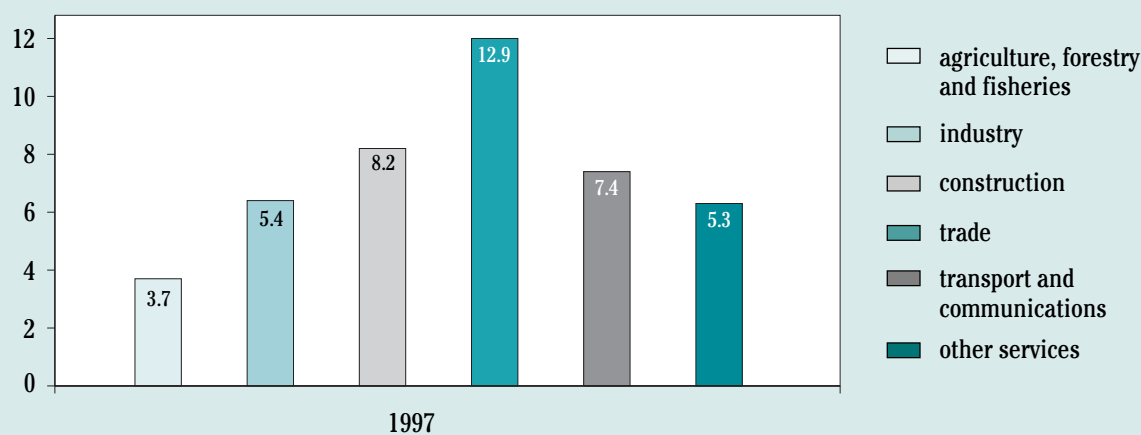
Country	1995	1996	1997
Bulgaria	2.1	-10.0	-6.9
Cyprus	5.5	2.0	2.4
Czech Republic	4.8	4.4	1.0
Estonia	4.3	4.0	11.4
Hungary	1.5	0.5	4.4
<b>Latvia</b>	<b>-0.8</b>	<b>3.3</b>	<b>6.5</b>
Lithuania	3.0	3.6	5.7
Poland	7.0	6.0	6.9
Romania	7.1	4.1	-6.6
Slovakia	6.8	6.9	6.5
Slovenia	4.1	3.5	3.8
<b>EU candidate states, average</b>	<b>5.6</b>	<b>4.1</b>	<b>3.6</b>
<b>EU, average</b>	<b>2.5</b>	<b>1.7</b>	<b>2.6</b>

*Table 1.2*      **Real GDP Per Capita  
(PPP US\$)**  
**in EU Candidate States**  
(percentage of EU average)

Country	1995	1996	1997
Bulgaria	28	25	23
Czech Republic	62	64	63
Estonia	32	34	37
Hungary	45	46	47
<b>Latvia</b>	<b>25</b>	<b>26</b>	<b>27</b>
Lithuania	28	29	30
Poland	36	38	40
Romania	32	34	31
Slovakia	43	45	47
Slovenia	65	67	68
<b>EU candidate states, average</b>	<b>38</b>	<b>40</b>	<b>40</b>

Figure 1.1

### 1997 Economic Growth by Sector (value added, percentage change on previous year)



However, production did not increase in mining, electric power, and heating. Production in the chemical, rubber, and plastics industries declined slightly.

As a result of the increase in overall economic activity, the construction industry has also expanded. The structure of the construction industry has changed completely. Compared to the pre-crisis period, renovation and reconstruction make up a much larger proportion of the total: businesses invest more and more in the renovation of buildings and office space, and the wealthier members of society spend more money on home improvement. However, there is relatively little residential construction. The construction of high-rise apartment buildings has practically stopped, and the construction of single-family homes is developing slowly. The construction of commercial and manufacturing properties has declined substantially, but public works and communications construction has grown as ports and roads are repaired.

The transportation and communications sectors, which are very important for Latvia's economy, are also experiencing dynamic growth. Transit trade and port services account for almost one-fifth of the exports of Latvian goods and services, while the revenues from the transit trade make up approximately one-tenth of GDP. This reduces Latvia's negative trade balance, thus improving the balance of payments. The majority of investments in 1997 were in the transport and communications sectors, which also accounted for the largest share of accumulated foreign investments: 34% of total accumulated foreign direct investments in Latvia at the end of 1997.

Growth in the agricultural sector was lower than the average rate of economic growth. Crop production increased, but production in the livestock sector continued to fall. Nevertheless, in comparison with

the continuous decline in the volume of output in previous years, the sector has stabilized.

Differential sectoral growth rates are causing changes in the structure of the Latvian economy, which is becoming increasingly similar to that of the developed countries. The service sector's share of GDP increases every year (see Figure 1.2). Since transit services constitute a large segment of Latvia's economy, the importance of the service sector can be expected to grow.

## Investment

A successful investment policy is one of the most important factors determining economic growth rates and national welfare. The **Latvia Human Development Report 1997** rated the level of investment as comparatively low. In this respect, the last few years have been a turning point. Since 1996 investment has grown relatively rapidly. In 1996 investment grew by 21%, and in 1997 by another 11%. At present investment makes up almost one-fifth of GDP (see Table 1.3). The growth of investment in manufacturing is especially significant.

The growth of investment can be explained by the general growth in economic activity (see also Chapter 4), the active policy of privatization and the strengthening of the financial system. The growing opportunities for financing purchases by leasing-to-own have also played their part.

Foreign direct investment also plays a vital role in Latvia's economy by promoting the introduction of modern technology and management techniques, strengthening the competitiveness of Latvian prod-

Table 1.3

**Components of GDP, 1997**

	Structure (percentage of total)	Real growth rates (percentage change on previous year)	Contribution to GDP growth (percentage of total GDP growth)
GDP	100.0	6.5	6.5
Private consumption	67.2	3.9	2.6
Government consumption	23.2	3.8	0.8
Gross domestic investment	19.7	10.3	1.9
– Fixed investment	19.4	11.1	2.0
– Change in stocks	0.3	–0.8	–0.1
Exports	50.5	9.9	5.4
Imports	–60.6	6.8	–4.2

ucts, and helping Latvian companies gain a foothold in the markets of the developed countries. In 1996 Hungary was the only Central European country to attract more foreign direct investment per capita than Latvia. In 1997 foreign direct investment reached its highest level since the re-establishment of independence – Ls 243.6 million – allowing Latvia to maintain its status as the second most successful state in Central Europe in this regard. From the beginning of the '90s to the end of 1997, foreign businesses have invested a total of Ls 749.6 million (more than US\$ 1.28 billion) in Latvia, which is Ls 305 (US\$ 517) per capita. The comparable figure for Estonia is US\$ 798, and for Lithuania US\$ 281.

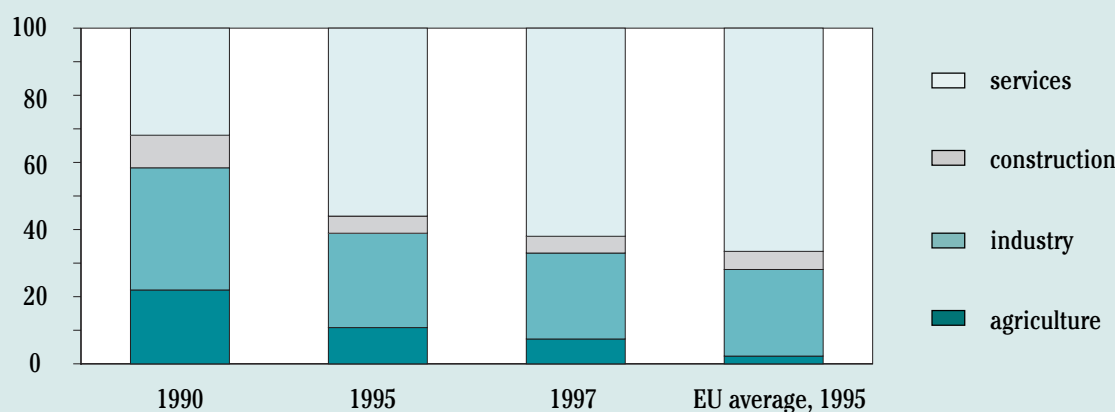
It is important to note that foreign direct investment in industry is growing rapidly, and in 1997 al-

most half of all foreign investments were in the processing industries. Foreign investment in Latvia could be even higher if it were not for investor uncertainty, caused by the frequent changes in legislation, the slow rate of land reform, the insufficient support for investment by municipalities, and the still unresolved questions regarding the border with Russia. As shown in Chapter 4 of this **Report**, these problems also hamper the work of local businesspeople.

It should be noted that most foreign investments are made in Rīga and other major cities (Daugavpils, Ventspils, Liepāja), which have a more highly developed infrastructure and provide easier access to the services necessary for business. Because of underdeveloped infrastructure, problems with power supply, and a lack of environmental protection measures

Figure 1.2

**Structure of the Latvian Economy, Compared to the EU Average**  
(percentage of total in terms of value added)



Latvia's rural areas have a hard time attracting investment. Equally important are the limited opportunities open to local governments and their lack of initiative in attracting and supporting investment. The current system of taxation provides no incentives for local governments with low levels of economic activity to promote local business and attract outside investors, since municipal revenues are not directly dependent upon business activity in a given locality. Investment is also held back by insufficient information, inertia, and a lack of initiative. There is often an expectation that an investor will arrive and do everything in order to create jobs for local workers. But passivity does not attract investments, they must be actively courted. For its part the state must enhance the ability of local businesses and municipalities to attract investment and stimulate competition between regions for investment.

The State Investment Programme also plays an important part in both economic and human development. Its current priorities are transportation and communications, energy, and environmental protection (see Figure 1.3). In the first area, investments are directed mainly to the construction of roads, the development of airports and railways, to maritime affairs, and to information technologies. Improving the efficiency of heating systems is the focus in the second area. Investments in environmental protection go mainly to improving the water supply and to waste management. Investments in these areas absorb approximately three-quarters of available funds annually, involving not only national and local government, but also private companies and financial institutions.

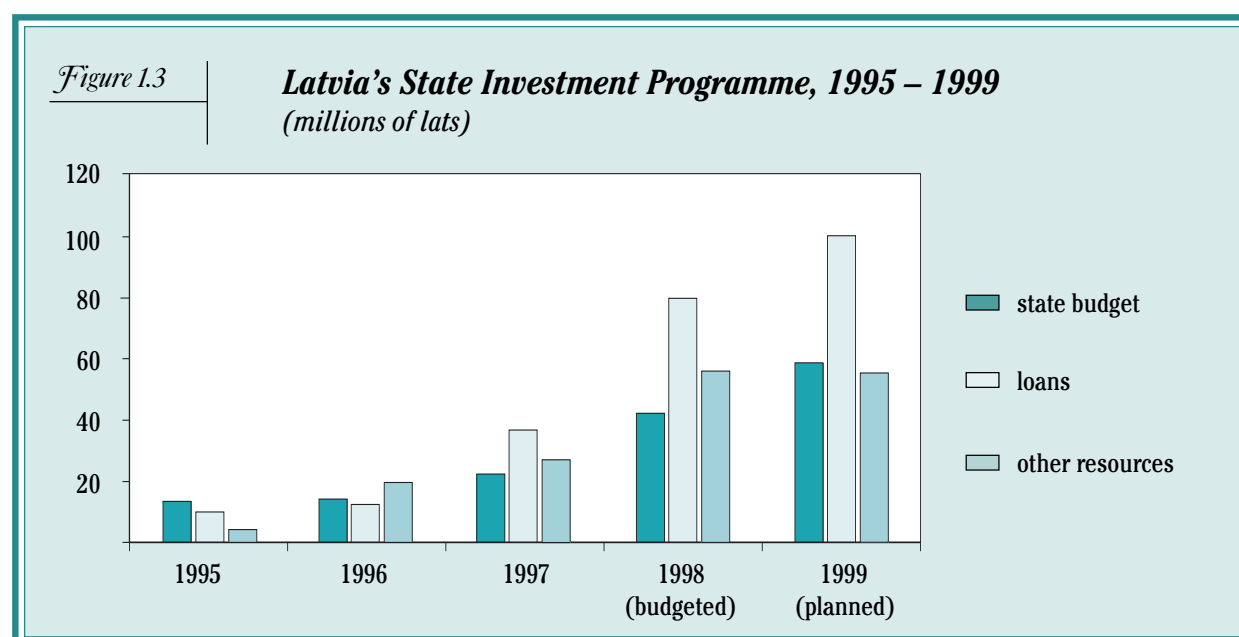
The State Investment Programme also contributes funds to the implementation of projects for social development. For instance, the Ministry of Wel-

fare is carrying out a reform of the welfare system that will receive Ls 22 million in funding from the state budget and from a World Bank loan. Plans call for Ls 17.6 million to go to health care reform and Ls 2.2 million to go to setting up a centre for disaster medicine and a system for its development. Projects for developing an educational information system (Ls 16.4 million) and for increasing the efficiency of expenditures in education (Ls 5 million) will contribute to the improvement of education and science.

Medium-term economic strategy foresees the gradual increase of investments from the state budget to 2.5% of GDP in 2003. In 1998 they amounted to Ls 68 million, or 2% of GDP. This is not enough to satisfy all the demands for improving the infrastructure. More opportunities should be created for increasing the percentage of the state budget devoted to investment and for encouraging the involvement of private capital. After the completion of projects funded by the State Investment Programme, domestic or foreign capital should be involved in their continuation or in supporting their successor organizations.

To increase private sector participation in infrastructure investment projects, a law on concessions has been drafted. When adopted, this law should set down the procedures for entrusting the rights to certain properties to a second party and also regulate the procedure for charging the public for the use of the concession. Concessions must be awarded only through a process of competitive bidding.

Unfortunately, investment policies are not sufficiently consistent. They change depending on the stated political goals of each successive government. Future investments could also be threatened by the low level of savings, which is still affected by linger-



ing mistrust of the banking system among parts of the population. In 1997 the national savings rate was 9.6% of GDP, covering only 48.7% of investments. Using foreign funds to pay for investments increases foreign debt, which in the future could negatively influence the current-account balance. It is important to find ways of stimulating the national savings rate, which would allow Latvia to decrease its dependency on foreign funding. This is especially important because the proportion of foreign direct investments could decline in the future. The experience of other transitional countries also indicates that a high rate of foreign direct investment is not sustainable in the long term.

### *The Budget and Human Development*

Expenditures from the Latvian state budget make up about 40% of GDP. Liberal economic theory, which serves as a guide for Latvian government policy, holds that economic development can be retarded and the effectiveness of state and local government expenditures decreased if a large proportion of GDP is taken up by the state budget. Therefore reform of the state sector and the reduction and reorientation of the role of the state are important priorities for national economic policy.

If the state controls too much of the economy, the effectiveness of budget expenditures is low and the tax burden heavy. High taxes create discontent among taxpayers and distortions in the market. The greater the role of the state, the faster expenditures increase, increasing the likelihood that the ability to generate budget revenue will be exceeded. This can lead to the growth of the budget deficit and the national debt.

Nonetheless, human development is basically funded from the state budget. The amount of money required for the effective implementation of programmes financed from the budget continues to increase. There is a need not only to launch new programmes, but also to assign new functions to existing programmes and to increase their funding. Therefore, demands on the state budget continue to grow. There is an ongoing debate about these issues. On the one hand, the representatives of certain parties and interest groups advocate the creation of a budget deficit in order to fund more programmes. On the other hand, the government contends that stable and sustainable economic development requires a fiscal policy based on balanced revenues and expenditures. The government argues that even if macroeconomic stability delays the resolution of various important social problems at present, it is the prerequisite for more rapid human development in the future. In this

way the government hopes that today's losses will be more than compensated in the future.

When measuring the financial needs of important social programmes against the possibilities afforded by the state budget, it is important to understand both sides of the story, in particular, the arguments against any increase of the fiscal deficit. The arguments for limiting the growth of the deficit are usually based on the need to reduce inflation. However, in Latvia limiting the fiscal deficit is also vitally important for another reason: macroeconomic stability can be threatened by a growing deficit in the balance of payments, if this is accompanied by decreasing flows of capital into the country (see Box 1.1). This occurred in the Czech Republic and resulted in a financial crisis and a currency devaluation.

Latvia's combined budget consists of the national and local government budgets which, in their turn, are divided into the basic budget and the special budgets. The basic budget covers the general expenditures of the national and local governments, whereas the special budgets are used to achieve specific goals. In 1997 the national basic budget made up 43.5%, the national special budget 37.6%, the municipal basic budgets totalled 16.5%, and the municipal special budgets 2.3% of Latvia's total budget expenditures.

All these budgets are paid for by tax revenues, which in 1997 comprised 43% of GDP. According to medium-term forecasts, tax revenue as a proportion of GDP will decrease in the future. By 2003, it could fall to 36.5%. The predicted fall in tax revenue as a proportion of GDP is linked to decreases in the payroll tax rate; to lower tax rates in free economic zones and in regions requiring special assistance; to a reduction in customs tariffs; and to the decline in non-tax revenues as privatization is completed.

Tax administration is systematically improving, but the narrowing of the tax base places additional pressure on the total state budget, particularly because ever more money must be allocated to human development and social programmes. Nonetheless, new taxes should not be introduced, because an increase in the tax burden makes the business climate worse, negatively affects real incomes, and stimulates efforts to avoid paying taxes.

The **Latvia Human Development Report 1997** emphasized that in 1997 the combined budget expenditures per capita were only Ls 552. In such circumstances, it is difficult for the government to support economic growth while simultaneously dealing with social problems. The alternatives open to politicians are limited. Therefore, the efficiency of budgetary expenditures must be increased. To achieve this goal, a number of steps are being taken: national and local government functions and resources are being more efficiently organized, the ratio of capital expenditures

## Box 1.1

***The Link between Trade, the Balance of Payments and Human Development***

In the context of free trade and economic globalization, the financial resources potentially available for human development should be seen not only in a national context, but also in relation to the international division of labour and trade, the competitiveness of the national economy, and the activities of international financial and humanitarian organizations. Positive changes have taken place in Latvia's trade balance since the publication of last year's **Report**. In 1997 growth in exports was 6% higher than growth in imports. GDP growth in 1997 was largely export driven. The export of goods, calculated in current prices, rose by 22.2%. Unfortunately, the export of services decreased slightly. The growth in exports was mainly to the West, and 49.3% of the total export of goods was to EU countries. These exports consist mostly of wood (54.5%). However, the export of textiles, metals, machinery, and foodstuffs to these countries also increased. In 1997 the major Western export partner was Great Britain (14% of exported goods). In the first nine months of 1998 Latvia's largest trading partner was Germany, taking 15.1% of Latvia's exports and contributing 16.9% to its imports.

In 1997 Latvian exports to the CIS remained at their previous level. Russia was Latvia's major export partner in 1997 (21% of goods exported). In 1998, as a result of

economic restrictions aimed at Latvia and of the financial crisis in Russia, Latvian exports to Russia decreased, especially foodstuffs and the products of light industry. This has had a negative impact on economic growth rates in Latvia.

Since the introduction of a free trade agreement with the Baltic states, total Latvian exports to Estonia and Lithuania have increased. Imports from these states, however, have grown even more rapidly, and Latvia's balance of trade with her nearest neighbours has worsened.

All in all exports in 1997 grew more rapidly than did imports, improving Latvia's balance of trade. Unfortunately, due to the unfavourable situation in Russia, in 1998 imports once again grew more rapidly than exports. The current account balance could, as a result, become acutely negative. It was already 6.3% of GDP in 1997, and could reach 8% in 1998. Although the current account deficit is not as high as in Estonia, it is nevertheless a potential source of economic instability in Latvia. At present, with large amounts of foreign money still flowing into the country, Latvia can still meet its external payments despite the negative current account balance. Nevertheless, considering the mobility of global capital flows, the negative current account balance presents a significant risk for Latvia's economy.

to operating expenses is being improved, and the procedures for planning, allocating, monitoring, and controlling budget expenditures are being refined.

The functions of local government are expanding as they assume greater responsibility for maintaining housing, providing municipal services, and carrying out social programmes. Therefore, an optimum level of decentralization should be established and the division of responsibilities between the national and local governments should be defined more clearly to make their mutual relationship more effective (see Chapter 2). As last year's **Report** indicated, a discussion about finding the right balance between centralization and decentralization is of fundamental importance to Latvia. These relations must be flexible and responsive to specific circumstances. More effective mechanisms for dialogue should be developed, allowing for a redistribution of functions if the present division of responsibilities proves to be ineffective.

The balanced budget policy implemented by the government has allowed for limits to be placed on the growth in budgetary expenditures. However, this policy restricts the possibilities of meeting the demands for

social services. It restricts salaries, the maintenance costs of government agencies, and investments, and thus has hindered human development. An increase in government spending on social needs should be considered.

It is important to organize budget expenditures more efficiently and to ensure a balance between operating expenses and investments (see Figure 1.4).

In 1997, only 2.3% of the consolidated expenditures of the combined state budget went to investments. Subsidies and grants, including those directed at households, made up 58.8%. Salaries (15.5%) and payments for goods and services (12.3%) are also important expenditures. The large share of the budget devoted to operating expenses and salaries indicates that more attention is being paid to current needs than to future prospects.

As has already been mentioned, the percentage of the combined budget devoted to investments is constantly increasing. In 1996, investments from the combined budget equalled 0.8% of GDP, in 1997 – 1%, and in 1998 they are expected to reach 2%. In 1998, the sum devoted to investments in the combined state budget will grow by 127%. However, these

investments are still too small to provide for the necessary improvements in the infrastructure, which is one of the most important prerequisites for economic growth. It is also necessary to ensure a rational distribution of funds among the various sectors of government activity, so that it is in line with the priorities of national and human development (see Figure 1.5).

It is forecast that social insurance, social security, and health care will make up 45.6% of expenditures from the combined budget in 1998. One of the main initiatives for reducing the burden of operating expenses on the state budget is the introduction of pension reform.

In the social sphere the state must ensure an adequate level of social security and a just distribution of benefits. People must also become more responsible for their own well-being. A system of incentives is being established that correlates social insurance payments with the desired level of social protection and benefits. Pension reform has gone the furthest in this respect. The task of the government is also to create a social insurance system that is transparent and that functions well in a market economy.

In the last years spending on health care and education has not grown in real terms because the nominal increases in financing have not exceeded the rate of inflation.

One of the most important tasks of health care reform was the centralization of funding in order to provide a base-line level of health care for everyone and to eliminate regional differences. At the beginning of 1997 the funding of the health care basic programme was Ls 25.10 per capita. The sources of funding for health care in 1997 and 1998 were the national basic

budget, the reserve fund for special expenditures (28.4% of income tax revenues, 50% of revenues from the alcohol excise tax, and 5% of revenues from the tobacco excise tax), and fees paid by patients.

To provide for a sustainable budget policy, a great deal of attention has been devoted to the more efficient organization of budgetary expenditures on civil service reform. As expenditures must be increased in priority sectors, the reform will help to eliminate unproductive overlaps of expenses and functions. Another way of freeing resources for priority sectors is to transfer to the private sector those activities which it can perform more efficiently than the government sector.

Salaries for public sector employees present a dilemma. On the one hand, they are a significant burden on the budget. On the other hand, salaries have not increased significantly over the last two years and as a result the civil service and the agencies funded from the budget have had a hard time attracting and retaining qualified personnel (see Chapter 2). Compensation policy in the state sector is currently under reconsideration. The elimination of redundant positions will allow for increases in the remuneration and the efficiency of civil servants and employees of institutions funded by the government. A situation will be achieved in which pay will correspond to performance.

By improving the management of expenditures, money from the budget could be spent more effectively. The planning, allocation, monitoring, and control of the budget is regulated by the Law on the Budget and Financial Management. Latvia has made significant progress in setting up the institutions necessary for fiscal management in a market economy.

Figure 1.4

**Economic Structure of Expenditures  
in the 1997 Consolidated Combined Budget**

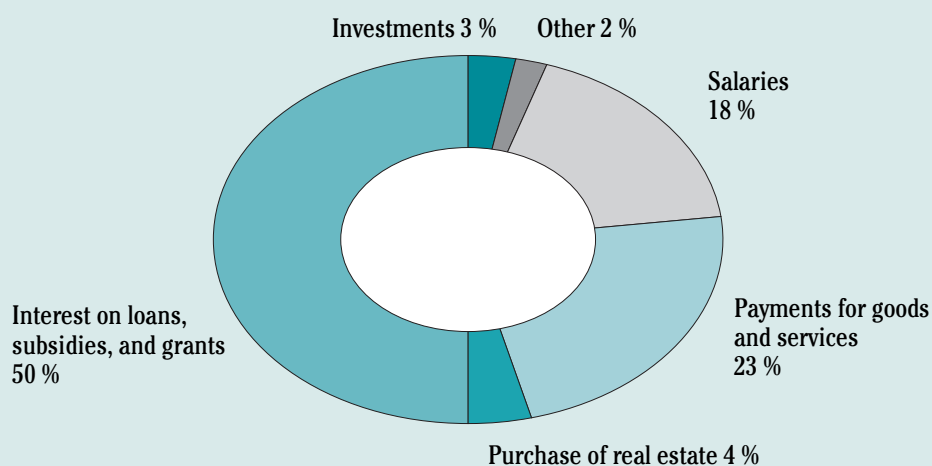
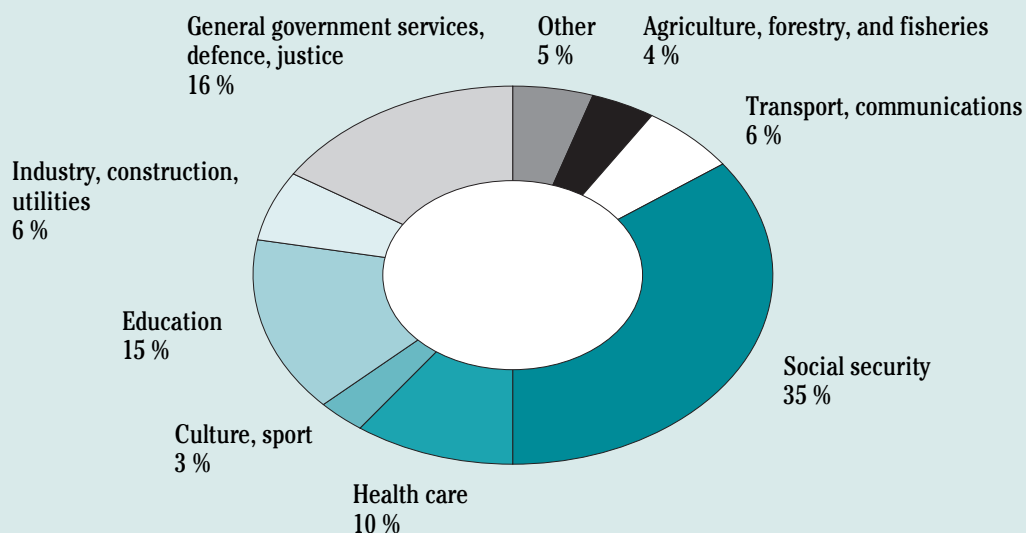


Figure 1.5

### Sectoral Structure of Expenditures in the 1997 Consolidated Combined Budget



The most important of these is the State Treasury system that was introduced to meet the needs of the government. Management of the budget has been improved as a result of the increased supervision of local government loans and the consolidation in the State Treasury of all government accounts. Management of the foreign debt has become more efficient thanks to the inclusion in 1997 of all loans and credit guarantees in the state budget.

The stringent control of budgetary expenditures is one of the most important elements guaranteeing macroeconomic stability. By the end of 1998 the internal control systems of the ministries will be reinforced by management audits in addition to the present financial audits.

### *Household Income, Consumption, and Stratification*

The **Latvia Human Development Report 1997** concluded that a large proportion of the population of Latvia is poor, making it impossible for them to live well-rounded lives. As can be concluded from the 1996 household budget survey conducted by the Central Statistical Bureau (CSB), these people have difficulties paying for housing, buying food and clothing, and providing for their health care, educational and entertainment needs.

The household budget surveys have continued.

7881 households were surveyed in 1997, making this the most extensive statistical survey conducted in Latvia, providing generally reliable and representative results. The survey shows that in 1997, compared to the previous year, nominal household income rose by 7.7%, whereas the consumer price index rose by 8.4% during the same period. This means that on average the population's purchasing power did not increase, but declined by 0.7%. Last year's **Report** pointed to the large income inequality between urban and rural residents, with higher poverty rates in the countryside, especially in Latgale. These trends continued in 1997 as real income fell more rapidly in rural households.

According to CSB data, private consumption (as an aggregate component of GDP) rose 3.9% in 1997 (at constant prices). However, the household budget survey indicates that actual consumption per household member has decreased by 1.6% (with growth in expenditures adjusted according to the consumer price index). According to experts at the Ministry of Economy, this contradiction can be explained by the fact that the results of the household budget survey apply to the majority of the population with average incomes, but they cannot be applied to the population as a whole. There is reason to believe that the survey has not fully taken into account consumption by the wealthier segments of the population. Their proportion in the population is not large, but the amounts they spend could be considerable (see Box 1.2).

In 1997, average disposable monthly household income, calculated per household member, was Ls 57.80 in Latvian urban areas, an 8.8% increase over

Box 1.2

### Statistics Regarding the Rich Are Incomplete

Some journalists have estimated that there are approximately one thousand rich people in Latvia. If that is the case, probability theory predicts that the household budget survey, with a survey sample of almost eight thousand households, should include between five and ten such families.

Income per household member of the wealthiest household included in the CSB household budget survey was Ls 2,610 per month. This household ran a farm, so their income could be seasonal or incidental, and family income may have been combined with income from production.

The monthly income of the wealthiest urban house-

hold was Ls 590 per household member. Of course, this is not enough to make anyone rich, and apparently this household is not among that thousand written about by the journalists.

Household budget surveys usually do not register the living conditions of the wealthiest. Since the surveys are voluntary, these people generally avoid providing any information. This can also be seen in sociological surveys. Moreover, CSB household budget surveys only collect data on income, expenditures, and consumption. They do not include questions about property and savings, but these are the factors that largely determine the extent of someone's wealth.

the previous year (for Rīga the figure was Ls 62.27, an increase of 10.1%). Urban income growth slightly exceeded the rate of inflation. Rural household income in 1997 were only Ls 49.86 per month, 4.5% more than the previous year, considerably lagging behind the rate of inflation (see Table 1.4).

Despite the fact that in 1998 the Saeima (Parliament) approved the Rural Development Programme, that a World Bank rural development project is underway, and that a programme for regions requiring special assistance has been launched, up to now national economic policy has not succeeded in im-

proving the rural population's well-being. Special attention should be paid to rural areas. 31% of Latvia's population lives in the countryside. Moreover, in a demographic crisis rural areas provide for greater population growth than urban areas.

Income rose faster than inflation in the Greater Rīga area (the cities of Rīga and Jūrmala, and the *rajoni* (districts) of Rīga, Ogre, and Tukums). In the historical regions of Vidzeme and Zemgale income and prices rose at approximately the same rate, but in Kurzeme and, in particular, Latgale income lagged behind inflation.

Table 1.4

### Sources of Disposable Income for Latvian Households, 1996 - 1997\* (monthly average per household member)

	Income in Lats (total monetary and non-monetary)		Income Structure (percentage of total)	
	1996	1997	1996	1997
Wages and salaries	25.97	28.66	50.4	51.7
Pensions	11.66	12.95	22.7	23.4
Other social transfers	2.49	2.68	4.8	4.8
Net income from agricultural production	4.97	4.67	9.7	8.4
Net income from private business and handicrafts	0.72	0.74	1.4	1.3
Other income	5.69	5.75	11.0	10.4
Total	51.50	55.45	100	100
of which non-monetary	8.12	7.46	15.8	13.5

\* Disposable income (monetary and non-monetary) includes wages and salaries, other income from paid employment (after taxes), social transfers, net income from business and agricultural production (after deducting the costs of production), income from the sale of real estate and other property, etc.

Table 1.5

**Structure of Expenditures for Latvian Households, 1996 – 1997**  
(monthly average per household member)

	Expenditures in Lats (total monetary and non-monetary)		Percentage change, 1997 on 1996	Structure of Expenditures (percentage of total)	
	1996	1997		1996	1997
Food	24.51	24.04	98.1	52.2	48.0
Housing and utilities	6.88	7.70	111.9	14.7	15.4
Transport	2.91	3.58	123.0	6.2	7.1
Clothing and footwear	2.74	2.93	106.9	5.8	5.8
Entertainment and leisure	2.01	2.38	118.4	4.3	4.8
Medicine and drugs	1.81	1.96	108.3	3.8	3.9
Household goods	1.21	1.54	127.3	2.6	3.1
Hotels, restaurants, and travel expenses	1.15	1.33	115.7	2.5	2.7
Communications	0.66	1.01	153.0	1.4	2.0
Education	0.37	0.44	118.9	0.8	0.9
Other goods and services	1.49	1.89	126.8	3.2	3.8
<b>Total</b>	<b>46.93</b>	<b>50.08</b>	<b>106.7</b>	<b>100</b>	<b>100</b>

The **Latvia Human Development Report 1997** called attention to the fact that in 1996 67.9% of the Latvian population lived below the poverty threshold – the crisis subsistence minimum as defined by the Ministry of Welfare. A year later a somewhat smaller percentage of households – 56.9% – lived under the crisis subsistence minimum. The percentage of the population living below the full minimum subsistence level remained virtually unchanged – 80.5% (the situation of the most impoverished is analyzed in Chapter 2). The reason for this is that the price of food rose more slowly than that of services and industrial products, and food makes up the largest part of the crisis subsistence minimum. This price dynamic was relatively favourable for the needy in urban areas and unfavourable for the rural population.

The continuing stratification of the population by income is confirmed by the Gini coefficient, which ranks households by deciles and measures income inequality.<sup>1</sup> In 1996 the Gini coefficient in Latvia was 0.30, whereas in 1997 it was 0.31. It should be noted that in the West income inequality as measured by the Gini coefficient is generally lower than in Latvia. For instance, until recently the Gini coefficient in Sweden was 0.20. Stratification by income poses a

serious threat to sustainable human development because it leads to inequality of opportunity.

Indications of a positive trend in household budgets appeared in the first half of 1998. In this period average disposable monthly income per household member was Ls 58.70, or 10.5% more than during the same period in 1997. The price of goods and services rose 6.0% during this time. Thus, purchasing power rose by 4.2%. However, the increase in income for the country as a whole was due entirely to the rise in incomes for urban households. The increase in income of rural households is within the limits of statistical sampling error (0.1%). When price increases are taken into account, the conclusion is that living standards for the rural population have continued to decline.

These trends observable in the midyear data should be approached with cautious optimism. The modest increase in income in the first half of the year could be interrupted by unfavourable developments in the second half of the year, such as the economic crisis in Russia or a poor harvest caused by bad weather in the third quarter of 1998.

Since their income is insufficient, households are only able to pay for the bare necessities. As a percentage of their total budget, food continues to be

<sup>1</sup> The Gini coefficient ranges from zero to one. If it is zero, incomes are distributed absolutely equally, but if it is one, one person receives all the income. The Gini coefficient has been calculated from the expenditure on consumption of one consumer unit (using the first, unmodified OECD scale), therefore the figure for 1996 differs from previously published figures.

the largest item in Latvian household expenditures. In 1997 it accounted for 48.0% of total expenditures. Compared to 1996, this percentage has decreased (see Table 1.5), since the price of food has increased more slowly than the price of other goods and services.

The caloric value of daily food consumption per household member has decreased from 2,490 calories in 1996 to 2,433 calories in 1997. Daily consumption of the most valuable meat products has declined even more rapidly. Many people have not been able to buy a sufficient amount of food even for comparatively low prices because of the rapid increase in so-called obligatory expenses (i.e., rent and utilities) that cannot be avoided.

There are significant differences between the structure of expenditures of different income groups. For the poorest ten percent of households, 60% of expenditures are on food, while for the wealthiest ten percent only 34% of expenditures are on food, a figure close to that in developed countries.

The second major item in Latvian household budgets is housing and utilities. These expenditures have increased both in absolute and in relative terms. Moderately poor households spend the highest percentage of their budgets on housing – 20%. The poorest households are simply unable to make these payments in full, so they allot only 10% of their budgets to housing (how the poor juggle their utilities expenses is described in Chapter 2). Wealthier households allot 13 to 14% of their spending to these obligatory expenses.

Pensioners are the most conscientious in paying the rent and, as a result, they often find themselves in financial difficulties. Housing expenses play the smallest role in the expenditures of the rural population, the majority of which lives on farms that they themselves own. These farms are often in need of repairs, which are put off until “better times.” Penalties for the non-payment or late payment of rent and utilities are becoming increasingly severe.

The third major type of expenditure is transport, which also has a tendency to increase due to rising fares. The percentage of other expenses in the household budgets is smaller.

The structure of expenditures for the majority of the Latvian population is patterned on a subsistence model, with a large percentage devoted to food and obligatory payments. This model has been predominant in Latvia for the past several years. A different structure of expenditures is developing for the 3 to 5% of the population that is relatively wealthy. Their structure of expenditures approximates that of the West, with relatively higher spending on clothing and footwear, culture and recreation, travel, hotels, etc.

A significant phenomenon appearing in the first half of 1998 is that household expenditures grew faster than income. As compared to the same period in 1997,

average household expenditures in 1998 rose by 15.9% while income rose by only 10.5%. This can be explained by the fact that some households have spent part of their savings and have made wider use of the opportunity to buy on credit or to take loans. One can conclude that these households have started to view their future prospects more optimistically.

### *Self-Assessment of Material Circumstances*

A synthesis of all the factors making up material circumstances is reflected in household self-assessments. The respondents were asked: “How would you assess the material circumstances of your household?” The replies have been combined in five categories (see Table 1.6).

Both in 1996 and 1997 approximately 58% of households assessed their material circumstances as bad or very bad. In 1997 the degree of satisfaction, also known as the consumer confidence indicator, improved by 0.1%, which is within the limits of statistical sampling error. (This indicator is calculated by subtracting the percentage that answer “bad” or “very bad” from the percentage that answer “good” or “very good,” ignoring neutral responses).

Farmers assess their material circumstances relatively better than others, even though their disposable income, on average, is lower than that of the households with employed members. This could be explained by a greater feeling of stability on the part of farmers due to the fact that they own land and a house and have a guaranteed supply of food from their farmstead.

Almost three-quarters of pensioner households assessed their material circumstances as bad. Moreover, their net satisfaction decreased by 1.2% between 1996 and 1997. Households without a steady source of income (included under “Other households” in Table 1.6) are even more pessimistic. These are materially and socially the most vulnerable groups, urgently requiring state support.

In the first half of 1998 household self-assessments of their material circumstances improved: 4.4% of Latvian households assessed their material circumstances as very good or good, 45.6% as average, 35.7% as bad, and 14.3% as very bad. The percentage assessing their situation as “average” or “bad” has increased, while the percentage considering their situation as “very bad” has decreased. Pensioner households and households without regular income still have the most negative assessments of their material circumstances.

Improvements in the self-assessment of material circumstances can be explained by positive trends in the standard of living in the first half of 1998 and by the fact that a certain segment of the population

Table 1.6

***Self-Assessments of the Material Welfare  
of Latvian Households, 1996 – 1997***

Self-assessment of household material circumstances	All households		1997			
	1996	1997	Households with at least one employed member	Farmers' households	Pensioners' households	Other households
Very good	0.2	0.2	0.2	0.2	0.1	0.2
Good	3.0	3.2	4.8	2.6	0.9	1.8
Average	39.2	38.9	46.3	51.7	26.1	19.6
Bad	28.7	28.0	27.7	27.1	30.4	21.3
Very bad	28.9	29.7	21.0	18.4	42.5	57.1
Net satisfaction	-54.4	-54.3	-43.7	-42.7	-71.9	-76.4

has become psychologically accustomed to poverty. Nevertheless, half of Latvian households consider their material circumstances to be bad or very bad.

### *Social Insurance and Social Assistance*

Social insurance and social assistance reform were analyzed in last year's **Report**. In this area a dialogue is forming in Latvia between the state, the individual, municipal governments, non-governmental organizations, and the private sector. The state has accepted the principles of a social security system. Its goal is to guarantee everyone a minimum level of social protection while apportioning the rights and responsibilities of the state and the individual so as to increase the role of individuals in their own and their families' social protection. This sometimes leads to a misunderstanding of state policy because many people are unable to take on the added responsibilities of the new system. As a result, both those who receive wages and those who receive social insurance benefits are forced to turn for support to the social assistance system, whose goal is to guarantee the social security and protection for those people who are unable to take care of themselves and who do not receive adequate support from other sources.

Much has been done in 1997 and 1998 to consolidate social reform. The administration of social insurance payments (the payroll tax) has been put in order and a number of laws on state social insurance have come into effect.

In 1997 the payroll tax was reduced from 38% to 37%. In spite of this reduction, revenues of the state social insurance budget increased by 19.4% in 1997.

The introduction of individual social insurance accounts, improvements in the administration of revenues, and the introduction of new social insurance laws have all been factors in this increase. As a result, incentives for employees to make their social insurance payments have increased. The reduction of the portion of the payroll tax paid by employers (see Chapter 4) has also acted as an incentive for them to make these payments.

The number of people with social insurance grew by 7,000 in 1997. Thanks to all these factors, the social insurance system started 1998 with a Ls 26 million surplus.

Social assistance has also received a larger "piece of the pie" as the amount of social assistance has grown and its quality has improved. Ls 83.35 million – 3.1% of GDP – was spent on social assistance in 1997.

In 1997 state social insurance expenditures rose by 10.4%. 90% of this spending is attributable to pension payments, including more than 70% for old-age pensions. Even though spending on pensions has increased, the standard of living of the elderly is becoming an ever more pressing problem.

Approximately 90% of old-age pensioners do not have a job. To lessen their poverty, 9,600 pensioners are paid a guaranteed pension that is larger than what they would receive based on their accumulated pension capital. At present this guaranteed pension is Ls 30. An additional 13,000 pensioners whose employment history exceeds thirty years have their pension capital calculated based not on their own low personal incomes, but on national wage averages. All this requires additional money from the payments made by the insured. The average pension is small, and is different for the various types of pensioners (see Table 1.7).

The indexing of pensions is also a significant issue. Until the year 2000 pensions that do not exceed three minimum wages are to be reviewed every six months, taking into account the consumer price index. Starting in 2000 a wage payments growth index will also be applied, ensuring not only compensation for decreases in purchasing power, but also the real growth of all pensions.

Pensions do not grow very much if they are indexed only according to changes in consumer prices. For the benefit of pensioners the methodology of calculating these changes was revised in November 1997. Previously pensions were indexed on the basis of real price increases since the previous indexation. Now they are indexed on the basis of expected price increases in the coming indexation period.

The average old-age pension is approaching the value of the basket of goods and services included in the crisis subsistence minimum for one person. At present it is 96% of this amount. Nevertheless, in the middle of 1998 the average pension was still only 68% of the full subsistence minimum for one person.

The fact that pensions are small is tied to the fact that wages are insufficient. The pension problem cannot be resolved by pension legislation alone. At present the social insurance budget can provide pensions which exceed the crisis subsistence minimum only at the expense of other groups, either by halting the development of other social insurance services or by increasing the size of social insurance payments.

How to escape this vicious circle? Only increased co-operation between the state, the individual, and the private sector in the field of pension reform can simultaneously improve conditions for pensioners and maintain all the present guarantees for the socially insured.

This reform has three levels, the first consisting of a universal state pension plan based on the principle of solidarity across generations, while the second and third levels introduce and develop parallel pension plans based on personalized accounts. This makes it necessary to radically change public awareness of and responsibility for providing for their income when they reach retirement age. The question is not who will bear the greatest burden of responsibility, but rather how can efforts be united to solve this problem.

The goal of the first level, universal state pension plan based on the principle of solidarity across generations (introduced in 1996) is to guarantee a retirement income proportional to former wages, based on the amount and duration of an individual's social insurance payments. Someone with an average length of employment retiring at the age of 60 would receive approximately 40% of their previous salary. The later one retires, the more one receives. This retirement income level is generally in line with that provided in other countries. However, since wages are low, pensions are also low, and do not allow many people to lead a normal life.

A draft law has been prepared on the second level of pension reform, based on a state plan with personalized pension accounts. According to this draft law, part of the state old-age pension payments would be invested independently of the generational solidarity plan. This could significantly increase pensioners' income and protect the funds of the state pension plan from political interests. Overall, such co-operation would stabilize the economic environment and relations between the people and the state, between employers and employees, and between the state and the private sector. The introduction of a state pension plan

*Table 1.7* | **Average State Pensions**  
(lats per month)

	1993	1994	1995	1996	1997
Average monthly pension of all pensioners registered at the Social Insurance Agency <sup>1</sup>	14.8	24.8	30.2	38.4 <sup>2</sup>	42.2 <sup>2</sup>
Old-age pensions	14.7	24.8	30.2	37.8	42.2
Disability pensions	15.6	27.6	33.3	38.4	42.6
Survivor's pensions <sup>3</sup>	17.2	24.4	28.7	32.7	36.3
Service pensions	2.9	7.8	13.0	36.8	44.6
Social pensions	11.3	16.5	19.7	—	—
Pensions accorded on the basis of special decisions	12.3	24.7	64.5	64.0	69.1

<sup>1</sup> Not counting pensioners registered at the Ministry of the Interior

<sup>2</sup> Not counting social security benefits

<sup>3</sup> Total pension for all survivors

## Box 1.3

**Education – An Investment for the Future**

Education is an important human development priority in Latvia, where investment in human resources could be one of the most effective paths towards welfare and social harmony. Within the last few years the percentage of young people (7-23 years old) attending schools has risen from 69.9% in the 1994/1995 school year to 78.2% in 1997/1998. The most rapid increase has been in higher education, where the number of students grew 15.5% between 1996/1997 and 1997/1998. In the same period the number of students at private educational institutions increased by 39.6%.

The **Latvia Human Development Report 1997** noted that education has also been touched by negative trends and by social stratification. Equal access to education has not been guaranteed for everyone. The children from prosperous urban families have the possibility of attending well-funded elite schools, while the poor, particularly in rural areas, have much more limited educational opportunities. Many of the best teachers leave their profession because of low wages. The unequal opportunities for acquiring a quality education encourage a large segment of the population to be passive with regard to continuing their own or their family's education and thus increasing their ability to compete on the labour market.

The UNDP study (made in collaboration with the World Bank and the ILO) *Listening to the Poor: A Social*

*Assessment of Poverty in Latvia* confirms that attitudes towards education differ considerably, depending on a person's education and social position. Educated parents are ready to make material sacrifices to assure their children a good secondary and higher education, which is the precondition for a well-paid job. According to CSB data, at the beginning of the 1997/1998 school year, 51% of students at institutes of higher education were paying for their education (as opposed to having it paid for by the state). Less educated parents have a tendency to believe that education is not particularly relevant for their children and that it does not provide for good job opportunities. One dangerous trend is educational stratification among the young, because it limits their future competitiveness and increases the number of undereducated people who are more likely to be unemployed in the future.

Education is analyzed in more detail in Chapter 3, paying special attention to the discrepancy between the present educational preferences of the young and the future demands of the market, and to the educational system's capacity to satisfy not only young people's desire to learn, but also to prepare them for those professions which offer real job prospects. As a market for education emerges, it is very important that institutions of higher education provide a high quality education. Adult education and retraining are also important as means of fighting poverty and actively promoting employment and business activity.

with personalized pension accounts will lead to the formation of large concentrations of savings, allowing the Latvian capital market to develop more rapidly, positively affecting the financial system as a whole, and contributing to economic development.

The legal foundation for the third level of pension reform, the introduction of private pension plans, is already in place. The first private pension funds have already handed in the documentation to receive their licenses and began operations in 1998.

As money accumulates, the utilization of these funds should be evaluated from a long-term perspective. This is a question of priorities, where the views of the state and the individual clash. Raising the retirement age is a decisive factor for the accumulation of this financial reserve. This means that retirement is postponed and the money thus accumulated is paid out in pensions somewhat later. If pensions are increased right away, there may not be enough money for future pensions. As indicated in the Introduction to this **Report**, sustainable human development requires that the expansion of choices and opportunities for the present generation does not diminish the op-

portunities for future generations and that every generation is treated fairly. The indexing of pensions in May 1998 made the needs of today's pensioners a priority. This will require a great deal of money and a readiness to take risks, draining reserves that will be necessary in the future. To provide for the necessary level of social security, Latvia must make use of the advantages of personalized pension accounts. Otherwise, as the rate of social insurance payments declines, there will be limited opportunities to raise pensions.

Competition between social service providers both in the state and private sector should be encouraged. This applies not only to the private pension plans of the third level of pension reform, but also to the state pension plan with personalized accounts. In the future this second level of pension reform will include the possibility for people to choose whether to entrust their money to the managers of the state pension fund or to a private pension fund.

A distribution of responsibilities and duties between the state, local government, and the individual is also starting to appear in the sphere of social assistance. By means of social assistance the state and lo-

cal governments are creating a safety net for people with inadequate incomes. Social assistance includes material assistance, social care, and rehabilitation.

Encouraging individuals to act on their own is an important direction in which to develop social assistance. Emphasis should be placed on assistance that promotes the integration or reintegration of an individual into society, restoring the individual's ability to provide for himself. Thus the focus is not on granting material assistance, but on providing the services that allow individuals to remain as active as possible and to retain their accustomed environment.

Responsibility for supplying and financing social assistance is divided between the state and local governments. The state's responsibility is to care for children whose parents are not known; to provide vocational training and professional rehabilitation for the disabled; to care for institutionalised persons with special needs and for orphans up to the age of two; and to provide social assistance for the homeless.

Local governments are responsible for providing social assistance benefits; home care for people who are not able to take care of themselves; social rehabilitation for risk groups (alcoholics, drug addicts, former prisoners); day-care centres for people with various needs; institutional care for children between the ages of 3 and 18 without parents and for persons of retirement age.

Spending on social assistance in 1997 grew by Ls 1.6 million, or 2%, compared with 1996. National budget expenditures rose by 8.5%, whereas expenditures from local government budgets decreased. Local government budget revenues do not cover all the required expenses. Just as the various local governments are on different levels of economic development, so are the social services they can provide. Social assistance benefits receive the most money from local government – 76%. The cost of institutional care, home care, and social rehabilitation has risen.

The structure of a local government's social benefit payments reflects the social priorities in that municipality and the most urgent needs of its residents. In 1997 42% of benefit payments went to pay for utilities. Next in importance (21%) were free or partially subsidized lunches for schools and kindergartens. The proportion of benefits spent on medical treatment has reached 8.5%.

Local governments are not so much responsible for organizing social care and rehabilitation for their residents as for providing them with the opportunity to receive these services. A local government can purchase these services from another local government, a non-governmental organization, a business, or an individual. However, at present the market for social services is very limited. If they wish to purchase social care services, local governments must

consider the costs of these services. They must be sure that the services will be provided at a reasonable cost and that they will be of sufficient quality. The answer to this problem could be market competition, which is only starting to develop.

## *Conclusions and Recommendations*

1997 was a successful year for the Latvian economy. GDP growth was higher than any year since the introduction of economic reforms. The year ended with a state budget surplus. The inflation rate was among the lowest of any of the countries in transition. The unemployment rate decreased slightly. Investments grew considerably, driven by an influx of foreign direct investments. However, infrastructure projects and the social sphere did not receive enough money because of the inadequate level of state investments. In the next few years investments funded by the state budget should be increased to at least 2.5% of GDP and 7% of the state budget.

A stable link has yet to be established between economic growth and human development. Although positive trends have appeared in household incomes, the unequal distribution of the rewards reaped from economic growth threaten the harmonious development of the nation. In 1997 the growth of personal consumption lagged behind GDP growth rates. Growth in consumption is held back by restrictive fiscal and monetary policy. The slow growth of incomes is an important factor deterring inflation. Should the flow of capital into Latvia slow down, it would become even more necessary to limit deficit spending.

The stratification of Latvia's population continues to grow. The material welfare of those people who receive their income from the budget (e.g., pensioners, teachers, doctors) is not improving, because the growth of their incomes is not directly tied to inflation. The relatively high rate of unemployment and the weakness of the labour unions does not promote wage increases in the private sector either.

To improve tax administration, substantial amounts of money should be invested in the development of new computer networks and databases. Taxpayers should be more stringently controlled and harsher penalties should be introduced for deliberate non-payment of taxes. However, these policies will not give immediate results and their effect will only be felt after several years.

To provide for sustainable human and national development, the growth in national welfare must be balanced and inclusive. At present this balance has been upset. In the last few years Latvia has witnessed rapid social stratification while general welfare has

remained at a low level. Therefore, measures should be taken to halt further polarization.

People must take more responsibility for their own welfare. This would also motivate them to bring their social insurance expenditures in line with the level of social security they desire. The social insurance system should be further improved so that it is acceptable to the majority of the population and functions well in the market economy. Extensive information and explanations should be provided about the pension reform so that people understand clearly how their pensions will be calculated when they retire. Such explanations should promote the responsible participation of the public in the social insurance system and create trust in the role and services of the private sector in the field of social insurance.

More attention should be paid to preventive health care, to providing the public with information and education about healthy life styles.

When making decisions about the prices and tariffs charged by the large state monopolies for their goods and services, consideration should be given to whether the average residents of Latvia will be able to pay for them without endangering their health and the welfare of their children. The privatization of the large state monopolies should be completed, observing the utmost requirements of openness and transparency.

Under present circumstances, when people's incomes are low and a free market for apartments has yet to be established, special steps should be taken to organize and protect low-income tenants. Co-operatives formed by tenants or by the owners of individual apartments should be encouraged. Rental boards could act as lower courts in rental disputes, providing legal assistance to less well informed tenants.

Not only legal, but also economic and statistical analysis should be taken into account when drafting legislation affecting the interests of large parts of the population. The groups that would gain and the groups that would lose as a result of the proposed changes should be identified. Special care should be taken to prevent such changes from causing further stratification.

The transition to a market economy has brought with it a range of problems confronting social service providers. The present social assistance system cannot provide for all those who are in need. There are a number of reasons for this: too many people have very low incomes and the number of people who need care and social rehabilitation is comparatively large. These services require substantial amounts of money which are provided by the taxpayers. At present most people expect the state to provide a wider range of social services than is possible, given today's limited budget. These questions are discussed in more detail in the following chapters. Co-operation between the state, the individual, and the private sector should be

developed. The private sector should be encouraged to become more actively involved in the provision of social insurance and social services. Individuals must be prepared to take on more responsibility for their own and their children's education, accommodations, health, and security in old age. Moreover, the responsibility of the state in these areas must also be maintained in the future.

The complexity of the system of social assistance benefits results in the inefficient use of funds. No standard has been set for the amount of money a municipal government should spend per resident. Local government budgets, which receive most of their money from personal income tax payments, are often too small to provide social assistance for everyone that might qualify. Therefore, it is necessary to develop a system of financing that would provide support from the state budget for those municipalities that do not have sufficient funds to cover their social assistance needs.

In order for the social assistance sector to develop more successfully, expenditures should be streamlined by developing alternative types of care, such as care at home, guardianship, foster homes, and day-care centres. The private sector should be encouraged to become involved in providing social assistance, thus expanding the market for services and developing competition. However, the state and municipal governments should retain control over the quality of the services transferred to the private sector or to NGOs.

Local government activities to support businesses and to attract investments should be encouraged. The current tax system provides no incentives for municipalities with low levels of economic activity to promote local business and attract outside investors, since local government revenues are not directly dependent on business activity in their territory.

In the future, public sector reform and the reorientation of the role of the state will be very important priorities for national economic and social policy. People-oriented economic and social development is directly linked to the pace, sequence, and quality of the reforms associated with transition. Latvia has reached a turning point. The policy of fiscal belt tightening has been justified from the point of view of short-term macroeconomic goals, but it has also created a series of negative consequences that have been described in this chapter. Latvia is a small country in demographic crisis, burdened by the social problems that were inherited from the Soviet period and then compounded by the transition period. The time has come for Latvia to make its economic policy more socially oriented. As shown in the following chapters, this will require a partnership between the state, the private sector, and the individual that is simultaneously more dynamic and more harmonious.