

BTI 2014 | Latvia Country Report

Status Index	1-10	8.41	# 12 of 129	
Political Transformation	1-10	8.75	# 11 of 129	➔
Economic Transformation	1-10	8.07	# 15 of 129	➔
Management Index	1-10	6.82	# 12 of 129	
	scale	score	rank	trend

This report is part of the Bertelsmann Stiftung's Transformation Index (BTI) 2014. It covers the period from 31 January 2011 to 31 January 2013. The BTI assesses the transformation toward democracy and a market economy as well as the quality of political management in 129 countries. More on the BTI at <http://www.bti-project.org>.

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Key Indicators

Population	M	2.0	HDI	0.814	GDP p.c.	\$	20968.6
Pop. growth ¹	% p.a.	-1.6	HDI rank of 187	44	Gini Index		34.8
Life expectancy	years	73.6	UN Education Index	0.868	Poverty ³	%	0.6
Urban population	%	67.7	Gender inequality ²	0.216	Aid per capita	\$	-

Sources: The World Bank, World Development Indicators 2013 | UNDP, Human Development Report 2013. Footnotes: (1) Average annual growth rate. (2) Gender Inequality Index (GII). (3) Percentage of population living on less than \$2 a day.

Executive Summary

The period from 2011 to 2013 saw Latvia rebound from the deep economic recession that had kept a stranglehold on state and society for two years. It also witnessed less successful attempts to refashion the political system and restructure ethnic relations in the country.

Latvia had one of the world's fastest growing economies in 2011 and 2012, with an equally positive outlook for 2013. The harsh austerity measures of 2008 – 2010, which saw taxes rise and public spending slashed, led to a near-balanced budget (with deficits of less than 2% in both 2012 and 2013), booming exports and the return of FDI. At a conference in Riga in mid-2012, Christine Lagarde hailed Latvia's "remarkable" achievements, attributing them to the government's "political will and ownership" as well as a willingness to "bite the bullet" and frontload reforms and not postpone the pain. After years of emigration, the Ministry of Economics has now prepared a program to lure Latvians back to the country. Politicians are convinced that Latvia will join the euro zone on 1 January 2014.

In the summer of 2012, then president Valdis Zatlers attempted to draw a line in the sand, calling a referendum on parliament in protest at the political interference of what he termed oligarchs. Zatlers claimed that Latvia's democracy was in danger. The people voted first to recall parliament and then in the parliamentary elections of 17 September 2011 rejected two of the three parties that represent primarily oligarch interests (so-called oligarch parties), while the other parties elected to parliament pushed the third oligarch party into opposition. However there has been little reform of the political system beyond this. Parties remain small, fractured and liable to implode at any moment. After his reelection bid for the presidency failed, Zatlers founded a party to compete in the parliamentary election (the eponymously named Zatlers' Reform Party). However, six of the party's 22 elected deputies defected from the party even before the first parliamentary sitting. The government coalition has been as fractious as its predecessors, with open conflict between ministers and parliamentary deputies defecting to vote with the opposition.

This can partly be explained by Zatlers' initial desire for a different coalition, the deeply symbolic gesture of a coalition with the Russian-speaking Harmony Center. However the six break-away deputies denied the two parties a parliamentary majority and, with the threat of more defections from the party, Zatlers was forced to walk away from Harmony Center, handing the coalition building to Unity Alliance and giving Valdis Dombrovskis his third successive government. The scorned Harmony Center went on to support a divisive referendum on the introduction of Russian as a second language. An opportunity for healing Latvia's ethnic division was lost. On 18 February 2012, 74.8% of participants in the referendum rejected official language status for Russian.

History and Characteristics of Transformation

The Latvian territories have been part of the Swedish, Polish, and Russian empires. However, throughout these different eras the de facto rulers of Latvia remained the Baltic Germans, who had first conquered Latvian territory in crusades against the pagans of Northern Europe in the early thirteenth century.

The modern Latvian nation arose in the mid-nineteenth century as a result of Tsarist peasant emancipation, urban industrialization and the subsequent emergence of an educated Latvian middle class. Independent Latvia emerged as the Russian empire collapsed in the aftermath of the First World War, with new countries forming across eastern and central Europe. The new Latvian state adopted a parliamentary constitution in 1922, although this failed to provide stability, with 13 government coalitions by 1934. This political instability, accompanied by an economic downturn in the early 1930s, led to a peaceful coup in 1934, and the benign dictatorship of Karlis Ulmanis. He had been the dominant figure of inter-war Latvia, having served as Latvia's first prime minister and as the head of the committee that declared Latvia's independence in 1918. These years of dictatorship are remembered with great popular affection largely because of the brutality and violence of the following Soviet and German occupations during the Second World War, and the Soviet Union's subsequent forced annexation of Latvia.

Soviet occupation after 1945 saw the collectivization of agriculture, an increased rate of industrialization and sharp demographic change. The large German and Jewish minorities had virtually disappeared as a result of the Holocaust and the dislocations of the Second World War, while many Latvians (largely the middle class elite) fled west or were deported to Siberia. The post-1945 era saw a large influx of Russian-speakers. The Soviet regime floundered in the 1980s as falling energy prices threatened economic stability, and the democratic reforms of Mikhail Gorbachev allowed Latvian nationalists to organize and compete in free elections. Three major factions emerged in the late 1980s: the radical nationalists of the Latvian National Independence Movement, the more moderate and inclusive Latvian Popular Front (LPF), and the anti-reform Interfront movement, an amalgamation of pro-Soviet forces primarily composed of ethnic Russian Latvian Communist Party members and Soviet officers who had settled in Latvia after retirement. The contemporary Latvian party system still largely reflects this order, with parties representing

radical Latvian nationalists, moderate centrist nationalists, and left-leaning pro-Russian-speakers in the Latvian parliament. The LPF won a majority in the 1989 elections for the USSR Congress of People's Deputies, and again in the 1990 elections for the Latvian Supreme Soviet, which voted to restore independence in May 1990, leading to parallel Latvian and Soviet government structures. De facto independence came after the failed August 1991 anti-Gorbachev coup in Moscow.

At this point Latvia faced a radical political and economic transition. The political transition to a multi-party democracy began with the re-adoption of the 1922 constitution and the first post-Soviet parliamentary elections in 1993. Since then Latvia has had seven parliamentary elections, all of which have been judged as free and fair by international observers. However Latvia's fragmented party system has made government stability difficult, with governments lasting, on average, little over a year. Other major political challenges included an agreement on the withdrawal of Russian forces from Latvian territory (reached in 1994), internationally acceptable rules on the naturalization of Russian-speaking Soviet-era immigrants, and accession to the major Euro-Atlantic organizations (Latvia joined the European Union and NATO in 2004).

Reform of the economy was equally challenging. Many of Latvia's largest industrial enterprises, such as the electronics manufacturer VEF and the minibus producer RAF, went bankrupt, while others were privatized or returned to their previous owners. Unemployment was high in the early 1990s, and the quality of public services fell as government receipts collapsed. Two currency reforms (first instituting the Latvian ruble, then the lats) and rampant inflation in the early 1990s, as well as the collapse of several commercial banks in the mid-1990s, wiped out many people's savings. However the mid-2000s saw rapid economic growth in Latvia, albeit primarily as a result of a construction and consumer-spending boom funded by cheap credit. The Latvian economy fell back to Earth in late 2008, and the government turned to an IMF-led international consortium for a financial bailout. A dramatic recession of unprecedented depth followed, with Latvia experiencing a cumulative GDP decline of 23.9%. Stabilization of the economy in 2010 led to modest growth and in October of that year, against expectations the Latvian electorate reelected the Valdis Dombrovskis government, which had undertaken sharp cuts in spending in 2009, 2010 and 2011. Dombrovskis returned to power once more after the early election of September 2011, called after then president Valdis Zatlers complained that parliament was in the hands of a number of oligarchs, threatening the very basis of democracy in Latvia. The subsequent election saw the vote for two of the three oligarch-dominated parties collapse, while the third such party was pushed into parliamentary opposition with a reduced number of parliamentary deputies.

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

Transformation Status

I. Political Transformation

1 | Stateness

The state has a monopoly on the use of force. Latvia has no serious domestic or external challenges to the current democratic regime.

The Latvian territories have long had a multi-ethnic composition. However the dislocations of the Second World War and the Russification policies of the Soviet era, which saw some 700,000 Russian-speakers (approximately one-third of the population) settle in Latvia, fundamentally changed the demographics of the state. The 1989 Soviet census of the Latvian SSR revealed that Latvians made up just 52% of the republic's population.

Partly as a reaction to this, the 1994 citizenship law granted citizenship to individuals, and their direct descendants, who were citizens before the Soviet occupation of 17 July 1940. This effectively denied automatic citizenship to the 700,000 Russian speakers who had moved to Latvia during the Soviet era.

External pressure from the EU, NATO, the Council of Europe and other Western international organizations led to a loosening of the citizenship law, and by the late 1990s anyone meeting residency and Latvian language requirements could be naturalized as a citizen. There was a sharp increase in naturalization after accession to the EU. In 2004 there were 16,064 people naturalized, 19,169 in 2005 and 16,439 in 2006. However, this figure fell in subsequent years, with just 2,080 naturalized in 2012, leaving 280,000 residents without citizenship in an overall population of 2 million. These non-citizens cannot vote in local, national or European elections, and are barred from certain public posts, but otherwise enjoy full economic and social rights and protection.

Little progress has been made in the integration of Russian-speakers. Latvians and Russian-speakers live in two distinct communities, with different newspapers, TV

Question
Score

Monopoly on the
use of force

10

State identity

8

shows, radio channels, and social media. Political parties are also aligned along an ethnic cleavage.

This ethnic division has become increasingly politicized over the last two years. February 2012 saw a (failed) referendum on establishing Russian as a second official language, further polarizing Latvians and Russian-speakers along ethnic lines. Russophone non-citizens were not entitled to participate in the referendum, but their participation still would not have resulted in an absolute majority for Russian as a second language.

Religious leaders of the Lutheran, Catholic and Orthodox faiths have criticized the encroachment of ‘Western liberal’ ideas – primarily the growing social and legislative acceptance of same-sex relationships – and have (less often) spoken out against economic inequality. Nonetheless none of the political parties represented in parliament has explicit links to a religious body and religion has little influence in a society which has the second lowest level of weekly religious observance (7%) in Europe.

No interference of religious dogmas
10

The severe economic recession of 2008 – 2010 resulted in the Latvian government adopting harsh austerity measures, including sharp cuts in education, healthcare and law-enforcement. Nevertheless, service provision continued. Moreover, access to European Union structural and cohesion funds has ensured ongoing improvements to Latvia’s communication, transport and basic infrastructure, regardless of budget constraints elsewhere.

Basic administration
10

2 | Political Participation

Latvia’s first early election was held on 17 September 2011, following a July referendum on the recall of parliament initiated by then president Valdis Zatlers. With a low turnout of 44.7%, 94.3% of voters supported the initiative. The resulting election involved 13 parties and electoral alliances, although only five were realistic contenders. Elections in Latvia are observed by international monitoring organizations and the 2011 election was adjudged free and fair in terms of management and accessibility.

Free and fair elections
9

The resulting government coalition was formed of three ethnic Latvian parties and excluded Harmony Center, the Russian-language party that had won the biggest share of the vote and thus the highest number of seats in the legislature. However, Harmony Center had adopted leftist anti-austerity rhetoric in its campaign, which sharply contrasted with the largely pro-austerity rhetoric of the governing parties and its exclusion from government was based on economic policy as much as ethnic bias.

Media access remains a concern. Ownership of the majority of both the Russian-language and Latvian printed press is opaque, leading to concerns of biased reporting

and “hidden advertising.” Recent legislative changes which limit party access to paid-for TV and radio advertising in the month before a parliamentary election have increased the relevance of the printed media, which had previously been in decline.

The 2011 referendum on the recall of parliament was called by the president because of concerns that three wealthy tycoons (known locally as “oligarchs”) were wielding disproportionate influence over political parties and government. The resulting September 2011 election saw support for the political parties of two of the three oligarchs collapse (with these two parties subsequently folding). Although the third party (the Green/Farmers Union, a political vehicle for the Mayor of Ventspils, Aivars Lembergs) was re-elected, it was excluded from the government coalition and went into opposition. At the same time, reforms to both party financing (which reduced limits on party private income and expenditure and the introduction of public party financing beginning 2012) and election advertising were introduced to limit the political influence of wealthy benefactors.

Effective power to govern
10

While there are no formal restrictions on association or assembly, Latvia experiences few political demonstrations or trade union protests. Even the austerity measures of 2008 – 2011 prompted only minor, largely peaceful protests. The Riga local authority has regularly attempted to ban gay pride and far-right nationalist parades, but the courts have overturned these bans.

Association / assembly rights
10

The constitution guarantees freedom of expression. Indeed, a long-running popular political interview show on Latvian public television is named after the article (100) that grants this freedom. The Latvian court system, particularly the Constitutional Court, has actively defended these rights.

Freedom of expression
9

However oversight of the media is deeply politicized. The National Radio and Television Council, which supervises electronic media, is elected by parliament and composed of party representatives. Ownership of much of the private media is opaque. Moreover, Latvian public television has become a political football in recent years with journalists complaining that the news division is being hollowed out by budget cuts while management interferes in editorial content. The majority of experienced journalists have left the news division in the last two years.

3 | Rule of Law

The Latvian parliament elects the president. Despite the key role that political parties have in selecting, nominating and voting for the head of state, all of Latvia’s post-Soviet era presidents have acted independently and have been known to return laws to parliament or otherwise challenged parliament within Latvia’s legislative framework. In May 2011, then president Valdis Zatlers triggered a referendum on the recall of parliament. Zatlers faced his own re-election a few weeks later, but

Separation of powers
9

parliament chose to replace him with Andris Berzins, a little-known back-bench deputy from the Green/Farmers Union party. However, Zatlers has remained in politics following the election of his eponymously named Zatlers Reform Party to parliament in the September 2011 poll.

The political executive (the Cabinet of Ministers) has continued to grow in strength as political parties have created more effective party organizations, and tightened internal discipline. However, the prime minister is a much weaker figure than in other European democracies, effectively controlling only his own party's ministerial portfolios, while other coalition parties maintain effective control of their own ministerial fiefdoms.

The Constitutional Court remains an important check on both the executive and legislature, returning laws when it judges them to be unconstitutional.

The judiciary in Latvia is formally independent and a distinct profession and organization. However, the de-facto independence of the judiciary is compromised by widespread perception of judicial corruption. Judges are regularly arrested and charged with various irregularities, such as accepting bribes in return for favorable verdicts.

Independent
judiciary
8

Politicization of the Constitutional Court began in 2010 when the parliament elected Vineta Muizniece, a parliamentary deputy, to Latvia's Constitutional Court despite her lack of qualifications as a judge or legal scholar. Although she was subsequently suspended from the post after being investigated and found guilty of forging parliamentary documents, she remains a member of the court. The authority of the judiciary was further undermined in late 2012 when a judge in the capital city of Riga was arrested and charged with forging documents (he had allegedly created employment contracts with non-existent people and pocketed the money).

Latvian legal and security authorities have proved largely incapable of prosecuting political corruption. This is best illustrated by the on-going case of Aivars Lembergs, the long-standing mayor of the wealthy port city of Ventspils. He is one of Latvia's three wealthy "oligarchs." Lembergs was accused of large-scale money laundering and corruption in 2000, briefly detained in prison, and then placed under house arrest while hindering investigation of the case as prosecutors alleged. In subsequent years there have been numerous interruptions in the case due to illness (of the accused, his lawyers, the judges, etc.) and other technical issues. This has revealed the ease with which the Latvian judicial system can be delayed and manipulated. As of early 2013 there is still no sign of the case coming to a conclusion. Foreign litigants are often skeptical about their chances of a free trial in Latvia, preferring to have their cases heard in the United Kingdom or elsewhere.

Prosecution of
office abuse
7

All of this has contributed to a widespread populist anti-elite attitude in Latvia. There is a widespread perception that politicians, top civil servants and successful business

figures are corrupt and that laws and business deals are subject to manipulation. This has resulted in low levels of mutual trust and social capital and open distrust of the judicial system. Frequent arrests of judges and low- to mid-level public servants (police officers, customs officials, bureaucrats) reinforces this view.

High-ranking political representatives have rarely been subject to prosecution or penalties in cases of borderline illegal activities or breach of elementary political ethics. Tolerance and mutual support is typical of the current political elite, and this approach has helped provide political stability. Nonetheless, the political influence of powerful oligarchs has captured considerable public attention.

Latvia has a national Ombudsman's office and as an EU member state also has recourse to the office of the European Ombudsman. The Ombudsman's office has regularly and consistently defended both individual and group rights (e.g., those of the Roma or low-income earners). The Latvian Constitutional Court ensures that laws and administrative practices do not conflict with the constitution, and has overturned several major laws passed by parliament, including a law which would have cut pensions as part of the 2009 austerity program. Latvia has no formal restrictions on the civil rights of women, religious groups or ethnic groups in Latvia. However, the gay rights issue continues to mobilize radical anti-gay movements (typically under the umbrella of the NoPride association) including far-right activists and mainstream churches (both Catholic and Protestant). In 2005 the Latvian parliament passed a constitutional amendment banning gay marriage. This amendment has widespread political support and is unlikely to be reversed in the immediate future.

Civil rights
9

4 | Stability of Democratic Institutions

Latvia's democratic institutions withstood the test of severe austerity measures (particularly spending cuts) between 2008 and 2010. Despite job losses and cuts to public sector salaries and certain investments (such as information technology upgrades), the parliament, executive, bureaucracy and judicial institutions continued to operate, make decisions and implement them. Although some rushed decisions (such as the previously mentioned pension reforms) were subsequently rescinded, this actually provides evidence that checks and balances work in the Latvian system, even under extreme conditions.

Performance of democratic institutions
9

All of Latvia's democratic institutions recognize the legitimacy of other institutional actors. This can be seen in the interaction of checks and balances between the president, parliament, cabinet of ministers and the Constitutional Court. However two weaknesses remain. Firstly, although there are mechanisms for the formal political participation of interest groups, trade unions and other civil society organizations, these organizations suffer from low membership and relatively poor finances (with the exception of the pro-business associations). Secondly, the political parties which

Commitment to democratic institutions
10

represent the interests of Russian-speakers remain excluded from government coalitions (although they are not excluded from power altogether; the pro-Russian Harmony Center has controlled Riga's local government since spring 2009). However, this can be explained by the incompatibility of their social-economic programs as much as ethnic prejudice.

5 | Political and Social Integration

The first four post-Soviet parliamentary elections (1993, 1995, 1998 and 2002) were marked by both voter volatility and party system fragmentation. Each election was won by a party formed less than twelve months before the poll, typically centered on a charismatic personality rather than political ideologies or policies. Further fragmentation and political realignment continued over the course of each government. While it may appear that the last three parliamentary elections (2006, 2010 and 2011) have produced a far more consolidated party system, this is largely the result of party fusion and amalgamation. Ethnic Latvian voters have low levels of party identification and vacillate between parties. In contrast, ethnic Russian voters have rallied around Harmony Center, which now has a virtual monopoly on the Russian-speaking vote. The party is now reaching out to the ethnic Latvian electorate in order to expand its share of the vote. Indeed, the ethnic cleavage between Russian-speakers and ethnic Latvians remains the only palpable cleavage. Ethnic Latvian parties differentiate themselves through charismatic leaders rather than competing policies. There are no party think-tanks nor, a tradition of using external think-tanks or research centers to generate ideas, a situation which represents a fundamental weakness in the Latvian system.

The weakness of individual parties can be largely explained by the operating principles of Latvian politics. Parties require just 200 members to register, resulting in small parties which are over-dependent on wealthy sponsors. Differences of opinion within parties are often settled by the establishment of a breakaway party. The last two governments have attempted to deal with these issues by (a) limiting party campaign expenditure and (b) cutting access to TV and radio advertising, which makes campaigning by party members more important. The introduction of public financing in 2012 (whereby parties receive a fixed sum of money relative to the number of votes gained in the previous parliamentary election) was also aimed at lessening the significance of private funding in politics.

Latvia has few effective associations or interest groups. Even the severe economic recession of 2008 – 2010 prompted minimal protest (largely marches, rather than strikes, by public sector trade unions). Many Latvians have chosen emigration (primarily to the UK and Ireland) over protest.

Party system

7

Interest groups

6

Trade unions, business and employers organizations, and associations representing students, pensioners and other interest groups mediate between society and the political system. Latvian legislation mandates that all important decisions should be discussed with relevant social partners. However, these organizations are not sufficiently funded and their operational capacity is low. They are allowed to participate and discuss but lack real influence.

The National Tripartite Council was convened during debates on the austerity measures of 2008 – 2010, but its members complained that it was at best marginalized by policymakers, and at worst ignored.

Informal economic and business interests retain the greatest influence, although the political marginalization of the “oligarchs”, and changes to party campaigning and financing rules give hope that these ties will weaken in the long run.

The economic downturn of 2008 – 2010 severely affected support for democracy in Latvia. According to a 2011 report by the European Bank for Reconstruction and Development (EBRD), Latvia was the only EU member state where less than 40% of the population favors democracy.

Approval of
democracy
8

Moreover, while trust in national political institutions has been rising along with the economic upswing, spring 2012 Eurobarometer data revealed that Latvia’s population still has extremely low levels of trust in the government (17%, compared to an EU average of 28%) and parliament (12%, compared to an EU average of 28%). However, this was a substantial improvement on the spring 2010 rates of, respectively, 13% and 6%.

Society in Latvia remains fragmented and mistrustful. Latvians have the lowest levels of trust in political institutions (particularly political parties and parliament) of all EU states, and similarly low levels of mutual trust. The foremost division is that between ethnic Latvians and Russian-speakers and this is likely to continue well into the future due to the ethnically divided education system and media. The ethnic political cleavage exacerbates this divide.

Social capital
7

Even the severe austerity measures of recent years have failed to rouse society from its apathy with only isolated, low-key sector-specific demonstrations, with little solidarity between professions.

At the same time Latvia has a strong tradition of public participation in various different cultural associations such as choirs, folk-dance groups and sporting clubs. People are reluctant to donate to organizations as they have little confidence that their funds will be used appropriately, but they are responsive to individual needs. Public campaigns for assistance to children or families in need are surprisingly well

supported. Individual grass-roots organizations (for example Ziedot.lv) and their actions also receive widespread supported.

However there are few politically-oriented interest groups, largely because there is no established tradition of donating financial or temporal resources to good causes. Indeed, a 2011 survey revealed that more Latvians distrust NGOs than trust them (by 20.1% to 32.4% respectively).

One promising recent development is the establishment of an entrepreneurial social initiative platform which allows the creation and distribution of online citizens' initiatives (www.manabalss.lv). Internal checks and balances ensure that initiatives are well-formulated and worthwhile. Once an initiative has 10,000 authenticated electronic signatures it is submitted to parliament. By the end of 2012, two initiatives submitted by the platform had been passed into law by the parliament.

II. Economic Transformation

6 | Level of Socioeconomic Development

The economic crisis of 2008 – 2010 and accompanying austerity policies led to a rise in inequality and poverty. Latvia has slipped from 44th to 48th in the UNDP HDI rankings (2010 and 2012, respectively). Moreover, while Latvia returned to growth in 2010, with GDP growth among the highest in the European Union for 2011 and 2012, it also retained the highest levels of inequality among member states, ahead of Bulgaria and Lithuania.

In January 2013 both the IMF and the European Commission asserted that the Latvian government had gone too far with its austerity measures after the government cut benefits, including the guaranteed minimum income level (which supports poor families) in the 2013 budget. Latvian political parties have shown little interest in tackling poverty and inequality and it becomes increasingly structural with each passing year.

Those at greatest risk of poverty include rural communities (especially those in the eastern region of Latgale which borders Russia and Belarus), pensioners, large families and the low-skilled, who were most likely to lose their jobs after the 2008 downturn. Poor employment prospects and a weak social safety net have prompted many Latvians to migrate to Western Europe, particularly Ireland and the UK. The best estimate is that some 200,000 people have left Latvia.

Question
Score

Socioeconomic
barriers

7

Economic indicators		2009	2010	2011	2012
GDP	\$ M	25875.8	24054.3	28417.3	28324.1
GDP growth	%	-18.0	-1.6	5.4	5.6
Inflation (CPI)	%	3.5	-1.1	4.4	2.3
Unemployment	%	17.1	18.7	15.4	-
Foreign direct investment	% of GDP	-0.2	1.8	5.3	3.2
Export growth	%	-14.1	15.6	12.6	8.4
Import growth	%	-33.5	17.9	22.2	3.1
Current account balance	\$ M	2283.7	723.6	-628.2	-473.4
Public debt	% of GDP	32.9	39.7	37.5	36.4
External debt	\$ M	42011.7	39741.4	38255.2	-
Total debt service	\$ M	7574.0	10546.9	8160.9	-
Cash surplus or deficit	% of GDP	-6.4	-6.8	-2.9	-
Tax revenue	% of GDP	13.4	12.7	13.2	-
Government consumption	% of GDP	19.6	18.4	17.8	15.3
Public expnd. on edu.	% of GDP	5.6	5.0	-	-
Public expnd. on health	% of GDP	4.1	4.1	3.6	-
R&D expenditure	% of GDP	0.46	0.60	-	-
Military expenditure	% of GDP	1.4	1.1	1.0	0.9

Sources: The World Bank, World Development Indicators 2013 | International Monetary Fund (IMF), World Economic Outlook 2013 | Stockholm International Peace Research Institute (SIPRI), Military Expenditure Database 2013.

7 | Organization of the Market and Competition

Latvia's membership of the European Union and the World Trade Organization guarantee the regulation and enforcement of market competition. However high levels of corruption and allegations of judicial bribery distort competition in areas such as state procurement. The shadow economy (estimated at between 20% and 40% of GDP), and widespread use of "envelope" (i.e. untaxed) salaries also contributes to unequal competition between enterprises.

Market-based
competition

8

As an EU member state, Latvia complies with both European and domestic anti-monopoly legislation and authorities. The Latvian Competition Council issued 97 resolutions in 2012, a marked increase on the 60 issued in 2011. This reflects the increased economic activity of the European Union's fastest growing GDP. The Council has energetically pursued both price-fixing and the abuse of dominant market positions.

Anti-monopoly
policy
10

Latvia's foreign trade is regulated and overseen by the European Commission.

Liberalization of
foreign trade
10

There has been a string of spectacular banking failures in Latvia in recent years. The first collapse came in the mid-1990s when Banka Baltija, Latvia's largest commercial bank, folded with debts of around \$400 million and more than 200,000 creditors (with 30% of all Latvian deposits held by Banka Baltija). A further 15 banks had folded by the end of 1995. Banking regulations and supervision were tightened and in 2000 a financial regulator (the Financial and Capital Market Commission) was created to monitor the sector. The banking sector was further consolidated when the largest Latvian banks were taken over by (mostly Scandinavian) banks, which now dominate the banking sector (the three biggest banks in Latvia in 2012 were Swedbank, SEB and Nordea). Nonetheless, bank failures continued. The great Latvian recession of 2008 – 2010 was triggered by the collapse, and subsequent government bail-out, of Parex, Latvia's oldest commercial bank. The Russian-owned Latvijas Krajbanka was declared bankrupt in December 2011. These failures prompted the head of the Financial and Capital Market Commission to resign and the institution was reorganized. Latvia has a high number of banks with non-resident capital (the exception being the Scandinavian-owned banks which have far tighter regulations regarding deposits), exceeding even the percentage of non-resident deposits in Switzerland.

Banking system
8

The Riga Stock Exchange (RSE) is part of the NASDAQ OMX chain of bourses. The volume of trading is very small, and very few Latvian enterprises are publicly listed.

8 | Currency and Price Stability

The Latvian lats is pegged at 0.702804 (+/- 1%) to the euro. The government aims to join the euro zone on 1 January 2014 and has thus focused on currency stability and maintaining low inflation in recent years. This was particularly challenging during the economic downturn of 2008 – 2010, when many politicians and a minority of economists called for a devaluation of the lats to allow the Latvian economy to recover. However the Latvian Prime Minister Valdis Dombrovskis (a former Bank of Latvia employee) and successive finance ministers, supported by the Governor of the Bank of Latvia, Ilmars Rimsevics, maintained a steady non-devaluation policy, and ensured that this was a key part of the IMF-led rescue package in late 2008. Over

Anti-inflation /
forex policy
9

90% of loans are held in foreign currencies (primarily the euro, but also loans US dollars and Swiss francs), and there were fears that devaluation would lead to a mass loan default and the subsequent collapse of the banking sector.

In the period between 2004 and 2007, before the crash, Latvia's inflation was the highest in the EU. After inflation rates of 15.3% in 2008 3.3% in 2009, Latvia recorded deflation of -1.2% in 2010 before returning to a modest inflation rate.

Latvia's public debt burden grew rapidly after the IMF-led international bailout in late 2008. Latvia emerged out of the Soviet Union with no public debt, and it had only increased modestly in subsequent years. However Latvian governments have been fiscally undisciplined until recently, running up budget deficits even during unprecedented double-digit GDP growth in the mid-2000s. Nevertheless, overall public debt remained low until the beginning of the economic crisis in late 2008. Latvia accepted an IMF-led bailout facility amounting to a total of €7.5 billion. This raised Latvia's public debt from 9% of GDP in 2007 to 19.7% of GDP in 2008, and then 36.7% in 2009. In order to balance the economy, Latvia's government introduced radical cuts to public spending. As a result, the budget deficit has steadily declined since a high of 7.1% in 2009 to less than 2% in 2013.

Macrostability

8

9 | Private Property

The private property rights of both Latvia's population and foreign investors are well regulated and satisfactorily protected.

Property rights

10

The private sector employs the bulk of Latvia's working population (75%) and drives GDP growth.

Private enterprise

9

Following Latvia's break from the Soviet Union in 1991, the state began privatizing state-owned assets. The privatization of small enterprises was underway quickly and was largely complete by 1995. However the privatization of larger enterprises proved far more complicated and only began with the establishment of the Latvian Privatization Agency in 1994. Privatization was a political battlefield, with the most profitable state-owned companies (those involved in the transit business or monopolies such as gas) undergoing a complicated, politicized and often controversial privatization process. The state still maintains a stake in some large enterprises, including a 51% share in the profitable telecommunications company Lattelecom (efforts to privatize it in the mid-2000s were thwarted by political interests) and the electricity monopoly Latvenergo, which has a 90% share of the market.

10 | Welfare Regime

Despite its adoption of a liberal, open, flexible and low-taxation economic model, a combination of public pressure and political populism has seen Latvia maintain a comprehensive, yet underfunded, welfare system. The state provides a number of benefits: pensions, child, maternity, illness etc. Many benefits, such as maternity payments, were reduced during the austerity era, although others, such as pensions, were left largely untouched after government efforts to reduce them were successfully challenged in the Constitutional Court. Latvia has a mixed pension system, with pensioners who worked during the Soviet era receiving small pensions based on receipts from current workers, while in 1995 a pension reform introduced a mandatory state-funded and a private-funded pension scheme for current employees. In 2006, a fourth pillar was added that envisaged additional payments for every year of insurance for those with very low pensions, but this payment was soon awarded to all pensioners, thus breaking the insurance principle of the pension budget. In June 2012 parliament decided to raise the current retirement age of 62 by three months each year, until a retirement age of 65 is reached (in 2025). Since salary levels are low and there is a small portion of population with high earnings, pension benefits are basically low, but with a wide gap between higher and lower amounts.

The health care system is a mixture of state and private financing. Certain visits to family doctors, specialists and procedures require co-payments. In addition, informal payments are frequently made to service providers. Former Latvian president Valdis Zatlers (2007 – 2011) has admitted accepting these payments while he was working as an orthopedic surgeon. Primary and secondary education is free, although there is a national shortage of nursery school places. Tertiary education is a mix of both public and private.

A public debate on Latvia's welfare system was initiated by the European Commission and the International Monetary Fund in January 2013, when both organizations criticized the Latvian government for cutting VAT and personal tax while simultaneously reducing social benefits for the state's poorest citizens.

All citizens, regardless of gender or ethnic origin, have equal access to the education system, public services, and employment. Latvia was ranked 15th in the 2012 Global Gender Gap Index rankings (an improvement on 18th in 2010, but a fall from 10th in 2008).

More than two-thirds of students in higher education are privately funded, and a great many of these are Russian-speakers who choose to study in their native language, as free public higher education is only available in Latvian. Students do have access to cheap student loans in order to finance their education, and the higher education

Social safety nets

7

Equal opportunity

8

system also allows students to hold part-time and, in some cases, even full-time employment, while enrolled in tertiary programs.

Individuals have recourse to the Ombudsman's office in the event of discrimination. Over the past few years the office has made rulings on the discrimination of Roma and sexual minorities in the labor market.

11 | Economic Performance

Between 2008 and 2010 Latvia saw a 23.9% contraction of its GDP, a historic high for an industrialized state, second only to the USA's Great Depression in the early 1930s. However, while the Great Depression lasted for four years, Latvia's contraction took place over just seven financial quarters. Latvia has since returned to economic growth, posting the EU's highest GDP growth (5%) in 2012, driven by rising exports, particularly in the SME sector. The current account deficit in 2012 was around 2%. Moreover, the economy is now more balanced, with a planned 2013 budget deficit of just 1.4% (compared to 1.9% in 2012), and inflation under 2%. Indeed, by the beginning of 2013 Latvia had fulfilled the Maastricht criteria for joining the euro zone and the government initiated a national euro changeover plan with the aim of introducing the euro on 1 January 2014.

While macroeconomic indicators indicate a balanced economy, Latvia nonetheless continues to suffer from high unemployment, running at 13.5% in late 2012, an improvement, in any case, on the 20.7% seen in 2010.

12 | Sustainability

Latvia has a vital environment and ecosystem, ranking second in the Environmental Performance Index (EPI).

Paradoxically, the environmental movement is actually quite weak in Latvia. The Green Party has long been the junior partner in a party alliance with the Farmers Union (which is largely financed by the Latvian oil and transport lobby), and green issues are largely disregarded in Latvian politics. Green voices were marginal in the Latvian government's debate on construction of the Visaginas nuclear power station in Lithuania (scuppered by a referendum in late 2012) or the construction of a liquified natural gas terminal in a Latvian port. Latvia's high performance in the EPI can be largely attributed to low (and declining) population density and the de-industrialization of the post-Soviet era. Moreover, a comparatively low level of economic development also means that consumption levels are lower in Latvia than in the EU as a whole.

Output strength
7

Environmental
policy
8

Successive Latvian governments have neglected investments in education and research and development. Spending on education has run at between 5% and 6% of GDP while just 0.4% of GDP goes towards research and development. This has resulted in sub-par performance in various international education indices such as the OECD's PISA report as well as international rankings of universities and research centers. Research and education were particularly hard hit by the austerity spending cuts of recent years.

A new education minister assumed office in October 2011, following the early parliamentary election of September 2011. Roberts Kilis has a doctorate in anthropology from the University of Cambridge, and was long employed as an Associate Professor at the Stockholm School of Economics in Riga. Kilis swiftly set about reforming the education system. He proposed restructuring the secondary school year, introduced sweeping changes to higher education financing and accreditation and a myriad of other reforms, big and small. However, Kilis overwhelmed the education sector with his proposals, provoking a severe backlash from teachers, students and researchers (although public opinion remained largely on his side). As a result, in early 2013 Kilis toned down his rhetoric and has attempted to engage more constructively with the research and education sector. But the fierce reaction from the sector will likely result in a weakening of his reforms.

Education policy /
R&D
8

Transformation Management

I. Level of Difficulty

Latvia has few structural constraints on its governance. Certainly, it is amongst the poorest countries in the EU (as of 2012, only Bulgaria and Romania were poorer), and this convergence gap with Western Europe was exacerbated by the great recession of 2008 – 2010. At the same time, however, as a Baltic Sea state, Latvia has growing economic and political links with the wealthy Nordic States. Its borders with Russia and Belarus, and widespread knowledge of the Russian language and culture, give Latvia unique trading and economic opportunities. Nonetheless low investment in education and healthcare means that the Latvian labor force remains less educated and unhealthier than its Western counterparts.

Structural
constraints

2

Latvian civil society is small, weak and fragmented. The biggest challenge it faces is financial. Latvia has no modern tradition of either membership in associations or charitable donations. As a result, civil society associations have few members and face constant financial struggles. This situation was actually exacerbated by accession to the European Union, with key sources of civil society financing, such as the Soros Foundation and Nordic governments, retreating from Latvia and heading towards the next countries in line for EU accession in other post-Soviet territories and the Balkans. However, EU financing (through structural, cohesion, social and other funds) has not been an adequate replacement, offering only project-based financing, not the long term operational financing these other actors had provided.

Civil society
traditions

4

At the same time, civil society lacks popular legitimacy. The forced voluntarism of the Soviet era has left the older generation skeptical of charitable and non-governmental activities. Moreover, all three major Latvian language daily newspapers (Diena, The Independent Morning Newspaper and Latvia's Newspaper) have adopted a language and tone that is skeptical of civil society, particularly any organizations or individuals associated with the Soros Foundation (the major supporter of civil society since the early 1990s).

The ethnic divide between Latvians and Russian-speakers (ethnic Russians and other eastern Slavs) has deepened over the last two years, albeit largely at the political rather than the social level.

Conflict intensity

4

While Latvians and a large part of the Russian-speaking community united in opposing the Soviet regime in the late 1980s, this fragile coalition fell apart after Latvia gained independence and political forces began organizing in advance of the first post-Soviet parliamentary elections in 1993. Many ethnic Latvians harbored deep-seated resentment at the post-1945 Russification of the Latvian state. While it was clear that forcible deportation would be unacceptable to the international community, mainstream nationalist thinking settled on withholding automatic citizenship from those who had settled in Latvia during the Soviet era. Thus the 1990s were marked by the battle over citizenship rights, with no small involvement from the international community, while the new millennium has so far been marked by battles over historical interpretation and language rights. The Russian-speaking community in Latvia has been assisted by major moral and financial support from the Russian Federation in the era of Putin and Medvedev.

The battle of historical narratives centers on the Second World War. Latvians consider the entry of Soviet forces into Latvia an invasion and occupation, while Russian-speakers portray it as essential in the battle against fascism. This conflict comes to a head every spring when Latvian nationalists march to the Freedom Monument on 16 March in honor of Latvian Waffen-SS war veterans (for Latvians, freedom fighters to Latvians; for Russian-speakers, fascists) and on 9 May when Russian-speakers celebrate the end of the Second World War (for Russian-speakers victory; for Latvians, the beginning of an illegal occupation).

The language war culminated in a referendum in February 2012, when Latvia's citizens voted on the introduction of Russian as a second language in Latvia. This was defeated by a margin of 75 to 25 (which roughly reflects the ethnic distribution of Latvian citizens). But while the Latvian population remains polarized along ethnic lines, this division does not translate into violence.

II. Management Performance

14 | Steering Capability

Successive Latvian governments have proven to be extremely capable in following international strategic priorities (conditionality) but much weaker domestically.

Every post-Soviet Latvian governments has prioritized integration with the West. This stability and clear sense of purpose led to Latvia joining the European Union and NATO in 2004 and it will, in all likelihood, join the euro zone on 1 January 2014

Question
Score

Prioritization
9

(the last major internal hurdle was passed on 31 January 2013, when the Latvian parliament approved the Euro Adoption Law in its second reading).

However Latvian governments have been guilty of economic and political backsliding after the elation of EU accession in 2004. The unexpectedly swift economic growth which followed was not accompanied by balanced budgets or prudent macroeconomic policy but by a massive spending binge that ended with the crash and recession of 2008 – 2010. The re-imposition of international conditionality following the IMF-led international bailout brought back balanced budgets, economic growth and likely accession to the euro zone.

The lesson here is that the presence of international actors marginalizes (or at least lessens) the role of Latvia's political "oligarchs" and other business interests.

The recent phase of austerity has Latvian government's remarkably high capacity for implementing its policies. In 2009, Dombrovskis oversaw a fiscal adjustment of 9.5% of GDP. Taxes went up, public sector salaries (and other expenditure) went down. Public protest was muted. This is all the more remarkable considering the frequency of government turnover (16 governments between 1993 and 2013 – although prime minister Valdis Dombrovskis has presided over the latter three). At the same time there has been a certain level of ideological continuity with each government composed of more or less center-right ethnic Latvian political parties.

Implementation
9

The Dombrovskis government has proved that it can be highly flexible, although Latvian governments have shown little ability to innovate.

Policy learning
8

After ascertaining the severity of the economic crisis after taking office in March 2009, the government of Prime Minister Valdis Dombrovskis quickly adapted government policy to the situation, and executed a fiscal adjustment of 9.5%. This was done in cooperation with international lenders who had bailed out Latvia with a €7.5 billion loan in late 2008. Latvia's record on policy adaptation in a changing environment was unimpressive after EU accession in 2004, with the government unable to balance the budget or use fiscal and legislative measures to cool down an obviously overheating economy.

The Latvian government has demonstrated minimal ability to innovate when acting alone. There are several reasons for this. First, Latvian political parties are not ideologically rooted, and thus lack a basic political compass or instinct. This was amply illustrated in 2010 when the then Finance Minister, Einars Repse (an experienced politician who had previously served as a prime minister) publicly hesitated over taxation, first considering cuts, then rejecting them, and finally proposing tax increases – all in the course of one day. Secondly, parties have no autonomous research capacities or even established links with think-tanks. Rather, politicians rely on civil servants for policy ideas, although much of the civil service is young, inexperienced and underfunded. Thirdly, effective monitoring and

evaluation has been undermined by severe disruptions and funding cuts in the public sector since late 2008.

15 | Resource Efficiency

Personnel management in the public sector remains a challenge. Latvia has no centralized recruiting procedure for hiring bureaucrats. Ministries and agencies manage these procedures, leading to highly dubious, non-transparent recruiting practices. Moreover, the highest ranking civil servants (the highest position being state secretary) are often hired and fired by ministers. In many cases state secretaries make their political allegiances known, and high profile bureaucrats often leave the civil service in order to enter national politics. Now, however, monthly salaries in ministries and public agencies are published on the internet, and public officials must submit annual financial declarations, which are also available to the public. The state sector does not really function as a cohesive whole due to the nature of Latvian government; ministries are divided between parties, which then become fiercely protective of their own sectors, and substantial reforms are turned into a zero-sum game.

Efficient use of
assets

7

The State Chancellery introduced a new concept for human resource management in public administration in November 2012. The government makes effective use of its own human resources, while human resources overall have declined due to low funding in education and sciences and a lack of available qualified jobs.

Coordination between ministries and other state institutions has remained problematic due to the party-based distribution of ministries. Moreover, the political parties which make up government coalitions are often in dispute, and this spills over into the effective management and coordination of government. The prime minister often has little control over ministries that are governed by other parties in the coalition. This was clearly seen in the multiple budget cutting exercises of 2008 – 2010 which were made across the board (e.g., each ministry cutting expenses by 20%) rather than on the basis of a functional audit of government and a clear vision of its future role. In the same way, a return to growth has resulted in increased budgets for all ministries without prioritization, such as investment in education or research and development.

Policy
coordination

7

Latvia continues to perform badly in international corruption rankings. This shortcoming was addressed by the creation of the “Corruption Prevention and Combating Bureau” (KNAB) in 2002. It was envisaged as an independent institution with the power to combat and prevent corruption at all levels of the state system. It has partially succeeded in this ambition, although its work has been hampered by constant political interference and instability at the leadership level (not least because

Anti-corruption
policy

6

the director is elected by the parliament, thus making the position part of the political horse-trading process).

KNAB has proved quite effective at fighting low-level corruption (bribes to police officers and low level bureaucrats) but has found political corruption a far greater challenge, particularly when those “oligarchs” or other influential figures under investigation turn the power of their print and electronic media against the bureau. Ventspils’s mayor Aivars Lembergs, for example, was first charged with corruption and money laundering in 2006, but his case has still not come to a conclusion.

Frustrated by this state of affairs, then Latvian president, Valdis Zatlers, called a referendum on the recall of parliament in May 2011. His specific fear was that Latvia’s democracy was in danger of “privatization” by three influential oligarchs. The subsequent referendum saw the public vote overwhelmingly to dissolve parliament (94.3% of voters, although the turnout was just 44.7%, primarily because the result was never in doubt). The resulting election saw Latvian voters dismiss two of the three parties representing the oligarchs’ interests, granting a small parliamentary majority to the three primary anti-corruption parties. They came to power in October 2011, announcing themselves as the “law and justice” coalition. This government has certainly given the Corruption Prevention and Combating Bureau a freer hand in fighting corruption, although it has yet to successfully prosecute a major political figure.

The Latvian government adopted a plan to fight the “shadow economy” in 2010, with the Finance Ministry and tax authorities acclaiming it a partial success due to fast-rising tax income, which exceeded target in 2011 and 2012.

16 | Consensus-Building

All major political actors agree on democracy and the market economy as the basis of the state. There is also broad agreement on continued membership of the European Union. However the major Russian-speaking political party (Harmony Center), and the Russian-speaking community in general, also favors closer cooperation with the Russian Federation. This bloc is less enthusiastic about NATO membership and, on 31 January 2013 effectively voted against Latvia joining the euro zone in the parliamentary vote which adopted Latvia’s euro change-over plan.

The military (4,000 strong) is firmly under civilian control and has refrained from entering the political fray. There are no significant organized groups opposing either Latvian democracy or the market economy (with “anti-globalists” rousing a mere dozen people to protest against the euro in January 2013). While there are a number of radical associations active at the political margins, these groups are closely

Consensus on goals
10

Anti-democratic
actors
9

supervised by the Security Police and Latvia's clandestine Constitutional Defense Bureau.

Latvia's only major cleavage is the divide between ethnic Latvians and Russian speakers. The last two years have been marked by increased polarization, primarily caused by a more active and emboldened Russian-speaker minority. The February 2012 language referendum saw emotional speeches by politicians from both sides (Russian speakers wanted "respect" and "recognition" while Latvians believed their culture was under threat), although this did not translate into societal violence. The referendum was motivated by the exclusion of the major Russian-speaking party, Harmony Center, from government, even though it gained the greatest share of seats in the September 2011 parliamentary election. Harmony Center claimed that this was discrimination against Russian-speakers while the Latvian parties claimed ideological incompatibility (Harmony Center is far more left-wing in its program and rhetoric than the Latvian parties).

Cleavage /
conflict
management
8

Further ethnically based referendums are planned for the future. There has been a push for a referendum on granting automatic citizenship to all residents in Latvia, while another groups have proposed an initiative to allow non-citizens to vote in local elections.

There are few institutionalized links between civil society and government. Political parties remain isolated from such organizations. Parliamentary committees, ministries and other political institutions have often asked civil society organizations to offer expert opinions in policy debates and the formulation of laws since accession to the European Union in 2004. However, ongoing institutional weaknesses within civil society organizations, as well as the influence of background economic actors and party sponsors, mean that their involvement is often of a symbolic rather than substantive nature.

Civil society
participation
6

Formal cooperation at the highest levels of government takes place through the National Tripartite Council which was created in 1998, but has only met intermittently since. However the 2008–2010 downturn, and the resulting tax hikes and cuts to public spending, revitalized the council and resumed regular meetings. Notwithstanding, civil society participants later questioned whether their suggestions had been heeded, and to what extent the meetings had taken place simply as a condition imposed by the international lenders. Certainly the role of the Tripartite Council has been marginalized since the economy improved.

Governments have proved responsive to the (rare) large protests seen over the last two decades. Public anger, as expressed in the November 2007 'Umbrella Revolution' in the Dom square, led to the resignation of Prime Minister Aigars Kalvitis, while the relatively small, violent anti-government protests of 13 January 2009 led to the collapse of the government led by Ivars Godmanis. At the same time,

however, public anger at the secretive way in which the last two state presidents were chosen and elected has not led to any substantial changes in the process.

Divisions between ethnic Latvian and Russian-speaking communities are a result of the Soviet occupation, and subsequent Russification, of Latvia. Recent years have seen several political leaders reaching across the ethnic divide. Ainars Slesers, one of Latvia's three influential oligarchs, attempted to recruit both Latvians and Russians to his unusual Christian pro-technocrat party ("Latvia's First Party"). In the 2009 Riga municipal election, his party adopted a "zipper" system in the ordinal ballot (i.e., a list of candidates with alternating nationalities – Russian-Latvian-Russian-Latvian etc. – was created). His party then formed a governing coalition in the city with the Russian-speaking Harmony Center. Latvia's First Party has since folded.

More significantly, Valdis Zatlers, the leader of the Zatlers Reform Party which came third in the 2011 early election, attempted to form a national government coalition with Harmony Center after the election. He was unable to come up with a parliamentary majority as the other Latvian parties refused to countenance a coalition with Harmony Center, while Zatlers also faced opposition even from within his own party.

17 | International Cooperation

Latvia's membership of the European Union is key to its future development. Harmonizing economic and political goals drives policymaking when ideologically rooted parties are not involved in the process. Moreover, financial resources made available by the EU are key to maintaining and developing the agricultural sector, and an important source of funding for higher education and research. Latvia received over €4.5 billion in structural and cohesion funds during the 2007–2013 financial period.

Latvia currently enjoys its highest ever level of international credibility. In 2012 it successfully 'graduated' from the IMF-led international lender program it began in 2008. At a conference in Riga that year, IMF president Christine Lagarde praised Latvia for its "collective determination and resilience" and cited it as an inspiration for other European countries. Prime Minister Dombrovskis is well regarded by his European contemporaries, having not just overseen severe austerity measures, but also being twice return to office notwithstanding. Latvia now hopes to use this political capital to join the euro zone in 2014.

Latvia is active in a number of regional organizations centered on the Baltic Sea (e.g., the Council of Baltic Sea States, the Nordic-Baltic 6 group within the EU, etc.) as well as a number of regional initiatives such as the Baltic macro-region (the Baltic

Reconciliation
8

Effective use of
support
9

Credibility
9

Regional
cooperation
10

Sea Strategy, or BSS, which aims to further governmental and regional cooperation among the EU countries which border the Baltic Sea). It has long benefited from regional cooperation with the wealthier states bordering the Baltic Sea (Germany, Sweden, Finland, and Denmark), as well as the Nordic countries of Norway and Iceland.

Despite a common past and closer geographic links, cooperation with Lithuania and Estonia has been far weaker. Institutions of cooperation do exist (e.g., the Baltic Council of Ministers), but they have little substantive output.

Latvia has also used the EU's Eastern "Neighborhood Policy" to promote democratization and the market economy in Georgia and to support Moldova and Ukraine – countries which the Latvian government feels could benefit from Latvia's experience in transitioning to a market democracy. Cooperation with these states remains a foreign policy priority.

Relations with Latvia's eastern neighbor, Russia, remain difficult at the political level, although economic relations are flourishing.

Strategic Outlook

Now that the Latvian economy has returned to balanced economic growth and euro accession is on the immediate horizon, Latvian policy-makers should focus on three major challenges which will shape Latvian society in the medium to long term: (1) rising inequality, (2) the demographic crunch, and (3) the underperforming higher education and research sector.

The deep economic recession which cut Latvia's GDP by 23.9% in less than two years affected all parts of society. The poorest segments of the population were particularly hit by cuts in benefits and were not spared by tax rises. Eurostat data revealed that 31% of the population in 2011 was "materially deprived." Latvia has the highest Gini coefficient in the European Union. And the poor continue to suffer. The European Commission and the IMF heavily criticized the 2013 Latvian budget for its failure to tackle inequality. The 2013 budget actually reduced the guaranteed minimum income, which benefits the poorest in society. The government claims that this and other spending cuts are designed to encourage people to enter the labor market. Instead, it has exacerbated inequality. Changes to the tax system – such as the imposition of a moderately progressive tax system or increases in luxury car and real estate tax – could target the wealthy and help reduce the strain on society caused by extreme inequality.

The results of the 2011 census found that the Latvian population had declined by around 200,000 over the previous 11 years. This was partly caused by a negative birth rate, but also by mass emigration following 2004's accession to the European Union, and once again when the economic recession hit home in 2008. Eurostat data reveals that the proportion of the population aged 65 and over has risen by 6.5%, while the proportion of 14-year-olds has shrunk by more than 7%. Successive governments have attempted to promote demographic growth through increased family and maternity benefits, but with little success. It will also be difficult to attract migrants back from the UK, Ireland and Denmark, especially those with school-aged children. With businesses in desperate need of skilled and semi-skilled employees, Latvia will have to begin a painful but necessary debate on immigration. Painful, because the results of half a century of Russification still divide society; necessary, because the economy needs young workers to grow.

Finally, Latvia has neglected the higher education and research sectors for over 20 years. The increased openness, transparency and competition brought by membership of the European Union, have revealed these sectors to be largely uncompetitive. Latvian students flock to universities elsewhere in Europe while only non-EU students enter the Latvian higher education sector from abroad (primarily to study medicine). Latvian research centers fare poorly in EU-funded research framework competitions. The new education minister was drawn from the higher education sector (and holds a PhD from Cambridge University). He has attempted to introduce radical financing and structural reforms in 2012, but was rebuffed and then challenged by the higher education establishment which largely prefers the status quo. Reforms which introduce stricter evaluations, performance-based financing and restructuring of higher education institutions (of which there are over 50 in Latvia) and research institutions is needed if Latvia is to continue to grow economically and converge with the Baltic Sea states and the European Union.