# Austerity Policy in Latvia and Its Consequences

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- Latvia witnessed rapid, but unbalanced economic growth after it joined the European Union. During the global financial and economic crisis, the country witnessed severe economic decline. In 2009, GDP shrank by 17.7 per cent.

- Until 2007 Latvia's debt level was one of the lowest among EU member states. From 2008 until 2010 Central government debt rose sharply from 19.8 per cent to 43.9 per cent of GDP.

- From 2008, restrictive fiscal policies were implemented which were among the most severe in Europe. Six consolidation packages were adopted from 2009 until 2012. Wage cuts in the public sector accounted for almost half of all spending cuts from 2009 until 2011, with wages falling by an average of 30 per cent.

- GDP grew again by 5.5 per cent in 2011, the highest growth rates among the EU member states. However, GDP is still only at the level of 2005.

- Unemployment is now a serious problem in Latvia. In May 2012, it stood at 15.3 per cent. During the past three years more than 100,000 inhabitants have left Latvia in search of work in other countries. Unemployment has changed from a cyclical to a structural phenomenon.

- Public opinion research shows that more than half of Latvia's inhabitants consider that the measures for overcoming the crisis are incorrect and even devastating.

## 1. Introduction

The political situation during the pre-crisis period which followed the elections to the ninth Saeima (Parliament) in 2006 was very volatile in Latvia. The government resigned as a result of extensive public protests and the political crisis in late 2007, thus making way for a new Cabinet of Ministers formed by Ivars Godmanis. The government and the parties that comprised it rapidly lost popularity during the economic and financial crisis due to several unpopular decisions, such as tax rises, spending cuts for social security, the rising national debt and the nationalisation of Parex Bank. Valdis Dombrovskis, a representative of former opposition party »New Era« (Jaunais Laiks), became Prime Minister after the resignation of Ivars Godmanis. The right-wing parties established the »Unity« (Vienotība) coalition in March 2010, which won the elections to the tenth Saeima in October 2010. In 2011, for the first time in the history of Latvia, the President exercised his constitutional right to call for the dissolution of the Saeima. The referendum organised for this purpose resulted in 94.3 per cent of voters voting in favour of dissolution. The aim of this drastic action was to restore trust in the state administration. The elections to the eleventh Saeima took place on 17 September 2011 and resulted in a »Unity« victory. A number of right-wing parties, including »Unity«, »Zatlers› Reform Party« (Zatlera reformu partija) and the National Alliance »All for Latvia!«- »For Fatherland and Freedom/ LNNK« (Nacionālā apvienība »Visu Latvijai!«-»Tēvzemei un brīvībai«/LNNK), formed a coalition. Since Latvian society is ethnically split into two camps – Latvians and Russian speakers – this was also a key determining principle shaping the coalition. The government consisted of parties oriented towards the Latvian electorate and »Harmony Centre« (Saskaņas centrs) and the »Union of Greens and Farmers« (Zaļo un Zemnieku Savienība) were left in opposition. After Valdis Dombrovskis was appointed Prime Minister the government continued to implement the austerity policy under his guidance. After the elections, both experts and the majority of the economically active inhabitants of Latvia (71 per cent) considered the governing coalition to be unstable. However, according to Prime Minister Valdis Dombrovskis, the coalition is engaged in constructive work and the government will be able to solve current problems successfully.

## 2. General Economic Condition of Latvia

Costs have increased and there are the first signs of slowing down in the development of the Latvian economy.

Latvia witnessed rapid, but unbalanced economic growth after it joined the European Union. From 2004 until 2007 GDP increased at an annual 10 per cent, one of the highest growth rates in the EU. High consumption and investments in real estate were the main driving forces of economic development. The global financial and economic crisis reached Latvia in the second half of 2008. Latvia witnessed the biggest decline in terms of economic activity in late 2008/early 2009: GDP fell by 3.3 per cent in 2008 in comparison to 2007, but by far the sharpest fall took place in 2009 when GDP shrank by 17.7 per cent. The government managed to stop the precipitous economic downslide in 2010, limiting the decrease of GDP to 0.3 per cent. GDP fell to the level of 2004 during the crisis.

The government imposed a pro-cyclical fiscal policy during the period of economic growth. Government spending grew at an average rate of 20 per cent per year from 2006 to 2008 and the speed of growth of government spending was much higher than that of GDP. During the pre-crisis period government spending was based on rising short-term budget revenues and government spending policy was aimed at satisfying current needs instead of ensuring sustainable development. Maintenance costs dominated expenditure and wages increased by more than 20 per cent per year, the highest point being 40 per cent in 2007. Wage increases in the public sector were faster than in the private sector as a result. The budget deficit was 0.4 per cent of GDP in 2007, but it increased to 4.2 per cent in 2008 and 9.8 per cent in 2009 as the economic situation deteriorated and budget revenues dwindled. The decrease in tax revenues from all tax categories entailed an increase in the budget deficit. The government managed to bring down the budget deficit slightly – to 8.2 per cent of GDP – by implementing budget consolidation measures. A significant decrease in the budget deficit – 3.5 per cent of GDP – was achieved in 2011.

Until 2007 Latvia's debt level was one of the lowest among EU member states, at a mere 9 per cent in 2007 (lower debt levels were found only in Estonia and Luxembourg). Latvia's high budget deficit and the attraction of funding from international lenders during the time when its borrowing capacity in international markets was limited set the stage for a rapid increase in the national debt. Central government debt rose sharply from 19.8 per cent to 43.9 per cent of GDP from 2008 until 2010.[1] External debt dominated in the state debt structure and its proportion increased from 48 per cent in 2008 to 86 per cent in 2011; this can be explained by the attraction of international borrowing and the issue of eurobonds.

Private sector debt increased significantly shortly after Latvia joined the European Union. The increase was fuelled by a rapid increase in cheap and easily available loans. The amount of private debt was 127.5 per cent of GDP before the crisis and increased during the crisis from 132.1 per cent of GDP in 2008 to 147.4 per cent in 2009.[2] Private debt decreased slightly to 140.9 per cent of GDP in 2010 as a result of commercial banks making accruals for doubtful debts and a decrease in lending.

With regard to the special budget for social insurance it should be mentioned that a surplus had been forming in the special budget since 2002 but unemployment grew and household incomes shrank as the crisis set in. This entailed a decrease in the special budget revenues and since 2009 the special budget has not been able to cover its costs. Thus savings from previous years are being used to balance the budget.

The labour market witnessed a sharp decline in demand as economic activity contracted. This entailed significant growth in unemployment. In 2008 the average unemployment rate was 7.5 per cent but it rose to 17.1 per cent in 2009, peaking in 2010 at 18.7 per cent.[3] The number of long-term unemployed increased fourfold.

One of the reasons for the Latvian economic crisis was unbalanced trade, evidenced by the high deficit in the current account. Imports changed dramatically as global trade flows decreased, income shrank and domestic demand dwindled. Within the EU, Latvia witnessed the biggest adjustments in its current account, from a 22.5 per cent deficit in 2006 to an 8.6 per cent surplus in 2009. The current account surplus was 3.0 per cent of GDP in 2010.[4] In terms of wages, pay rises were very high during the pre-crisis period: the growth rate was 32 per cent in 2007 and 20.5 per cent in 2008. Moreover, the speed of pay rises was more rapid than the increase in productivity, which hovered around 6–7 per cent. This pushed inflation into the two-digit range and economic competitiveness deteriorated as a result. Wages shrank significantly during the crisis, especially in the public sector.

## 3. Budget Consolidation

The government implemented a restrictive fiscal policy from 2008. Six consolidation packages were adopted from 2009 until 2012 with the purpose of ensuring mid-term financial sustainability. Generally, consolidation measures in the amount of 16.6 per cent of GDP were implemented from 2008 until 2011: 6.6 per cent concerned budget revenues and the remainder budget expenditure. Fiscal consolidation in Latvia was among the most severe in Europe.

Within the framework of budget adjustments several changes were introduced in tax legislation which took the form of tax increases or expansion of the tax base. Value added tax was raised from 18 per cent to 22 per cent, while the reduced tax rate was increased from 5 per cent to 12 per cent; the reduced tax rate for electricity and natural gas was abolished. Excise tax rates for cigarettes, alcohol and fermented beverages, as well as petrol and natural gas were reviewed several times and increased as a result. In 2010, personal income tax was raised from 23 per cent to 26 per cent. Simultaneously, the personal income tax base was expanded, including all capital income and applying a 10 per cent tax rate for dividends and interest and a 15 per cent tax rate for capital increases. The non-taxable monthly minimum was increased to 90 lats as of 1 January 2009 but it was decreased to 35 latsas the economic situation deteriorated. This had a negative impact on welfare, particularly of the vulnerable segments of the population. Personal income tax rate was cut again to 25 per cent in 2011 and non-taxable minimum increased from 35 to 45 lats.

1. General government gross debt. See: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tsieb090&plugin=1

2. Private debt as a percentage of GDP, non-consolidated annual data. http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&plugin=1&language=en&pcode=tipspd10

3. Harmonised unemployment rate by gender: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&language=en&pcode=teilm020

4. Balance of the current account. http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tec00043

In the meantime, the compulsory social security contribution rate for the employed was increased to 11 per cent in 2011. Changes in the real estate tax law were approved that included homes in the tax base and applied a differentiated rate depending on cadastral value. The government provided budget adjustments mainly by increasing the employment income tax burden, which was already fairly high in Latvia; increasing it even further would harm economic development.

Significant consolidation was carried out on government spending during this period. Fiscal adjustments provided for notable cuts in funding for the Ministry of Transport (mainly slashing expenditure on reconstructing state motorways and capital repairs and compensating losses to providers of public transport services), as well as the Ministries of Welfare and Health. State capital investments have shrunk substantially, by approximately 36 per cent from 2008 to 2011, as a result of the austerity policy.

In 2009, the government cut the wages of public sector employees. This accounted for almost half of all spending cuts from 2009 until 2001, with wages falling by an average of 30 per cent. Wages were flexible during the crisis. Besides the increase in the minimum wage, wages continued to decrease. A moderate increase (4.5 per cent) in wages took place in 2011, as the economic situation improved. Furthermore, average wages in the private sector picked up at a slightly more rapid pace than the those in the public sector.

The government attempted to reduce the base of allowances due to the impact of the crisis. For this reason amendments to laws providing for restrictions on entitlements to unemployment benefits, sick pay, maternity, paternity or paternal benefits were adopted and will remain until 2014. Adjustments in restrictions on unemployment benefits were also introduced. These adjustments have a material influence on benefits related to family planning and they will have a negative impact on the already difficult demographic situation in Latvia. In 2009–2011 childbirth allowances were cut by almost 35 per cent, child care and paternal benefits by 40 per cent and child care allowance for a child younger than 1 year by almost 38 per cent; sick pay (per day) was slashed by 27 per cent. In the unemployment benefit system the period of receiving benefits was decreased from 9 months to 6 or 4 months, depending on length of service. In order to cut social costs the government froze the indexation of pensions and compensation for survivorship and loss of work capacity until 2013. When consolidating the budget for 2009 the government resolved to decrease pensions for retired people who are still working by 70 per cent and for non-working retired people by 10 per cent. However, the Constitutional Court repealed this decision. The Saeima (Parliament) adopted adjustments to the law on pensions on 14 June 2012 providing for the increase of the retirement age from 62 to 65 years by three months per year starting from 2014. In order to acquire additional revenues for paying pensions, the rate of social insurance contributions to the funded pension scheme was decreased to 2 per cent in 2009. This will inevitably have a negative impact on the balance and sustainability of the Latvian pension system because this, in essence, is a loan from future retired people.

## 4. The Reasoning behind Consolidation

The State Treasury has borrowed funds in both local and international markets on an annual basis. International rating agencies reduced Latvia's rating several times in late 2008 due to the economic downslide and imbalances and instability in the Latvian banking sector. This resulted in Latvia's borrowing opportunities in the international financial markets being rather limited. Besides, the Latvian government provided substantial liquidity support to stabilise the banking sector by bailing out Parex Bank. The structure of Latvia's economy was internationally uncompetitive and incapable of ensuring external equilibrium. For this reason a decision to turn to international lenders for financial aid was adopted because the state was actually on the verge of bankruptcy.

An international lending programme provided financial aid to stabilise the Latvian economy and restore growth from 2008 until 2011 in the amount of 7.5 billion euros. The IMF and the EU worked out special conditions for implementing fiscal and financial policy, as well as structural reforms to improve economic competitiveness. International lenders carried out a total of five supervision missions, thus contributing significantly to the process of budget consolidation and structural reforms.

## 5. Key Driving Forces of Reform and Austerity Policy

Even though the consolidation measures were difficult and unpopular, according to government representatives and Prime Minister V. Dombrovskis, they were necessary to prevent an excessive budget deficit and to establish, in the long run, conditions for a stable fiscal policy, economic growth and restoring international trust in Latvia. The model for overcoming the crisis was supported by the Bank of Latvia. Representatives of the Central Bank were categorically against devaluation of the national currency. The model of internal devaluation was selected as the instrument to ensure economic growth. The Bank of Latvia actively propagated the need for an austerity policy and implementation of structural reforms. Representatives of the IMF and the European Commission supported the austerity policy and exercised strong control over its implementation. Representatives of the commercial banking sector, predominantly foreign – and more particularly Swedish – capital, were also supportive of the austerity policy, claiming that this was the only solution to stabilise the economic situation.

## 6. The Consequences of Austerity Policy

Latvia's macroeconomic situation is becoming more stable and GDP growth reached 5.5 per cent in 2011, the highest among the EU member states.[5] This indicator reached an annual rate of 6.8 per cent during the first quarter of 2012. However, GDP is still only at the level of 2005. Investment has been the key driving force of this GDP rise, but it still lags significantly behind pre-crisis levels. Positive developments can be observed in the investment sector as productive investments in manufacturing and transport are growing at a faster pace. The budget for 2012 was approved with a deficit of 2.5 per cent which is lower than the one stipulated in the international borrowing programme, namely 3 per cent, providing for an increase in the state consolidated budget. The data for the first quarter of 2012 show that revenue performance is better than planned, which points clearly to a more rapid recovery of domestic demand. Planned state consolidated general budget spending for 2012 is lower than in 2011 due to the restrictive fiscal policy. Spending on human capital intensive sectors as health care (–6.3 per cent), education and science (–11.2 per cent) and social security was reduced. The amount of spending in the state consolidated budget for 2012 will decrease by more than 16 per cent compared to previous years. As a result of the austerity policy the government did not have to make full use of the funds granted within the international aid programme: only 4.4 billion euros or 59 per cent were actually utilised. Doubtless, increasing tax rates have fostered the growth of the shadow economy, which the government had sworn to combat. International studies show that the volume of the shadow economy is very high, among the highest among EU member states.[6]

There was a small deficit of 1.2 per cent in the external trade balance in 2011[7] Expenditure cuts led to an increase in exports: Latvia was among the leading EU member states in terms of increasing exports as early as 2010. The statistical data on exports for 2011 also evidenced this increase, and Latvia, along with its neighbouring Baltic States, is a leader among European countries in terms of export growth.

Foreign direct investments experienced a sharp rise in 2011. Reinvested profit was also a driving factor. In total, the inflow of foreign direct investments into Latvia reached 5.5 per cent of GDP in 2011, the biggest inflow since 2007.

Unemployment is a serious problem in Latvia and the government is still unable to tackle it. Although unemployment fell to 16.2 per cent in 2011 and to 15.3 per cent in May 2012, it is still very high.[8] During the past three years more than 100,000 inhabitants have left Latvia in search of work in other countries. Unemployment has changed from a cyclical to a structural phenomenon and therefore getting a grip on it will be much more time consuming and expensive. This also means higher budget spending. Poverty has become a very topical issue as a result of the austerity policy. Even though the

5. Iekšzemes kopprodukts – galvenie rādītāji.- Latvijas statistika, http://www.csb.gov.lv/statistikas-temas/iekszemes-kopprodukts-galvenie-raditaji-30248.html

6. Friedrich Schneider. Size and Development of the Shadow Economy of 31 European and five other OECD countries from 2003 to 2011. – http://www.econ.jku.at/members/Schneider/files/publications/2011/ShadEcon31.pdf

7. Santa Bērziņa Tekošais konts kā tautsaimniecības termometrs. Kāda ir vēlamā temperatūra. 08.05.2012.)

8. Recent developments in unemployment at European and Member State level: http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Unemployment_statistics

poverty risk index in Latvia decreased from 25.9 per cent in 2009 to 19.3 per cent in 2011, it is still among the highest in the EU.[9] Also, in comparison to other member states in the EU, Latvia has the highest inequality with regard to income: the Gini Coefficient was 35.2 in 2011, improving only slightly since 2008 when it was 37.7.[10] Gross domestic product per capita was 58 per cent of the EU average in 2011 (only Romania and Bulgaria present poorer results).[11]

## 7. The Political Consequences of Austerity Policy

The austerity policy has caused discontentment in society because government decisions often seem insufficiently justified. Studies conducted by the public opinion research centre confirm that more than half (53 per cent) of Latvia's inhabitants consider that the measures for overcoming the crisis are incorrect and even devastating. According to recent data from the DNB Latvia barometer 76 per cent of inhabitants criticised the government in April 2012.[12]

Dissatisfaction with budget development, the requirements of the international lenders and the course of structural reforms has been expressed by the social partners: the Confederation of Employers (in the context of tax increases) and the Free Trade Union Confederation of Latvia (in the context of social policy). Several austerity policy instruments were disapproved of by »Harmony Centre«, the largest party in the Saeima and the biggest opposition alliance. A handful of foreign and Latvian Keynesian economists disapprove of large-scale austerity measures.[13] The devaluation of the national currency was presented as an alternative to overcoming the crisis and it has some support. The propagators of devaluation claim that the economy would have shrunk less than under austerity.[14]

9. At-risk-of-poverty rate by poverty threshold, age and gender: http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=ilc_li02&lang=en

10. Gini coefficient: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&plugin=1&language=en&pcode=tessi190

11. GDP per capita in the Member States ranged from 45 per cent to 274 per cent of the EU27 average in 2011: http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-20062012-AP/EN/2-20062012-AP-EN.PDF

12. See: http://www.db.lv/politika/dombrovskis-reitingi-un-popularitate-nevar-kavet-svarigu-lemumu-pienemsanu-372750

13. Paul Krugman, Defining Success Down in the Baltics.- http://krugman.blogs.nytimes.com/2012/07/01/defining-success-down-in-the-baltics/

14. See J. Ošlejs: Devalvēt un pārvērst parādus latos, valstij kompensējot bankām radītos zaudējumus: http://www.ekonomika.lv/oslejs-devalvet-un-parverst-paradus-latos-valstij-kompensejot-bankam-raditos-zaudejumus; M.Weisbrot: Latvia's EU Handcuffs: http://www.guardian.co.uk/commentisfree/cifamerica/2010/jan/15/latvia-economy-eu-imf; »Devaluation in Latvia: Why not?«: http://www.economonitor.com/analysts/2008/12/31/devaluation-in-latvia-why-not/; M.Weisbrot, R.Ray »Latvia's internal devaluation: A Success story?« http://econintersect.com/wordpress/?p=16831

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