

Ministry of Economics

Republic of Latvia

**ECONOMIC
DEVELOPMENT
OF LATVIA**

REPORT

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JULY 2007

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Dear reader,

Experts of the Ministry of Economics have prepared the 26th **Report on the Economic Development of Latvia**. The first Report was published in September 1994 and the following Reports since 1995 were published traditionally twice a year in June and December. The present Report, just like the previous ones, provides evaluation of economic situation in Latvia and progress of reforms as well as offers economic development forecasts.

I note with satisfaction that rapid economic growth continues protractedly in Latvia. GDP has increased by 10.4% on average annually since 2004 and went up even faster in 2006 (by 11.9%). Also 2007 started successfully for Latvian economy. GDP in the 1st quarter grew by 11.2% in comparison with the respective period of the previous year. Fast GDP growth certainly reduces our country's backwardness from the old EU member states and I am convinced that economic growth in Latvia will remain at a high level also in the next years.

We are satisfied with our success but also are clearly aware of the existing problems and are forming an appropriate policy to solve them. One of the main risks for economic development in Latvia is constituted by high inflation rate and large current account deficit due to high domestic demand.

Inflation rate of Latvia is determined by many factors that sometimes are mutually unrelated, among them structural changes pertaining to EU membership, rise of world prices for energy resources, changes of administratively regulated prices, etc. However, the most essential factor is rapidly growing domestic demand stimulated both by fast increase of wages and by rapidly growing volume of crediting. At the same time, it should be noted that inflation has not been an essential obstacle to fast growth up to now. However, the high inflation rate remaining already for three years may pose a threat to stability and further growth of Latvian economy in the current conditions. That is why Latvian government pays special attention to solution of this problem and, in March 2007, the Cabinet of Ministers approved the action plan to curb inflation, which is oriented to reduction of the domestic demand.

Priority for work of the Ministry of Economics is promotion of business activity and knowledge-based economy. By implementing the *Action Plan for Improvement of Business Environment*, Latvia improves its global positions every year. In the World Bank survey "*Doing Business in 2007: How to reform*", Latvian business environment takes the 24th place among 175 countries, which is by two positions higher in comparison with the previous year.

In order to raise competitiveness of Latvia, the Cabinet of Ministers has approved the Entrepreneurship Competitiveness and Innovation Promotion Programme for 2007–2013. The programme defines specific measures for improvement of business environment, fostering access to finances, development of new entrepreneurship initiatives and promotion of

their competitiveness, encouraging awareness of society about the role of innovation in promotion of competitiveness, promotion of co-operation of industrial, educational and scientific sectors, transfer and commercialisation of knowledge, and fostering development of industries and rise of their productivity. Funding in the amount of LVL 464 million is planned for implementation of these measures, int. al., attracting LVL 420 million from the EU Structural Funds. I want to stress that currently, working out criteria for use of EU funds, more and more attention is paid to the regional aspect.

Among main challenges for the Ministry of Economics in the next years will be implementation of energy development policy in order to raise safety of energy supply and reduce dependence on imported energy resources.

For achievement of the set goals, we will continue the dialogue with our social partners (entrepreneurs and non-governmental organisations representing them). This is the only way how to ensure sustainable growth in the long-term perspective.

In the Report, you will find information on both the development of main economic and social indicators, growth of national economy sectors, external economic environment, and government's economic policy for promotion of growth and employment, foreign trade policy, utilisation of the EU Structural Funds and the Cohesion Fund, innovative and entrepreneurial policy and other economic reforms. In the conclusion, the authors of the Report give recommendations for improvement of the national economic policy.

The Cabinet of Ministers has not assessed all issues addressed in the Report hence many conclusions on the economic development of the country and proposals for further action reflect purely the opinion of experts of the Ministry of Economics.

I hope that the Report will be useful to economists and entrepreneurs and everyone interested in the issues of the economic development of Latvia and will encourage exchange of opinions between public institutions, various organisations and interest groups, economists and other stakeholders.

I would like to express my gratitude to the authors of the Report.

July 2007



Jurijs Strods,
Minister of Economics

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Abbreviations

Abbreviations

CEE	Central and Eastern Europe
CEES	Common European Economic Space
CF	Cohesion Fund
CHP	Thermal power station
CIF price	Price of goods created by the value of goods inclusive of freight and insurance costs till the border of the importing country
CIS	Commonwealth of Independent States
CPCB	Corruption Prevention and Combating Bureau
CRPC	Consumer Rights Protection Centre
CSB	Central Statistical Bureau
CSMEC	Council of the Small and Medium-Sized Enterprises and Crafts
DDA	Doha Development Agenda
DPI	Producer price index for products sold in the domestic market
EAGGF	European Agricultural Guidance and Guarantee Fund
EC	European Community
ECB	European Central Bank
EEA	European Economic Area
EMU	Economic and Monetary Union
ERDF	European Regional Development Fund
ERM II	European currency rate mechanism
ESA	European System of National Accounts
ESF	European Social Fund
EU	European Union
EU-15	European Union before enlargement on May 1, 2004
EU-25	European Union after enlargement on May 1, 2004
FCMC	Financial and Capital Market Commission
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FIFG	Financial Instrument for Fisheries Guidance
FOB price	Price of goods created by the value of goods inclusive of freight and insurance costs till the border of the exporting country
FTA	Free Trade Agreement
GDP	Gross domestic product
GVA	Gross value added
HPS	Hydroelectric power station
ICT	Information and communication technologies
IMF	International Monetary Fund
INTERREG	Community Initiative concerning Transnational Co-operation on Spatial Planning and Regional Development
ISPA	Instrument for the Structural Policies for Pre-accession
IT	Information technologies
IUVI	Import unit value index
JSC	Joint stock company
LATAK	Latvian National Accreditation Bureau
LEPP	Latvian Export Promotion Programme

LGA	Latvian Guarantee Agency
LIDA	Latvian Investment and Development Agency
LLC	Limited liability company
LVS	Limited liability company “Latvijas standarts”
ME	Ministry of Economics of Latvia
MLBL	Mortgage and Land Bank of Latvia
MRDLG	Ministry of Regional Development and Local Government
NATO	North Atlantic Treaty Organisation
NEC	National Economy Council
NDP	National Development Plan
NGO	Non-governmental organisation
PCA	Partnership and Cooperation Agreement
PHARE	The Economic assistance programme of European Union for countries of Central and Eastern Europe
PPI	Producer price index
PPP	Public and private partnership
R&D	Research and Development
ROA	Ratio of profit against losses to assets
ROE	Ratio of profit against losses to capital and reserves
RSE	Riga Stock Exchange
SEA	State Employment Agency
SF	European Union Structural Funds
SJSC	State Joint Stock Company
SME	Small and medium-sized enterprises
SOLVIT	Efficient Solving of Internal Market Problems
SPD	Single Programming Document
SRS	State Revenue Service
TDI	trade defence instruments
ULC	Unit labour costs
UN	United Nations
USA	United States of America
VAT	Value added tax
WTO	World Trade Organisation
XPI	Producer price index for exported products

Measures

EUR, EURO	Euro, single currency of the EMU
PJ	Peta-Joule
kV, kWh, GWh	Kilovolt, Kilowatt hour, gigawatt hour
LVL	Latvian lats (national currency of Latvia)
SDR	Special drawing rights, IMF approved currency
USD	US dollar

Conventional designations

–	Magnitude zero / absent
...	Data not available or too uncertain

1. ECONOMIC SITUATION: BRIEF OVERVIEW

Reforms implemented in Latvia and integration in the EU have left a positive impact on economic development of the country. **Latvia has shown the highest economic growth rates in the EU.** Since 2004 the average annual growth of gross domestic product (GDP) in Latvia was 10.4%, in 2006 GDP increased even faster by 11.9%. Rapid economic growth of Latvia continues in 2007 as well. GDP in the 1st quarter of this year has increased by 11.2% in comparison with the respective period of 2006.

High growth rates are mostly ensured by the stable dynamics of domestic demand, which is fostered by growth of income, stability of the financial system, expansion of credit opportunities, accession to NATO and EU, and formation of positive future expectations. Private consumption in 2006 exceeded the level of the preceding year by almost 20%. Investments in fixed assets also increased rapidly and were considerably bigger in 2006 (by 18.3%) than in the preceding year.

High domestic demand encourages imports that increased by 17.5% in 2006, noticeably exceeding the growth rate of exports (by 5.3%). A growth based on rapid increase of domestic demand is risky, as it increases the external imbalance and vulnerability of the financial sector. In order to limit domestic demand, on March 6, 2007 the Cabinet of Ministers supported the measures to reduce inflation, which pertain to the budget and taxation policies, crediting and other areas that can improve the situation in the real estate market, the labour market and productivity as well as competition policy.

Economic activity increases in all major sectors of national economy. The biggest contribution to the growth in the recent years is made by service sectors. Increased domestic demand especially fosters development of trade, hotels and restaurants, which in total has grown by 15.5% on average annually in the period of 2004-2006. Financial intermediation and real estate transactions, rent, computer services and other commercial services in total grew by 12.4% on average annually in the mentioned period.

Increased household income and spread of consumer loans are expected to foster further growth of trade (especially non-food consumer goods) and other commercial services, but the growth rates will be lower than up to now. It is expected that the growth of real estate prices will cool down and growth rates of crediting will decrease.

The rapid rise of investments has a favourable influence on development of construction. In the period of 2004-2006, output in construction has grown by 14.1% on average every year. The output grew by 13.6% in 2006. Construction of streets and roads,

residential and commercial buildings, hotels, industrial and other objects grows fast. The construction sector is expected to maintain high development rates also in the future due to development of mortgage lending, increased economic activity and investments as well as implementation of projects financed from EU funds.

Contribution of manufacturing to the growth is more moderate. In the period of 2004-2006, output of manufacturing has grown by 6.2% on average every year. In these years, the biggest contribution to industrial growth was made by wood industry, machine building and metalwork production.

Output of manufacturing increased by 6.2% in 2006. Growth rates were high in chemical industry, production of textile articles and metalwork production. The rapid growth of these sectors was mainly due to expansion of export opportunities. In other sectors, growth rates remained at the previous level or slightly decreased. Growth of wood processing (one of the biggest Latvian export sectors) is slow for the second year already, and production volumes even slightly diminished in 2006. Modernisation and reconstruction of production and usage of resources from EU funds will raise productivity and competitiveness of the sector, hence it is expected that industry will continue developing.

Growth rates of agriculture lag behind the overall growth rates of national economy. Output of the sector decreased by 2.8% in 2006 due to unfavourable weather. Further development of agriculture will depend on adjustment of agricultural production facilities and products to EU standards and quality criteria and on the external demand. Latvia's accession to the EU ensures more equal competition opportunities for farmers on the EU internal market, while the support from EU funds facilitates modernisation of agriculture and diversification of agricultural activities.

Transit services are important for Latvian national economy and constitute approximately 15% of the revenues from Latvian exports of goods and services or about 5% of GDP. Although transit services grow by volume, their share in national economy in general and in the transport and communications sector decreases. This is explicable by the fact that the domestic demand of transport sector services has grown faster than their external demand in the last years. Two-thirds of the growth in the transport and communications sector depends on the domestic demand (development of communications, warehousing, parking services, tourism, etc.) and only one-third depends on the external demand (transit).

On the whole, the transport and communications sector has grown by 11.0% on average annually in the period of 2004-2006 and by 9.3% in 2006. After

accession to the EU, cargo transportation has increased especially fast and passenger transport services are growing, among them air transport services.

The Ministry of Economics forecasts that **GDP in Latvia will grow by 9.5% in 2007.**

In order to maintain stable macroeconomic environment, **the Bank of Latvia implements *de facto* policy of fixed national currency exchange rate.** This reduces uncertainty, eliminates exposure to currency risk and gives entrepreneurs a stable base for planning and price determination. As from January 1, 2005, the national currency lat (LVL) is re-pegged from the SDR currency basket to the euro at the rate EUR 1 = LVL 0.702804. Change of the LVL peg was determined by Latvia's plans to join the

European Exchange Rate Mechanism II (ERM II) and, after fulfilment of required criteria, join the Economic and Monetary Union (EMU).

Since May 2, 2005, Latvia has joined ERM II with the existing exchange rate of the lat against the euro, namely, EUR 1 = LVL 0.702804. When the EU Council decides that Latvia is ready to take part in EMU, the Latvian national currency will be substituted by the euro and the Bank of Latvia will discontinue implementing an independent monetary policy. Timetable for the euro introduction, which is approved by the Cabinet of Ministers, foresees Latvia's joining EMU on January 1, 2008. Taking into account that the target set by the government has become unachievable due to high inflation, situation is being assessed and a new date for joining EMU will be set.

Table 1.1

Latvia: Key Indicators of Economic Development

	2003	2004	2005	2006	2007 f
	(growth against the preceding year, %)				
Gross domestic product	7.2	8.7	10.6	11.9	9.5
Private consumption	8.2	9.5	11.5	19.8	10.0
Public consumption	1.9	2.1	2.7	4.0	3.0
Gross fixed capital formation	12.3	23.8	23.6	18.3	15.0
Exports	5.2	9.4	20.3	5.3	9.0
Imports	13.1	16.6	14.8	17.5	18.0
Consumer prices	2.9	6.2	6.7	6.5	8.0
	(in % of GDP, unless indicated otherwise)				
Central government budget fiscal balance	-1.6	-1.0	-0.2	0.4	0
Central government debt	14.4	14.5	12.0	10.0	9.0
Current account balance	-8.2	-12.9	-12.6	-21.1	-22.6
Foreign direct investments (flows)	2.7	4.6	4.5	8.1	7.0
Employment rate	61.8	62.3	63.3	66.3	67.0
Unemployment rate (15-74 years)	10.6	10.4	8.7	6.8	6.0

f – forecast

Relatively high inflation rate has been observed in the last years. Faster growth of inflation in 2004 was mainly due to a combination of several one-time factors (rise of administratively regulated prices, harmonisation of indirect tax rates, inflation expectations related to Latvia's accession to the EU, and high world oil prices). Inflation rate remained high in 2005 and 2006 mostly due to increased world fuel prices and second-round inflation (spiral), stimulated by the marked increase of wages in the previous years and high growth rates of crediting. Relatively high rate of inflation is also expected in 2007, because an essential increase of administratively regulated prices and raising the excise tax rates on tobacco products and fuel are envisaged.

Inflation will decrease gradually in medium-term period, as the influence of the mentioned price-raising factors will go down and the government will carry out inflation reduction measures.

Due to the growing domestic demand and in order to hold down the credit growth rate, the Bank of Latvia has raised the refinancing rate and the reserve requirement several times since March 2004. However, the impact of such measures in Latvia is limited by the fixed exchange rate regime and several specific factors, such as relatively easy access by banks to foreign resources and relatively big share of loans granted in foreign currencies in the credit structure.

The above-mentioned action plan to reduce inflation, supported by the Cabinet of Ministers, envisages, among other things, to carry out several measures for control of the growth of crediting. So, granting credits will require setting a compulsory initial payment of at least 10-15% of the credit volume as well as defining the maximum credit volume against the value of collateral. It was also decided to establish a single general register of borrowers, including all financial institutions (both the mortgage and consumer

credits), so that the financial institutions would be aware of the true amount of debts of their customers.

The budget deficit in Latvia is lower than 3% of GDP, defined by the Maastricht criteria. Central government budget had a surplus in the amount of LVL 47.4 million or 0.4% of GDP in 2006. Fiscal deficit of the central government consolidated budget approved by the Law "On the State Budget for 2007" is LVL 177.8 million or 1.3% of GDP in 2007. However, the Cabinet of Ministers, supporting the "Report on Development of Consumer Price Inflation and Proposals for its Reduction" on March 6, 2007 decided to achieve a balanced budget in 2007 already. Balanced fiscal balance of the central government consolidated budget is planned in 2008, while the central government consolidated budget with a surplus is planned in 2009 and 2010.

Review of "basic expenditures" of the state budget, ensuring reduction of these expenditures, is an important medium-term fiscal policy measure. In order to ensure this, the Cabinet of Ministers, at its meeting on March 20, 2007 decided that ministries have to carry out the institutional audit and assess the efficiency and effectiveness of functions to be performed with a goal to reduce state budget expenditures. Besides, medium-term budget planning and strategic planning are being gradually introduced in ministries in order to raise efficiency of budget spending.

Central government debt in Latvia is among the lowest in the EU, and its level in the medium term is expected to remain considerably lower than the Maastricht criterion.

One of the main economic development risks in Latvia is a relatively high current account deficit caused by high domestic demand and steep growth of investments in particular.

The current account deficit in 2006 amounted to 21.1% of GDP and was by 8.5 percentage points higher than in 2005. The increase in the negative balance of current account in 2006 was caused by deterioration of both the balance of goods and incomes and the balance of services and current transfers.

It must be noted that the current account deficit is covered by foreign direct investments and long-term loans. Reserve assets of the Bank of Latvia increase and its net foreign reserves fully cover the reserve money. The current account deficit does not create immediate threat to macrostability but makes to assess sustainability of economic development seriously.

Gradual decrease of the current account deficit in medium term is forecasted, mainly due to slower growth rates of domestic demand and faster growth of exports ensured by structural reforms. However, the demand for imports will remain relatively high due to further modernisation of national economy and its growing openness.

EU is the main trading partner of Latvia. Trade with EU member states has been constantly expanding since restoration of Latvia's independence,

and currently 75% of Latvian exports and imports are linked to the EU. In 2006, most of Latvia's foreign trade turnover was made up by trade with Germany (13.7% of the total amount), Lithuania (13.6%), Estonia (9.4%), Russia (8.2%), Poland (5.6%) and Sweden (5.5%).

After accession to the EU, trade of Latvia with Lithuania and Estonia as well as with other new EU member states has grown very fast. Latvian trade with other Baltic states in two years has more than doubled in comparison with the period before the accession.

In 2006, the value of exported products exceeded the level of 2005 by 14%, while imports increased considerably faster by 31.1%. In 2006, exports to CIS countries increased fastest and their value was by almost one-third higher than in the previous year, with substantial increases in exports of foodstuffs, chemical products and various machines and equipment. Exports to EU member states grew by 12% and the biggest contribution to this growth was made by increased exports of foodstuffs and machines and equipment.

With the economic growth, income of the population is also growing. Despite a considerable rise of prices, the real income of employees in the period from 2004 till 2006 has increased by 29.9%, but in 2006 alone – by 15.6%. The total increase of wages in 2006 was greatly affected by the high inflation of the previous years as well as by rise of wages of employees of several budgetary institutions (e.g., teachers and physicians).

Increase of old-age pensions in 2006 was also considerable (by 19% or LVL 15 higher than in 2005). Level of real pension increased by 12% in this period.

As from January 1, 2006, the minimum monthly wage was increased from LVL 80 to LVL 90, the monthly non-taxable minimum was increased from LVL 26 to LVL 32, and the monthly tax allowance for dependent person was raised from LVL 18 to LVL 22. As from January 1, 2007 the minimum monthly wage is increased to LVL 120, the monthly non-taxable minimum is increased to LVL 50, and the monthly tax allowance for dependent person is raised to LVL 35.

Economic development in Latvia in the last years makes a positive impact on the situation in the labour market. In the last 3 years, the number of employed people rose by 2.6% on average annually (in 2004-2006), while the unemployment rate decreased from 10.5% in 2003 to 6.8% in 2006.

Although the population of working age diminishes, the number of economically active persons increases and the employment rate grows. In the last three years (2004-2006) the employment rate has increased by 4.5 percentage points. In 2003 the employment rate in Latvia was 1.1 percentage points lower than the EU average, while in 2006 it exceeded the EU average by 1.6 percentage points.

Female employment in Latvia is higher than the EU average and this difference tends to grow, as the female employment rate in Latvia exceeded the EU

rate by 2.9 percentage points in 2003 and by 5.1 percentage points in 2006. Male employment in Latvia tends to increase every year but still lags behind the average EU rate (by 4.7 percentage points in 2003 and by 1.6 percentage points in 2006).

The number of unemployed people decreases not only due to the increased employment rate. In the recent years after Latvia's accession to the EU, labour outflow takes place to some old EU member states (Ireland, United Kingdom and Sweden) where labour markets are open to citizens of the new EU member states. Therefore, shortage of labour force in several sectors starts developing in Latvian labour market.

The economic growth potential is best characterised by the growth of investments. In the last three years (2004-2006), investments in fixed assets increased by 81% (by 22% on average annually). As regards growth of investments and their share in GDP, Latvia has one of the highest indicators among EU member states.

Investments are promoted by several factors, especially such as financial stability, continuous improvement of business environment, high domestic demand, rather low real interest rates, influx of foreign capital, etc. At the same time, a relatively low tax burden and increased sale of manufactured products due to the growing demand made a positive impact on the financial situation of companies, thereby increasing opportunities to make investments.

At the end of 2006, foreign direct investments (FDI) accumulated in Latvia amounted to LVL 4037.2 million or 36% of annual GDP volume. The volume of incoming FDI has markedly increased after Latvia's accession to the EU. In the last three years, foreign businessmen have made contributions in the form of direct investments to Latvian national economy in the amount almost four times bigger than in the period of

2001-2003. Their volume in 2006 was twice bigger than in 2005.

In the sectoral structure of accumulated FDI, investments in service sectors make a bigger share. The most voluminous investments in 2005 and 2006 were made in the banking sector. The volume of FDI accumulated in Latvia per capita was LVL 1768 or USD 3299 at the end of 2006.

Three-fourths of FDI are related to EU member states, and the biggest investors are entrepreneurs of Sweden (17% of accumulated FDI at the end of 2006), Estonia (13.1%) and Germany (11.7%). 7.7% of investments are from Russia.

The reforms carried out in the previous decade have strengthened the private sector, conditions favourable for development have been created and the business environment is improving. Investments continue to grow rapidly, encouraging modernisation of production and introduction of new, more productive technologies. Accession to the EU has a particularly positive impact on development of Latvian economy. Main growth risks are related to high inflation, rapid increase of wages and problems of imbalance of the external sector. Inflation and growth of production costs are not favourable for external competitiveness of Latvia. As the level of external debt and its servicing costs grow, borrowing opportunities will decrease and this may limit the domestic consumption. External risks are related to prices of energy resources and the situation in Latvian export markets. Growth in 2007 may retain the high up-to-now rate, however, the rate would diminish by several percentage points. This will be determined by more moderate rates of the private consumption growth. The annual GDP growth can be expected to be 6-8% in the medium-term.

2. Development of World Economy¹

Development of world economy in 2006 was rather fast (growth by 5.4%). Growth of US was limited by unfavourable fluctuations of the real estate market, while growth of the euro zone countries was the most rapid in the last six years, mainly due to the strong domestic demand.

The rapid growth and rising oil prices at the beginning of 2006 raised concern about inflation indicators, but inflation stabilised as the growth and oil prices decreased in the 2nd half of the year.

Instability of financial market, high inflation, growth of oil prices, and (with a smaller probability) global imbalance are considered risks to global development in the nearest future.

Total growth for 2007-2008 is forecasted slightly more moderate than in the previous year (see Table 2.1).

Table 2.1

GDP Growth
(percentage against the preceding year)

	2002-2004 on average	2005	2006	2007 f	2008 f
World	4.1	4.9	5.4	4.9	4.9
USA	2.7	3.2	3.3	2.2	2.8
Japan	1.5	1.9	2.2	2.3	1.9
EU	1.8	1.9	3.2	2.8	2.7
CIS	7.2	6.6	7.7	7.0	6.4

Source: "The World Economic Outlook April 2007", International Monetary Fund, <http://www.imf.org>
f – forecast

The rapid economic growth of the **United States** at the beginning of 2006 slightly slowed down in the 2nd half of the year. Although the private consumption kept growing, the housing market developed weakly, investments were at a low level, and the weak demand as well did not allow successful development of industry, especially automotive industry and construction.

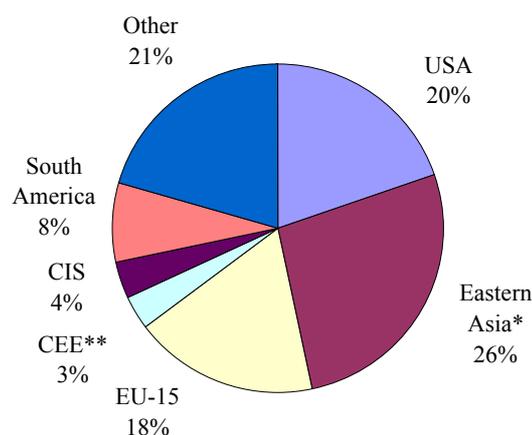
Increase of growth rates in USA in 2007 is forecasted as 2.2%, while the growth may increase in 2008 (to 2.8%).

Economy of **Japan** developed rather slowly in the 1st half of 2006, mainly due to unexpected decline of consumption, while the growth was quite rapid in the 2nd half of the year. The real growth in 2006 on the whole was higher than the potential one, mostly due to increases of private investment and export volumes.

The growth of Japanese economy in 2007 and 2008 is forecasted at the level of 2.3% and 1.9% respectively, mentioning unstable private consumption and possible decline of exports as risks.

Figure 2.1

The World GDP Ratio by Groups of Countries in 2006
(structure, GDP by purchasing power units)



Source: "The World Economic Outlook September 2006", International Monetary Fund, <http://www.imf.org>

* Japan, China, South Korea, Malaysia, Singapore, Thailand, Philippines
** Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Malta, Poland, Romania, Serbia and Montenegro, Slovakia, Slovenia, Turkey

Economic growth in the **old EU member states** in 2006 was almost twice faster than in the preceding year, due to the stable domestic demand and growing investments. Good indicators were also observed in the labour market, manifesting in the lowest unemployment rate in the last 15 years (7.6% at the end of 2006).

It is expected that the growth in 2007 will be slightly more moderate (by 2.3%), but also this growth is above the potential one. The growth rate in 2008 may be similar (in the amount of 2.3%).

2006 was a rather successful year for the economy of **Germany**. Growth was mainly due to increased exports, growing investment and substantial incomes from the world football championship finals tournament that took place in the summer. VAT rate changes in Germany may negatively affect inflation this year.

Growth in Germany in 2007 on the whole is forecasted slightly lower than a year ago (by 1.8%), while it is forecasted in the amount of 1.9% for 2008.

¹ In this chapter, data from "World Economic Outlook", International Monetary Fund, April 2006 and "Economic Forecasts Spring 2006", European Commission were used, unless indicated otherwise.

Table 2.2

Main Macroeconomic Indicators of the Developed Countries

(percentage)

	GDP growth			Consumer price changes			Investment (% of GDP)			Current account deficit (% of GDP)			Budget deficit (% of GDP)		
	USA	EU	Japan	USA	EU	Japan	USA	EU	Japan	USA	EU	Japan	USA	EU	Japan
2005	3.2	1.9	1.9	3.4	2.3	-0.6	19.7	20.3	23.4	-6.4	-0.4	3.6	-3.7	-2.4	-4.8
2006	3.3	3.2	2.2	3.2	2.3	0.2	20.0	20.9	24.1	-6.5	-0.8	3.9	-2.6	-1.8	-4.3
2007 f	2.2	2.8	2.3	1.9	2.2	0.3	19.0	21.4	24.7	-6.1	-0.9	3.9	-2.5	-1.4	-3.8
2008 f	2.8	2.7	1.9	2.5	2.2	0.8	18.9	21.8	24.8	-6.0	-1.0	3.6	-2.5	-1.3	-3.5

Source: "The World Economic Outlook April 2007", International Monetary Fund, <http://www.imf.org>

f – forecast

Growth in **France** in 2006 was slightly weaker than forecasted before. It was mainly supported by the private consumption as well as growth of employment. The growth was hindered by oil product prices growing in the 1st half of the year and by unfavourable fluctuations of the euro exchange rate.

Growth in France in 2007 on the whole is forecasted similar as a year ago (in the amount of 2%), while a slightly faster growth is forecasted in 2008 (by 2.4%).

Growth in the **United Kingdom** in 2006 was rather fast (at the level of 2.7%), mainly due to the domestic demand as well as increased investment and exports. Growth at a rather high level is forecasted also in the future on the basis of increased employment and productivity. Risks may be related to the growing inflation and various external factors.

Growth in the United Kingdom in 2007 and 2008 is forecasted at a rather high level (in the amount of 2.9% and 2.7% respectively).

Table 2.3

Main Macroeconomic Indicators of the New EU Member States and Candidate Countries

(percentage)

	GDP growth				Consumer prices				Current account deficit (% of GDP)			
	2005	2006	2007 f	2008 f	2005	2006	2007 f	2008 f	2005	2006	2007 f	2008 f
Total	5.5	6.0	5.5	5.3	4.9	5.1	4.8	3.7	-5.3	-6.7	-6.6	-6.5
Estonia	10.5	11.4	9.9	7.9	4.1	4.4	4.8	5.3	-10.5	-13.8	-12.9	-12.2
Latvia	10.2	11.9	10.5	7.0	6.7	6.5	7.3	6.5	-12.7	-21.3	-23.0	-22.7
Lithuania	7.6	7.5	7.0	6.5	2.7	3.8	3.5	3.4	-7.1	-12.2	-12.3	-11.0
Czech Republic	6.1	6.1	4.8	4.3	1.8	2.5	2.9	3.0	-2.6	-4.2	-4.1	-4.2
Hungary	4.2	3.9	2.8	3.0	3.6	3.9	6.4	3.8	-6.7	-6.9	-5.7	-4.8
Poland	3.5	5.8	5.8	5.0	2.1	1.0	2.2	2.9	-1.7	-2.1	-2.7	-3.6
Slovakia	6.0	8.2	8.2	7.5	2.8	4.4	2.4	2.3	-8.6	-8.0	-5.7	-4.6
Slovenia	4.0	5.2	4.5	4.0	2.5	2.7	2.7	2.4	-2.0	-2.3	-2.6	-2.5
Bulgaria	5.5	6.2	6.0	6.0	5.0	7.3	5.3	3.6	-11.3	-15.9	-15.7	-14.7
Malta	2.2	2.5	2.3	2.3	2.5	2.6	2.4	2.3	-10.5	-11.2	-11.5	-11.0
Cyprus	3.9	3.8	3.9	4.0	2.6	2.5	2.1	2.1	-5.6	-6.1	-5.2	-5.1
Romania	4.1	7.7	6.5	4.8	9.0	6.6	4.5	5.0	-8.7	-10.3	-10.3	-9.8
Croatia	4.3	4.6	4.7	4.5	3.3	3.2	2.7	2.8	-6.4	-8.1	-8.3	-7.8
Turkey	7.4	5.5	5.0	6.0	8.2	9.6	8.0	4.3	-6.3	-8.0	-7.3	-6.8

Source: "The World Economic Outlook April 2007", International Monetary Fund, <http://www.imf.org>

f – forecast

Growth rates in the **new EU member states and candidate countries** are high. Exports have grown rather fast, also due to the growing demand from the old EU member states. The domestic demand also increased, influx of FDI rose and the employment rate went up.

Growth may slightly diminish in the next years. Decline of the external demand as well as deterioration of financial conditions, which may lessen willingness of foreign investors to invest in the region, are mentioned as risks.

According to IMF calculations, the growth in the region in 2007 (by 5.5%) may be slightly slower than in 2006, while in 2008 it may slightly decrease to 5.3%.

The remarkably highest growth rates among EU member states are still maintained in the **Baltic States**. Not only the “low start level” and dynamic development of foreign trade but also the successful macroeconomic policies and the especially successful development of business environment and investment attraction policy are mentioned as the basis for this growth (Lithuania and Estonia are among the 20 most successful countries of the world in the World Business Environment Survey of the World Bank).

Also further growth rates in the Baltic States are still forecasted at a high level, and the growth in Lithuania and Estonia in 2007 on the whole may reach 7% and 9.9% respectively, while in 2008 the growth may slightly stabilise to 6.5% and 7.9% respectively.

Growth in the group of **Commonwealth of Independent States** (CIS) in 2006 is still evaluated as successful; exports, especially encouraged by the rise of energy product prices, and the steadily growing domestic demand are mentioned as the basis for this growth. As concerns individual countries, one can conclude, that the current account status of oil product exporting countries has considerably improved, while the current accounts of other countries have deteriorated due to the growing imports. In the next few years, growth in this group of countries may decline due to decreased external demand and exports.

Although the growth rates in 2007 may be slightly slower than a year ago, they will remain at a rather high level of 7%, while in 2008 the growth may slightly stabilise to 6.4%. It is recommended for the region on the whole to pay bigger attention to diversification of export goods of the primary sector. In view of the presently low investment level of the region, the necessity to attract investments more actively is emphasised.

Table 2.4

**Main Macroeconomic Indicators
in the Group of CIS Countries**
(percentage)

	2005	2006	2007 f	2008 f
GDP growth	6.6	7.7	7.0	6.4
of which in Russia	6.4	6.7	6.4	5.9
Consumer prices	12.4	9.6	9.0	8.3
of which in Russia	12.7	9.7	8.1	7.5
Current account balance (% of GDP)	8.8	7.7	5.0	4.4
of which in Russia	10.9	9.8	6.2	5.0

Source: “The World Economic Outlook April 2007”, International Monetary Fund, <http://www.imf.org>
f – forecast.

Although a decrease of global growth rates is forecasted, mainly due to the slowdown of growth of the USA and the euro zone countries, the global growth is still projected rather positively. Possible unfavourable fluctuations of the US real estate market, potential growth of inflation, rise of oil prices and global imbalance are considered the main development risks. Taking into account the abovementioned risks, attention must be paid to development and implementation of structural policies. Growing domestic demand, especially in the European countries, is considered a factor that may favourably affect the global growth. On the whole, the global growth in 2007 and 2008 is projected in the amount of 4.9%.

3. GROWTH AND PRODUCTIVITY

3.1. GDP Dynamics and Productivity

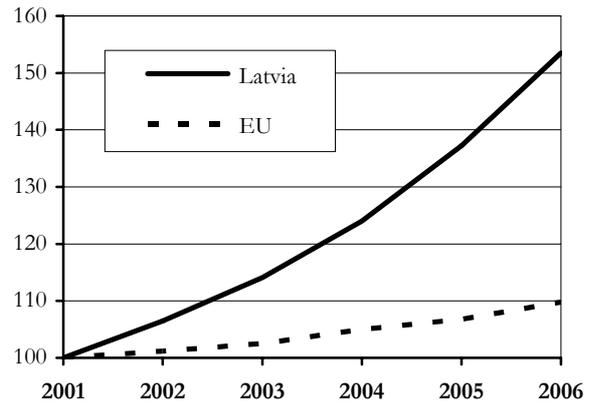
Rapid economic growth is observed in Latvia for several years. In the last three years (2004-2006), GDP went up annually by 10.4% on average.

Growth was especially fast in 2005 and 2006 (by 10.6% and 11.9% respectively). The steady growth is ensured by stable dynamics of the domestic demand and ability to expand export markets.

Although the average growth of EU member states has been rather slow in the last years, the growth rates of the new EU member states are high and steady, especially of the Baltic States, including Latvia. Besides, the GDP growth in 2006 and the 1st quarter of 2007 was the most rapid in Latvia.

Figure 3.1

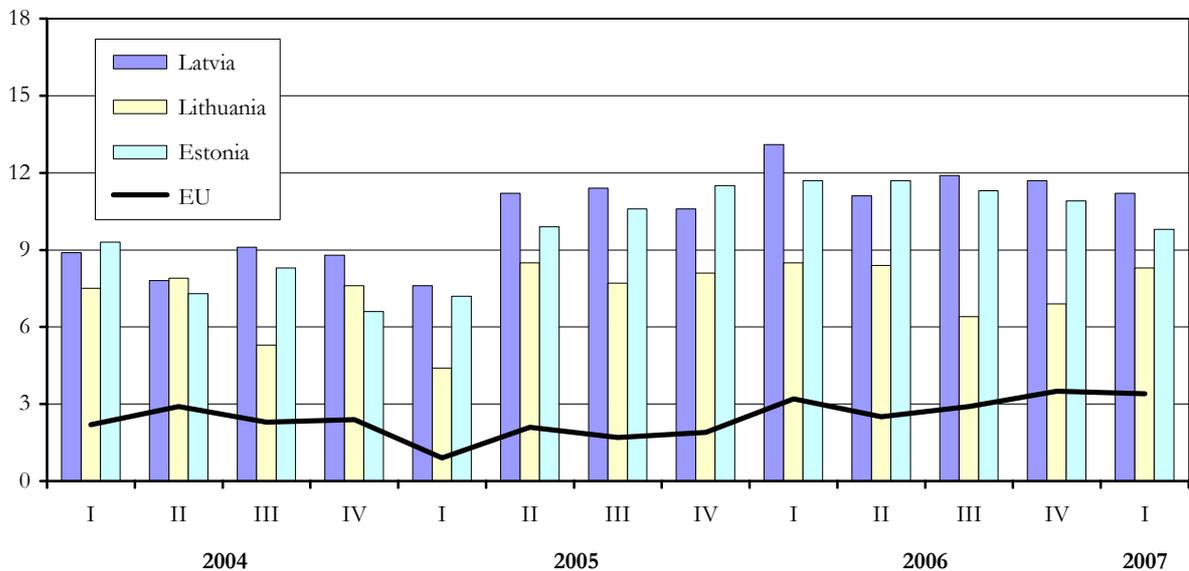
GDP Growth in Latvia and EU
(2001 = 100%)



Source: Eurostat

Figure 3.2

GDP Growth in Latvia, Lithuania, Estonia and EU, Quarterly Profile
(percentage change against the corresponding quarter of the preceding year)

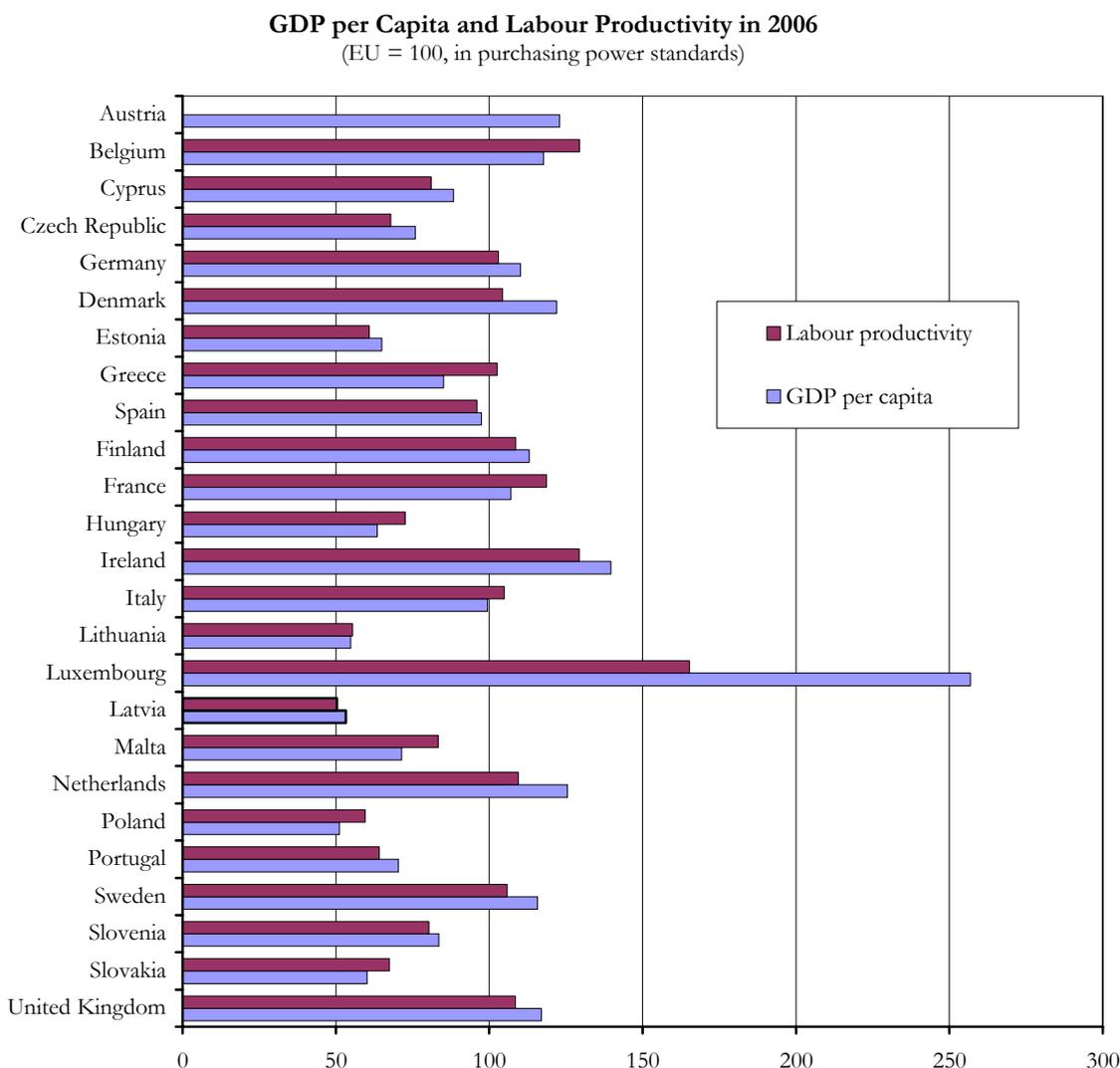


Source: Eurostat

In 2006, Latvian GDP per capita in purchasing power standards was 50% of the EU average (according to the estimation by Eurostat). In

comparison with 2004, the backwardness from the average EU level was reduced by 6.6 percentage points.

Figure 3.3



Source: estimation by Eurostat

Table 3.1

Productivity by National Economy Sectors – Value Added per Person Employed

	Annual average real changes in the period of 2004-2006 (%)	Level in current prices (LVL per person employed) in 2006
Primary sectors	7.7	3192
Manufacturing	8.0	7306
Electricity, gas and water	2.6	14372
Construction	-0.9	6344
Trade, hotels and restaurants	9.4	10860
Transport and communications	8.4	16550
Other services	7.8	24605
Public services*	3.7	6860
Total national economy	7.7	9256

* Public administration with healthcare and education

Increase of Latvian GDP was mainly fostered by the productivity growth and, to a smaller extent, by the increase of employment. The rate of productivity growth in the last 3 years exceeds 7%: productivity increased by 7.5% in 2004, 8.7% in 2005 and 7% in 2006.

Productivity is increasing faster in trade, transport and communications, and manufacturing. However, its level in manufacturing still lags behind the indicators of several service sectors. For example, the productivity level in financial services is 2 times higher than in manufacturing.

3.2. GDP Expenditure

3.2.1. Aggregate Demand

The main impulse to the fast growth in the last years is the stable increase of the domestic demand. Both the private consumption and investments have grown substantially.

Expansion of export opportunities plays a smaller role in the growth. Contribution of net exports to the growth is negative in the last three years. Situation was slightly better in 2005, when exports increased faster than imports and its growth also exceeded the increase of the private consumption.

Table 3.2

Expenditure of Latvian GDP
(percentage)

	2004			2005			2006		
	structure	growth rates	contribution to growth	structure	growth rates	contribution to growth	structure	growth rates	contribution to growth
Gross domestic product	100.0	8.7	8.7	100.0	10.6	10.6	100.0	11.9	11.9
Private consumption	62.9	9.5	6.0	62.5	11.5	7.3	65.2	19.8	12.7
Public consumption	19.5	2.1	0.4	17.4	2.7	0.5	16.9	4.0	0.6
Gross fixed capital formation	27.5	23.8	6.6	30.6	23.6	7.5	34.4	18.3	6.5
Inventories	5.7	–	0.7	3.8	–	-4.4	3.7	–	0.2
Net exports	-15.6	–	-5.1	-14.4	–	-0.2	-20.2	–	-8.1
– exports	44.0	9.4	3.8	47.8	20.3	8.2	44.2	5.3	2.3
– imports	-59.6	16.6	-8.9	-62.2	14.8	-8.5	-64.4	17.5	-10.4

In 2006 the growth was faster, but bigger role in the growth was played by the domestic demand (its record growth reached 17.2%). This was mainly affected by favourable crediting conditions (especially of mortgage crediting), but the private consumption was also favourably affected by the fast growth of wages and by leasing opportunities. Growth of exports fell to 5.3%, which substantially deteriorated the Latvian trade balance and caused a big current account deficit at the end of 2006.

3.2.2. Private and Public Consumption

In the last three years, the disposable income of households¹ in Latvia amounts to 59.7% of GDP on average. The private consumption expenditures were 63.7% of GDP on average, but reached 65.2% of GDP in 2006, therefore the net savings are negative (see Table 3.3).

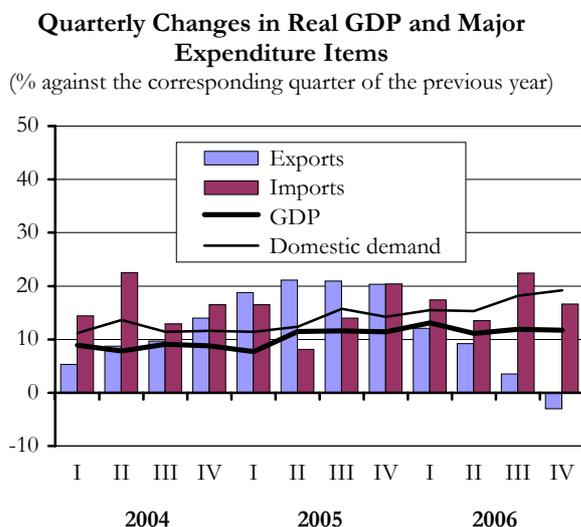
Table 3.3

Disposable Income and Final Consumption
Expenditures of Households, Net Savings

	2003	2004	2005	2006e
Disposable income of households (changes in % against the preceding year)	13.4	17.7	20.3	20.4
Final consumption expenditures of households (changes in % against the preceding year)	11.5	17.2	21.2	29.7
Net savings in % of disposable income	-3.4	-3.0	-3.8	-11.7
Net savings in % of GDP	-2.0	-1.8	-2.3	-6.9

e – estimation by the Ministry of Economics

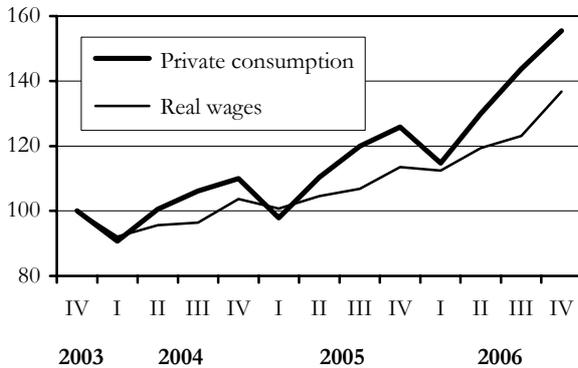
Figure 3.4



¹ Disposable income – income in cash and the cash value of goods and services obtained in kind, received in form of wages and salary, other income for work (after deduction of taxes), transfers, net income (income after deduction of production costs) from entrepreneurial activity and agricultural production, income from property, rent, etc.

Figure 3.5

Growth of Real Wages and Private Consumption, Quarterly Profile
(4th quarter of 2003 = 100)



Dynamics of the disposable income and final consumption expenditures shows that, in the last two years, consumption expenditures grow considerably faster than income, resulting in increase of the debt of households against the income. Besides, tax payments of households grow faster than social

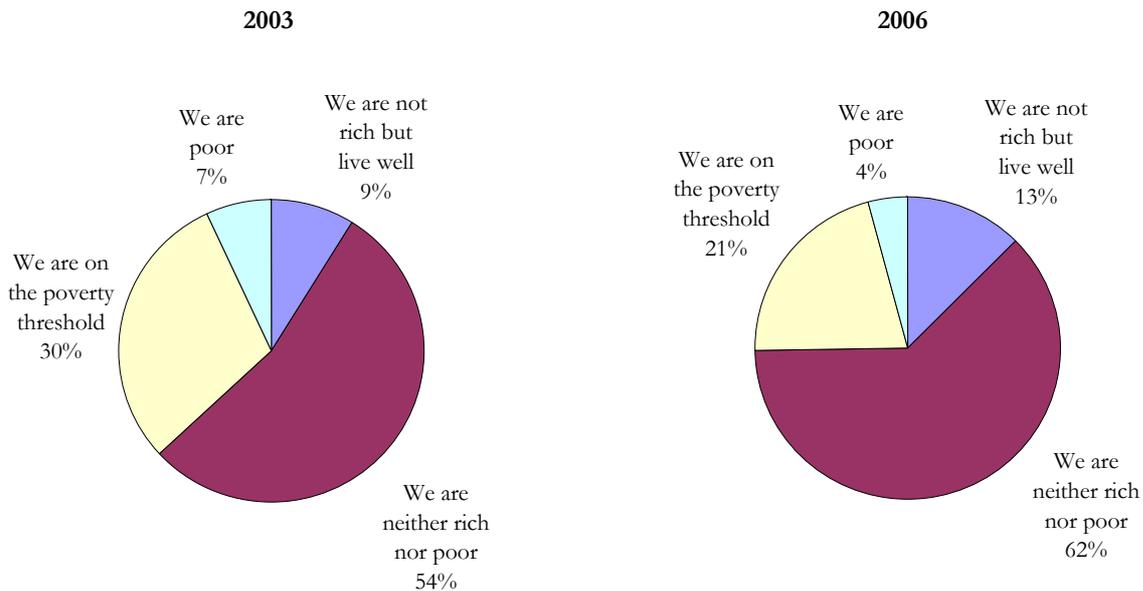
allowance revenues, thereby the growth rate of the disposable income of households is slower than the growth of wages.

Increased differences in growth of real wages and private consumption in 2005-2006 mean that, with increase of wages, households afford to spend more and more, besides, in the amount bigger than the growth of income.

More optimistic assessment of their economic situation by households and hence their opportunities to spend more is indicated by results of the survey of self-appraisal of material condition of households in 2006. The proportion of those respondents, who believe that they are not rich, but live well is increasing gradually. At the same time, the proportion of those respondents, who believe that they are on the poverty threshold or poor is decreasing. The fact that the number of those households that consider themselves not being rich, but living well has also increased in the countryside, comparing the results of 2006 (11%) with the results of 2005 (7.8%), causes satisfaction.

Figure 3.6

Self-Appraisal of Material Condition of Households
(breakdown by answers of respondents, %)



However, self-appraisal of material condition is still different in various Latvian regions. The biggest share of households answering “we are not rich, but live well” is in Kurzeme (18%) and Riga (15%). The answers “we are on the poverty threshold” or “we are poor” are most often given in Latgale (35%). However, in comparison with the previous year, also the assessment of the material condition of households living in Latgale has improved.

3.2.3. Investment

Investment¹ is one of the most important factors of economic growth of Latvia. More than one-fourth of the national income is used for investment every year. During the last three years (2004-2006) investment increased by 81% (by 22% on average annually).

As indicated by *Eurostat* data, average annual growth rates of investment in Latvian economy exceed

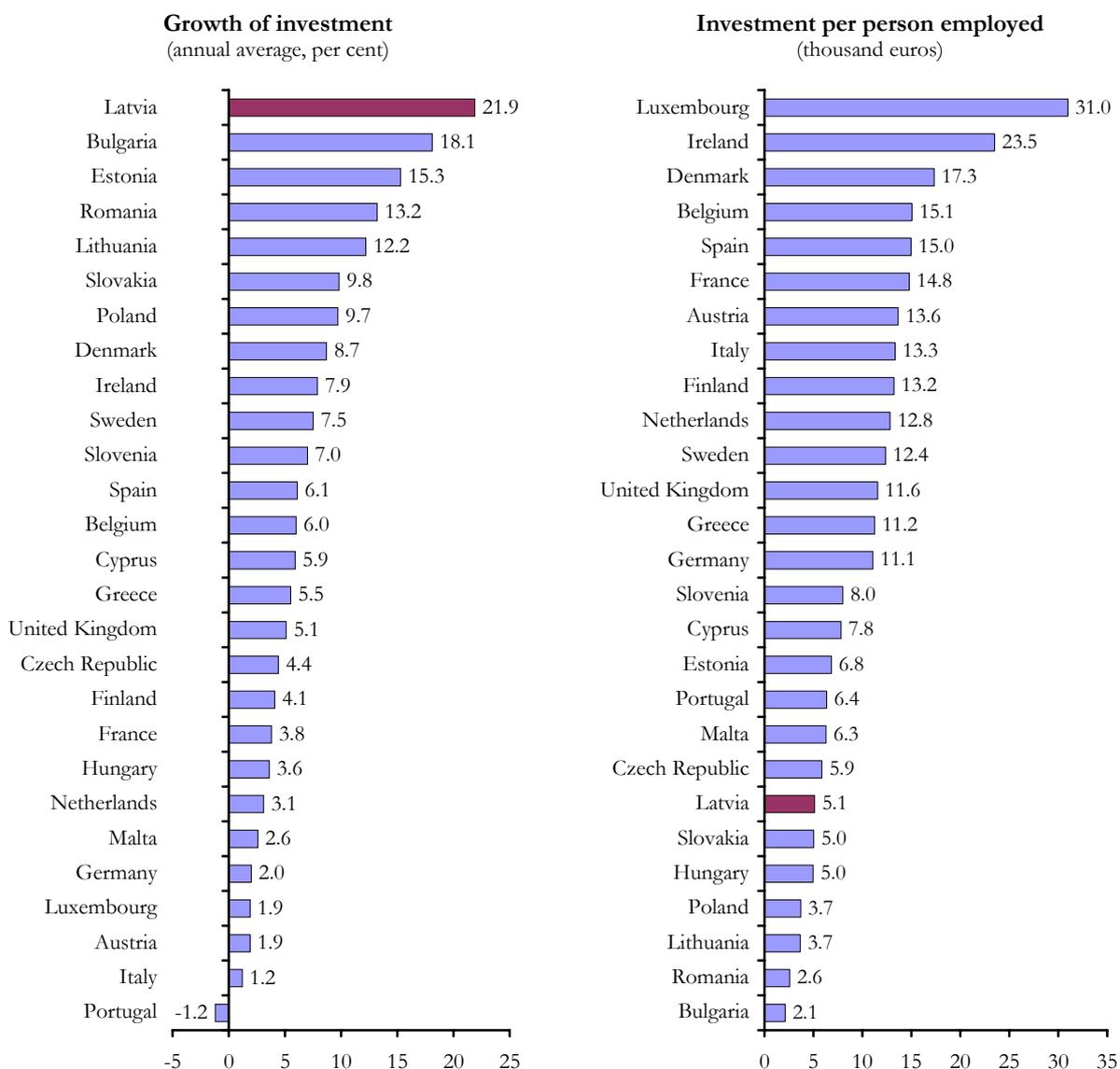
¹ Gross fixed capital formation or investment in fixed assets

the average annual investment growth rates in EU member states almost six times. However, it should be noted that Latvia almost two times lags behind the EU

average indicators of the volume of investment per person employed.

Figure 3.7

Volume of Investment per Person Employed and Investment Growth in EU Member States in 2004-2006



Source: Eurostat

The rapid investment dynamics was greatly affected by expanded access to financial resources, which was determined by two main circumstances: firstly, the intensified inflow of foreign capital since Latvia's accession to the EU, and, secondly, the improvement of financial position of companies due to relatively low tax burden and high domestic demand. In almost all sectors, the profit margin (return on sales) in 9 months of 2006 was higher than in the corresponding period of 2005. In turn, growth of profits in several sectors ensured preservation of high interest cover. Although the volume of debt grew rapidly, the volume of interest payments increased at a moderate pace, indicating preservation of favourable

financing conditions. Also results of a conjuncture survey indicate that the financial position of industrial companies keeps improving.

Investment increased by 18.3% in 2006, which is slightly slower than in 2005. Share of investment in GDP grows every year and reached 34% in 2006.

According to provisional data, the investment in the public sector³ in 2006 was by 6% lower than in 2005, while investment volumes in the 1st quarter of

³ The public sector includes enterprises and organisations of the central and local governments, business companies with the share of central or local governments or their enterprises in equity capital in the amount of 50% or more, social and religious organisations and enterprises owned by them, and budgetary institutions.

2007 were by 62% bigger than in the respective period of the preceding year.

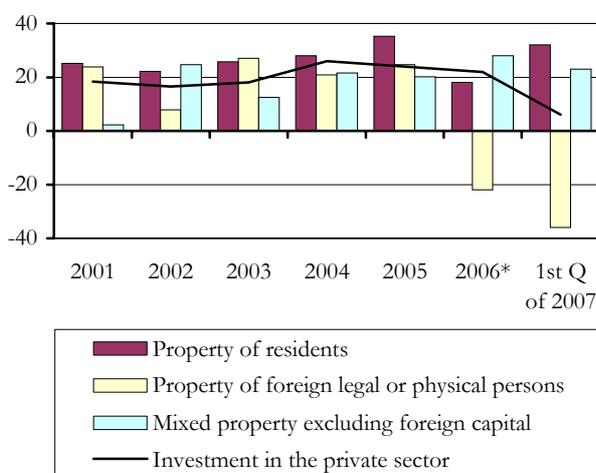
Table 3.4

Gross Capital Formation			
	2004-2006 (average per year)	2005	2006
Real growth			
GDP	10.4	10.6	11.9
Gross capital formation	16.6	8.5	18.9
– gross fixed capital formation	21.9	23.6	18.3
% of GDP			
Gross capital formation	35.6	34.4	38.1
– gross fixed capital formation	31.3	30.6	34.4
– changes in inventories	4.3	3.8	3.7

The investment in the private sector made 67.6% of the total volume of investment. It increased by 22% in comparison with 2005, while the investment in the 1st quarter of 2007 was by 6% bigger than in the corresponding period of 2006.

Figure 3.8

Fixed Investment Dynamics in the Private Sector by Property Forms
(percentage against the preceding year)



* estimated using the quarterly data

Since 2004, the investment in companies owned by residents increase by almost 30% every year, while the investments in companies owned by non-residents have decreased in the last years. So, it decreased by 23% in 2006, while the investment during three months of 2007 was by almost one-third smaller than in the 1st quarter of 2006.

On the whole, it should be noted that investment growth rates both in the private and the public sector have increased by at least 10 percentage points since 2004.

Sectoral structure of investment⁴. Since Latvia entered the EU, the investment dynamics have grown considerably. During two years since the accession, investment volumes grew by 39% in production and by 22.3% in services, while in the first two years since the accession they increased by 56% and 46% respectively.

Table 3.5

Fixed Investment by Sectors
(excluding investment in individual construction, %)

	Average 2004-2005	2006*	3 months of 2007*
Growth			
Primary sectors	30.2	-4.7	3.2
Manufacturing	26.5	-6.0	-6.0
Electricity, gas and water supply	12.6	-18.0	285.0
Construction	42.1	8.0	39.0
Trade	17.9	24.3	15.2
Transport and communications	9.4	-2.0	6.0
Other commercial services	26.8	83.0	16.0
Public services	28.8	10.2	29.1
Total	22.2	12.0	20.0
Structure			
Primary sectors	5.0	4.3	3.5
Manufacturing	16.1	16.2	16.7
Electricity, gas and water supply	8.6	9.5	14.7
Construction	3.9	4.8	4.4
Trade	15.1	16.9	13.5
Transport and communications	14.3	13.0	12.4
Other commercial services	21.7	24.1	22.5
Public services	15.3	11.3	12.2
Total	100	100	100

* estimated using the quarterly data

Along with the rapid growth of investment, certain changes have also been observed in the sectoral structure of investment. Since 2001, the investment dynamics in production sectors was almost 1.5 times faster than in services. Such development trends determined that the share of production sectors in the sectoral structure of investment increases gradually. Investment in production sectors in 2006 made up 34.7% of the total investment in Latvian national economy.

During three months of 2007, in comparison with the corresponding period of the previous year, investment increased by 37% in production and by 16% in services.

⁴ Investment in breakdown by sectors is presented according to the non-financial investment statistics that does not include all investment in fixed assets.

Table 3.6

Dynamics and Structure of Investment in Manufacturing
(%)

	Growth rates			Structure		
	Average 2004-2005	2006*	3 months of 2007*	Average 2004-2005	2006*	3 months of 2007*
Food industry	22.9	-11.2	-16.3	28.4	23.8	18.5
Light industry	-10.8	12.2	-24.2	3.5	4.0	2.3
Wood processing	17.6	19.0	-59.2	24.9	30.6	17.9
Paper industry and publishing	31.6	-13.3	145.6	6.9	6.5	19.6
Chemical industry and related industries	16.4	21.7	200.0	6.2	7.2	11.3
Production of other non-metallic mineral products	75.6	45.0	-25.6	8.4	9.8	8.9
Production of metals and metal articles	33.0	-46.5	18.6	7.3	6.7	6.1
Production of machines and equipment	51.2	-34.9	38.7	8.3	6.8	7.4
Other industries	50.4	-15.5	158.5	6.1	4.5	8.0

* estimated using the quarterly data

Growth of investment in services in 2004- 2005 was especially fast in such sectors as hotels and restaurants, real estate transactions, and education. Investment in these sectors increased by almost 50% on average annually. Rapid investment dynamics also remained in 2006 and the 1st quarter of 2007. Investment in the “real estate transactions” sector in 2006 was twice higher than in 2005. Investment attractiveness of the sector is determined by high capital return mostly based on growing demand for housing.

Since Latvia’s accession to the EU, annual investment growth rates became almost twice faster also in manufacturing, and investment in this sector in 2005 was 1.5 times higher than in 2003. Hence, although the investment in manufacturing in 2006 was slightly lower than in 2005, its volume is considerable.

Food industry and wood processing have the leading positions in terms of investment volumes in manufacturing. The share of these two sectors in the investment in manufacturing was 54.4% in 2006. Since 2004, investment grew especially fast in such sectors as production of other non-metallic products (by 65% on average annually), production of motor vehicles, trailers and semi-trailers (85%), and production of chemical substances, their products and chemical fibres (51%).

Since 2004 on the whole, the investment in manufacturing sectors of high and medium technologies grows the fastest. During the last three years, the investment in high technology sectors increased by 22.3% on average annually, in medium technology sectors – by 18.8%, and in low technology sectors – by 13.3%. In the 1st quarter of 2007, the investment in high technology sectors grew 2.3 times and constituted 12.3% of the total investment in manufacturing, while the investment in low technology sectors declined by 24%. Such trends may indicate certain capital saturation in low technology sectors and drain of their development potential, which is also

greatly affected by producer price competition pressure from cheap labour countries.

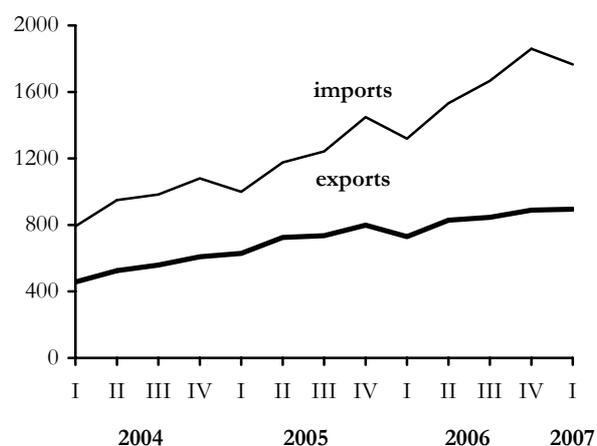
3.2.4. Exports and Imports

Exports and imports of commodities

Exports of Latvian commodities in 2006 grew at a more moderate pace than in 2005 (by 14% in current prices), while imports increased much faster (by 31.1%). Exports increased already slightly faster in January-May 2007 (by 23.6% in comparison with the corresponding period of the previous year), while imports of commodities grew very fast in January-May 2007 (by 30.4%).

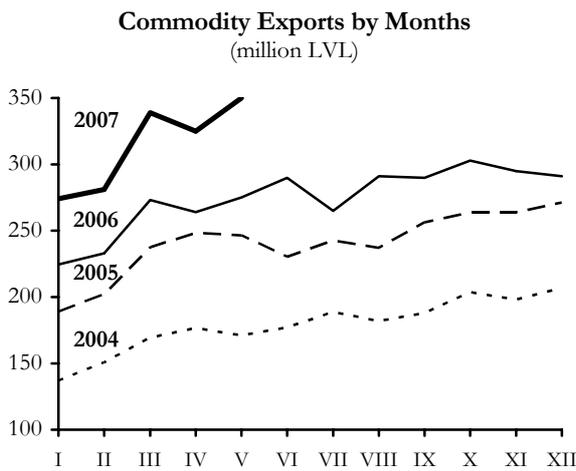
Figure 3.9

Commodity Exports and Imports by Quarters (million LVL)



In 2006, the **commodity exports** were favourably influenced by the rise of the export unit value that exceeded the value of the previous year by 9.7%, as world prices grew in several groups of goods.

Figure 3.10



Commodity exports in 2006 went up in almost all groups of goods, especially metal-working products, which accounted for almost 27% of the total growth of exports. Exports of mineral products, which had increased very fast in 2005, considerably decreased in 2006 (mostly to EU member states), and exports of wood and wood products did not increase (see Table 3.7).

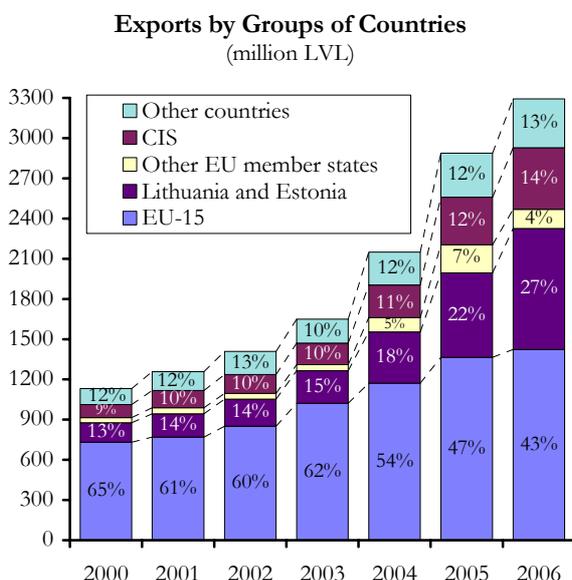
In January-May 2007, exports of metal-working products as well as exports of wood products and machinery kept increasing faster.

Table 3.7

Exports by Main Groups of Commodities (FOB prices)

	2006		January-May 2007	
	Structure (%)	Increase against 2005 (current prices, %)	Structure (%)	Increase against January-May 2006 (current prices, %)
Total	100	14.0	100	23.6
including:				
wood and wood products (IX)	22.5	3.1	22.8	18.7
metals and metal articles (XV)	14.8	28.7	16.3	41.6
light industry products (VIII; XI-XII)	8.8	7.8	8.3	12.1
agricultural and food products (I-IV)	13.2	23.4	12.8	25.4
products of chemical industry and allied industries, plastics (VI-VII)	9.8	38.4	10.3	28.1
machinery (XVI)	9.8	20.2	10.0	45.5
mineral products (V)	5.5	-31.3	4.1	-15.1
transport vehicles (XVII)	6.0	78.5	6.7	38.0
other commodities (X; XIII-XIV; XVIII-XXII)	9.5	7.7	8.7	9.3

Figure 3.11



Exports to EU-25 countries in 2006 were by 11.3% bigger than in the previous year. Like the total Latvian exports, also exports to EU-25 countries increased in almost all groups of commodities with the exception of mineral products. The biggest growth in exports to EU-25 countries was provided by metal-working products. Exports to EU-25 countries were slightly bigger in January-May 2007 (by 25.8%).

Exports to CIS countries in 2006 continued increasing at a rather rapid pace by 30.4%. The biggest increases were observed for exports of machinery and chemical industry products. Exports to CIS countries kept growing rapidly in January-May 2007 (by 33.4%).

Increase of **commodity imports** in 2006 was observed in all groups of commodities and the biggest increases were in the groups of transport vehicles and machinery, which accounted for 22.8% and 19.1% respectively of the total increase of imports. These two groups also accounted for a half of the increase of commodity imports in January-May 2007.

Figure 3.12

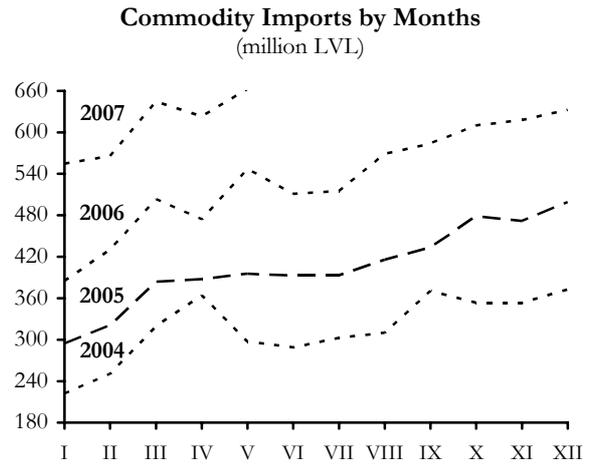


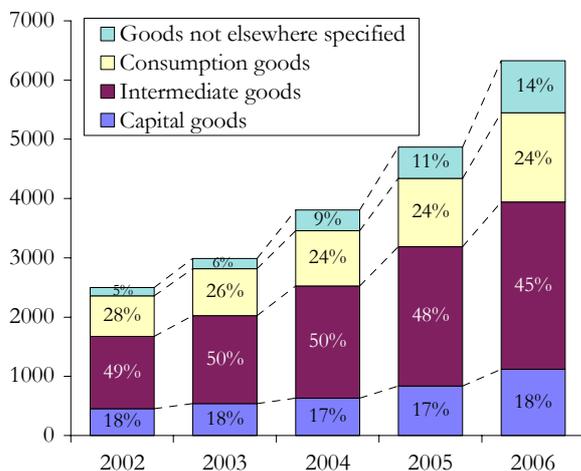
Table 3.8

Imports by Main Groups of Commodities (CIF prices)

	2006		January-May 2007	
	Structure %	Increase against 2005 (current prices, %)	Structure (%)	Increase against January-May 2006 (current prices, %)
Total	100	31.1	100	30.5
including:				
wood and wood products (IX)	2.5	13.4	3.6	71.1
metals and metal articles (XV)	9.5	35.5	9.9	40.5
light industry products (VIII; XI-XII)	5.8	26.7	5.7	20.0
agricultural and food products (I-IV)	11.1	24.8	10.5	22.9
products of chemical industry and allied industries, plastics (VI-VII)	13.0	29.3	13.3	20.7
machinery (XVI)	19.7	29.9	20.9	47.6
mineral products (V)	13.4	13.5	11.4	4.5
transport vehicles (XVII)	13.6	66.0	14.4	43.4
other commodities (X; XIII-XIV; XVIII-XXII)	11.0	36.2	10.3	26.7

Figure 3.13

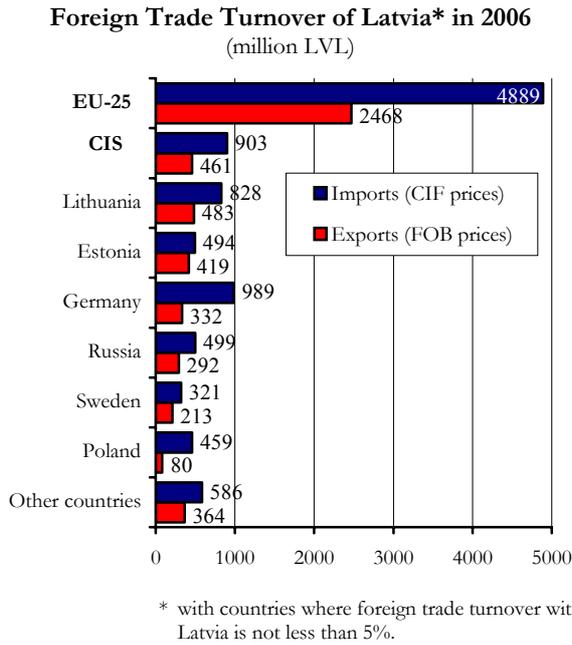
Imports by Classification of the Broad Economic Categories (in connection with basic indices of national accounts, in current CIF prices, million LVL)



As viewed by classification of the broad economic categories, the imports have been almost unchanged in the last five years (see Figure 3.13).

The biggest **trading partners** of Latvia in 2006 were Lithuania (13.5% of the total foreign trade turnover), Germany (13.5%), Estonia (9.4%), Russia (8.3%), Sweden (5.6%) and Poland (5.5%).

Figure 3.14

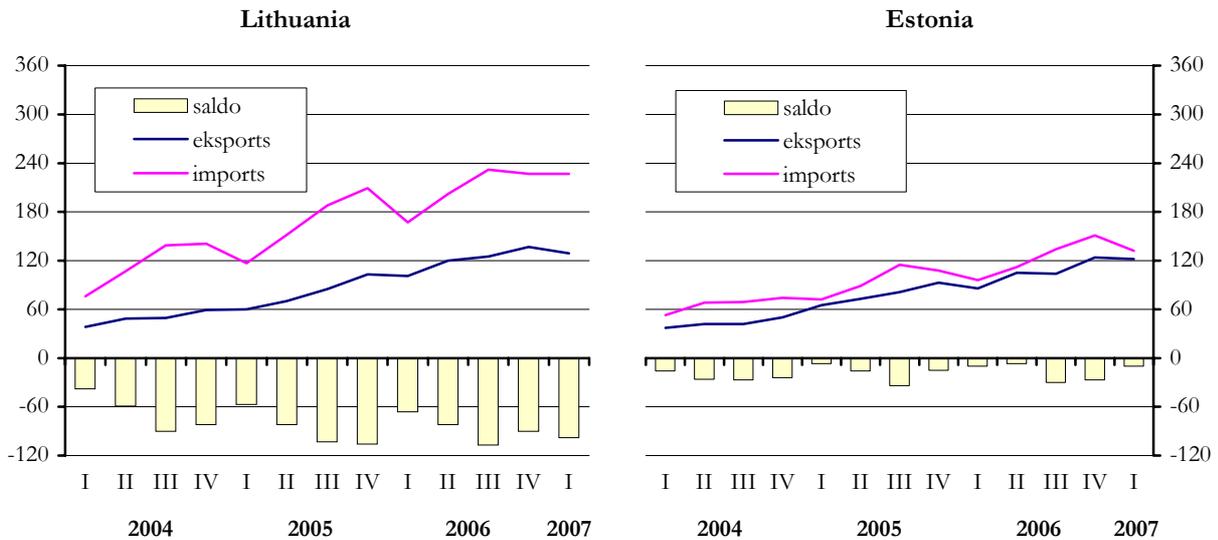


After Latvia's accession to the EU, foreign trade of Latvia with **Lithuania** and **Estonia** still grew rapidly. In comparison with 2003, Latvian foreign trade with these countries has increased three times, but a considerable negative balance still remains (see Figure 3.15).

As Figure 3.15 shows, the negative balance of foreign trade with Lithuania (imports exceeded exports by 72% in 2006) is bigger than with Estonia (18%). The main groups of commodities exported to Estonia and Lithuania are food and chemical industry products, while the main imported commodities are mineral products and transport vehicles.

Figure 3.15

Latvian Foreign Trade Turnover with Lithuania and Estonia by Quarters
(million LVL)



Exports to Lithuania increased rapidly in 2006 (by 51.7%), and the biggest contributions were made by the groups of food and chemical industry products. Imports from Lithuania in this period grew at a more moderate pace (by 24.4%). Latvian trade transactions with Lithuania increased considerably at the beginning of 2007 as well (in January-May 2007, the exports increased by 28.7% and the imports grew by 34.9%).

In trade with Estonia, Latvian exports grow faster than imports (by 34.2% and 28.9% respectively in

2006; in January-May 2007, the exports increased by 41.2% and the imports grew by 42%).

Exports and imports of services

The clearly negative balance of commodity trade of Latvia is partly covered by the positive balance of services (see Table 3.9). According to the data of the balance of payments, the balance of services has slightly deteriorated in 2006, as exports of services continue growing at a slightly more moderate pace than imports (see Table 3.9).

Table 3.9

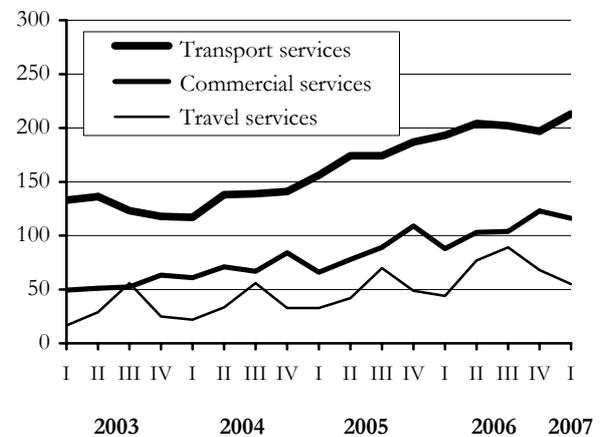
Exports and Imports of Services in 2006

	Million LVL			Structure (%)		Changes against 2005 (%)	
	exports	imports	balance	exports	imports	exports	imports
Services – total	1492.0	-1106.6	385.4	100	100	21.6	25.4
including:							
Transport services	796.7	-351.9	444.8	53.4	31.8	15.4	24.1
– sea transport	303.2	-83.1	220.1	20.3	7.5	3.5	36.2
– air transport	104.6	-124.0	-19.4	7.0	11.2	35.9	24.1
– other transport	389.0	-144.9	244.1	26.1	13.1	21.4	18.1
Travel	277.4	-400.4	-123.0	18.6	36.2	43.1	21.0
Commercial services	397.3	-336.0	61.3	26.6	30.4	23.0	33.6
Other services	20.5	-18.3	2.2	1.4	1.6	6.6	11.4

Slightly more than half of the exports of services is made by the revenues from transit haulage. 2006 was a rather successful year for the transit business, as cargo turnover in ports increased and volumes of rail and road transport services grew.

Growth of revenues from incoming tourists and increase of commercial services are significant. It must be noted that the amount of expenses by foreign tourists in Latvia continue approaching the amount of expenses by Latvian travellers abroad.

Figure 3.16

Exports of Services by Quarters
(million LVL)

3.3. Contribution of Sectors

3.3.1. Structure and Dynamics of the Economy

The structure of Latvian economy in sectoral profile has changed in favour of service sectors in the last years. The share of service sectors in the value

added has increased to 74.8% in 2005 from 71.8% in 2000. Construction, trade services, transport and communications have grown faster than other sectors of the economy in terms of both the value added and the number of employees.

Table 3.10

Structure of the Economy
(%)

	By value added		By number of employees	
	2000	2006	2000	2006
Primary sectors	4.8	4.0	14.5	11.6
Manufacturing	13.7	11.9	17.9	15.0
Electricity, gas and water supply	3.6	2.5	1.9	1.6
Construction	6.1	6.8	5.9	10.0
Trade, hotels and restaurants	17.9	22.4	17.7	19.1
Transport and communications	14.0	13.0	8.3	9.2
Other commercial services	23.0	25.0	12.4	14.0
Public services	16.9	14.4	21.4	19.5
Total	100.0	100.0	100.0	100.0

The structure of the economy in terms of employment differs considerably from the structure by value added due to the notable difference between productivity levels in various sectors of the economy.

The rapid economic growth in the recent years was ensured both by increased domestic demand and expanded export opportunities. Increase of domestic demand had a direct impact on the fast growth of several service sectors, while increased volumes of industrial production were mainly based on rising exports.

In the last three years (2004-2006), increasing trade (wholesale and retail) and other commercial services contributed to almost two-thirds of the growth. The contribution by manufacturing is considerably smaller and also lags behind the contribution by the construction and transport and communications sectors.

The growth of *trade* as an economic sector has been driven mostly by the domestic demand, but a little over one-tenth is related to the trade mediation services provided to non-residents. This share increases every year.

Table 3.11

GDP Growth
(%)

	Growth rates		Contribution to growth	
	2006	Average 2004-2006	2006	Total 2004-2006
Primary sectors	0.4	4.9	0.0	0.7
Manufacturing	6.2	6.2	0.9	2.8
Electricity, gas and water supply	4.0	3.6	0.1	0.4
Construction	13.6	14.1	1.0	3.2
Trade, hotels and restaurants	17.3	15.5	3.9	10.9
Transport and communications	9.3	11.0	1.4	5.2
Other commercial services	16.7	12.1	4.0	9.5
Public services	4.4	4.1	0.6	1.9
GDP	11.9	10.4	11.9	34.5

Increase of output of various commercial services is related to the rapid development of financial mediation as well as increase of services involving real estate.

Two-thirds of the total demand of the *transport and communications* sector is determined by the domestic demand that is stable and has increased faster than the external demand in the recent years. This refers especially to communications as well as supporting and auxiliary types of transport activity, such as warehousing, parking services and operation of travel agencies. The external demand for transit services is unstable. The significant growth rates in the transport and communications sector in 2004-2006 were ensured by increased transportation both of cargo and of passengers as well as by development of the communications industry. In cargo transportation, the amount of cargo transported

by motor vehicles grew substantially and contributed most to the overall growth. Contributions by railway transport and port services to the growth of the sector were smaller. Passenger transport services increased substantially, especially in air transport.

Rapid growth of investment has a favourable impact on the development of the *construction* sector that is growing at a rate much higher than the average growth in the economy.

3.3.2. Manufacturing

Manufacturing has shown a stable growth in the last years (2002-2006), but it still lags behind the average growth of the economy.

Table 3.12

Growth of Manufacturing*
(per cent)

	Average annual growth 2002-2006	Growth in 2006	January-March 2007 / January-March 2006
Manufacturing – total	6.3	4.8	2.4
Food industry	5.6	4.8	4.1
Light industry	2.7	8.5	0.2
Wood processing	5.8	-1.4	-8.2
Paper industry and publishing	5.4	8.8	24.3
Chemical, rubber and plastic industry	13.5	21.4	16.6
Manufacture of other non-metallic mineral products	12.4	4.7	22.2
Production of metals and metal articles	6.8	8.1	16.0
Production of machinery and equipment	8.8	-0.3	7.0
Production of electrical and optical equipment	20.7	8.7	15.2
Production of transport vehicles	1.1	-2.8	1.9
Other industries	7.0	6.0	1.4

* according to operational statistics

In majority of sectors, most of the output is being exported, therefore the growth of sectors largely depends on expansion of export opportunities.

However, demand for the output of these sectors has recently started increasing in the domestic market.

Table 3.13

Structure of Manufacturing
(per cent)

	By value added 2006*	By number of employees 2006	Share of exports in sector's sales 2006
Manufacturing – total	100	100	50.0
Food industry	19.2	20.8	24.3
Light industry	7.4	12.9	76.0
Wood processing	21.3	20.3	67.3
Paper industry and publishing	8.2	6.7	23.5
Chemical, rubber and plastic industry	8.4	5.4	56.5
Manufacture of other non-metallic mineral products	6.2	4.0	19.9
Production of metals and metal articles	10.5	8.8	67.0
Production of machinery and equipment	3.5	4.3	74.1
Production of electrical and optical equipment	5.2	4.1	65.8
Production of transport vehicles	3.7	4.0	72.8
Other industries	6.2	8.8	56.7

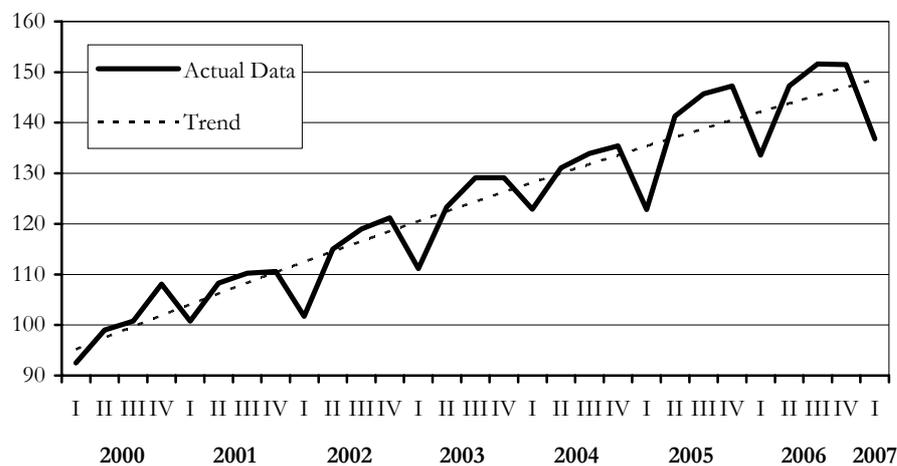
* estimation by the Ministry of Economics according to operational information

In 2006, growth was faster in those sectors products of which are much demanded in the domestic market, with the exception of food industry. On the whole, production volumes of manufacturing

increased by 4.8% during the year, as growth rate was notably more moderate in wood processing that is one of the main export sectors of Latvia.

Figure 3.17

Dynamics of Manufacturing Growth by Quarters
(level of 2000 = 100)

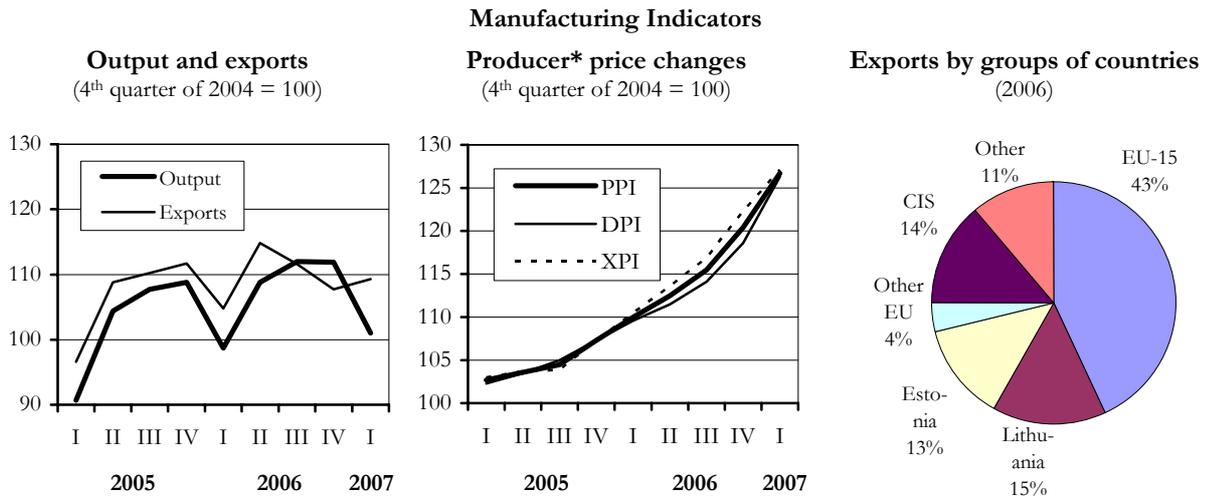


Manufacturing growth trend on the whole is even without marked accelerations or declines. Decreased growth of particular sectors is compensated by increased growth rates in other sectors. In almost all sub-sectors of manufacturing industry, the results of 2006 in comparison with 2000 indicate increased volumes of production (with the exception of production of transport vehicles). After accession to the EU, growth rates increased in paper industry and publishing, chemical industry, production of construction

materials and in production of electrical and optical equipment. In other sectors, growth rates remained at the previous levels or slightly decreased.

In the period after accession, exports to Estonia and Lithuania expanded most substantially and the growth of exports to these countries was bigger than to the other EU member states. Exports of manufacturing products to CIS countries also increased rapidly.

Figure 3.18



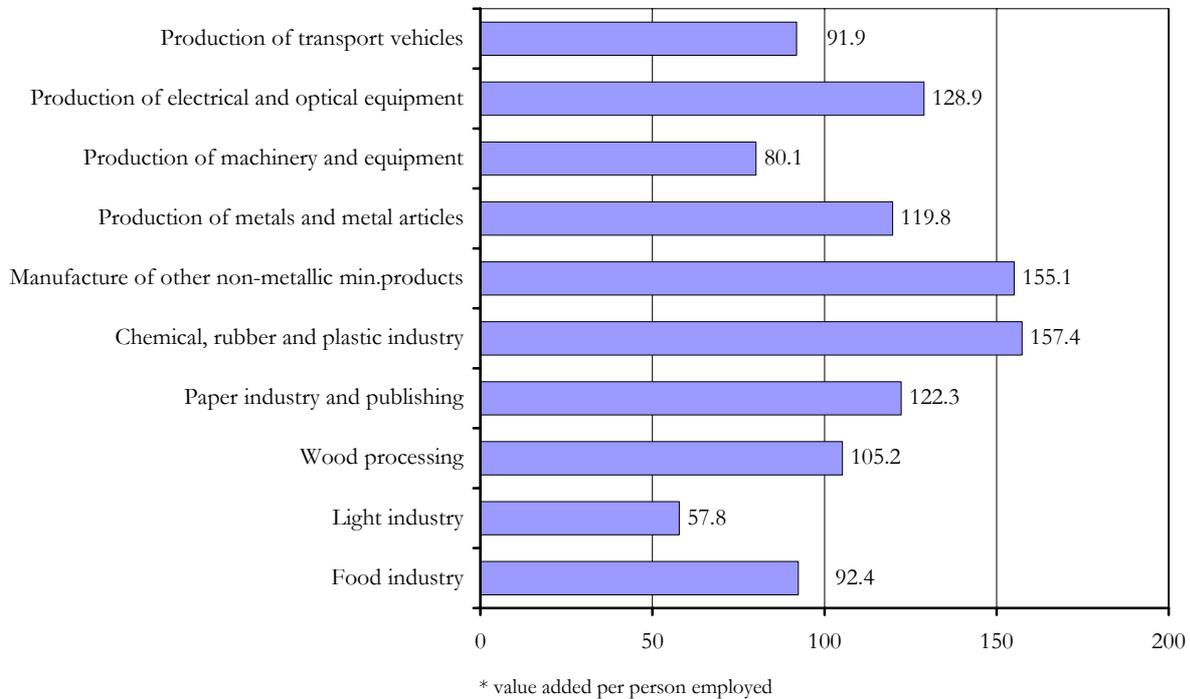
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Producer prices have increased considerably in all sectors during the last two years, besides, the prices for domestically sold products and for the exported ones have increased equally.

In Latvian manufacturing, level of productivity is the highest in chemical industry and production of construction materials, but is relatively low in majority of machinery sectors. Only textile industry has lower productivity.

Figure 3.19

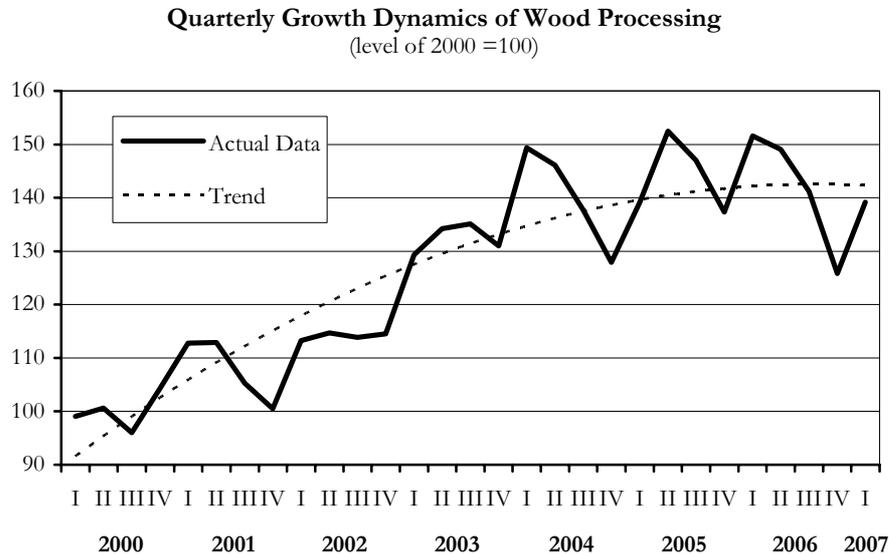
Level of Productivity* of Manufacturing Sectors in 2006
(average level of manufacturing = 100)



Wood processing is one of the biggest sectors of Latvian industry. Its value added makes up one-fifth of the manufacturing output. This sector has shown the fastest growth since restoration of Latvia's independence, nearly tripling its output in this period.

However, the growth of this sector has become more moderate in the last two years. High share of exported products (two-thirds of the output) is characteristic for the wood processing sector.

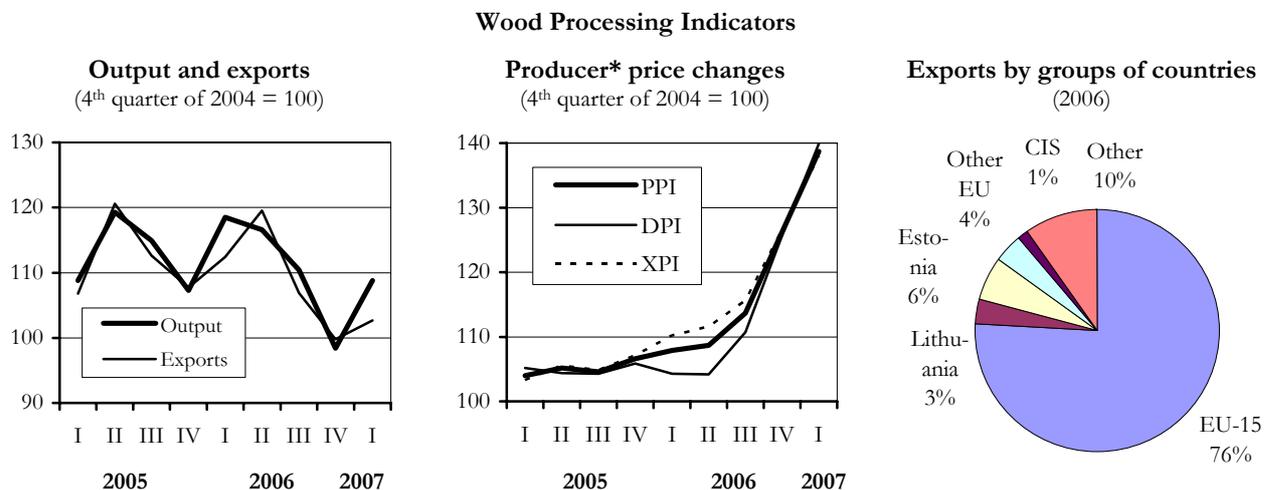
Figure 3.20



2006 was especially unfavourable year for wood processing, as demand for products of wood processing considerably decreased in Europe. Production volumes in this sector fell by 1.4% in 2006.

Decreased exports of wood products to EU-15 member states were slightly compensated by the rapid growth of exports to Estonia and Lithuania as well as other new EU member states.

Figure 3.21



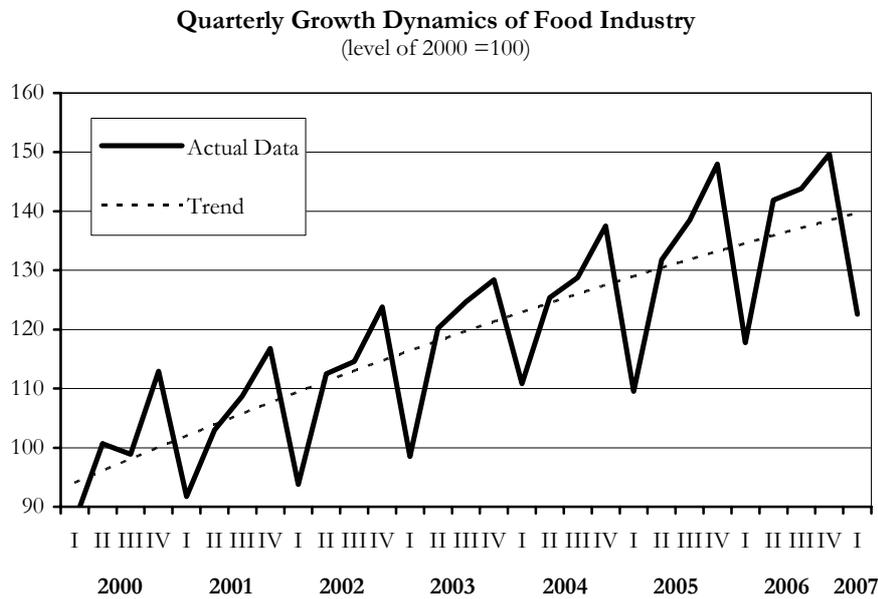
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Producer prices in wood processing in 2005-2006 grew equally fast for both the domestically sold and the exported products. Prices for the exported

products grew faster at the beginning of 2006, favourably affecting the export of products.

Food industry is the biggest sector in Latvian manufacturing and accounts for one-fifth of the value added in manufacturing.

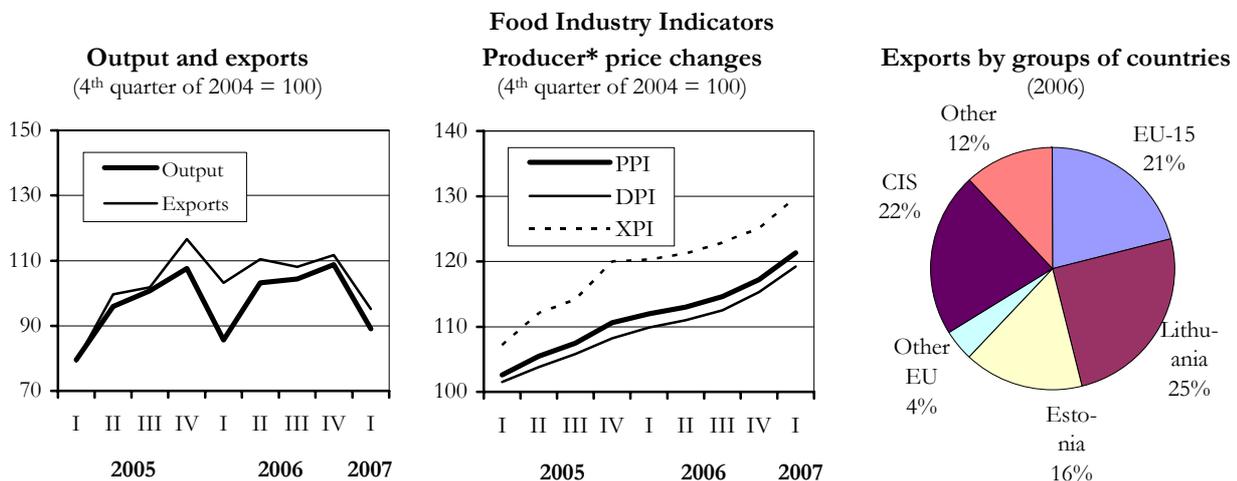
Figure 3.22



Approximately 75% of the total food industry output is consumed in the domestic market. The rest is exported mostly to Estonia, Lithuania and Russia. With accession to the EU, the demand for Latvian foodstuffs increased in all trade directions – both to Russia and other CIS countries and to the EU.

Exports to EU member states rose more than 1.5 times mostly due to the increased demand in Estonia and Lithuania. Exports of food products to Lithuania and Estonia constitute more than half of the total exports of Latvian food products to EU member states.

Figure 3.23



* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

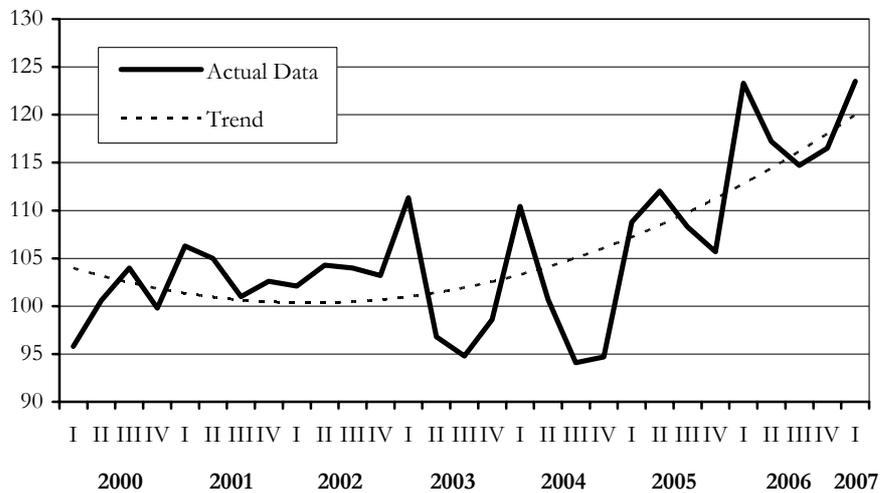
Export prices for food products increased rapidly as from 2005. Prices in the domestic market rose at a more moderate pace.

Light industry (production of textile and leather products) makes up approximately 7% of the total value added in manufacturing. Only about one-fourth

of the light industry output remains in Latvia. Most of the output (three-fourths of exports) is being exported to EU member states.

Figure 3.24

Quarterly Growth Dynamics of Light Industry
(level of 2000 =100)



Until 2005, the production volumes and exports of the *textile industry* did not increase, and they even decreased in production of clothing. Growth of production volumes only revived in 2005.

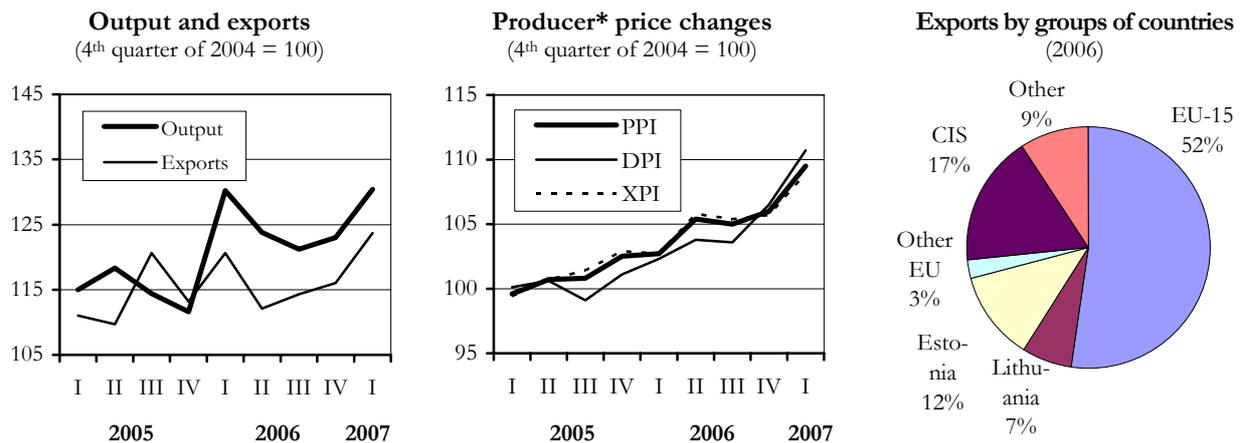
production volumes despite the rapid rise of prices in the last years.

Main sales markets for Latvian textile industry are in the EU member states. Due to the poor demand in the EU member states and high competition in the sector, it is hard for Latvian producers to expand

As already mentioned, growth is observed in the sector as from 2005. Output of 2006 exceeded the previous level by 8.5%, mainly due to increased exports to CIS countries, as well as Lithuania and Estonia. Exports to the old EU member states did not increase during this period.

Figure 3.25

Textile Industry and Production of Clothing

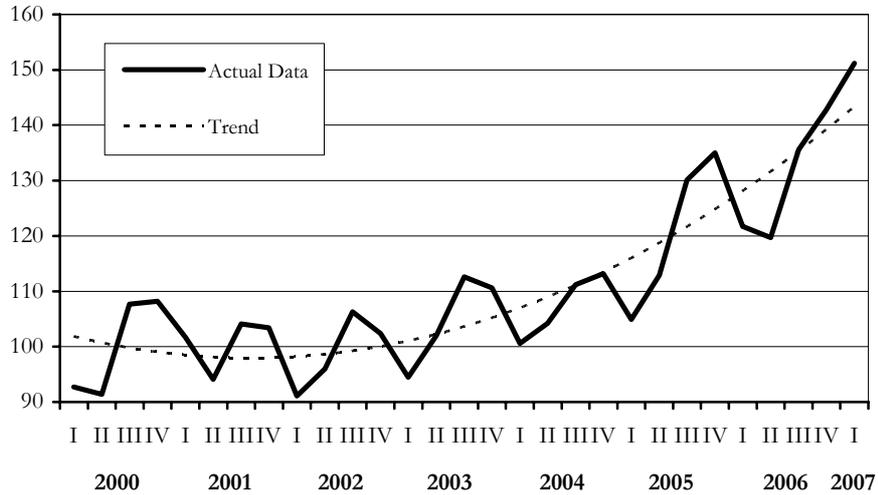


* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Paper industry and publishing is characterised by rather fast growth as from 2005, mainly due to increased exports and rise of export prices.

Figure 3.26

Quarterly Growth Dynamics of Paper Industry and Publishing
(level of 2000 = 100)



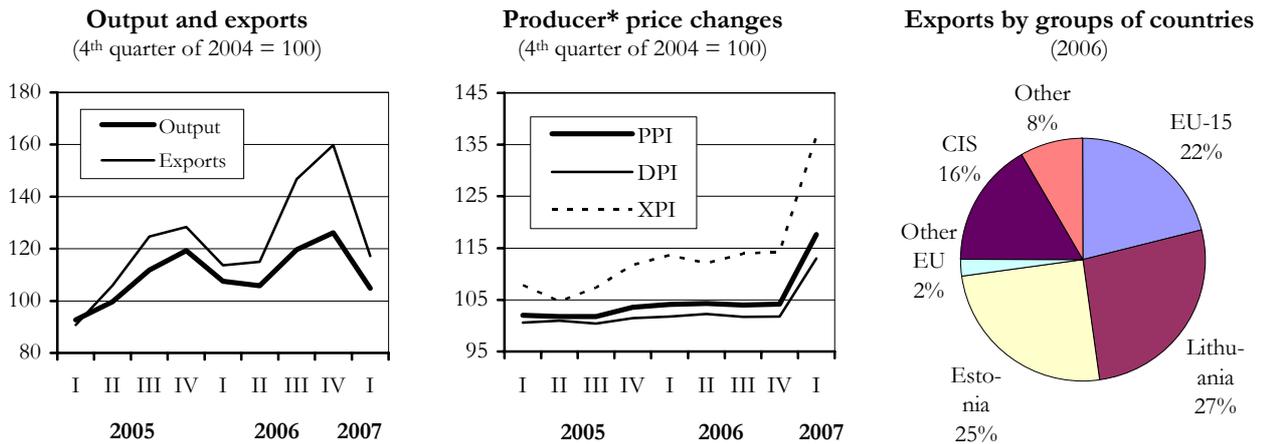
Main sales products for exported products in this sector are Lithuania and Estonia. Opportunities to expand into markets of other EU member states are poor, although export volumes to these countries are slightly increasing.

Until 2005, the growth of export prices was much slower than the average price growth, because a relatively big share of exports is related to CIS

countries and other countries outside the EU, and trade conditions with these countries deteriorate due to the low exchange rate of the US dollar that is one of the main currencies of account in these directions of trade. As from 2005, the situation improves due to increased US dollar exchange rate and growth of export volumes.

Figure 3.27

Paper Industry and Publishing Indicators

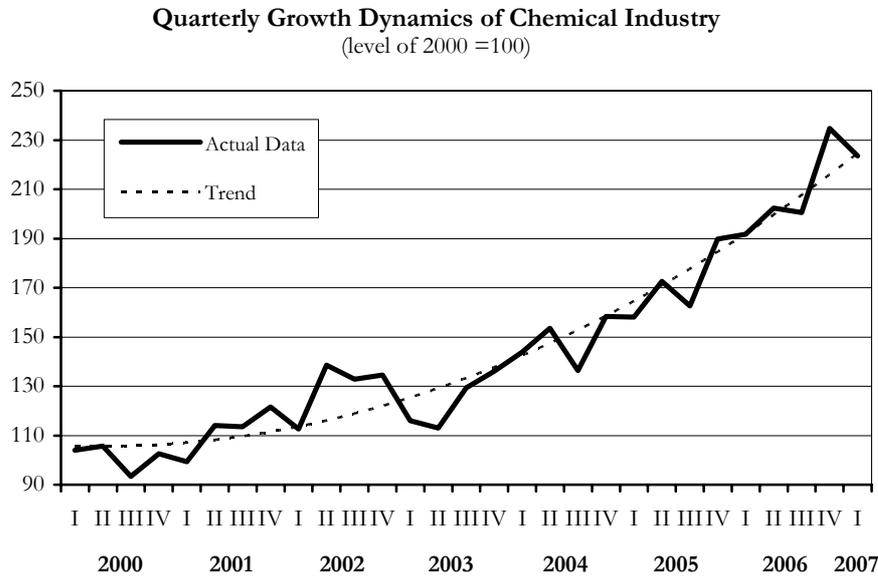


* PPI – producer price index, DPI – producer price index for products sold in the domestic markets, XPI – producer price index for exported products

Chemical industry in Latvia has stable traditions, highly skilled specialists, long history of producing a wide range of products for both the final consumption and the intermediate consumption and a good base for

research. Chemical industry accounts for approximately 8% of the total value added of manufacturing.

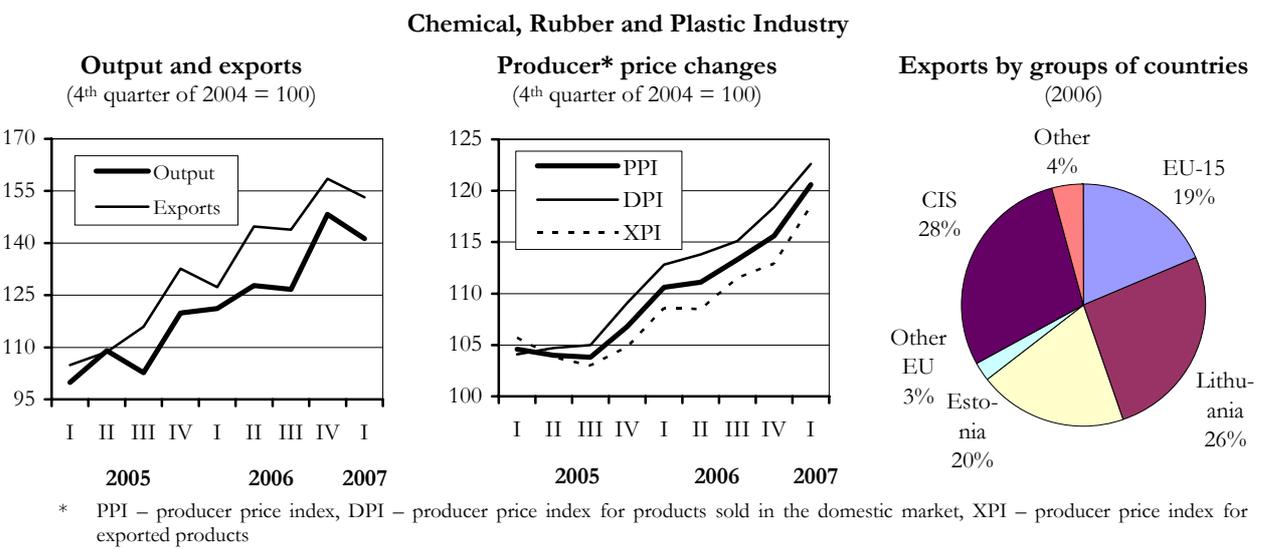
Figure 3.28



Traditional sales markets for Latvian chemical industry products are mainly in CIS countries, Lithuania and Estonia. Markets in the old EU member states do not increase. The sector has poor competitiveness in markets of the developed countries. Exports to Lithuania and Estonia make up about two-thirds of exports to EU member states.

Growth of the sector has not been steady in the last 5 years. There have been periods of decline, e.g., after the considerable growth of production volumes in 2002 they fell in 2003 and rapidly grew again in 2004 (by almost 20%) greatly due to increased demand in CIS countries. Growth rate was also high in 2006 (by more than 20%).

Figure 3.29

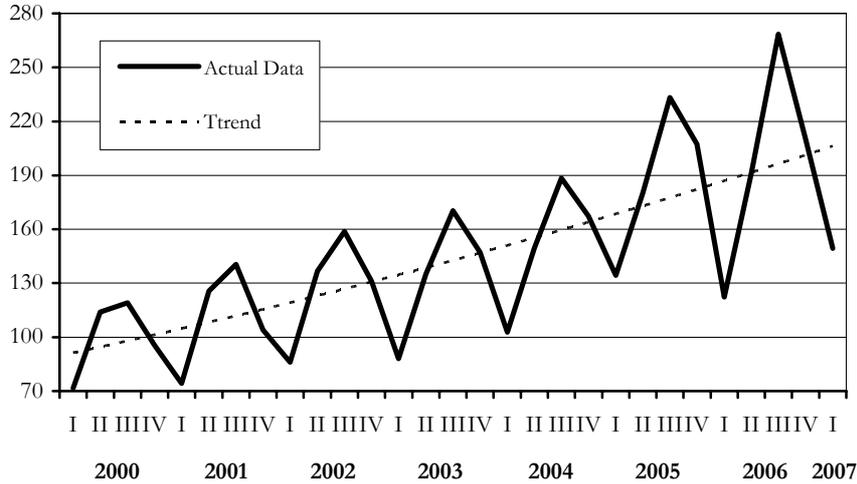


Manufacture of other non-metallic mineral products (mostly construction materials) has very unstable growth rates. After steep growth by 15.3% in 2002, the growth was more moderate in 2003 (by 5.4%),

rather fast again in 2004 and 2005 (by 12.5% and 24.1% respectively), and more moderate again in 2006 (by 4.7%).

Figure 3.30

Quarterly Growth Dynamics of Manufacture of Other Non-Metallic Mineral Products
(level of 2000 = 100)



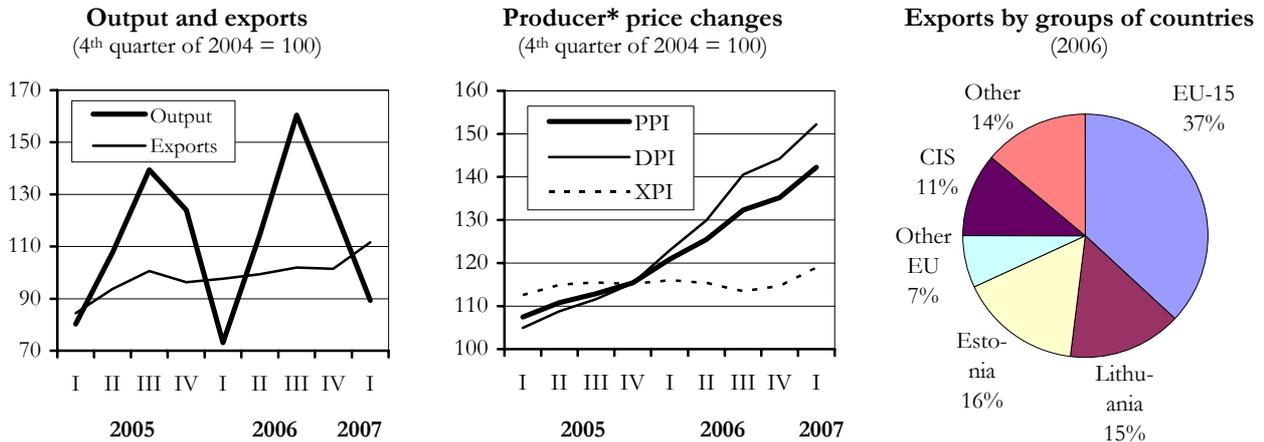
Increase of the domestic demand is the main incentive for growth of the sector. Also growth of exports was considerable in 2004 and 2005, which was very favourably affected by the increase of export

prices. Exports to EU-15 member states grew especially fast in 2005.

Production volumes fell in the 1st quarter of 2007 mainly due to the unfavourable climatic conditions that reduced the domestic demand.

Figure 3.31

Manufacture of Other Non-Metallic Mineral Products



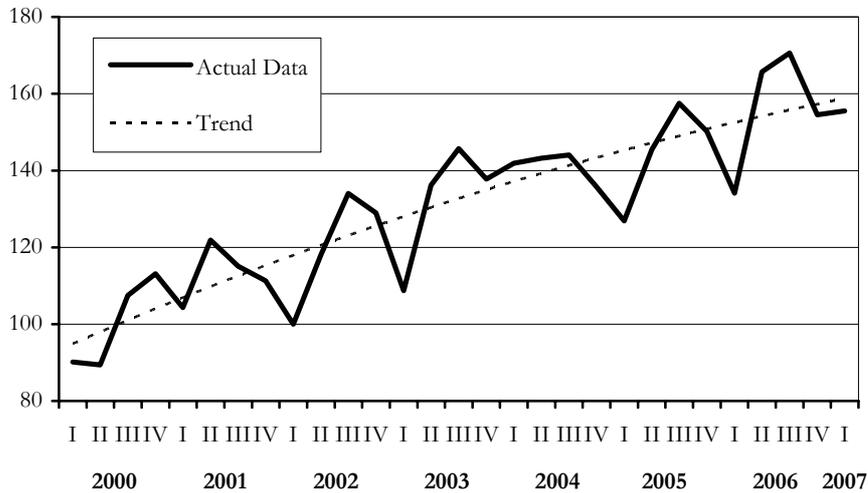
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Sectors of *production of metals and metal articles* constitute more than one-tenth of the total value added of manufacturing. Exports account for almost 70% of the total sold products of these sectors.

The domestic market share tends to expand recently. Development of construction has resulted in increased demand for finished metal articles.

Figure 3.32

Quarterly Growth Dynamics of Production of Metals and Metal Articles
(level of 2000 = 100)



Average growth in the sector reached almost 7.7% in 2002-2003. 2004 was unfavourable year for the sector, with decreased production volumes due to the decline of exports, and growth only revived in the 2nd quarter of 2005. Production volumes in 2006 exceeded the level of the previous year by 8.1%.

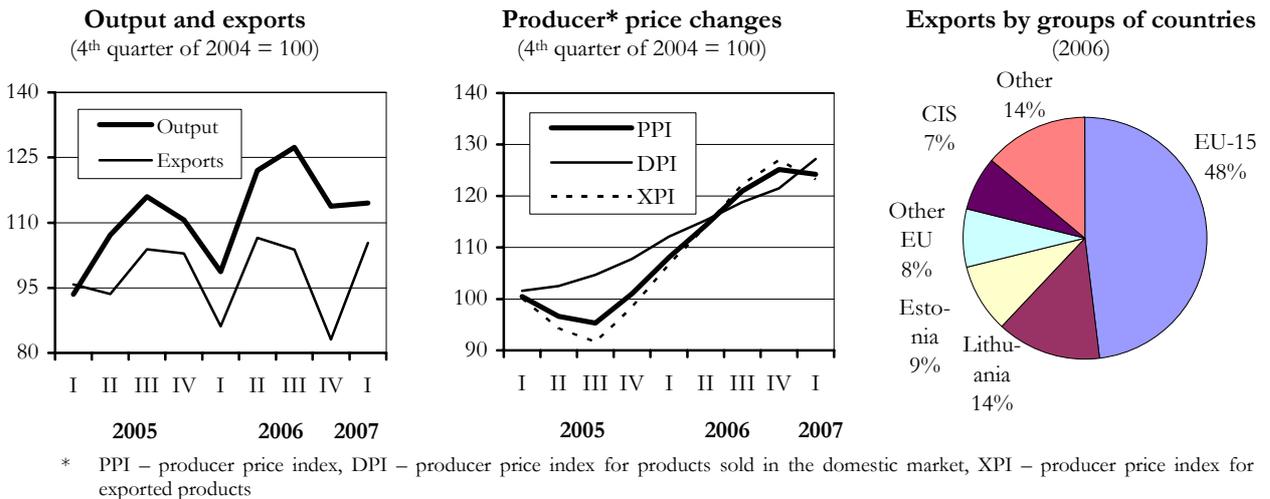
sold and the exported products, and the increase was considerably faster for the exported products.

Producer prices in the sector have substantially increased in the last years both for the domestically

Metals and metal articles produced in Latvia have high competitiveness around the world, but most of them are linked with EU member states (almost 80% of exports), and almost half of the products is being exported to the old EU member states.

Figure 3.33

Production of Metals and Metal Articles

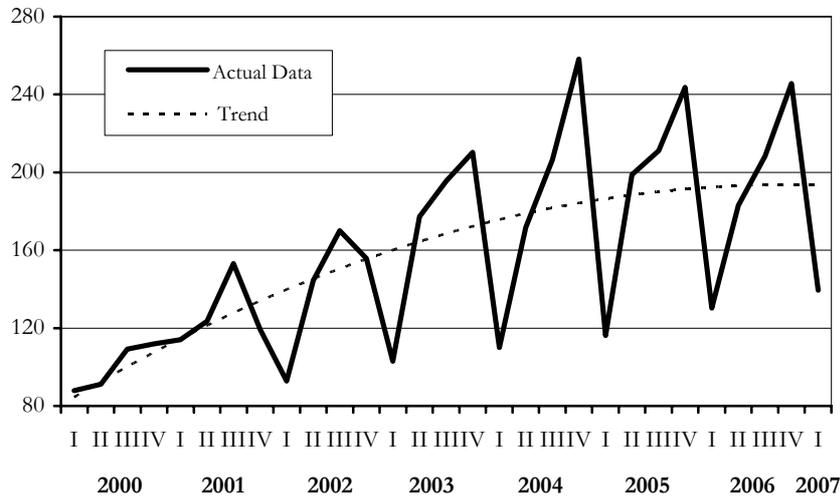


Production of machinery and equipment is a rapidly growing sector and its production volumes have almost doubled in the last five years. It is a

typically export-oriented sector, as three-fourths of the products are being exported.

Figure 3.34

Quarterly Growth Dynamics of Production of Machinery and Equipment
(level of 2000 = 100)



Growth of the sector was especially fast in 2001-2003, when its annual growth rates exceeded 10%. After accession to the EU, the growth of the sector is not so rapid and was mere 3% in 2005 and 4.4% in 2006.

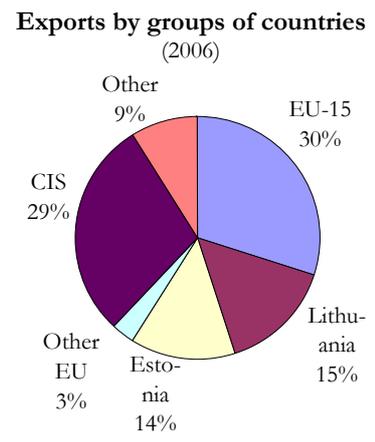
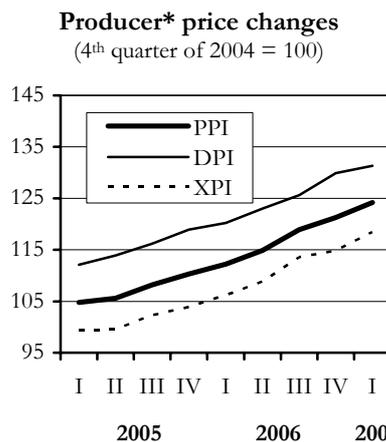
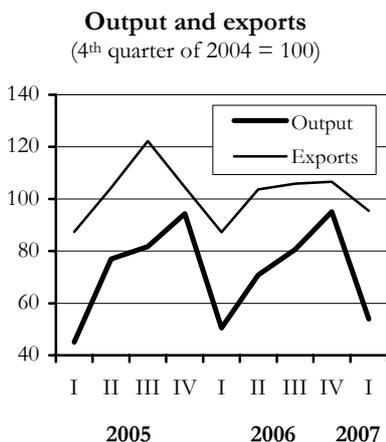
products to the EU are directed to Lithuania and Estonia. Relatively big share of the sector's exports is related to markets of CIS countries.

Main sales markets of the sector are EU member states, and almost half of the exports of the sector's

With increased demand in the domestic market, prices for products sold domestically have gone up rapidly in the last years.

Figure 3.35

Production of Machinery and Equipment



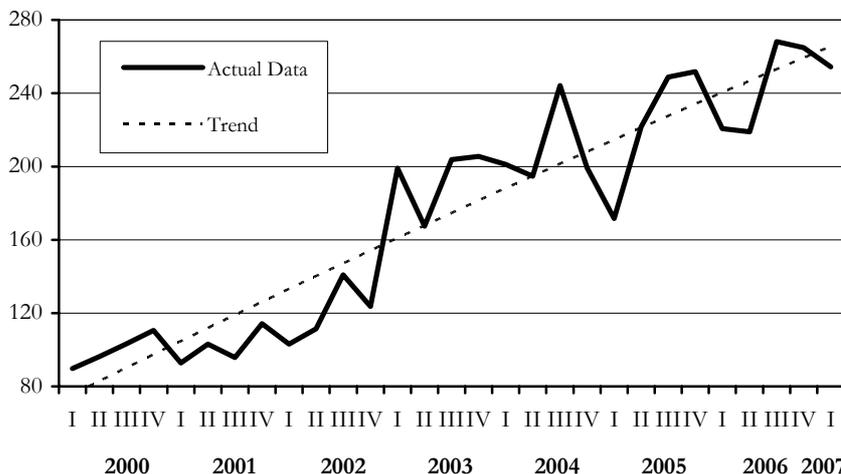
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Production of electrical and optical equipment has developed rapidly in the recent years, especially in 2002 and 2003. Production volumes of the sector in 2003 exceeded the level of the previous

year by 60%. After accession to the EU, growth of the sector slowed down, but remained at a stable level (6-8%).

Figure 3.36

Quarterly Growth Dynamics of Production of Electrical and Optical Equipment
(level of 2000 =100)



Production volumes of the sector have almost doubled in the last five years. Growth of the sector was especially fast in 2003 (by 62%). After accession to the EU, its growth is not so fast and was mere 6.5% in 2005 and 8.7% in 2006.

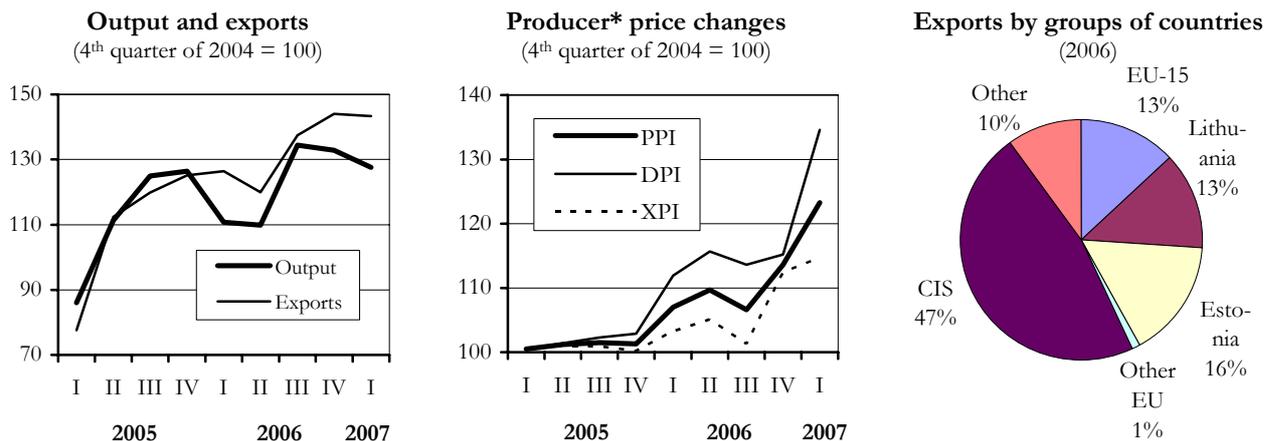
Stable partners in trade of products of the sector are CIS countries and Estonia, and exports to the

developed countries have especially increased during the last year.

The sector exports about two-thirds of its products. The domestic market share increases in the recent years, and also producer prices for products sold in the domestic market grow faster.

Figure 3.37

Production of Electrical and Optical Equipment

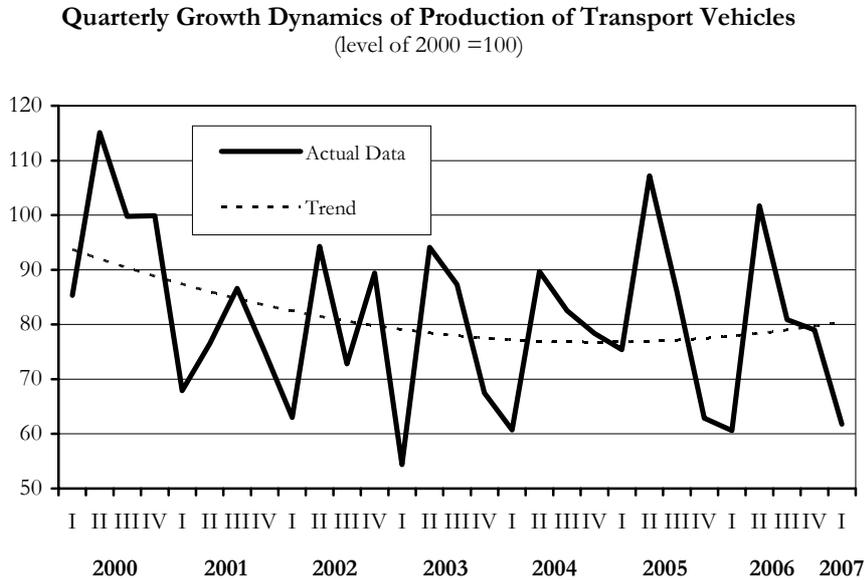


* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Production of transport vehicles is the only manufacturing sector that does not manage to increase production volumes, and they are lower by almost one-fifth in comparison with 2000. Although

the volumes were slightly raised in 2004 after decreased output in the previous years, growth of the sector in 2006 decreased by almost 3% in comparison with 2005.

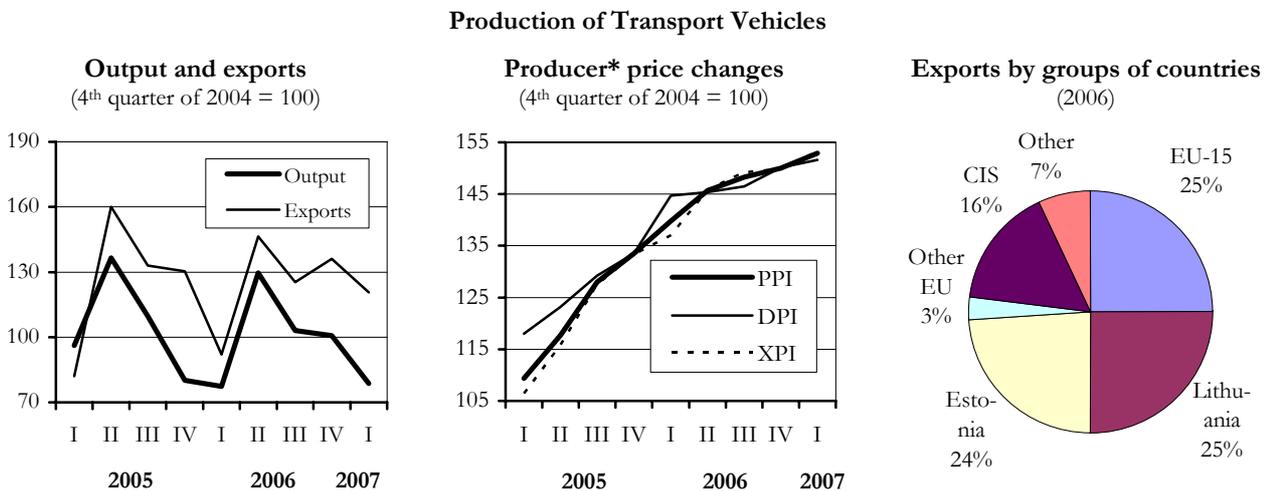
Figure 3.38



Most products of this sector are being exported. Export markets are rather evenly distributed in various sale directions – both to EU member states, among them Lithuania and Estonia, and to CIS countries and other countries of the world.

The share of products sold domestically in the total sales of products increases year by year, while the prices for products sold in the domestic market and in the foreign market grow almost equally.

Figure 3.39



* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

3.3.3. Energy Sector

Both the imported (natural and liquefied gas, oil products, coal) and local energy resources (wood and peat) are used in Latvia to provide fuel, electricity and heat to national economy sectors, commercial consumers and population. Part of electricity is generated by Latvian HPPs and CHPs, whereas other part is imported. Mainly the imported fuels (natural gas

and oil) and local fuels (wood) are used in the heat generation.

In 2005, the total energy consumption of Latvia was 204 PJ, and 60.4% of this consumption was ensured by imports of energy resources mostly from Russia (natural gas comprising 32.7%, heavy oil – 1.6%, other oil products – 26.6%, coal – 1.5%). Among local energy resources, wood was used the most (firewood, remainders of woodworking, wood

chip, wood briquettes and granules), comprising 29.1% of the total energy consumption. Share of the

electricity generated by Latvian HPPs and wind power stations in the total energy consumption was 6%.

Table 3.14

Consumption of Energy Resources in Latvia¹
(thousand tons of equivalent fuel – ktce²)

Consumption of energy resources	2000	2001	2002	2003	2004	2005
Energy resource consumption – total	5259	5740	6466	6583	6764	6969
of which:						
natural gas	1560	1980	1847	2138	2114	2155
light fuel products and other oil products	1366	1313	1610	1727	1798	1859
heavy oil, shale	406	269	233	166	132	113
firewood, peat, coke and other types of fuel	1267	1475	2084	1854	1987	2057
coal	94	123	99	90	87	107
electricity (HPPs, wind generators and imported from abroad)	566	580	593	608	646	678

¹ Source: CSB and the Ministry of Economics.

² 1 ktce = 0.02931 PJ.

Volume of *electricity* generation directly depends on the flow of the Daugava river. Also electricity imports from Russia, Estonia and Lithuania play a quite substantial role in the electricity supply.

In 2005, the state JSC “Latvenergo” generated 64.5% of the required electricity, 30.5% was supplied

by other countries and 5% was purchased from small producers of electricity. In comparison with the preceding year, the electricity consumption has increased by approximately 3.7%.

Table 3.15

Electricity Supply in Latvia¹
(billion kWh)

Components of electricity supply	2000	2001	2002	2003	2004	2005
Total electricity supply	5.922	6.163	6.323	6.608	6.786	7.053
Electricity generation – total	4.136	4.280	3.975	3.975	4.689	4.905
of which:						
HPPs ²	2.799	2.801	2.433	2.216	3.044	3.267
CHPs ³	1.163	1.246	1.238	1.363	1.225	1.278
other CHPs	0.150	0.198	0.263	0.298	0.306	0.255
small HPSs	0.020	0.032	0.030	0.050	0.065	0.058
wind generators	0.004	0.0034	0.011	0.048	0.049	0.047
Imports of electricity	1.786	1.883	2.348	2.633	2.097	2.148

¹ Source: state JSC “Latvenergo”, Ministry of Economics, CSB

² Daugava cascade and Aiviekste HPP (HPP of state JSC “Latvenergo”)

³ CHP of state JSC “Latvenergo”

Some key conclusions from the annual assessment report of Transmission System Operator on situation in the electricity supply of Latvia are presented below:

- in analysis of the former operation regimes of the energy system, there were no periods, when capacities would not be adequate with the demand. Capacities are provided by power stations situated both in Latvia and in neighbouring countries;
- taking into account the big proportion of HPPs with an operation regime fully depending on the flow of the Daugava river, the capacities of power plants presently situated in Latvia are insufficient to cover the demand for capacity at any moment. Energy supply of the country depends on power plants of Latvia and neighbouring countries operating in the basic

regime. Unlike other countries, Latvia has a notable deficit of basic capacities of electricity;

- taking into account the planned development of 330 kV network in Rīga region, it is also advisable to implement the 2nd round of the reconstruction project of Rīga CHP-2, building also the second 400 MW block or smaller blocks with an equal total capacities or an equal generating source in the mentioned region. This will allow to maintain and expand the basic electric capacities in Latvia. One should also consider construction of a Kurzeme power plant with capacity of up to 400 MW in perspective, because, in the period after 2009, the current excess capacity generated by energy systems of neighbouring countries will decrease and also opportunities of Latvia to ensure electricity import will decrease;

- throughput of transmission network can meet the demand for electricity with a sufficiently big reserve in the normal (standard) regimes. Connections of the transmission network with neighbouring countries are sufficient to ensure import and export of electricity. After 2015, it will be necessary to strengthen the transmission network of the Latvian energy system in Kurzeme.

Consumption structure of the *centralised heat supply* has not changed in the recent years, with central heating comprising 65-70% and hot water supply making 30-35%. Of the total amount of sold heat energy, 2.5% was sold to industry, 73.4% to households and 24.1% to other consumers.

The biggest consumers of natural gas are CHPs and heat supply enterprises of "Latvenergo" (61%), industry (21%), and other consumers (18%). Rīga region accounts for 80% of the total natural gas consumption in Latvia. Natural gas is not used at all in Latgale region, with the exception of Daugavpils and Rēzekne cities and Preiļi district. In Kurzeme region, natural gas consumption is the biggest in Liepāja and reaches 11% (by JSC "Liepājas siltums" and JSC "Liepājas metalurģs"), while in Zemgale region it amounts to 4% (in Jelgava city and Bauska district).

Oil products are used both as heating fuel and liquid fuel. Prices in the oil product market are liberalised and competitive in regard to other types of heating fuel. Free market principles function in the area of oil product deliveries in Latvia.

Oil products have an important place in Latvian market of energy resources; their market share is slightly lower than 30%, including the share of heavy fuel in oil fuel balance amounting to approximately 6%. The biggest consumers of heavy oil are heat supply (66.7%) and industry (14%). Complying with above-mentioned requirements of EU Directive 1999/32/EC, the Cabinet of Ministers adopted Regulation No. 125 "Regulation on the Limitation of Sulphur Content in Certain Liquid Fuels" on March 2,

2004. It is expected that the heat supply companies that used heavy oil for heat generation will replace this type of fuel with other energy resources.

Latvia has started creating oil product reserves. The total volume of oil product reserves is envisaged for 90 days, which is determined by the EU Council Directive 98/93/EC of December 14, 1998, amending Directive 68/414/EEC imposing an obligation on member states of the EEC to maintain minimum stocks of crude oil and/or oil products. Creation, storage and recording of the reserves is a difficult process both financially and technically. For this reason, the Concept on Formation of the State Oil Product Reserve was worked out in co-operation with Latvian fuel traders and approved on June 27, 2006. The concept prescribes that the country is responsible for 54-day oil product reserve and entrepreneurs are responsible for 36-day oil product reserve, taking into account the average daily consumption of oil products in the previous year. On June 27, 2006 the Cabinet of Ministers accepted Regulation No. 541 "Procedure for Establishment and Storage of Oil Product Reserve" that regulates the procedure for oil product reserves created by entrepreneurs. However, through establishment of imperfections in the approved concept in regard to creation of oil product reserve of the state share, it will be corrected to enable attraction of financial resources.

Solid fuels used in Latvia are coal imported from CIS and local fuels (firewood and peat). The forecast of firewood consumption depends on the extent to which regions will manage to change from the extensive use of firewood to its rational use. In the total fuel consumption, the share of firewood is already quite substantial and has reached 29-30%. The biggest consumers of firewood are households (48.7%), heat supply companies (21.8%), industry (mainly wood processing companies) and other consumers (29.5%). Firewood and coal are used evenly across all regions of Latvia. Use of peat in the energy sector keeps decreasing.

3.4. Development of Regions

By the Cabinet of Ministers Instruction No. 271 of April 28, 2004 "On Statistical Regions of the Republic of Latvia and Administrative Units Included in them", Latvia was divided into six statistical regions (see Table 3.16).

There is a marked difference between Rīga and other regions of Latvia in terms of economic activities (see Figure 3.40). Difference of **GDP level** (GDP per capita) between other regions is not so pronounced. In 2004, the biggest part of Latvian GDP (almost 60%) was produced in Rīga. The second biggest region by contribution to GDP was Kurzeme (11.9%).

Table 3.16

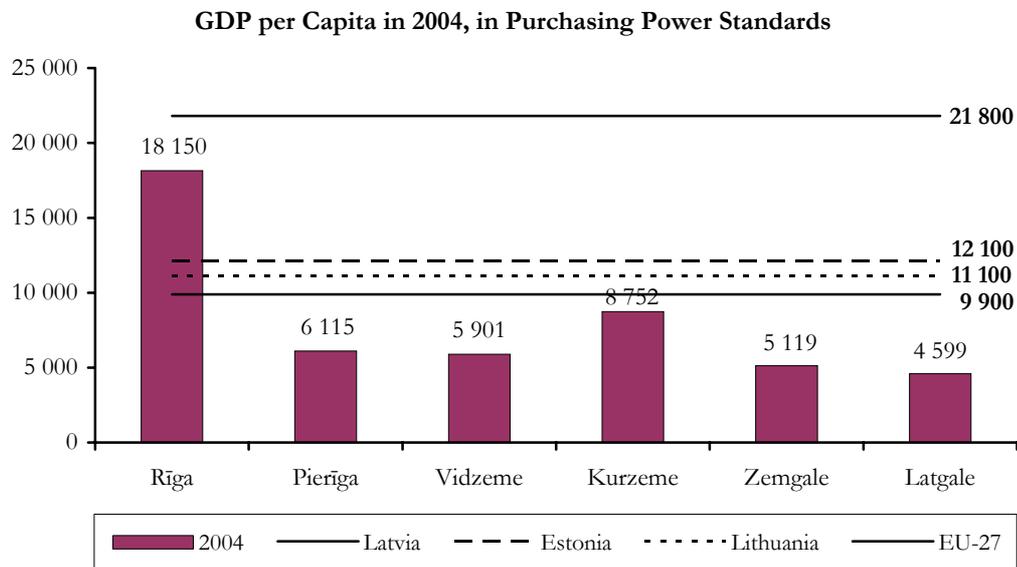
Area, Population and Population Density of Latvia's Statistical Regions at the Beginning of 2007

	Area (% of the total)	Population (% of the total)	Number of inhabitants per km ²
Latvia	100	100	35.3
Rīga	0.5	31.7	2 351.8
Pierīga	15.7	16.4	36.8
Vidzeme	23.6	10.5	15.8
Kurzeme	21.1	13.4	22.5
Zemgale	16.6	12.5	26.5
Latgale	22.5	15.5	24.4

In 2004, GDP per capita in Rīga reached 83.3% of the EU-27 average in purchasing power standards, while this indicator in Latgale amounted to mere

21.1%. Hence, the difference between GDP levels of these two regions is quadruple.

Figure 3.40

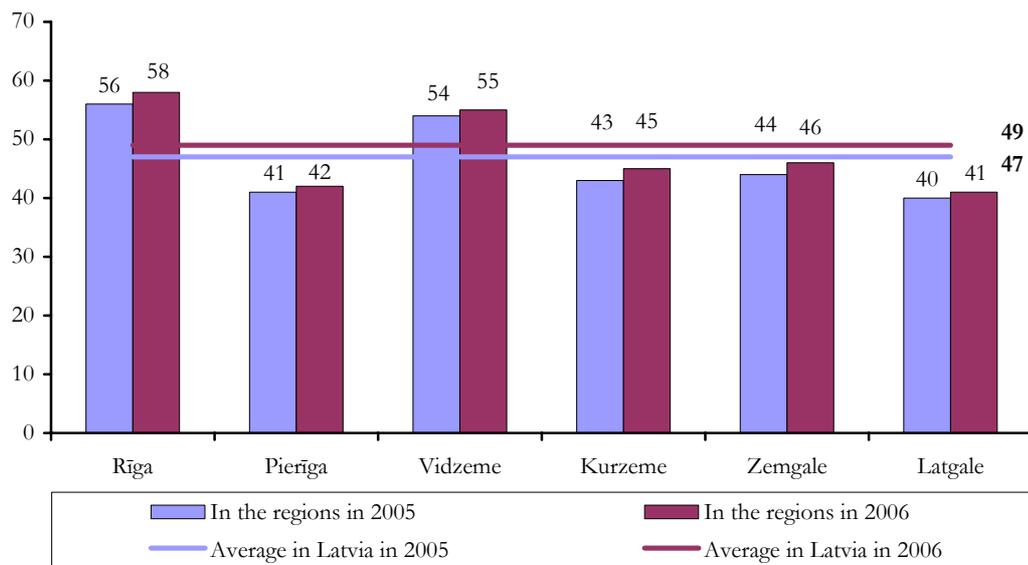


The **number of active statistical units** (self-employed persons, sole proprietors, commercial companies, agricultural and fishing farms) is growing gradually in Latvia. The number of active statistical units in Latvia increased by approximately 2 units in 2006. This indicator is approximately the same in Pierīga, Kurzeme, Zemgale and Latgale regions (41-46 units per 1000 inhabitants). In Rīga and Vidzeme

regions, this indicator is higher than the average in the country. Although the level of active statistical units in Vidzeme region is higher than the average and is close to the level in Rīga, the number of commercial companies making bigger contribution to GDP is relatively higher in Rīga than the number of self-employed persons and agricultural and fishing farms dominating in Vidzeme region.

Figure 3.41

Economically Active Statistical Units* of the Market Sector per 1000 Inhabitants
(provisional data)

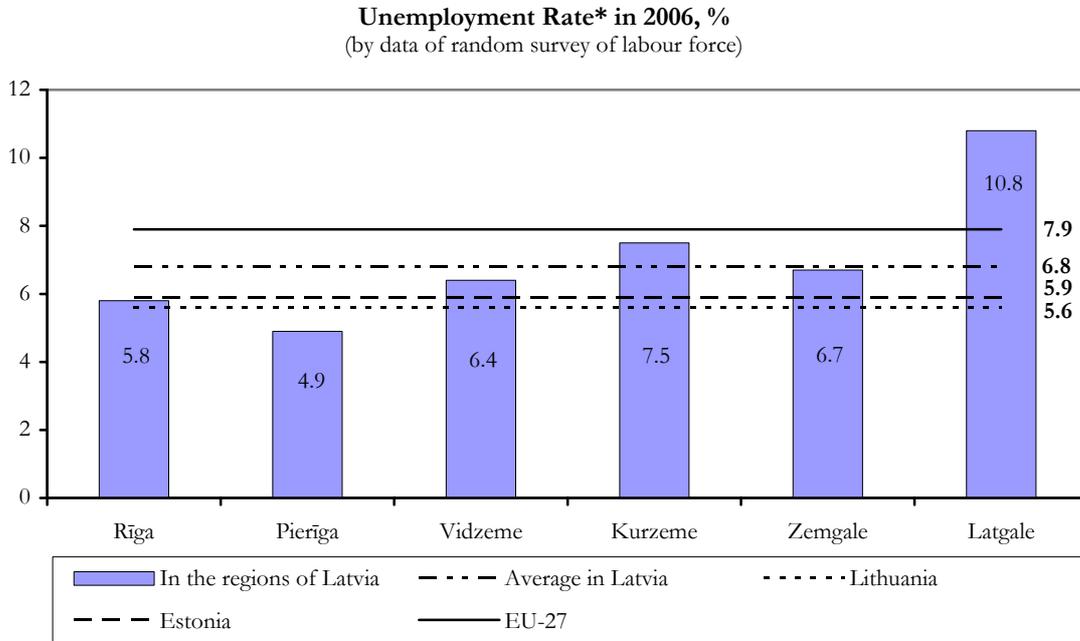


* Statistical units of the market sector are: self-employed persons, sole proprietors, commercial companies, agricultural and fishing farms.

Decline of **unemployment rate** was observed in 2006, when it decreased by 2.1 percentage points in comparison with 2005. The rapid economic growth in 2006 fostered creation of workplaces and unemployment rate decreased in many Latvian regions. Unemployment fell sharply in Pierīga and Kurzeme regions (by 3 and 3.3 percentage points respectively),

while in other regions it decreased by approximately 2 percentage points. High unemployment, in comparison with other regions, remains in Latgale region (see Figure 3.42). In 2006, unemployment rate in Latvia was lower than the EU average (7.9%), but was slightly higher than in Lithuania and Estonia (5.6% and 5.9% respectively).

Figure 3.42

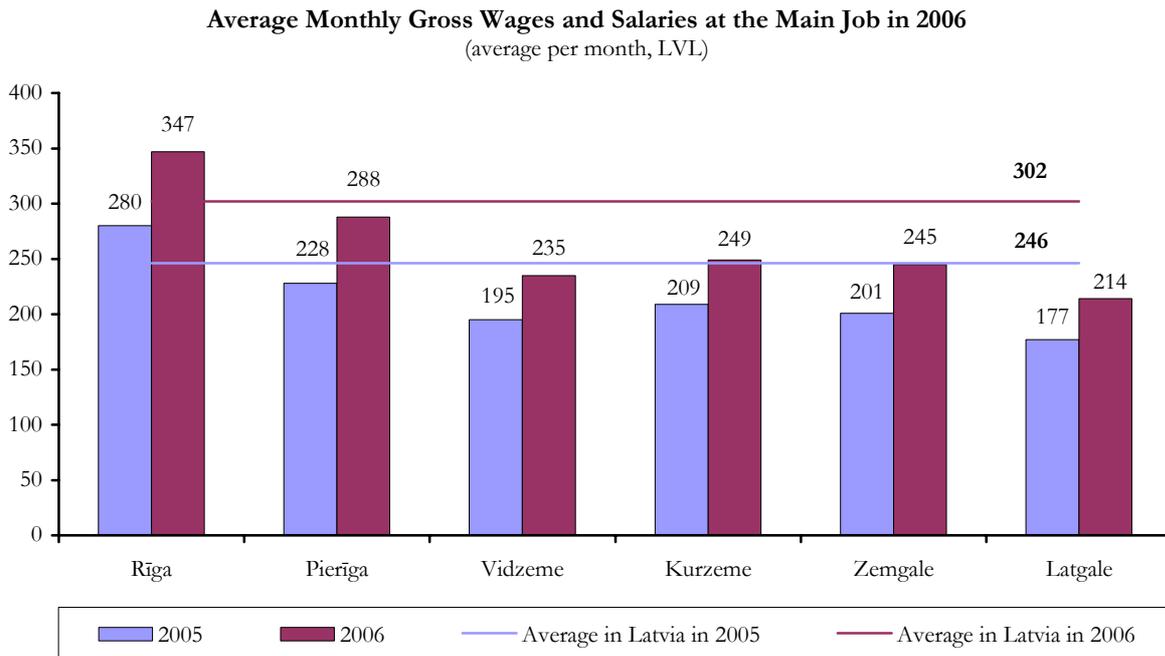


* share of job seekers in the economically active population; persons in the age of 15-74 years.

Along with the growth of demand for labour force and high inflation rate, **wages** rapidly increased in 2006 (by 23%). They grew fastest in Pierīga region (by 26.3%), while growth of wages in other regions

was approximately the same and made up 21-23%. The highest wages are paid in Rīga, while the lowest ones are paid in Latgale (see Figure 3.43).

Figure 3.43

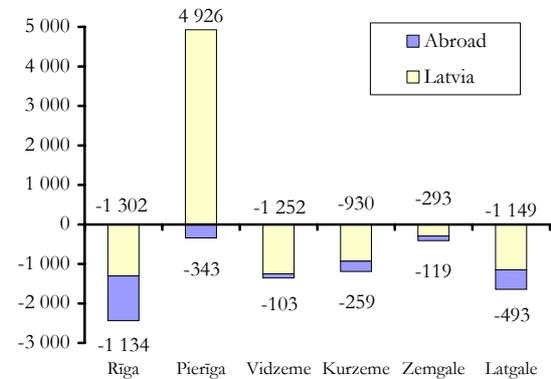


Despite the rapidly grown wages in the country, the long-term **migration** abroad of the population increased from 564 persons in 2005 to 2451 persons in 2006, i.e., more than 4 times. Higher migration abroad was in Rīga and Latgale – 1.6 and 1.4 persons per 1000 inhabitants respectively (1 per 1000 on average in Latvia). Higher negative long-term migration within Latvia was observed in Vidzeme (5.2 persons per 1000 inhabitants). It is typical that inhabitants from Vidzeme more willingly migrate to Rīga or Pierīga, not abroad. Foreign migration from Vidzeme is by two times lower than in the country on average (0.4 persons per 1000 inhabitants). Higher positive balance of migration was only observed in Pierīga region (see Figure 3.44). One has to conclude that rapidly growing wages and construction boom have possibly motivated people to buy private properties in Pierīga region. Besides, it must be noted that not all people arriving from other regions register their

residence, so the data may poorly reflect the real situation.

Figure 3.44

Net Long-Term Migration of Population in 2006



3.5. Forecasts

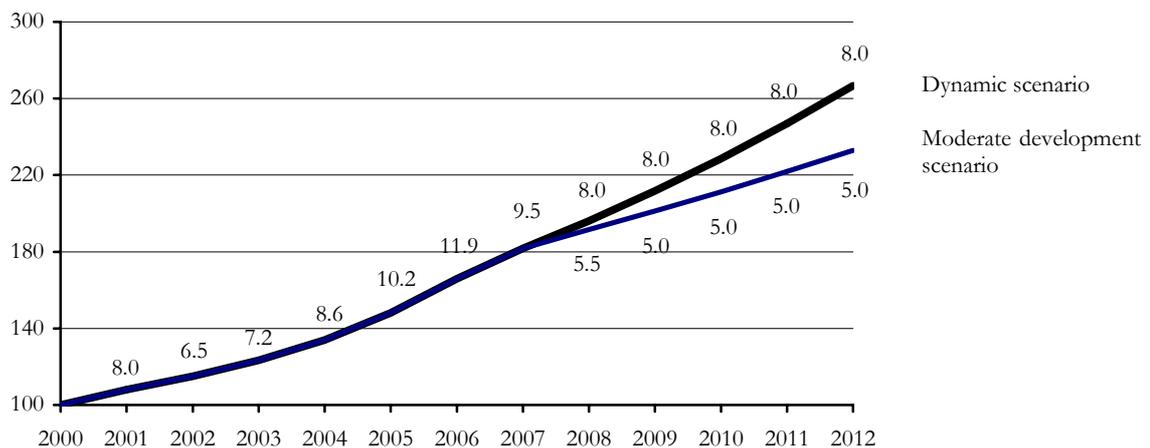
The Ministry of Economics has developed two scenarios of economic development forecasts for the medium-term period (until 2012): in the dynamic development scenario, economic development in the medium-term maintains the current high development

rates or slightly lower ones (dynamic scenario). In the slower development scenario, economic growth slows down due to decreased external and domestic demand (moderate development scenario).

Figure 3.45

Forecast of Latvian GDP

(percentage, 2000 = 100)



Development prospects in 2007 and 2008

According to forecasts, the private consumption and GDP will increase at the same rate. This will be ensured by growing incomes of population both through the increase of wages and continued active crediting, although the rate of growth will be slower than in the previous two years.

Investment will increase faster than the private consumption, which will be affected by the growth of previous years and the positive future expectations of

entrepreneurs as well as the good crediting conditions. Investment growth will also be stimulated by the opportunities to use EU funds, which will increase both the public and private sector investments. Stricter approach to crediting conditions by commercial banks may slightly decrease the investment growth rates, especially in 2008.

Growth of the domestic demand directly affects development of service sectors but its influence on the growth of industry is smaller.

Growth of *industry* is closely linked with opportunities to increase exports of goods, which should be assessed in three sales directions – to the EU, Russia and other CIS countries, and the closest neighbouring countries Lithuania and Estonia.

It should be noted that expansion of Latvian export possibilities in EU markets is associated not only with the growth of demand for imports of these countries, but also to a great extent with the ability of Latvian entrepreneurs to expand their market by using the economic advantages of offering cheaper products with appropriate quality.

Lithuanian and Estonian markets are an essential possibility to enlarge Latvian exports. Latvia has a negative trade balance with both neighbouring countries despite the fact that exports of Latvian goods to these countries go up rather fast every year. It is possible to accelerate expansion of Latvian exports to these neighbouring countries, and particular attention should be paid to this task, not forgetting about the competition pressure created by Lithuanian and Estonian businesses on Latvian business in the

domestic market of Latvia, which has a rather significant impact on development of certain Latvian industries.

Expansion of export possibilities to Russia in the next few years may be fostered by agreements between the EU and Russia on mutual trade conditions as well as good growth prospects of Russia in the nearest years in connection with high prices of oil products. There are rather good prospects to increase exports to other CIS countries, such as Belarus, Ukraine and countries of Central Asia.

The fast rise of wages, promoted not only by high inflation, but also by the growing emigration of labour force to richer EU member states that have opened their labour markets to the citizens of the new EU member states, has started having a negative impact on the industrial development. Rise of wages reduces competitiveness in some industries, especially those where the present maintenance of competitiveness is mostly linked with the use of the cheap labour force, such as textile industry, machine building, etc.

Table 3.17

Forecast of Latvian GDP by Sectors
(growth in per cent against the preceding year)

	2007	2008*	2009-2012 * (annual average)
Gross domestic product	9.5	5.5 / 8.0	5.0 / 8.0
Primary sectors	5.9	4.5 / 5.0	3.0 / 5.0
Manufacturing	2.8	5.0 / 8.0	5.0 / 10.1
Electricity, gas and water supply	-0.5	2.0 / 3.0	2.0 / 3.0
Construction	14.4	9.0 / 15.0	6.1 / 15.2
Trade, hotels and restaurants	14.9	8.0 / 9.0	6.0 / 7.0
Transport and communications	8.1	5.0 / 8.0	5.9 / 7.8
Other commercial services	11.2	6.0 / 8.5	5.0 / 8.4
Public services	3.0	2.0 / 2.5	2.0 / 2.5

* dynamic scenario in the denominator, moderate development scenario in the numerator

The main growth risks are related to the high inflation, rapid increase of wages and problems of the imbalance of external sector. Inflation and growth of production costs are unfavourable for the external competitiveness of Latvia. As the level of the external debt and its servicing expenses increase, opportunities of borrowing will decrease, and this may reduce the domestic consumption.

Measures of the inflation-curbing plan adopted by the government (see Chapter 4.2) may reduce the domestic consumption as from the 2nd half of 2007, which, in turn, will slow down development of several service sectors and growth of some industries oriented to the domestic market.

The poor growth of manufacturing in 2007 is related to the slow development of the traditional sectors (such as textile industry, food industry, and wood processing), which has a negative impact on the total indicators of manufacturing growth. In turn, the

rapid development of such sectors as printing and publishing industry, chemical industry, production of construction materials, production of metals and metal articles, and production of machinery and equipment in 2007 allows to forecast that the total growth of manufacturing in 2008 may be faster than in 2007.

External risks of the economy are linked with prices for energy resources and the situation in Latvian export markets. However, the Ministry of Economics does not forecast substantial changes of growth trends in 2007 and 2008.

Development prospects in 2009-2012

Strengthening of Latvia's competitiveness in conditions of the EU single market, Latvia's ability to absorb the EU structural funds, and external conjuncture conditions will determine the speed of growth in this period.

Table 3.18

Forecast of Latvian GDP by Expenditure Category
(per cent, in comparison with the preceding year)

	2007		2008*		2009-2012 * (annual average)	
	structure	growth rate	structure	growth rate	structure (in 2012)	growth rate
Gross domestic product	100	9.5	100	5.5 / 8.0	100	5.0 / 8.0
Private consumption	63.1	10.0	63.2 / 63.5	6.0 / 9.0	65.6 / 63.5	5.2 / 7.2
Public consumption	15.9	3.0	15.4 / 15.1	2.5 / 3.0	14.3 / 12.7	2.5 / 2.7
Gross fixed capital formation	36.1	15.0	37.8 / 38.0	6.0 / 9.0	35.5 / 35.2	4.0 / 6.6
Changes in inventories	5.9	-	1.9 / 1.4	-	0.6 / 2.5	-
Exports	44.8	9.0	45.6 / 46.9	5.0 / 10.5	45.8 / 49.8	5.7 / 10.8
Imports	-65.8	18.0	-63.9 / 64.9	4.0 / 8.0	-61.8 / -63.6	5.0 / 9.5
Export-import balance	-21.0	-	-18.3 / -17.9	-	-16.0 / -13.8	-

* dynamic scenario in the denominator, moderate development scenario in the numerator

The main problems during this period should be associated with the potential rise of wages and thereby with the decrease of competitiveness of Latvian so-called *cheap sectors* in the world markets. Such sectors are textile and food industries and, partly, metalworking and some sectors of machine building. The share of these sectors in Latvian economy is very big, therefore their replacement with manufacturing of other sectors' products cannot be achieved within a short time. Rise of productivity in all national economy sectors (both high and low technology sectors) is the only way to retain the high growth rate of Latvia.

Although it is forecasted that the investment growth rates in the period of 2009-2012 may essentially decline in comparison with the rapid growth of 2004 and 2006, the structure of investment has to be cardinally changed in favour of investment in manufacturing and other export-oriented sectors (especially high technology sectors), reducing the share of investment in service sectors, such as trade and various commercial services, including real estate.

On the other hand, growth rates of economic activities in Latvia will also be greatly determined by the global development dynamics. If growth rates in the developed countries will be low, the growth of Latvia will be more moderate and will lag behind the dynamic growth version by 2-3 percentage points.

4. MACROECONOMIC STABILITY

4.1. Public finances

4.1.1. Fiscal Policy and Public Debt

Latvian government implements a fiscal policy aimed at balanced economic growth and stability of public finances.

The main priorities of the government for 2005-2008 in the area of fiscal policy¹ are to fulfil the Maastricht fiscal criteria and ensure efficiency of the budget spending by:

- gradually reducing the deficit of the general government budget, ensuring formation of balanced budget in the long-term;
- introducing medium-term (3-5 years) budget planning. To introduce the strategic planning in ministries in order to ensure purposeful development and efficient spending of public budget resources;
- checking the usefulness and efficiency of budget programmes, to prevent inappropriate spending of budget resources.

As seen in Table 4.1, the deficit of the sector of general government² in Latvia is lower than 3% of GDP allowed by the Maastricht Treaty. In 2006, the sector of general government had a surplus in the amount of LVL 47.4 million or 0.4% of GDP.

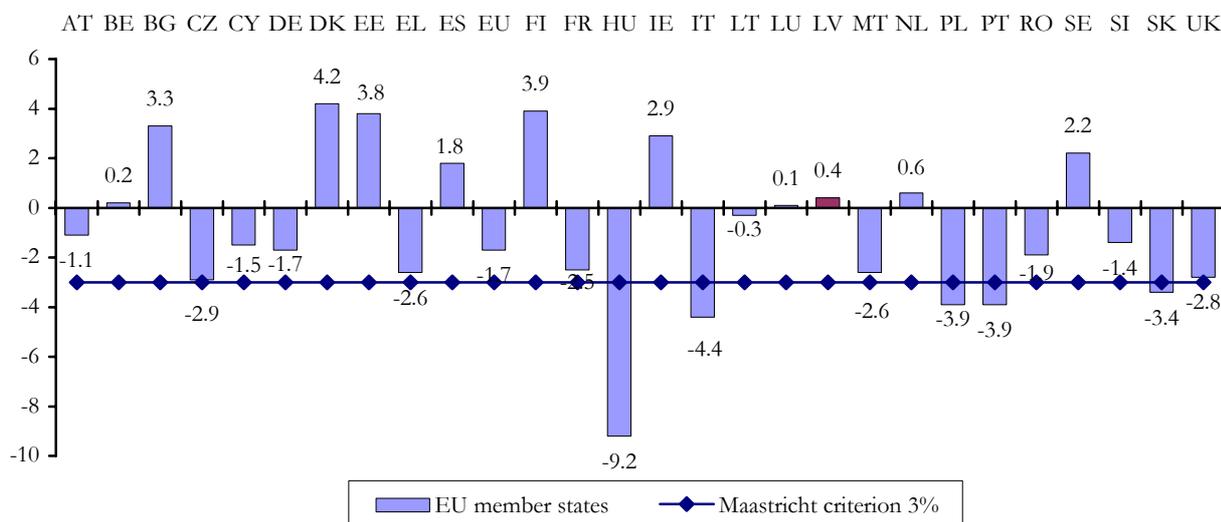
Table 4.1

General Government Budget

	2003	2004	2005	2006	2007
Revenues (million LVL)	2120.2	2583.2	3191.6	4210.1	4905.7
(% of GDP)	33.2	34.7	35.2	37.4	38.2
Expenditures (million LVL)	2223.6	2659	3211.5	4162.7	5072.6
(% of GDP)	34.8	35.8	35.5	37.0	39.5
Balance (million LVL)	-103.5	-75.8	-19.9	47.4	-166.9
(% of GDP)	-1.6	-1.0	-0.2	0.4	-1.3

Figure 4.1

General Government Budget Deficit in EU Member States in 2006
(% of GDP)



AT – Austria, BE – Belgium, BG – Bulgaria, CZ – Czech Republic, CY – Cyprus, DE – Germany, DK – Denmark, EE – Estonia, EL – Greece, ES – Spain, EU – EU-27, FI – Finland, FR – France, HU – Hungary, IE – Ireland, IT – Italy, LT – Lithuania, LU – Luxembourg, LV – Latvia, MT – Malta, NL – Netherlands, PL – Poland, PT – Portugal, RO – Romania, SE – Sweden, SI – Slovenia, SK – Slovakia, UK – United Kingdom

¹ Defined in the *National Lisbon Programme of Latvia for 2005-2008* (see Chapter 6.1).

² According to the methodology of the ESA 95 European System of National Accounts. By determining how EU member states take into account the accordance of the government budget deficit and debt to the criteria established by the Maastricht Treaty, the results of their notification according to the methodology of the ESA 95 European System of National Accounts are used. The indicators calculated according to this methodology are set after the so-called principle of accrual basis, but the general government budget deficit calculated by the Ministry of Finance is set after the cash principle, and that is why they slightly differ.

As seen in Figure 4.1, the average level of the budget deficit in the EU was 1.7% of GDP in 2006 (2.4% of GDP in 2005, 2.7% of GDP in 2004). Fiscal balances improved in all EU member states (with the exception of Italy, Hungary, Romania and Slovakia) in 2006. In 2006, the biggest general government deficits as percentage of GDP were observed in Hungary (-9.2%), Italy (-4.4%), Poland (-3.9%), Portugal (-3.9%), and Slovakia (-3.4%). 11 EU member states (among them Latvia) showed general government surplus in 2006.

The budget of 2007 is maximally directed towards the rise of the living standard of society, therefore a fast reduction of the budget deficit was not planned. Hence the state budget deficit in 2007 is approved by the Law “On the State Budget for 2007” in the amount of 1.3% of GDP.

On March 6, 2007, the Cabinet of Ministers, supporting the “Report on Development of Consumer Price Inflation and Proposals for its Reduction”, decided to reach a balanced budget in 2007 already. Balanced fiscal balance of the general government consolidated budget is planned in 2008, while the general government consolidated budget is planned with a surplus in the following years (in the amount of +0.1% of GDP in 2009 and +0.3% of GDP in 2010).

Review of the “base expenditures” of the state budget, ensuring their reduction, is an essential measure of the medium-term fiscal policy and is mentioned as one of the most important ones in the context of inflation-curbing. In order to achieve this, the Cabinet of Ministers decided (at its meeting on March 20, 2007) that ministries have to carry out the institutional audit and assess the efficiency and effectiveness of the functions to be performed, in order to reduce the state budget expenditures.

For the sake of higher efficiency of budget spending, the medium-term budget planning and strategic planning are gradually introduced in ministries (see Box 4.1), hence formation of the budget is based on financing of action policy goals and results.

Main priorities of public expenditures in the budget for 2007 are: creation of a functioning healthcare system, management of crisis in the system of internal affairs, improvement of the educational system, modernisation of the social security system, strengthening the administrative and institutional capacities of law enforcement bodies, efficient planning, attraction and use of public financial resources of EU funds and the European Economic Area, transition of the defence system to professional armed forces, creation of a high-quality modern cultural infrastructure, modernisation of the public administration system and strengthening its capacity.

For a medium-term, continuation of reforms to raise operation efficiency of the systems of health and internal affairs, ensuring increase of financial resources for state defence, security and participation in NATO, and provision of co-funding for absorption of EU financial resources are forecasted.

Through implementation of a socially responsible policy, the minimum monthly wage was increased from LVL 80 to LVL 90 as from January 1, 2006 and to LVL 120 as from January 1, 2007, the untaxed minimum was raised from LVL 26 to LVL 32 as from January 1, 2006 and to LVL 50 as from January 1, 2007, and the monthly allowance for dependent person was increased from LVL 18 to LVL 22 as from January 1, 2006 and to LVL 35 as from January 1, 2007.

Box 4.1

Medium-term budget planning

On August 22, 2006, the Cabinet of Ministers approved the draft concept “On Introduction of the Strategic Planning and Medium-Term Budget Planning in the Public Administration” that prescribes development of a budget law for one year, at the same time also developing a resource framework for three years. It is envisaged to introduce a medium-term 3-year budget planning, starting with the budget planning for 2008.

During the process of preparing the medium-term budget framework, the Cabinet of Ministers Instruction No. 157 “On Medium-Term Budget Goals and Priority Directions for 2008–2010” and the Cabinet of Ministers Regulation No. 198 “Regulations Regarding Methodology for Determination of the Maximum Permissible Total Amount of State Budget Expenditures and the Maximum Permissible Total Amount of State Budget Expenditures for Each Ministry and Other Central Public Institutions for Medium-Term” were adopted.

The medium-term budget planning prescribes that priorities of state budget expenditures are defined. Priorities of state budget expenditures for the next three years are defined in the Cabinet of Ministers Instruction No. 157 of March 21, 2007 “On Medium-Term Budget Goals and Priorities for 2008–2010”. It is determined that the budget goal in 2008–2010 is to promote achieving objectives set in the *Latvian National Development Plan*. The instruction sets the following priority directions of development required for fulfilment of the medium-term goal of the state budget:

- creation of a knowledge-based society;
- balanced and sustainable development of the economy;
- ensuring the health, spiritual and social needs of an individual;
- sustainable development of the country, balanced development of regions and good management.

Tax policy of Latvian government foresees decreasing the tax burden on entrepreneurship in order to promote economic development and ensure competitiveness of the economy. In order to achieve

this goal, the following measures have been undertaken:

- the rate of social security contributions is reduced from 38% in 1996 to 33.09% in 2003;

- the corporate income tax rate is lowered from 25% in 2001 to 15% in 2004;
- the real estate tax rate is brought down from the maximum level of 4% in 2000 to 1.5%.

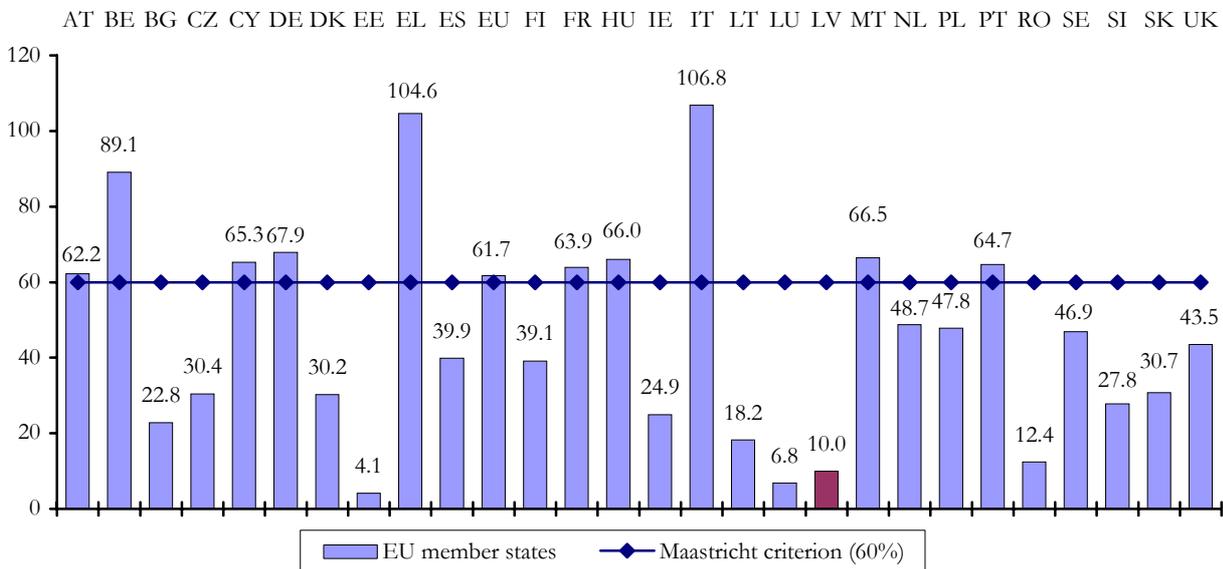
On March 6, 2007, the Cabinet of Ministers, supporting the “Report on Development of Consumer Price Inflation and Proposals for its Reduction”, decided not to reduce tax rates during the current rapid development.

Due to the reduction of tax rates, the tax revenues in percentage of GDP have dropped from 32.9% in 1998 to 29.3% in 2006. Meanwhile, the tax base was expanded, excluding taxable exemptions and improving administration of revenues.

The level of the **general government debt**¹ in Latvia is the third lowest in the EU (see Figure 4.2). In 2006, the EU average level of the general government debt was 61.7% of GDP (62.9% of GDP in 2005, 62.2% of GDP in 2004). General government debts exceeded the Maastricht criterion (i.e., 60% of GDP) in EU-10 member states in 2006. In 2006, the highest general government debts in percentage of GDP were observed in Italy (106.8%), Greece (104.6%) and Belgium (89.1%), while the lowest general government debts in percentage of GDP were registered in Estonia (4.1%), Luxembourg (6.8%), Latvia (10%) and Romania (12.4%).

Figure 4.2

General Government Debt in EU Member States in 2006
(% of GDP)



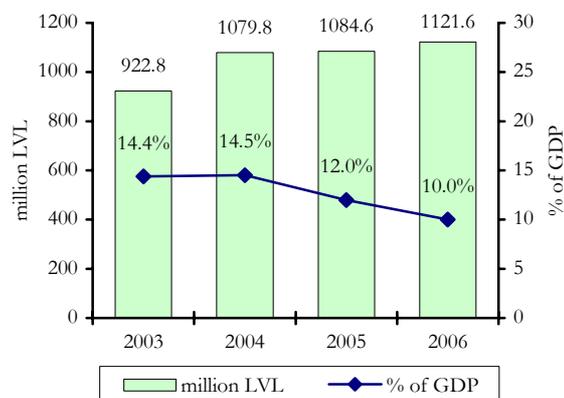
AT – Austria, BE – Belgium, BG – Bulgaria, CZ – Czech Republic, CY – Cyprus, DE – Germany, DK – Denmark, EE – Estonia, EL – Greece, ES – Spain, EU – EU-27, FI – Finland, FR – France, HU – Hungary, IE – Ireland, IT – Italy, LT – Lithuania, LU – Luxembourg, LV – Latvia, MT – Malta, NL – Netherlands, PL – Poland, PT – Portugal, RO – Romania, SE – Sweden, SI – Slovenia, SK – Slovakia, UK – United Kingdom

In the last years, the general government debt in Latvia has increased from LVL 923 million at the end of 2003 to LVL 1122 million at the end of 2006, while it has decreased in percentage of GDP from 14.4% to 10% of GDP respectively (see Figure 4.3).

On May 2, 2007, the government supported the *Macroeconomic Development and Fiscal Policy Framework for 2008–2010* developed by the Ministry of Finance. It determines the development of public debt by 2010 (see Table 4.2).

Figure 4.3

General Government Consolidated Gross Debt by Nominal Value at the End of the Year



¹ According to the methodology of the ESA 95 European System of National Accounts

Table 4.2

Development of Public Debt in 2006-2010*

	2006	2007	2008	2009	2010
	actual data	forecast			
Debt of state and local governments, by national methodology (accounting value/consolidated), million LVL	1115.1	1180.6	1423.0	1474.9	1461.1
<i>% of GDP</i>	<i>9.9%</i>	<i>8.8%</i>	<i>9.2%</i>	<i>8.4%</i>	<i>7.4%</i>
Public debt (accounting value/consolidated), million LVL	998.2	1063.7	1306.1	1358.1	1344.2
<i>% of GDP</i>	<i>8.9%</i>	<i>8.0%</i>	<i>8.4%</i>	<i>7.7%</i>	<i>6.8%</i>
<i>Internal debt, million LVL</i>	<i>418.0</i>	<i>490.9</i>	<i>535.6</i>	<i>550.6</i>	<i>550.6</i>
<i>External debt, million LVL</i>	<i>580.3</i>	<i>572.9</i>	<i>770.5</i>	<i>807.5</i>	<i>793.7</i>
Public debt servicing costs, million LVL	47.4	46.7	51.8	61.3	62.6
<i>Internal debt servicing costs</i>	<i>20.4</i>	<i>20.3</i>	<i>24.0</i>	<i>28.1</i>	<i>27.9</i>
<i>External debt servicing costs</i>	<i>27.1</i>	<i>26.4</i>	<i>27.7</i>	<i>33.1</i>	<i>34.7</i>

* data of the Ministry of Finance

In order to ensure financing of the public budget deficit, the state attracts resources both from the internal and the external capital markets, using a variety of financial instruments.

In the external financial market, it is envisaged to attract resources through the use of loans from international financial institutions, issues of securities of private or public placement, and credit lines and short-term loans from foreign commercial banks. Issuing Eurobonds¹ is the most effective instrument for attraction of a big volume of resources, increasing volumes of the current issues or issuing new ones, so the opportunities to use the instrument of Eurobonds in the period until 2008 are being evaluated. However, the usable borrowing instruments as well as the time and volumes of borrowing and maturity terms will depend on the public budget execution indicators, situation in the domestic and international financial markets, central government debt portfolio indices and other factors. The potential volume of issue would be one of the most essential issues in the decision on issuing Eurobonds, as increasing the total volume of the new or supplemented issue to at least EUR 500 million would, at the same time, raise the liquidity of securities and ensure opportunity to include this instrument in the international platforms of security trade.

On the basis of the forecasted public budget balance and the assumption that the central government debt commitments will be refinanced, it is forecasted that the central government debt in medium-term will show a downward trend in regard to GDP and will decrease to approximately 7% of GDP in 2010. Hence, by using the assumption that the local government debt assumed outside the Treasury will keep the current development trend and will not create a substantial increase in the medium-term, it is forecasted that also the general government debt in the medium-term will show a similar trend, not exceeding 8% of GDP in 2010.

4.1.2. Budget Revenues

Total revenues of the sector of general government increased substantially in 2006. They amounted to LVL 4210.1 million or 37.4% of GDP in 2006, which was by 31.9% more than in 2005. In the 1st quarter of 2007, the revenues were LVL 1129.7 million or by 31.4% more than in the 1st quarter of 2006.

Tax revenues constitute approximately 80% of the total budget revenues. Non-tax revenues relate to operations of the public sector. For instance, revenues from dividends, interest payments for loans and state deposit, various state fees and collected fines are included in the state budget. Non-tax revenues in the local government budget are payments for issuance of various licences, revenues from entrepreneurship and property, payments for educational services and public utilities, etc.

¹ Up to now, Latvia has tapped the international capital market several times, issuing Eurobonds in 1999, 2001 and 2004. In 2004, Latvia issued Eurobonds with the hitherto largest volume of EUR 400 million and the longest maturity (10 years).

Table 4.3

Budget Revenues (% of GDP)				
	2003	2004	2005	2006
General government consolidated budget revenues	33.0	33.9	35.3	35.6
I Tax revenues	27.9	27.2	28.1	29.3
1. Indirect taxes	10.8	9.9	11.2	11.8
– value added tax	7.2	6.5	7.5	8.3
– excise tax	3.3	3.2	3.5	3.3
– customs duties	0.3	0.2	0.2	0.2
2. Income taxes and property taxes	8.0	8.4	8.3	8.7
– corporate income tax	1.5	1.7	2.0	2.3
– personal income tax	5.7	5.9	5.6	5.8
– property taxes	0.8	0.8	0.7	0.6
3. Social security contributions	8.8	8.6	8.3	8.5
4. Other taxes	0.3	0.3	0.3	0.4
II Non-tax revenues	5.1	6.7	7.2	6.3

Tax revenues grow faster than GDP. In 2006, tax revenues amounted to LVL 3299 million or by 29.6% more than in the previous year. The biggest contributions to the growth of the total tax collection were made by the value added tax, social security contributions and personal income tax. These three taxes make up more than 77% of the total tax collection. The main factors determining growth of tax revenues are the rapidly increasing private consumption and inflation.

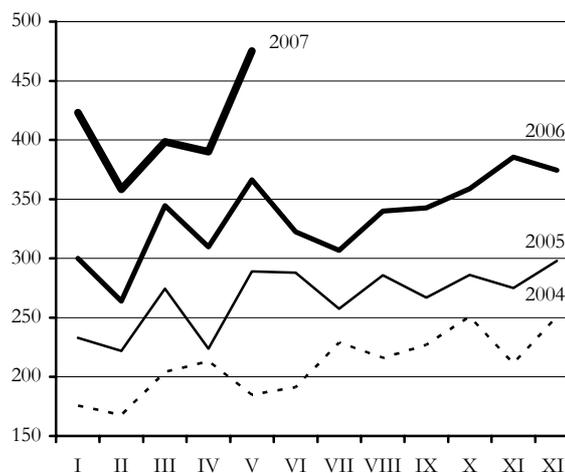
Tax revenues of state basic budget on average were by 9.2% bigger than planned at the beginning of the year. Personal income tax and value added tax were collected in amounts considerably bigger than planned (by 19.2% and 12.1% respectively).

Rapid increase of tax revenues continued at the beginning of 2007. The total tax collection increased by 33.9% in comparison with the 1st quarter of 2006.

The structure of taxes has not changed substantially since 2003. However, the shares of consumption and capital taxes slightly increased and the share of employment taxes decreased in 2006 (see Figure 4.6).

Almost half of the total tax revenues are made up by **employment taxes** (social security contributions and personal income tax). The rapid growth of the collection of employment taxes in 2006 was due to the increase of pay for work in national economy (by 23.1%) and the total increase of the number of employed persons (by 5.2%).

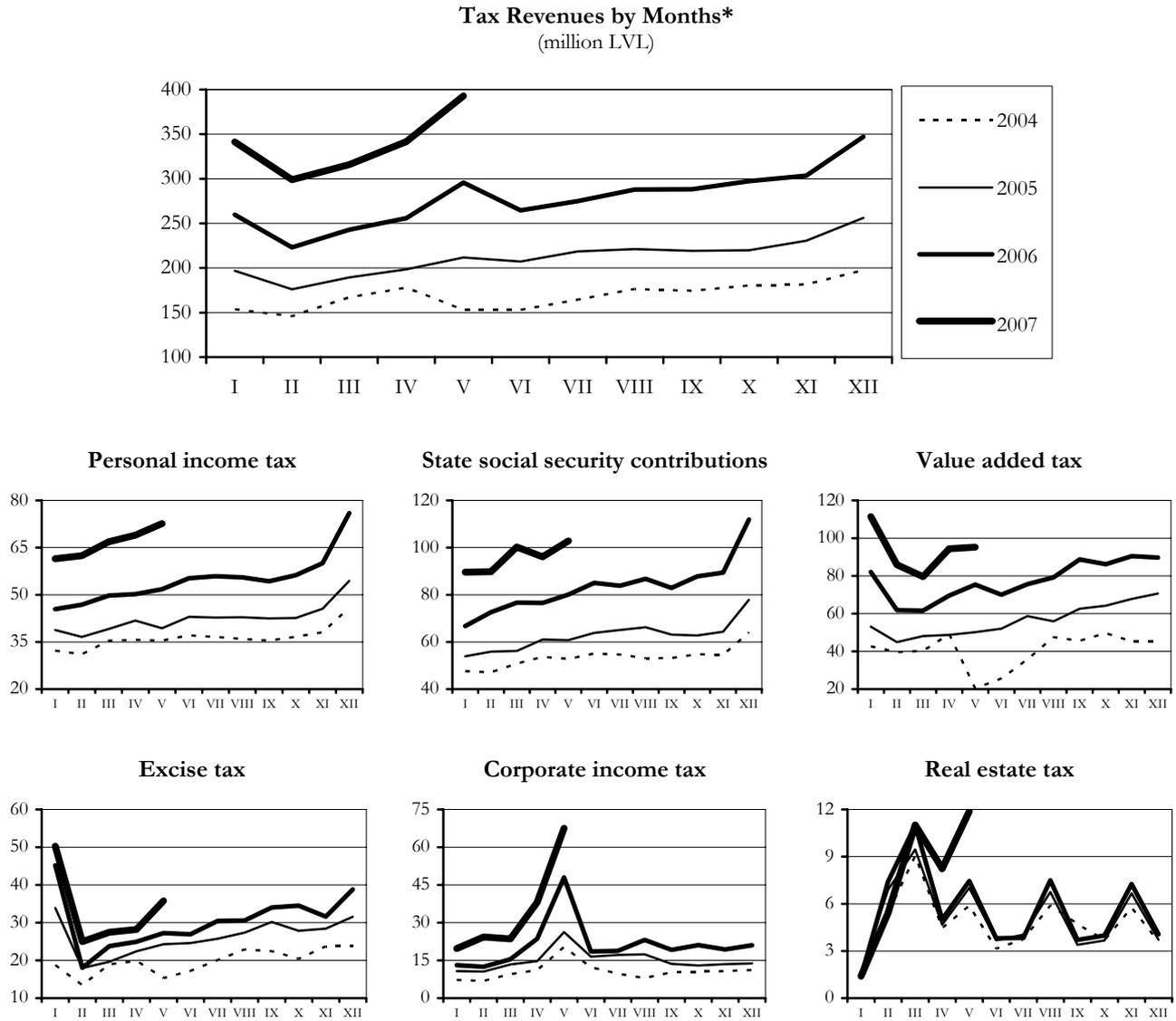
Figure 4.4
General Government Consolidated Budget Revenues by Months*
(million LVL)



* according to official data of monthly reports of the Treasury.

Collection of a particular tax exceeded LVL 1 billion for the first time in the history of Latvian budget, as revenues from social security contributions in 2006 amounted to LVL 958.4 million. Personal income tax revenues also increased substantially in the past year (by 29.1%).

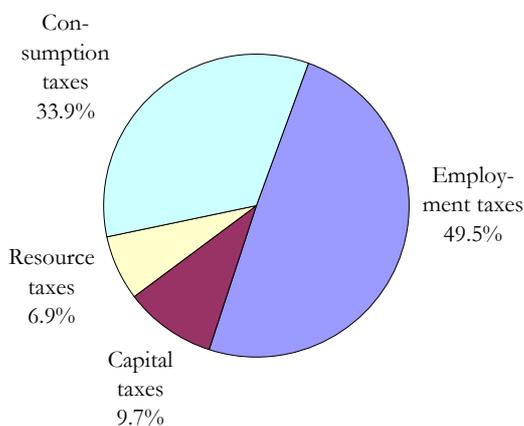
Figure 4.5



* according to official data of monthly reports of the Treasury.

Figure 4.6

General Government Consolidated Budget Tax Revenues by Tax Groups in 2006
(%)



The second biggest tax group are **consumption taxes** (value added tax, customs duties, excise tax on alcohol, tobacco, non-alcoholic beverages and coffee, as well as tax on cars and motorcycles). Value added tax makes up 82% of all consumption taxes.

Collection of the value added tax increased considerably in 2006 (by 37.4%) due to rapid rise of the domestic demand and high inflation rate. Rise of collection of this tax is also observed at the beginning of 2007. Rise of revenues from consumption component of the excise tax in 2006 (by 26.5%) was affected by increased consumption of excise goods and rise of excise tax rates.

Revenues from the tax on cars and motorcycles increase very fast. These revenues amounted to LVL 13.7 million in 2006 (by 43.9% more than in 2005), which can be explained by ever-growing number of firstly registered cars.

Law "On the State Budget for 2007" envisages a more moderate growth of revenues from consumption taxes in comparison with 2006. It is planned that the

value added tax revenues will increase by 28% and the excise tax revenues will grow by 14%.

Revenues from **capital taxes** (corporate income tax and real estate tax) made up 9.7% of the total tax revenues in 2006.

Collection of the corporate income tax increases rapidly in the recent years, because profits of entrepreneurs go up along with the fast economic growth. Corporate income tax was collected in 2006 in the amount by 40.5% higher than in 2005. Collection of this tax keeps increasing in the 1st quarter of this year.

Real estate tax revenues usually increase at the end of a quarter due to the procedure for collection of this tax. Collection of the real estate tax in 2006 was by 7.7% bigger than in 2005, while revenues from this tax in the 1st quarter of 2007 decreased by 9.8% in comparison with the corresponding period of the previous year. This is related to the fact that the tax base for buildings is changed as from 2007, which now is their cadastral value as for land and not their balance value as previously. Buildings do not constitute a taxation object anymore. Besides, the procedure for calculation of the tax on buildings is also changed. Growth of real estate tax revenues is observed in April and May, which is related to the ever-growing volumes of construction and commissioning of new buildings.

The group of **resource taxes** comprises the excise tax on oil products, the natural resource tax and the electricity tax. The share of these taxes in the total tax revenues has slightly decreased in comparison with 2005.

Revenues from the excise tax on oil products make up about 60% of the total excise tax collection. Collection of the excise tax on oil products in 2006 exceeded the level of the preceding year by 10.9%. This was mainly due to increased consumption of oil products and excise tax rate.

Natural resource tax is aimed at restricting uneconomical use of natural resources and environmental pollution, reducing production and sale of products that pollute environment, and encouraging introduction of new improved technologies that would diminish environmental pollution. All collected natural resource tax revenues are used only for financing such activities and projects that are directly linked with environmental protection, rehabilitation, recovery, utilisation or processing of environmentally harmful waste, exploration and renewal of natural resources. Collection of this tax increased by 6% to LVL 11.0 million in 2006.

A new tax – the electricity tax – is introduced in Latvia as from January 1, 2007. In accordance with the adopted Law on Electricity Tax, the tax in the amount of LVL 0.35 per MWh is applied to the electricity supplied to end consumers. Rate of the tax is the same for the electricity used for commercial activity and for the electricity not used for this purpose. Electricity tax is paid by persons supplying electricity to end consumers, among them electricity producers, distribution system operators, electricity vendors

as well as autonomous producers that produce electricity for their own consumption. Slightly above LVL 40 thousand were collected in 3 months of 2007.

4.1.3. Budget Expenditures

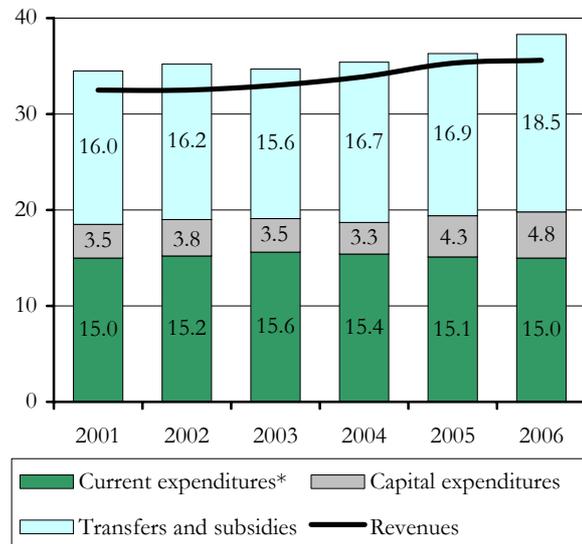
General government expenditures amounted to LVL 4162.7 million in 2006, which was by 29.6% more than in the previous year. Expenditures of the government sector as percentage of GDP were 37% in 2006.

The biggest share in the government expenditures is made up by transfers (50.1%) and current expenditures (37.8%). Transfer expenditures contain subsidies for the population (pensions, allowances, grants) and for institutions and organisations, while labour costs make up about half of the current expenditures.

In 2006, capital expenditures increased most rapidly (by 39.2%), while current expenditures and transfer expenditures grew at a slightly more moderate pace. The rapid growth of capital investment is related to absorption of EU structural funds resources, especially to the state co-funding for implementation of various infrastructure projects, e.g., for renovation of roads, railway, etc. Growth of current expenditures is explained mostly by increased pay for work of public sector employees.

Figure 4.7

Revenues and Expenditures of General Government Consolidated Budget (% of GDP)



* With payments for borrowings and credits

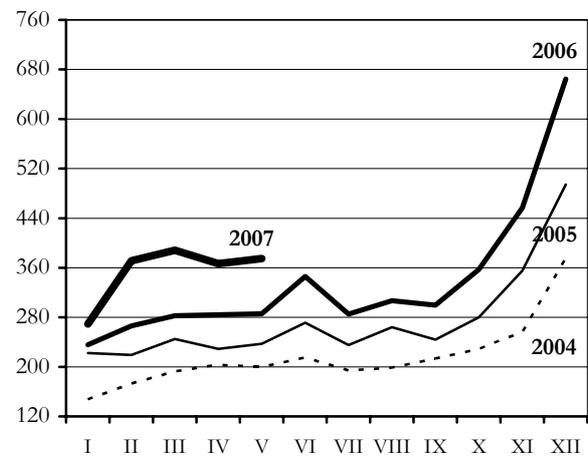
Government expenditures increased at the beginning of 2007 but the growth rates of expenditures are expected to decline as a result of the plan for curbing the consumer price inflation, as it is envisaged to achieve balanced budget in 2007, pay bigger attention to quality of expenditures and restrict rapid growth of wages in the public sector, strictly

observing the wage increase schedules co-ordinated with social partners and approved by the government, and stop the growth of the number of employed persons in the public sector, paying bigger attention to labour productivity.

The biggest shares in the total expenditures regarding government functions in 2006 were made up by social security and education, while the fastest growth was shown by expenditures for economic activity (by 45.8%) and for defence (by 45.6%).

Figure 4.8

Expenditures of General Government Consolidated Budget by Months*
(million LVL)



* according to official data of monthly reports of the Treasury.

Table 4.4

Expenditures of the Consolidated Budget Regarding Government Functions
(percentage)

	2004		2005		2006*		1 st quarter of 2007
	structure	of GDP	structure	of GDP	structure	of GDP	structure
Expenditures – total	100.0	35.8	100.0	35.5	100.0	37.0	100.0
General government services	15.0	5.4	14.3	5.1	13.7	5.1	14.7
Defence	3.6	1.3	3.5	1.2	4.0	1.5	2.5
Public order and safety	5.2	1.9	5.8	2.0	6.1	2.2	6.3
Economic activity	12.2	4.4	13.1	4.7	14.8	5.5	16.6
Environmental protection	1.7	0.6	2.3	0.8	2.4	0.9	1.2
Management of municipal areas and housing	2.1	0.8	1.9	0.7	2.4	0.9	2.1
Health	11.1	4.0	10.8	3.8	10.8	4.0	9.1
Recreation, culture and religion	3.5	1.3	3.4	1.2	3.6	1.3	3.2
Education	16.3	5.8	17.3	6.1	16.8	6.2	19.3
Social security	29.3	10.5	27.6	9.8	25.5	9.4	24.9

* evaluation by the Ministry of Economics

Financial surplus of the general government consolidated budget is LVL 275 million in five months of 2007; however, in view of the peculiarities of the state budget execution cycle (i.e., state budget expenditures grow in the 2nd half of a year), the surplus formed at the beginning of the year will be used to finance the expenditures prescribed by the state budget law in the months left of the year.

Public demand is made up by the public consumption or public services (their value is determined by the volume of provided public services) and public investment that is the capital investment for

budget resources. The public demand constitutes approximately one-fifth of the total domestic demand.

The volume of public services grows considerably slower than GDP and private consumption. Public demand increased by 4.9% in 2006, while the average growth in 2003- 2006 was 6.6%. In the last four years, the consumption of local governments has increased faster (by 4.5%), while the central government consumption grew by mere 1.3% in the period of 2003-2006. Public investment has increased by 39.1% on average since 2003, which is linked with absorption of the EU structural funds.

Table 4.5

Public Demand

	% of GDP				Real growth against the preceding year (%)			
	2003	2004	2005	2006	2003	2004	2005	2006
Public demand	23.8	22.6	20.7	20.3	9.0	7.6	5.1	4.9
Public consumption	21.4	19.5	17.4	16.9	1.9	2.1	2.7	4.0
– central government	12.9	11.2	10.6	9.3	5.0	-3.0	9.6	-5.7
– local governments	8.5	8.4	6.8	7.6	-2.5	9.8	-6.6	19.4
Gross fixed capital formation	2.4	3.1	3.3	3.4	105.5	43.9	16.4	8.6
– central government	1.2	1.7	2.1	1.7	211.4	59.2	38.0	-15.5
– local governments	1.2	1.4	1.1	1.7	53.6	28.8	-10.2	54.1

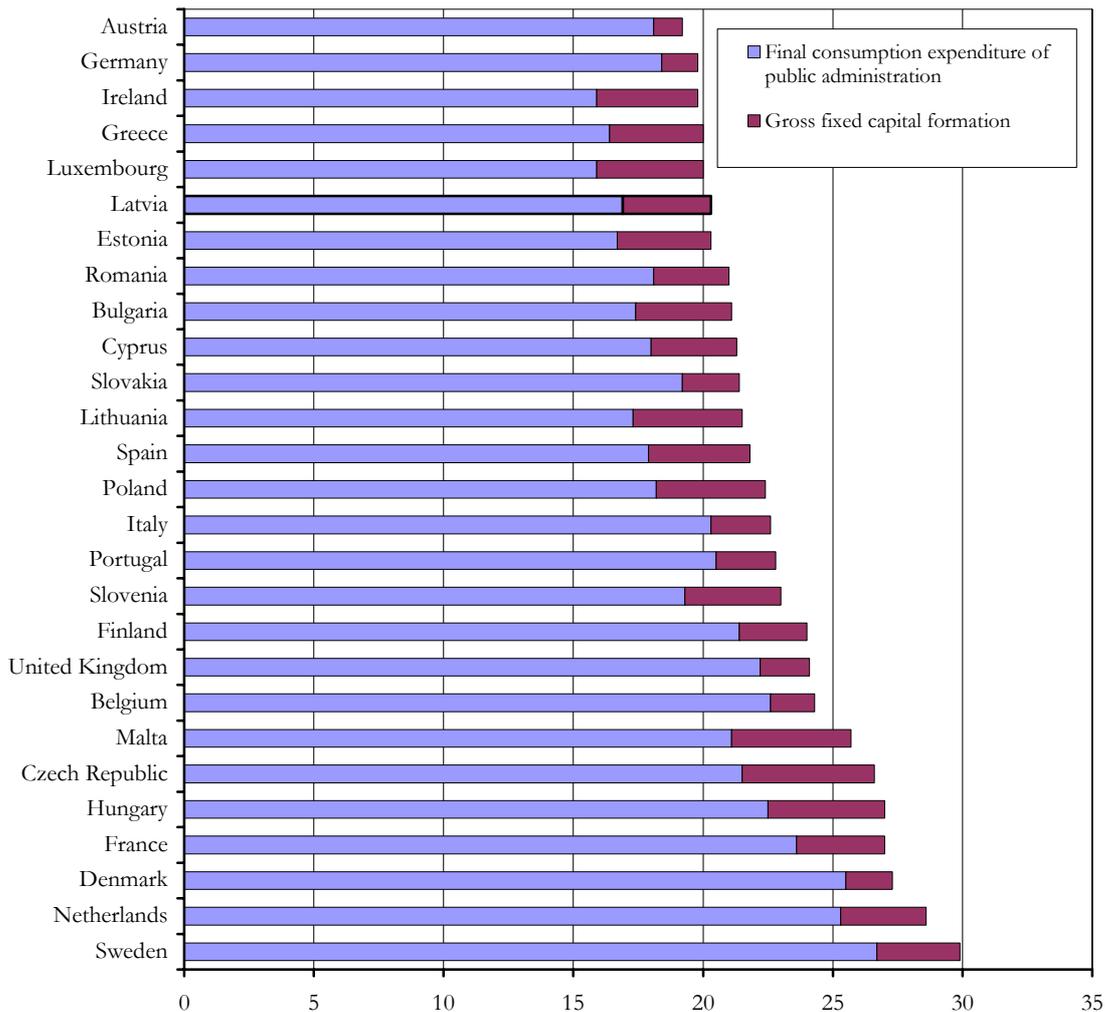
In comparison with other EU member states, Latvia has the sixth lowest share of the public demand in GDP. The share is lower than 20% of GDP only in Austria, Germany and Ireland. Public demand in Sweden makes up almost 30% of GDP.

In assessment of public investment in fixed assets, Latvia has the third lowest indicator among the new

EU member states. It is lower only in Romania (2.9% of GDP) and Cyprus (3.3% of GDP). Among all EU member states, investment level as percentage of GDP is the highest in Czech Republic (5.1%), Malta (4.6%), Hungary (4.5%) and Lithuania (4.2%).

Figure 4.9

Public Demand in EU Member States in 2006
(% of GDP)



* by Eurostat data

At present, changes are being made in the procedure, by which public investment is administered in order to provide sustainable solutions to planning, implementation and supervision of equitable development of national economy in Latvia and its regions,

including harmonised and predictable implementation of the public investment policy and equitable development of national economy in regions (see Box 4.2).

Box 4.2

Public Investment Programme

Since 1995, Latvia carried out centralised planning of investment as an important part of state budget expenditures in order to ensure efficient use of the limited public finances for measures of development of the considerably worn infrastructure. The Ministry of Economics and the Ministry of Finance co-ordinated this centralised planning by working out the Public Investment Programme. Public investment was planned for development of infrastructure owned both by the central government and by local governments, earmarking resources in the amount of approximately 1% of GDP from the state basic budget and attracting credit resources or project implementers' financial resources in the amount of up to 2% of GDP.

Public investment programmes as an integrated programming instrument for projects of sectoral ministries and local governments are widespread mainly in the developing or transition economy countries. Integration of public investment in particular strategic plans is observed in the developed countries.

The Public Investment Programme was established with the goal to support and finance state priorities for development of infrastructure through centralised planning, as one ministry co-ordinated funding or co-funding from the state basic budget. In regard to accession to the European Union (hereinafter EU), aid from EU pre-structural funds became available for Latvia; after accession to the EU, Latvia got support from the Cohesion Fund and the EU structural funds; for their absorption, a separate financing planning procedure was worked out, which decentralised the overall public investment planning process.

After many inter-institution meetings on issues of development of various policy documents and normative acts of state importance during the last year, a common viewpoint of ministries about usefulness of the Public Investment Programme as a separate instrument for planning the total investment is being formed gradually – public investment would not be planned separately from the common policy planning, as public investment is only a part (although very important one) of expenditures.

Stable place in the hierarchy of policy planning documents is taken by the National Development Plan for 2007-2013 (hereinafter NDP), which will be fixed as the hierarchically highest medium-term policy planning document by the Development Planning System Law.

By harmonising viewpoints and forming a common understanding on development of the country in the immediate and distant future, NDP sets the strategic goal of development of Latvia and defines the main lines of action, for which a stable growth of the country and society must be ensured.

NDP also has a task to focus attention of society to a common goal, ensuring co-ordination and balance of activities, purposeful channelling of financial resources to attainment of country's development goals and creation of necessary preconditions.

Hence inclusion of NDP positions and made proposals into other planning documents, their interconnectedness and provision of financing are very important. This refers both to policy planning documents (such as guidelines in some sector) and to operational strategies of ministries (medium-term planning documents used by ministries for planning of development, operation and budget, assessment of operation and supervision of budget execution).

Co-ordinated planning and supervision of country's development on the whole is ensured by the National Development Council (Cabinet of Ministers Regulation No. 129 of February 13, 2007 "Bylaw of the National Development Council").

Despite the transition from one form of public investment planning to another one, the Ministry of Regional Development and Local Government (hereinafter MRDLG) believes that it is necessary to introduce public investment in a co-ordinated way, establishing a unified instrument of public investment policy planning in the country. This means that it is important to continue forming the planning and supervision system of public investment policy in order to ensure adoption of co-ordinated decisions about the planned public investment and assessment of its conformity in accordance with the policy goals set in policy planning document (Governmental Declaration, NDP etc.) before and after approval of the public investment in the annual and medium-term state budget.

According to viewpoint of the State Chancellery, all new policy initiatives basically correspond to the investment criteria, and all public investments before their initial inclusion in the state budget are new policy initiatives. By co-ordinating the draft Cabinet of Ministers instruction "Procedure by which operational strategies of the State Chancellery, ministries and secretariats of special assignment ministers have to be updated in 2007" (Cabinet of Ministers Protocol No. 16, Paragraph 8 of February 27, 2007), an inter-institution agreement that investment will not be separated in institution strategies was reached.

Taking into account the abovementioned, the Ministry of Economics believes that public investment may not be planned separately from the common policy planning in the particular sector and the Public Investment Programme as a separate investment-planning instrument is not useful. At the same time, one should consider the necessity for summary of information about public investment, which is currently unavailable due to the lack of methodological guidelines and the decentralised access to information.

In order to provide sustainable solutions to planning, implementation and supervision of equitable national economy development in Latvia and its regions, including harmonised and predictable implementation of public investment policy and equitable national economy development in regions, MRDLG plans to start discussions with the State Chancellery about establishment of a unified co-ordinated system for planning and supervision of the public investment policy in the country in order to put it under competence of MRDLG as the responsible institution for supervision and assessment of regional development. Hence MRDLG would take over the planning, implementation and supervision of the public investment policy from the Ministry of Economics.

After takeover of this field of competence, MRDLG will have to prepare a concept on establishment of a unified co-ordinated system for planning and supervision of the public investment policy in the country as well as make the necessary amendments to the respective legal acts in force and develop new legal acts in order to specify further development of the public investment policy planning.

4.2. Prices

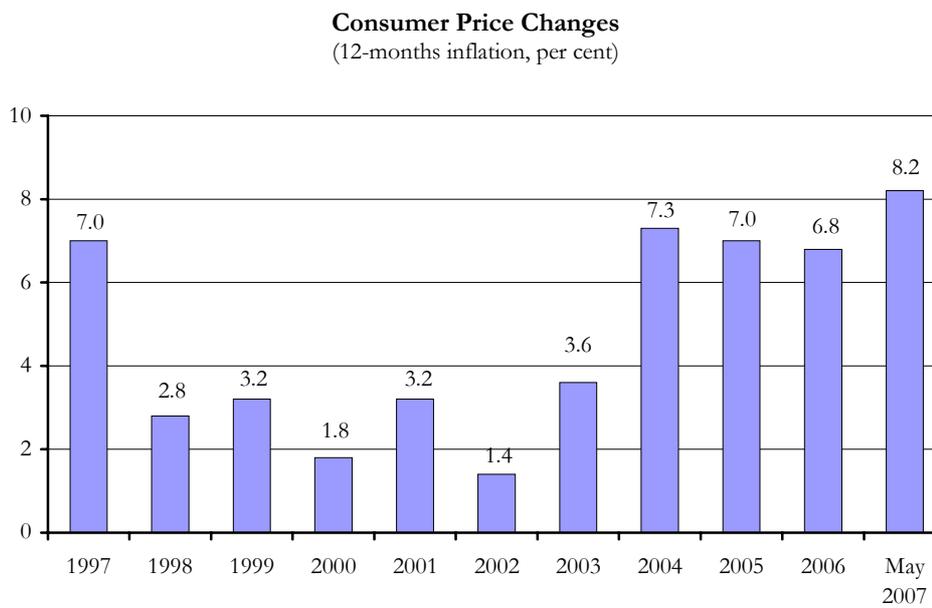
4.2.1. Consumer Prices

Consumer price inflation in Latvia in the period of 1998-2003 was close to the inflation rate in the

developed countries and among the lowest in Central and Eastern European countries.

In 2004-2006, prices in Latvia grew at a fast pace that was among the highest in the EU member states.

Figure 4.10



Growth of prices in 2006 was slower than in the previous two years, but still at a relatively high level. Approximately 60% of the growth was made by core inflation and 20% of the growth was related to the increase of administratively regulated prices mainly due to risen prices of heat energy and gas.

Growth of prices increased again at the beginning of 2007 and, in the first 5 months of the year, was 1.5 times faster than in the respective period of the previous year.

The high growth rate of prices in 5 months of 2007 on the whole was determined by three main factors:

- the 2nd round effect of the sufficiently high inflation rate (inflation spiral) of 2004 and 2005, which was fostered both by high volumes of mortgage crediting and by substantial increase of wages;
- the rise of administratively regulated prices. At the beginning of 2007, prices for water supply and sewerage, payment for electricity and rent increased. As from May 2007, tariffs for natural gas supply rose. Prices of heat energy on the whole increased by 12.8% in one year;
- the rise of world prices for oil, which substantially affected the increase of domestic fuel prices by 14% (May against December of the previous year).

Figure 4.11

Consumer Price Changes by Months
(December of the previous year = 100)

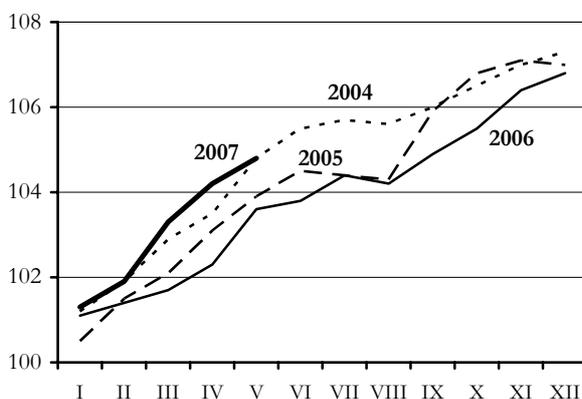
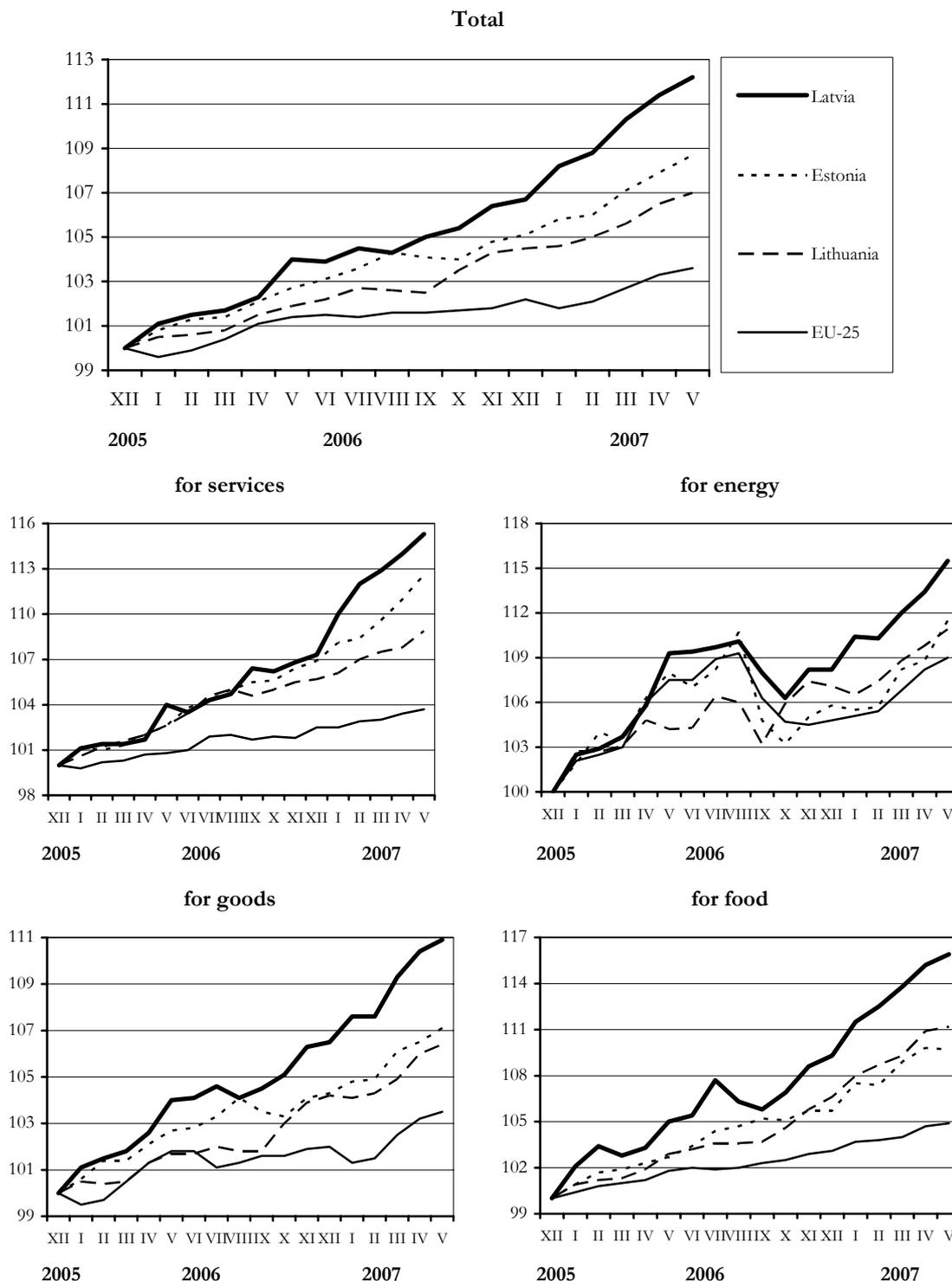


Figure 4.12

Harmonised Consumer Price Index of Latvia in Comparison with EU Average, Lithuania and Estonia



Source: Eurostat

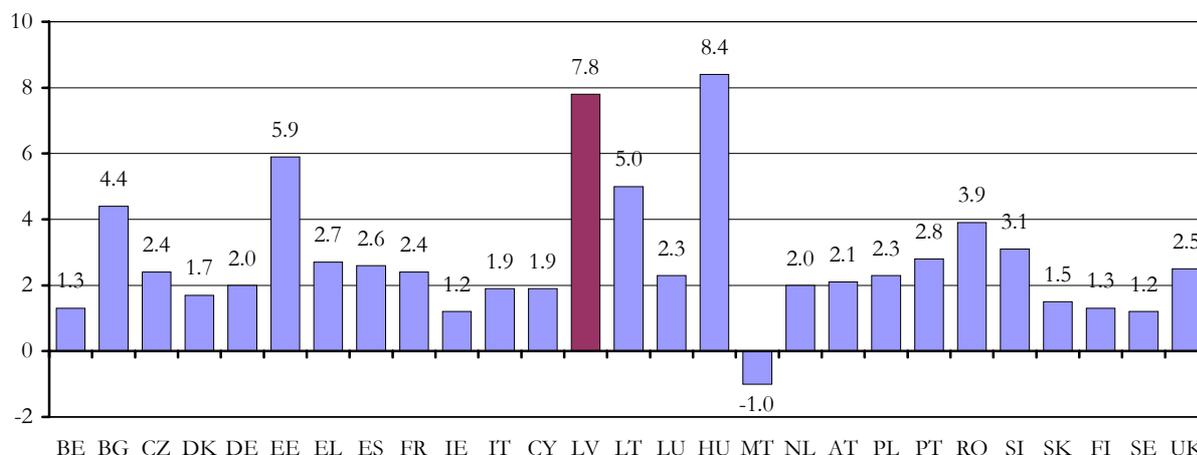
As already noted, consumer price inflation in Latvia in the last three years was one of the highest among EU member states. At the beginning of 2007, only Hungary had higher consumer price inflation.

It was lower in the neighbouring countries Lithuania and Estonia, amounting to 5% and 5.9% respectively (see Figure 4.13).

Rise of prices in Latvia was observed in practically all groups of goods and services, especially for food products and services. In one year, energy prices grew faster in Lithuania (by 6.4%), in Latvia and the EU in total they increased by 5.6% and 1.5% respectively, while the rise of energy prices in Estonia was the lowest among the Baltic States (3.3%).

Figure 4.13

Consumer Price Changes in EU Member States in May 2007
(annual inflation, %)



AT – Austria, BE – Belgium, BG – Bulgaria, CZ – Czech Republic, CY – Cyprus, DE – Germany, DK – Denmark, EE – Estonia, EL – Greece, ES – Spain, FI – Finland, FR – France, HU – Hungary, IE – Ireland, IT – Italy, LT – Lithuania, LU – Luxembourg, LV – Latvia, MT – Malta, NL – Netherlands, PL – Poland, PT – Portugal, RO – Romania, SE – Sweden, SI – Slovenia, SK – Slovakia, UK – United Kingdom
Source: *Eurostat*

Under the current conditions, high inflation rate that remains already for three years may pose a threat to stability of Latvian economy and its further growth. Accordingly, Latvian government pays special

attention to solution of this problem. In March 2007, Latvian government approved the anti-inflation plan that contains a set of several measures (see Box 4.3).

Box 4.3

Anti-inflation plan

The plan approved in March 2007 contains a set of two main measures:

- the first group of measures is related to reduction of aggregate demand. These measures have to eliminate the main incentive of the rapid growth of prices, and results of these measures may affect the inflation rate already some months after their introduction;
- the second group of measures is related to the so-called preventive measures with regard to the rise of productive capacity of the national economy, so that the financial resources inflowing into economy (both domestic and foreign ones) would be invested in development of production sectors of goods and services, which increases the supply side of the economy. To be sure, the impact of these measures on inflation is not expected immediately after their introduction, but their efficiency will show up in the long run.

Measures of the *first group* include strengthening the fiscal responsibility, improvement of taxation policy and control over growth of crediting, i.e., they are directly oriented to reduction of the domestic demand.

It is envisaged to achieve balanced budget in 2007 already. One should also note the introduction of the 3-year budget planning, which will allow more efficient planning of budget expenditures. It is also envisaged to raise efficiency of the public sector without increasing the number of employed persons in it.

It is also expected to change the taxation policy with regard to real estate, taxing the incomes from sale of the real estate as well as differentiating and increasing duties related to purchase and registration of property.

In the control over growth of crediting, it is envisaged to introduce the requirement for commercial banks and providers of leasing services to determine solvency of the customers and grant loans only on the basis of their legal incomes, create a common general register of borrowers, and determine a compulsory initial payment for loans to be granted in the amount of at least 10-15% of the loan.

Measures of the *second group* are closely linked with promotion of the supply side factors, and their positive influence on inflation is subordinate and directed to stability of prices in the long run. These measures include promotion of economic activities, rise of productivity, improvement of energy efficiency, and promotion of competition.

One would especially note the long-term plan for the rise of productivity, which envisages support to development of new products and technologies and their introduction in production, investment projects of high value added, industrial research jointly conducted by businessmen and scientists and development of new products, and promotion of creation and development of company clusters.

It is vital to improve competition conditions in such spheres as trade, construction and market of building materials, and fuel market. Appropriate amendments to the Competition Law are being worked out and improvement of market surveillance measures is being prepared.

Influence of the plan's implementation on inflation may appear already in the 2nd half of 2007, but it will mainly affect the inflation processes in 2008 and the following years. That is why the Ministry of

Economics forecasts the average growth of consumer prices in 2007 at a rather high level (by 7.8%) that is by approximately 1.2 percentage points higher than in 2006.

Forecasting the inflation for 2007, the following main factors affecting price changes were taken into account:

- rise of prices will be substantially affected by the growing wages, which in turn will increase the 2nd round effect of the high inflation of the previous years and will affect inflation expectations;
- inflation will be promoted by expected rises in energy prices (increased tariffs for electricity, natural gas and heat);
- dynamics of price growth may slightly decrease in comparison with the previous years, as fuel prices stabilise and competition increases in markets of industrial goods (impact of globalisation).

4.2.2. Producer Prices

Producer prices grew slowly in 2000-2003. Their fluctuations were mainly related to currency rate changes, as changes in export prices greatly determine the overall dynamics of producer price changes.

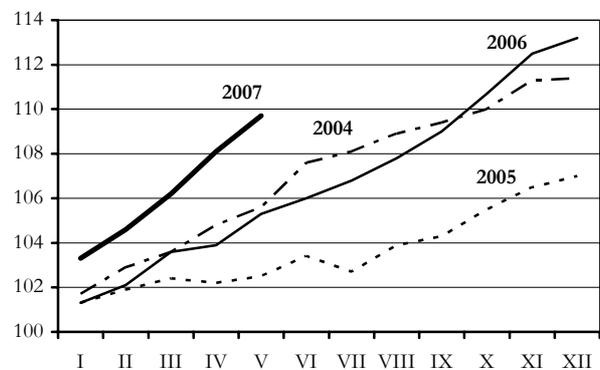
In 2004, producer prices went up much faster by 11.4% (December over December). In 2005, the producer price growth was already more moderate (by 7%). However, as data for 11 months of 2006 show, the increase of producer prices is much faster than in the respective period of the previous year – by 12.5% in comparison with December of the previous year and by 13% during the year (November 2006 over November 2005), which is the highest price growth in the last 10 years. This was mostly due to the increased prices in production of wood and wood products (except furniture) and to the increased tariffs for electricity, gas, steam and hot water supply.

As indicated by data for 5 months of 2007, the growth of producer prices is almost twice faster than in the corresponding period of the previous year – by 9.7% (May over December of the previous year), which was mainly due to increased prices in production of wood and wood products and rise of tariffs for electricity, gas, steam and hot water supply.

Latvia, being a country with a small and open economy, producer prices largely depend on changes of foreign trade prices that are determined by the world prices of the respective products and currency rate fluctuations. As world prices and/or currency rates change, incomes from export and expenses on import also change, causing direct or indirect changes of domestic prices.

Figure 4.14

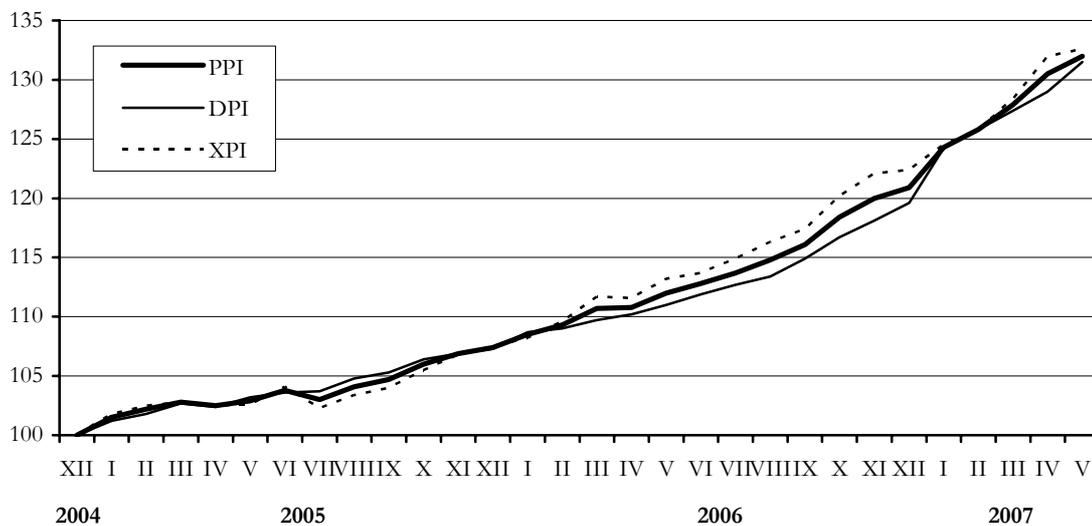
Producer Price Changes by Months
(December of the previous year = 100)



During the year (May 2007 over May 2006), prices for manufacturing products sold in the domestic market rose faster (by 18.5%) than prices of exported manufacturing products (by 17%).

Figure 4.15

Producer Price Dynamics in Manufacturing
(December 2004 = 100)



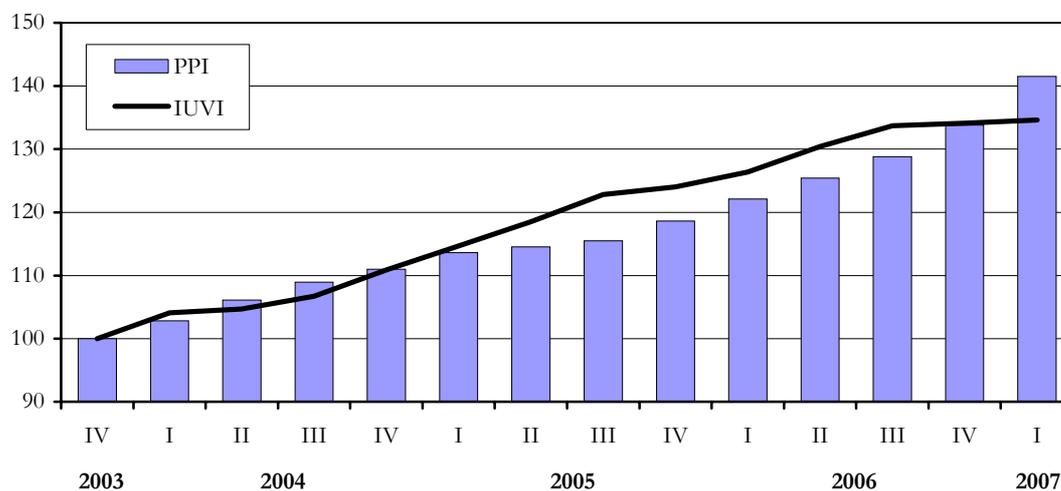
PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

The growth of prices for products sold domestically was triggered not only by the rising domestic demand, but also by the growth of export prices, as supply of some products in the domestic market fell.

The price growth of exported products in 2006 and at the beginning of 2007 was mainly affected by the rise of world prices.

Figure 4.16

Import Price Dynamics in Comparison with Producer Price Dynamics
(4th quarter of 2003 = 100)



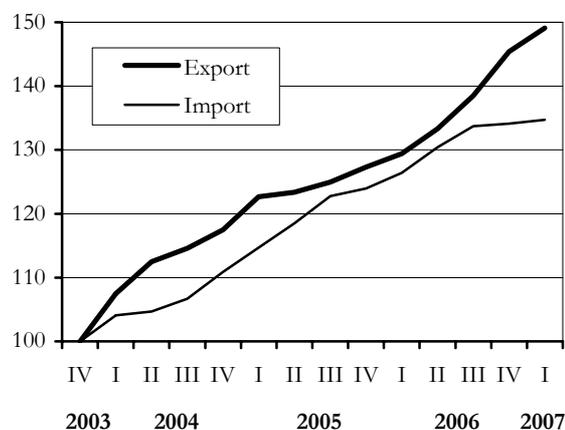
PPI – producer price index, IUVI – import unit value index

Rise of producer prices, in comparison with import price dynamics, reached the rise of import prices in the 4th quarter of 2006, but already exceeded it in the 1st quarter of 2007. The more moderate increase of import prices was greatly determined by the decline of value for machinery, mechanisms and electrical appliances.

Increase of the export unit value in 2005 and the 1st half of 2006 was almost at the same level as for the import unit value, however, slightly exceeding it. In the 2nd half of 2006 and at the beginning of 2007, the growth of export prices more than twice exceeded the increase of the import unit value, which was mostly determined by the rise of export unit value for wood and wood products.

Figure 4.17

Dynamics of Import and Export Prices
(4th quarter of 2003 = 100)



4.3. Balance of Payments

4.3.1. Current Account

Latvia typically has a relatively big **current account** deficit. The main cause of the deficit is the markedly negative trade balance. About one-seventh of this balance is covered by the positive balance of services. Mostly negative current account balance is covered by foreign direct investment and other long-term capital flows. The reserve assets of the Bank of Latvia are growing.

In 2005, the current account deficit slightly diminished with improvement of the trade balance, as the exports of goods rose faster than the imports (see Chapter 3.2.4).

Trade balance considerably deteriorated in 2006 (see Table 4.6), as the imports of goods increased faster than the exports due to the growing domestic demand; as a result, the current account deficit of the balance of payments reached 21.1%.

Domestic demand in Latvia is bigger than GDP, creating the current account deficit. This means that

also foreign savings should be used to finance domestic investment.

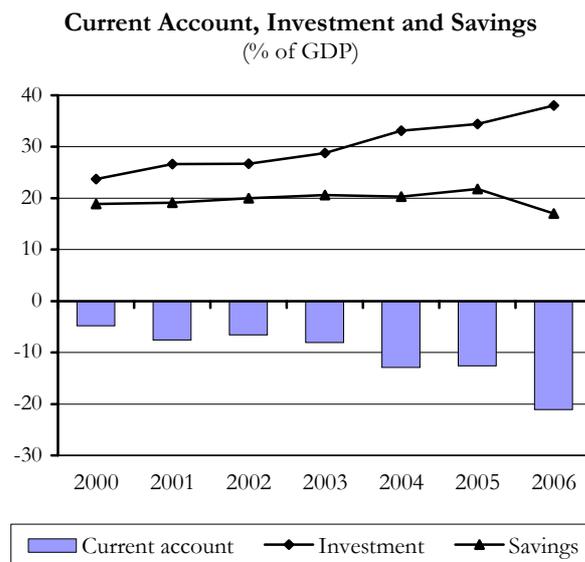
Table 4.6

Latvian Balance of Payments
(percentage of GDP)

	2004	2005	2006
A. Current account	-12.9	-12.6	-21.1
Trade balance	-20.2	-18.9	-24.4
<i>exports</i>	30.6	33.5	30.0
<i>imports</i>	-50.9	-52.4	-54.5
Balance of services	4.4	3.8	3.4
Net income	-2.1	-1.2	-2.5
Current transfers, net	5.0	3.7	2.4
B. Capital account	1.0	1.3	1.2
C. Financial account	14.2	16.5	30.0
Direct investment	3.9	3.7	7.4
<i>abroad</i>	-0.8	-0.8	-0.7
<i>in Latvia</i>	4.6	4.5	8.1
Portfolio investment	1.7	-0.7	-0.1
<i>assets</i>	-0.2	-1.6	-1.3
<i>liabilities</i>	1.9	1.0	1.2
Other investment	9.0	13.9	22.4
<i>assets</i>	-12.9	-2.7	-9.3
<i>liabilities</i>	21.9	16.6	31.7
D. Net errors and omissions	0.6	-2.0	-0.3
E. Reserves	-2.9	-3.2	-9.8

As seen in Figure 4.18, the level of savings against GDP in Latvian economy has not essentially changed in the recent years and amounts to approximately 20%, while in 2006 it decreased to 17%. In contrast, the level of investment in the economy is high, especially after accession to the EU.

Figure 4.18



Thus, the imbalance between domestic savings and investment (the current account deficit) is a regular phenomenon in Latvian economy during the recent years of the rapid growth. Until now, it has not caused problems for stability of the economy, as the

deficit is mostly covered by non-debt flows. Moreover, faster growth of investment in comparison with the growth of other domestic demand items increases the productive capacity of Latvian economy and hence improves the competitiveness of economy.

The current account deficit essentially reflects the fact that the domestic demand grows faster than the domestic supply, which means that the growth of residents' expenditures is faster than the growth of incomes.

The steadily high growth of the domestic demand is based on several factors. Inflow of foreign capital, which stimulates increase of crediting mostly through the financial sphere, would be noted especially. Unfortunately, both the attracted foreign capital and the domestic savings are predominantly channelled to investment in real estate and to a lesser extent for development of production sectors. This means that production of goods poorly competes with other sectors in terms of capital attraction, especially with the real estate sector.

From the macroeconomic viewpoint, Latvian current account deficit is based on fundamental factors and is greatly determined by the convergence of national economy to a higher level of development. However, on the other hand, there are several factors indicating some problematic aspects in regard to the high level of current account deficit in Latvia:

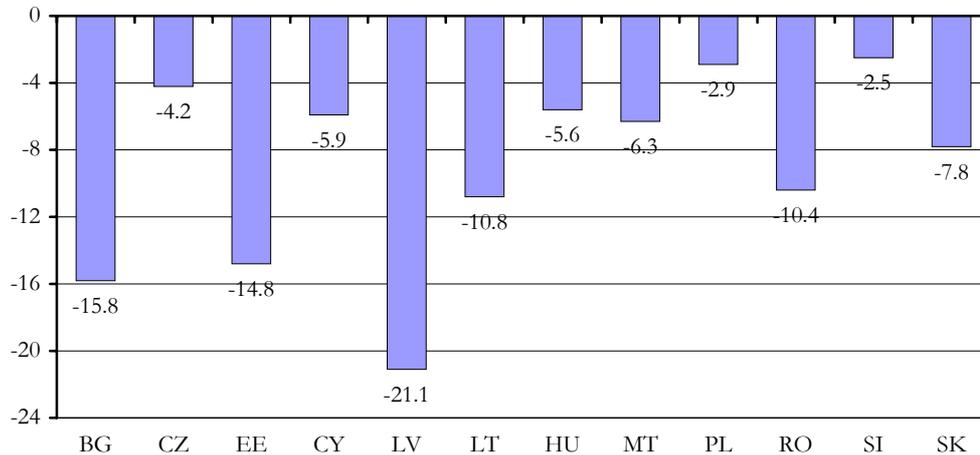
- debt flows, which are mostly related to the increased volume of financing attracted by Latvian commercial banks from parent banks abroad, grow rapidly in the structure of the attracted capital in the recent years;
- the attracted capital is used not only for investment that increases the production potential of Latvian economy, as a rather big part of this capital is channelled to transactions in real estate markets;
- Latvia has greatly specialised in the supply of goods with a low value added for external markets, and the intensity of export of goods with a higher value added in Latvia is among the lowest in the region, besides, Latvia has not substantially improved its positions in this respect during the last years;
- Latvian industry depends on import of intermediate goods to a great extent, and the share of intermediate goods in imports has not diminished in the course of time; this indirectly indicates that no considerable re-orientation to production of goods with higher value added has occurred in the supply side of Latvian economy;
- the export intensity of Latvian goods sector is low (in comparison with Lithuania and Estonia), which indicates that Latvia uses export opportunities to a relatively smaller extent than other countries similar to Latvia in the region.

All new EU member states have a negative savings-investment balance, which is mainly linked with the high level of investment. Domestic savings are too small to implement restructuring and modernisation of the national economy.

In 2006, the Latvian current account deficit against GDP was the highest among the new EU member states (see Figure 4.19). No country was with a positive current account balance, and the lowest current account deficit was in Slovenia.

Figure 4.19

Current Account Balance of the New EU Member States in 2006
(percentage of GDP)



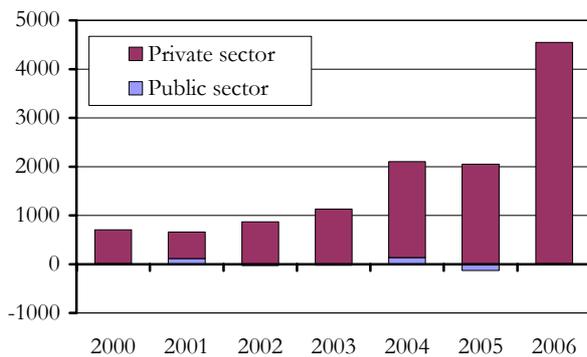
BG – Bulgaria, CZ – Czech Republic, CY – Cyprus, EE – Estonia, HU – Hungary, LT – Lithuania, LV – Latvia, MT – Malta, PL – Poland, RO – Romania, SI – Slovenia, SK – Slovakia
Source: Eurostat

4.3.2. Financial Flows

In order to balance the external sector in case of a large current account deficit, it is important to look at the nature of coverage of the current account deficit and financial flows.

Figure 4.20

Inflow of Foreign Investment into Latvian Economy
(million LVL)



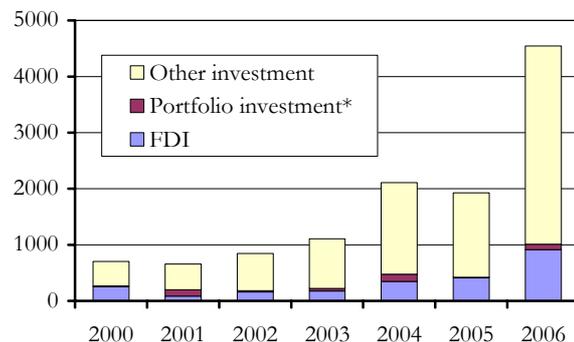
Enhanced inflow of foreign capital, ensured by liberalisation of financial flows, started in Latvia at the beginning of transition. There are no limitations to conversion of the national currency in Latvia. Foreign companies may freely withdraw their investment and profit after paying taxes. Also every resident of Latvia is free to use financial services of any foreign company. There are no restrictions for transactions

with securities and stock. Buying and selling of real estate is not restricted, either.

Foreign investment is mainly drawn in by the private sector. As from 2004, foreign investment increased rapidly and its volume even doubled in 2006 in comparison with the previous year.

Figure 4.21

Inflow of Foreign Investment into Latvian Economy by Types of Investment
(million LVL)



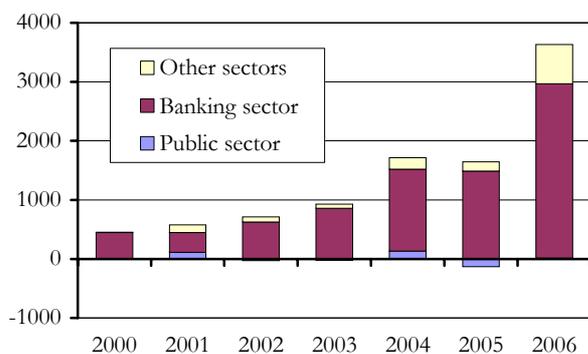
* portfolio investment with financial derivatives

Inflow of foreign direct investment in 2004 and 2005 was with a twice bigger volume than in the preceding years and covered 39% and 32% respectively of the negative current account balance, while in 2006 it covered 38.5% of the current account deficit.

The share of portfolio investment in the incoming financial flows is small and does not exceed 10% in the last three years. The balance of portfolio investment slightly improved in 2006 but still was negative, as more Latvian banks increased investment in debt securities abroad.

Figure 4.22

Net Foreign Investment Flows in Different Sectors* (million LVL)



* excluding foreign direct investment

The majority of foreign investment consists of “other investment”, namely, financial transactions that are not included in direct and portfolio investment. These are trade loans, other credits and borrowings, cash and deposits, etc.

The volume of foreign financial resources attracted by commercial banks has substantially increased in the last years and constitutes the most voluminous share of financial flows. The open regime of the financial account and the fixed currency exchange rate foster free movement of funds in and out of the banking system.

Therefore, Latvia is a capital-attracting country. In 2006, the attracted capital exceeded GDP by 41%, while the debt of Latvia to the rest of the world was 112.8% of GDP, including the central government debt (5.7%). The amount owed to Latvia by the rest of the world equalled to 72% of GDP.

4.3.3. Foreign Direct Investment

Attracted foreign capital is one of the most important financial sources for investing in fixed assets. According to Latvian savings–investment balance, the level of domestic investment in Latvia during the last three years exceeded the level of national savings by almost 15 percentage points, which means that the attracted foreign capital covered 44% on average of the funding for investment in fixed assets, incl. foreign direct investment (FDI) by 19.2%.

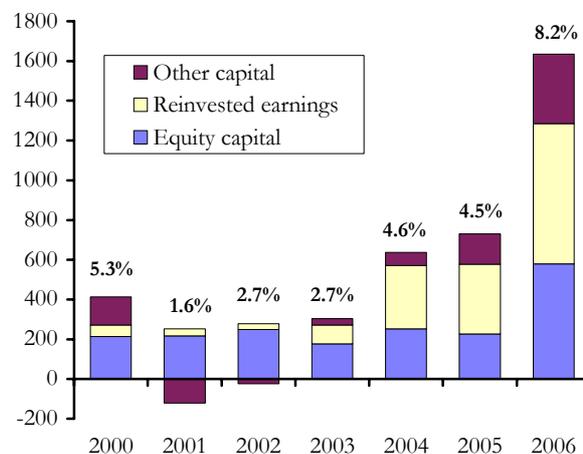
By the end of 2006, foreign entrepreneurs had invested LVL 4037.2 million or almost 36% of GDP

into Latvia in the form of direct investment, which amounted to LVL 1769.7 or USD 3294.3 per capita. Latvia took the 9th place among the new EU member states by this indicator in 2005.

With Latvia’s accession to the EU, the volume of the FDI inflow has increased considerably. In the last three years, foreign entrepreneurs have invested into Latvian economy in the form of direct investment almost four times more than in the period from 2001 to 2003. The volume of the FDI inflow in 2006 was twice bigger than in the preceding year and reached LVL 915.9 million (USD 1634.8 million). Rapid increase of FDI flows in the last three years is also observed in Lithuania (2 times), Estonia (2.5 times) and some other new EU member states. Inflow of foreign capital in the form of direct investment into the new EU member states increased by 1.5 times on average since the accession to the EU. It must be noted that such changes in dynamics of the FDI inflow are not observed in the old EU member states. To a certain extent, this indicates susceptibility of foreign investment to changes of geopolitical situation of the country. Also profitability of FDI¹ in the new EU member states is higher than in the old EU member states and has a trend to grow in the recent years. Profitability of FDI in Latvia was 18% in 2006 or 2.5 times higher than in 2003.

Figure 4.23

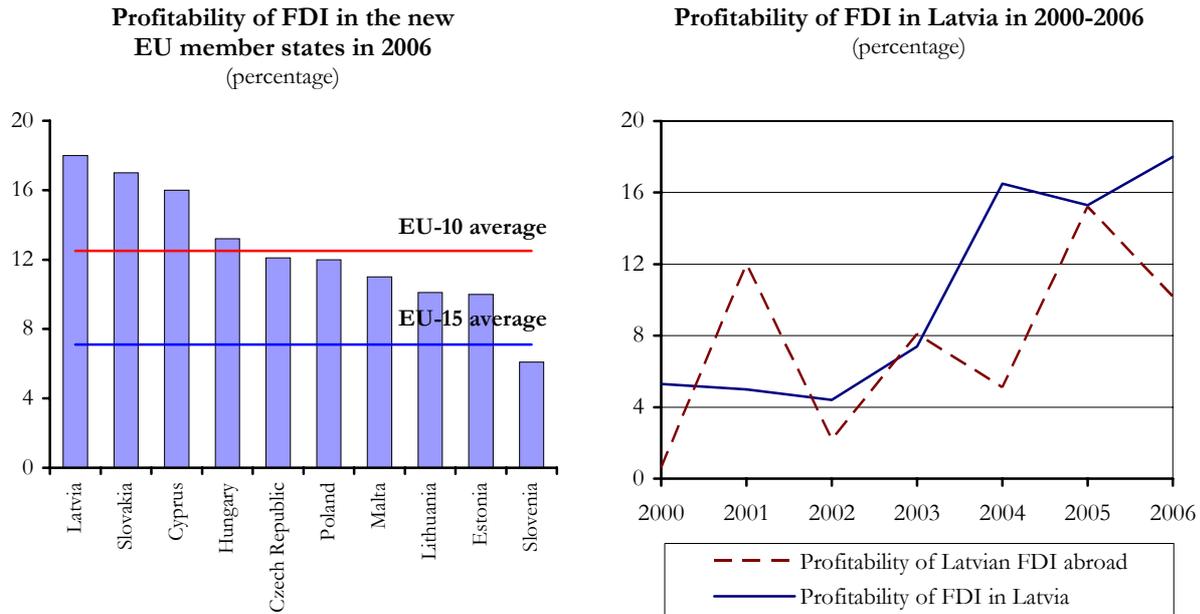
FDI in Latvia (received during the year, million US dollars, % of GDP)



Investment abroad by Latvian entrepreneurs grows every year. In 2006, it increased by 42.4% in comparison with 2005 and amounted to LVL 239.6 million. More than half of Latvian investment was made in Switzerland (mostly in the trade sector) and Lithuania (in trade and financial mediation). Profitability of Latvian direct investment abroad was 10.2% in 2006.

¹ Profitability of FDI is calculated as the ratio of the income from FDI in the current year to the FDI stock at the end of the previous year.

Figure 4.24



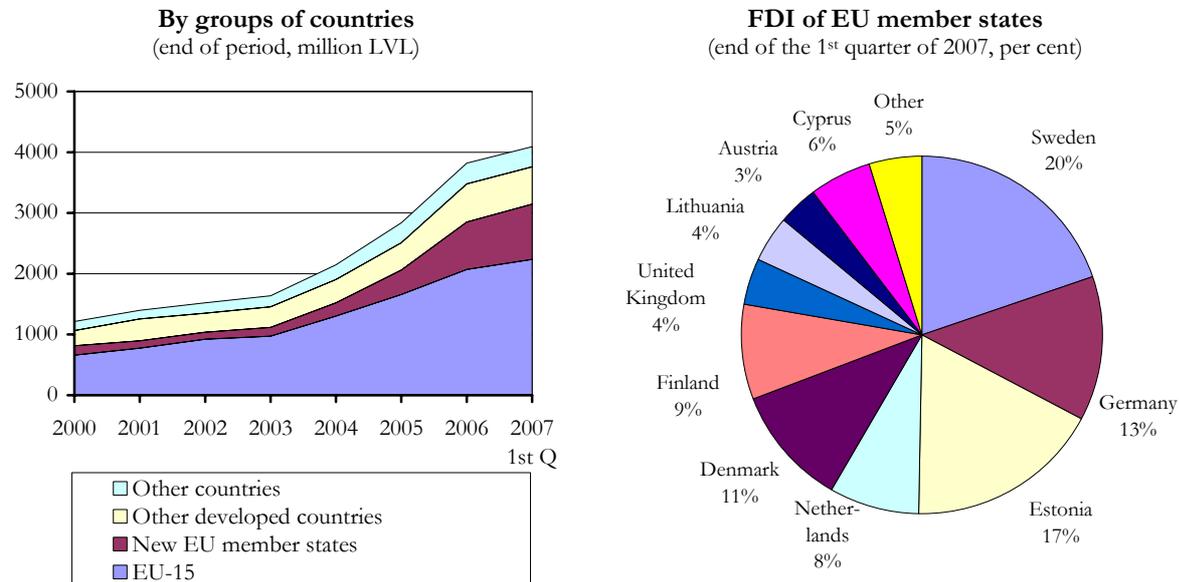
Source: Eurostat database, Latvian balance of payments.

Geopolitical structure of the FDI stock in Latvia has not changed essentially since 2004. Direct investment of developed countries in Latvia increased more than twice during the last three years and constituted 70.7% of the total FDI stock at the end of

2006. The majority of it is made up by investment of EU member states. At the end of 2006, investment of EU member states constituted 74.6% of the total FDI stock in Latvia.

Figure 4.25

FDI Stock



Investors from the new EU member states have become more active since 2004. In the last three years (2004-2006), the FDI stock of these countries increased 5.4 times, while the direct investment of the old EU member states in Latvia grew 2 times. Hence the share of the new EU member states in the structure of the FDI stock rose by 12 percentage points to 20.4% or almost one-third of the FDI stock of EU member states in Latvian economy at the end of 2006. High growth rate also remained in the 1st

quarter of 2007 (by 16.5%). Among the new EU member states, Estonia has marked leader positions (61.2% of the FDI stock of the new EU member states). Lithuanian investment has increased by 39.4% and 31.4% respectively at the end of 2006 and in the 1st quarter of 2007 and constituted 13% of the FDI stock of the new EU member states at the end of 2006.

The biggest amounts of investment are received from Sweden, Estonia, Germany and Denmark. FDI

stock of these four countries made up almost 50% of the total FDI stock in Latvian economy at the end of 2006. Markedly dominant sectors exist in all mentioned countries (except Denmark). Swedish FDI was focused in the sectors of financial services (42%) and commercial services (29%). Almost 70% of Estonian FDI is in the financial services. German entrepreneurs have mainly invested in the energy sector (45% of German FDI stock in Latvian economy).

The highest share in the sectoral structure of the FDI stock belonged to the commercial services sector until the end of 2004; as from 2005, the leading positions in attraction of FDI are taken by financial services. The share of this sector in the structure of the FDI stock was 28% at the end of 2006. LVL 724.6 million in the form of direct investment was invested in the sphere of financial services during the last three years, and this constitutes almost one-third of the FDI attracted in Latvian economy in three years.

FDI stock both in goods and services more than doubled in the last three years. In the sphere of production of goods, FDI growth was especially fast in the energy sector (5.7 times) and construction (3.8 times). FDI growth was less rapid in manufacturing (by 54%).

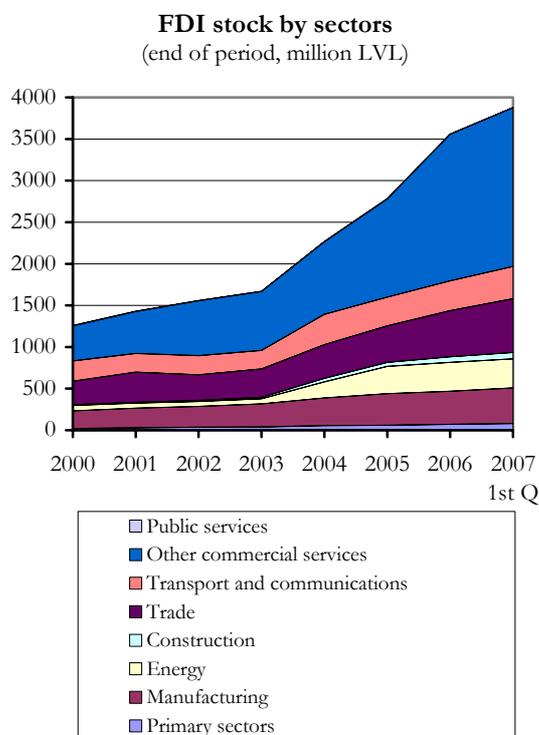
In the 1st quarter of 2007, the FDI stock increased by 6.5% (by 6% in the sphere of production of goods and by 10% in the sphere of services). Almost half of the FDI attracted in this period is invested in the sector of commercial services, including real estates. Big transactions were carried out in trade where the FDI stock increased by 16.5% in 3 months of 2007 and made up 33% of the FDI inflow. Steadily high FDI growth rate remained in the construction sector (by 17%). FDI growth rate in financial mediation was more moderate than in the previous years (4.3%).

FDI stock in manufacturing has risen by 4.6% in 2006 and by 7.7% in the 1st quarter of 2007.

The most attractive manufacturing sectors for foreign investors are food industry, wood processing and manufacture of other non-metallic mineral products. FDI stock in these sectors made up 74% of the total FDI stock in manufacturing at the end of the 1st quarter of 2007. It should be noted that these are low and medium-low technology sectors. In the last three years, FDI in these sectors has increased by 54.9%, while the FDI stock in high and medium-high technology sectors has decreased by 23% and made up 8.1% at the end of the 1st quarter of 2007. This indicates that the relatively low accessibility of labour force and natural resources is still important in the attraction of foreign capital in Latvia.

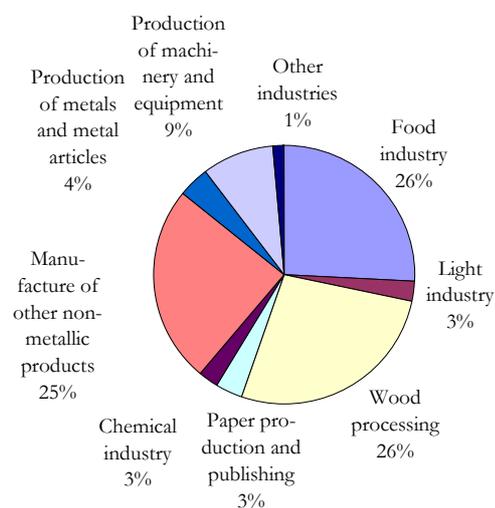
Figure 4.26

FDI Stock by Sectors



FDI stock in manufacturing

(end of the 1st quarter of 2007, per cent)



A lot is being done in Latvia in order to improve the investment environment. Big role in this process is played by the Latvian Investment and Development Agency that was founded as the non-profit organisation state JSC "Latvian Development Agency" in 1993 and reorganised as the state agency "Latvian

Investment and Development Agency" (LIDA) in 2003. One of the most important priorities for operation of LIDA in the sphere of investment attraction is attraction of such projects that are based on knowledge and technologies.

4.4. Financial and Capital Markets¹

4.4.1. Monetary Policy and the Exchange Rate

The Republic of Latvia Law “On the Bank of Latvia”² prescribes that the main goal of the Bank of Latvia is to maintain price stability in the country. The central bank is an independent decision-making institution not subordinated to decisions or instructions of the government or governmental institutions. The Bank of Latvia performs its functions under supervision of the Saeima.

Since the middle of February 1994, the Bank of Latvia had unofficially pegged the exchange rate of the lat (LVL) to the SDR³ basket of currencies (1 SDR = LVL 0.7997) thus *de facto* implementing the policy of fixed currency exchange rate. As from January 1, 2005, the peg of the lat to the SDR basket is replaced with the peg to the euro (1 EUR = LVL 0.702804). The change of the lat’s peg was determined by Latvia’s plans to join the European Exchange Rate Mechanism II (ERM II) and, after fulfilment of the required criteria, to join the Economic and Monetary Union (EMU)⁴.

As from May 2, 2005, Latvia has joined the ERM II with the already existing exchange rate of the lat against the euro, namely, 1 EUR = LVL 0.702804. ERM II allows standard fluctuations of the exchange rate within +/-15% around the central or peg rate. However, Latvia resolves to unilaterally keep the exchange rate fluctuations within +/-1%, retaining the former width of the corridor of lat’s fluctuations, which was habitual to the financial market, has existed since pegging the lat to the SDR in 1994 and was kept when the lat was pegged to the euro on January 1, 2005.

On July 21, 2005, the Cabinet of Ministers adopted decision to establish the Management Committee for Introduction of the Single Currency of the European Union in Latvia with a task to develop the plan of measures required to ensure successful joining the euro zone by Latvia (see Box 4.4). The timetable for introduction of the euro, approved by the Cabinet of Ministers, envisages that Latvia will join the EMU on January 1, 2008. Taking into account that the target set by the government has become unachievable due to high inflation⁴, the situation is being assessed and a new target date for joining the EMU will be set.

Box 4.4

Euro changeover plan

On March 6, 2006, the Cabinet of Ministers approved the *Latvia’s National Euro Changeover Plan* that prescribes carrying out several measures in regard to adjusting and ensuring technical operation of the normative base for money and payment system, financial system, public debt management, budgetary accounting and statistics, business environment and consumer protection, taxes and social security, as well as for informing society.

Along with approval of the *Latvia’s National Euro Changeover Plan*, the *Action Plan for Introduction of the Single European Currency in Latvia* was also approved, which is Annex 1 of the former. The Action Plan incorporates general and practical measures for the changeover to the euro, the responsible institutions and terms for implementation of the defined activities.

At present, the *Communication Strategy for Euro Changeover in Latvia* and the *Communication Action Plan for Euro Changeover* have been developed and approved by decision of the Management Committee of the euro introduction project.

It must be noted that introduction of the euro in Latvia will be an issue of EU multilateral relations, affecting the common interests of all EU member states. Therefore the timetable for introduction of the euro, approved by the Cabinet of Ministers, will only get an official status after completion of all negotiations and other formal procedures. As soon as the European Council passes the decision on Latvia’s readiness to participate in the EMU, the national currency of Latvia will be replaced with the euro and the Bank of Latvia will terminate implementation of independent monetary policy. Until then the lat will remain the national currency of Latvia.

The Bank of Latvia operates like the so-called currency board, freely buying and selling foreign currencies. The Bank of Latvia has managed to gain credibility without using the formal currency board system and to get experience, at the same time using wide range of market-oriented monetary instruments fully compatible with the monetary policy instruments available to ECB.

In order to keep a fixed exchange rate, it is necessary to have a sufficient amount of foreign reserves. Up to now, no problems had been experienced in this area in Latvia. Net foreign reserves

¹ Data of the *Financial and Capital Market Commission* and the Bank of Latvia are used in this chapter.

² The Bank of Latvia is the central bank of the state.

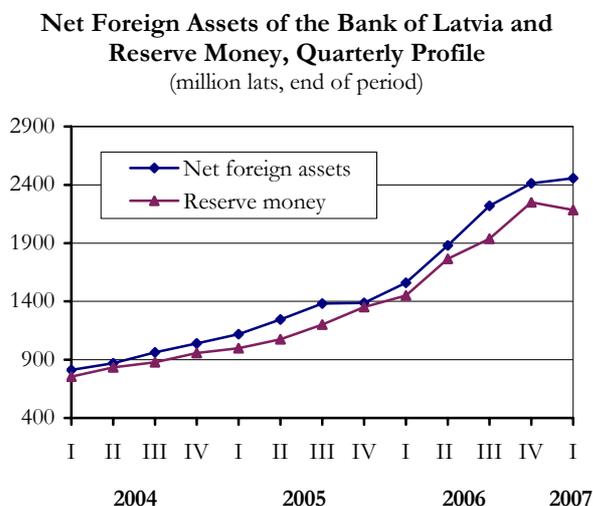
³ Special Drawing Rights – SDR; currency code according to the classification of currencies international standard ISO 4217 – XDR.

⁴ Participation in the EMU is laid down in the EU Treaty of Accession but Latvia can select its own timeline for introduction of the euro.

⁵ On March 6, 2007, the Cabinet of Ministers supported the action plan to curb inflation. The most essential inflation-curling measures are related to budgetary and taxation policies, crediting and other spheres, which may improve the situation in the real estate market, labour market and productivity, and the competition policy.

of the Bank of Latvia constantly cover the reserve money (see Figure 4.27), and their amount equals to the value of goods and non-factorial services imported by the country in 3-4 months.

Figure 4.27



The coverage of reserve money (currency in circulation and deposits in the Bank of Latvia) with net foreign assets was 112.5% at the end of March 2007. Net foreign assets of the Bank of Latvia have gone up by 57.5% in comparison with the end of March 2006.

Foreign currency reserves are invested in safe and liquid financial instruments, mainly in debt securities issued by governments of the USA, euro zone countries, United Kingdom and Japan, as well as by agencies of these countries and international organisations. Foreign reserves of the Bank of Latvia (including gold reserves) amounted to USD 4509 million at the end of 2006 (USD 2361 million at the end of 2005, USD 2022 million at the end of 2004, USD 1535 million at the end of 2003).

The Bank of Latvia calculates the real effective rate of the lat¹ against the currencies of 13 countries that are the main trading partners of Latvia². It shows the relative export competitiveness of Latvia in global markets (see Figure 4.28).

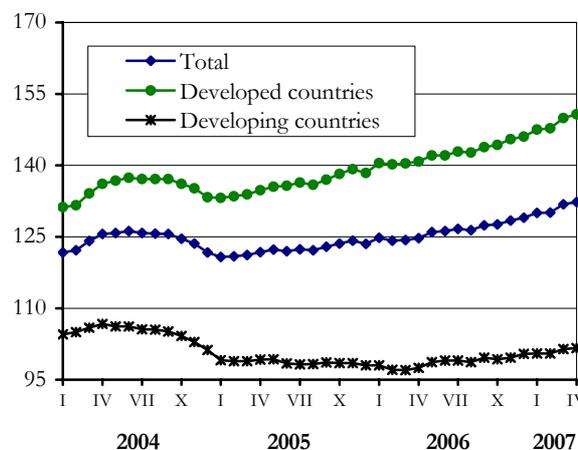
The real exchange rate of the lat depreciated with regard to currencies of both the developing and the developed countries in 2002 and 2003. However, since 2004, it tends to appreciate with regard to currencies of the developed countries due to relatively high inflation. Decline of the real effective exchange rate of the lat is favourable for Latvian exporters.

¹ Real exchange rate of the lat encompasses changes of the nominal rate of the lat against the currency of a trade partner state of Latvia as well as consumer price changes in Latvia compared with consumer price changes in the trade partner state. The real rate is calculated by dividing the nominal rate index with the ratio of foreign and domestic price indices.

² Denmark, Finland, France, Germany, Italy, Netherlands, Sweden, the United Kingdom and the USA are included in the group of developed countries, while Estonia, Lithuania, Poland and Russia are included in the group of developing countries.

Figure 4.28

Index of the Real Effective Exchange Rate of the Lat*
(by months)



* Calculated from the average monthly exchange rates, which is the price of the domestic currency unit in foreign currency. The base for the index is December 1995 (1995 = 100).

4.4.2. Market Structure and Development

In the financial and capital market of Latvia, bank assets make the biggest share (96%) in the total assets.

21 banks and three branches of foreign banks operated in Latvia at the end of 2006. Also credit institutions or their branches, which are registered in European Economic Area (EEA) countries and have submitted applications to the *Financial and Capital Market Commission*³, may provide banking services in Latvia.

The banking system of Latvia has stabilised during the process of biggest bank mergers and takeovers in 1998-2001. Almost all banks are in private hands (at the end of 2006 the state owned 8.2% of the total paid-up equity capital of banks). Only the *Mortgage and Land Bank of Latvia* is fully owned by the state. Foreign shareholders owned 68.8% of the total paid-up equity capital of banks at the end of 2006 (58.6% at the end of 2005, 57.8% at the end of 2004).

The market share of the five biggest banks has slightly increased in the last years and amounted to 69.4% of the total assets, 77.3% of loans and 69.9% of deposits at the end of 2006 (67.3%, 75.7% and 69.6% respectively at the end of 2005).

Total amount of bank assets reached LVL 15.9 billion at the end of 2006, growing by 45.4% during the year, while the amount of issued loans went up by 56.2% and the volume of attracted investment increased by 25.1%. To a great extent, this growth occurred due to the rapid development of crediting and improved efficiency of banking activity. Loans issued to companies make up slightly more than half of the

³ 150 notifications from EEA countries about willingness of banks of these countries to start providing financial services in Latvia without opening a branch were received by the middle of 2007.

credit portfolio of banks. However, a substantial growth is observed in loans issued to households.

Commercial banks operate with profit. In 2006, the total profit of the banking sector reached LVL 265.9 million¹ (after deduction of taxes), i.e., by 37.7% more than in the preceding year when the profit amounted to LVL 193.1 million. In 5 months of 2007, the profit of banks was LVL 149.6 million, which is by 61% more than in the respective period of 2006.

Return on assets (ROA)² reached 2.1% at the end of 2006, while return on equity (ROE)³ reached 26.3% (2.1% and 27.1% respectively at the end of 2005, 1.7% and 21.4% respectively at the end of 2004). The volume of services provided by Latvian banking sector is still substantially smaller than in the developed countries. Moreover, a considerable part of Latvian population has not yet started to use banking services.

16 insurance companies, of which five were life insurers and 11 provided non-life insurance, as well as three branches of foreign insurance companies operated in Latvia at the end of 2006. In Latvian financial and capital market, the share of insurance companies in the total assets is slightly below 2%.

Total of gross premiums written in the insurance market reached LVL 204.1 million in 2006, which was by 31% more than in 2005, while the volume of paid gross indemnities was LVL 95.2 million or by 41% more than in 2005.

Accession to the EU has encouraged increase of competition in this sector. Since May 1, 2004, non-bank financial institutions of EU member states no longer need to receive licence or open a branch in Latvia in order to offer their services in this country. Foreign companies now are allowed to insure assets of their subsidiaries in Latvia not only with local insurers, and this has reduced the growth of real estate insurance volumes in the Latvian market. 266 notifications by insurance supervision bodies of 22 European Economic Area countries on the intention of insurers licensed in these countries to use the principle of service provision freedom in Latvia were received by December 31, 2006.

Securities market plays an important role in attraction of investment. At present, the necessary legal base for development of securities market has been created in Latvia, which complies with requirements of EU directives, and institutions required for functioning of this base have been set up. Yet, the stock market in Latvia is poorly developed, so its influence on the economic development of the country is small.

At the end of 2006, market capitalisation of Latvian companies at Riga Stock Exchange (RSE)⁴

was LVL 1430 million or 12.7% of GDP (LVL 1492 million or 16.5% of GDP at the end of 2005, LVL 849 million or 11.4% of GDP at the end of 2004). 40 companies were listed on the stock exchange at the end of 2006 (45 companies at the end of 2005).

The RSE capitalisation index OMXR (January 1, 2000 = 100) reached 656 points at the end of 2006 (676 at the end of 2005, 414 at the end of 2004). Growth of the capital market in the nearest future might be positively influenced by appearance of such stable investors as pension funds and investment companies in the securities market and by the efficiency of raising capital through the securities market.

As from July 1, 2001, supervision over the financial sector is being carried out by the **Financial and Capital Market Commission** (FCMC). FCMC took over the functions that had been previously performed by the Credit Institutions Supervision Board of the Bank of Latvia, Securities Market Commission and State Insurance Supervision Inspection. FCMC was established to promote protection of interests of investors, depositors and insured persons as well as support development and stability of the financial and capital market.

Normative acts regulating operation of Latvian banks essentially comply with requirements of the EU banking directives. National regulations in some cases are even stricter than required by the EU directives. For example, the minimum capital requirement is 10% (Directive 2000/12/EC states that the minimum level is 8%), whereas higher risk weights are established with regard to central governments and credit institutions in B zone countries. Banks and insurance companies prepare their annual reports in line with international accounting standards.

In accordance with the *Law on Deposit Guarantees*, the maximum guaranteed amount of compensation to one depositor for a deposit in one bank is being increased gradually (EUR 15 000 as from January 1, 2006 until December 31, 2007). The law stipulates that the compensation will reach EUR 20 000 as from January 1, 2008. As from January 1, 2003, the compensation is also guaranteed to legal persons in the same amount as to physical persons.

LVL 48.6 million were accumulated in the Deposit Guarantee Fund at the end of 2006, i.e., by 41% more than at the end of 2005. It has to be noted that, since the fund started operating, its resources have not been used to pay the guaranteed compensations because no case of the inaccessibility of deposits in banks or savings-and-loans companies has occurred in Latvia during this period of time.

In order to guarantee protection of insured persons in Latvia, Protection Fund for the Insured was established in 1999. LVL 2.5 million were accumulated

¹ Non-audited data.

² ROA – ratio of profit/losses to assets.

³ ROE – ratio of profit/losses to capital and reserves.

⁴ Riga Stock Exchange is the sole licensed stock exchange in Latvia, which offers trade in securities in public circulation as well as quotation of securities and information services. It is a part of the OMX Group that manages stock exchanges of Stockholm, Helsinki,

Copenhagen, Iceland, Riga, Tallinn and Vilnius and hence provides access to approximately 80% of the securities market of the Nordic countries and Baltic States.

in this fund at the end of 2006. The *Investor Protection Law* is in force since 2002, which stipulates that investors are entitled to receive compensation if investment service providers (banks and brokerage firms) cannot honour their commitments.

4.4.3. Deposits and Loans

Stability of the banking sector, growing welfare of population and increasing economic activity predetermine stable growth of the basic monetary indicators of the banking system of Latvia. The growth of monetary indicators, which had been observed in the previous years, was also retained in 2006 and at the beginning of 2007 (see Table 4.7 and Figures 4.29 and 4.30).

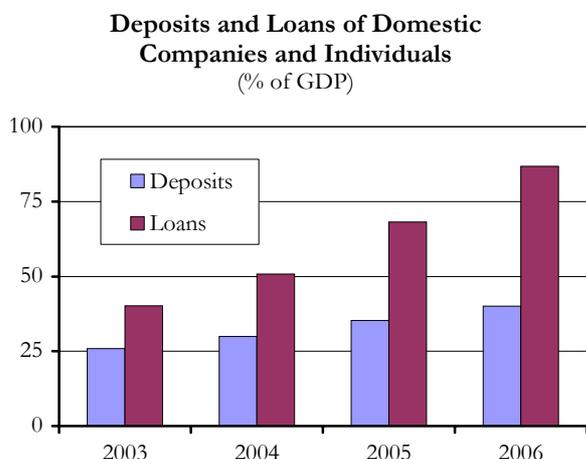
Table 4.7

Monetary Indicators of the Banking System of Latvia
(end of period)

	2003	2004	2005	2006
	(million lats)			
Net foreign assets	75.4	-231.0	-1326.6	-2634.7
Net domestic assets	2183.4	3098.9	5311.2	8114.6
Domestic loans	2822.0	3948.1	6441.3	9877.4
to government (net)	250.2	173.4	266.3	100.5
to companies and individuals	2571.8	3774.7	6175.0	9776.9
Other assets (net)	-638.6	-849.2	-1130.1	-1762.8
Broad money M2X	2258.7	2867.9	3984.7	5479.9
Currency in circulation (less vault cash balance)	601.1	645.4	786.4	969.3
Deposits of individuals and companies	1657.7	2222.4	3198.3	4510.6
of which:				
demand deposits	941.7	1295.6	2020.2	2974.5
time deposits	716.0	926.8	1178.1	1536.1
	(changes against the preceding period, per cent)			
Domestic loans	40.8	39.9	63.1	53.3
of which:				
to companies and individuals	39.0	46.8	63.6	58.3
Broad money M2X	21.1	27.0	38.9	37.5
Currency in circulation (less vault cash balance)	10.7	7.4	21.8	23.3
Deposits of individuals and companies	25.4	34.1	43.9	41.0
GDP (in current prices)	11.0	16.3	21.8	24.3

Although volumes of both the deposits and granted loans have considerably increased in recent years, their share in GDP (see Figure 4.29) is still substantially lower than in the developed countries.

Figure 4.29



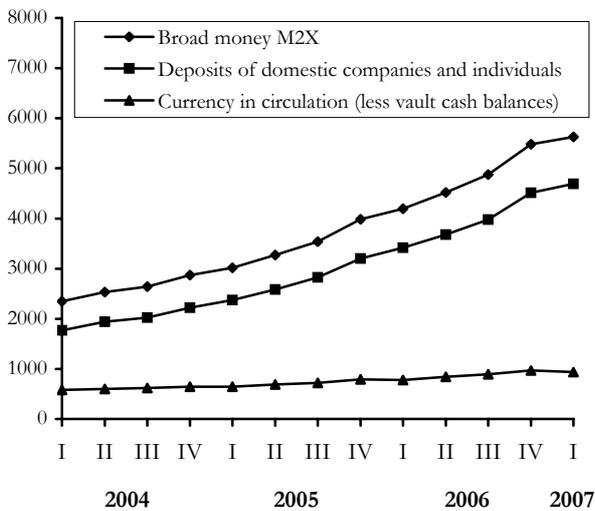
The **share of deposits** of companies and individuals drawn by residents in percentage of GDP amounted to 40% in 2006. The share of deposits of companies and individuals increased by 41% in 2006. 60% of all deposits drawn by residents were deposits in LVL, whereas the rest was deposited in foreign currencies. Dominant role in deposits is played by demand deposits whose share in the total deposit structure was 68% at the end of 2006 (71% at the end of 2005).

The share of deposits of non-residents in the total volume of deposits is relatively high in Latvia. However, this share is shrinking (from 54% at the end of 2004 to 47% at the end of 2005 and 40% at the end of 2006)¹.

¹ To compare: the share of non-residents in the total deposits makes up 16% in Estonia and 8% in Lithuania.

Figure 4.30

Dynamics of Broad Money (M2X) and its Components, Quarterly Profile
(end of period, million LVL)



The relatively high share of short-term deposits and non-resident deposits is a certain risk factor. Dramatic decrease of deposits in case of economic shocks could seriously affect Latvian banking system on the whole. However, due to strict supervision and control of the banking system, such probability is small. Most of the liabilities drawn by non-residents are placed into liquid assets, and risks related to dynamic quantitative changes of these deposits are managed well. Trust in banks is also enhanced by the *Law on Deposit Guarantees*.

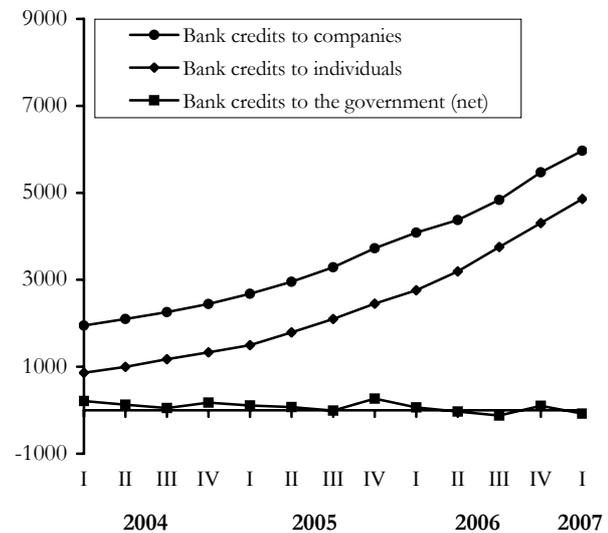
The proportion of **loans** to companies and individuals against GDP was 87% in 2006¹. In the last years, the volume of loans has increased by 50-60% annually. Both the enlivened economic activity and the reduction of credit risks have encouraged the growth of crediting.

At the end of 2006, 90% of total loans to non-banks were issued to resident borrowers, of which 46% were received by private non-financial companies, 44% – by households, and 9% – by financial institutions.

23% of total loans granted to resident borrowers were loans in lats. The share of loans issued in lats and US dollars in the credit portfolio is gradually decreasing, while the share of loans issued in euros is increasing and amounted to 73% of the credit portfolio at the end of 2006, i.e., by 14 percentage points more than a year ago.

Figure 4.31

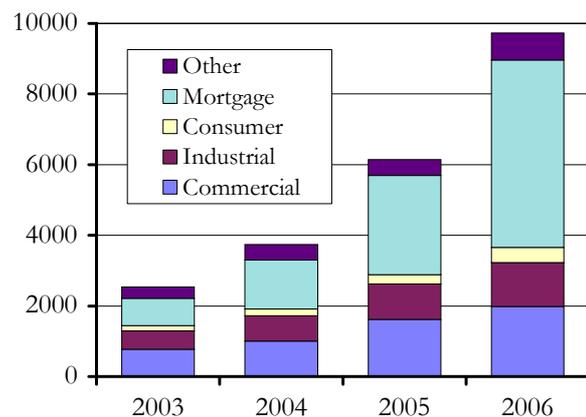
Bank Credits to Domestic Companies, Individuals and the Government, Quarterly Profile
(end of period, million LVL)



Mortgage crediting develops rapidly. The volume of issued mortgage loans rose by 89% in 2006. The share of mortgage loans in credit portfolios of banks has grown from 22% at the end of 2002 to 46% at the end of 2005 and 55% at the end of 2006. The share of commercial loans (to increase current assets of companies) in the total credit portfolios of banks was 20% at the end of 2006, while the share of industrial loans (for acquisition of fixed assets and financing of long-term investment projects) amounted to 13% (see Figure 4.32).

Figure 4.32

Volume and Structure of Loans to Domestic Companies and Individuals
(end of period, million LVL)

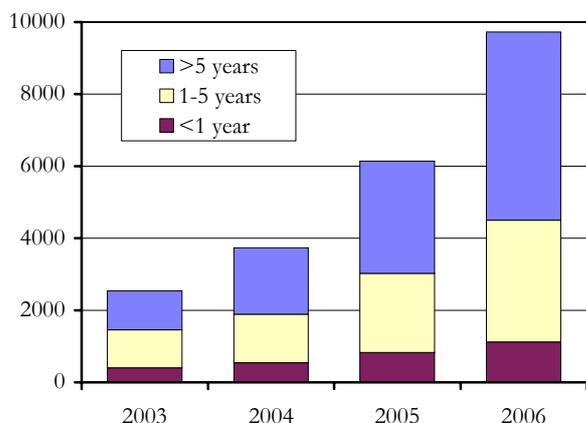


Some positive changes have taken place concerning the loan term and the quality of credit portfolio. The share of short-term loans in the total structure of loans is decreasing, whereas the share of long-term loans is increasing (see Figure 4.33). The share of long-term loans in the total credit portfolio was 52% at the end of 2006.

¹ To compare: the proportion of loans against GDP at the end of 2006 was 80% in Estonia, 47% in Lithuania and above 100% in euro zone.

Figure 4.33

Term Structure of Loans to Domestic Companies and Individuals
(end of period, million LVL)



While the amounts of crediting are increasing, the quality of loans is not decreasing. At the end of 2006, the quality of loans issued by banks was as follows: 99.3% of all issued loans were evaluated by banks as standard loans, 0.2% were evaluated as loans under supervision, and only 0.4% were evaluated as

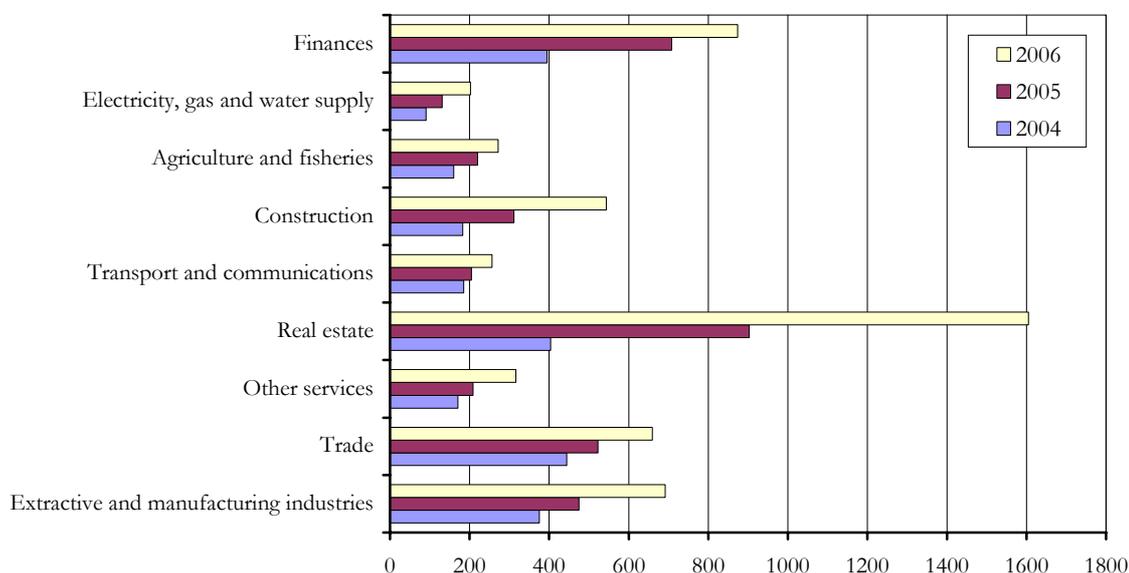
loans generating no income (sub-standard, doubtful, or lost)¹. In compliance with requirements of the Bank of Latvia, loans generating no income are secured by special savings hence this category of loans does not present a serious threat to stability of banks. Special savings for claims against non-banks reached LVL 57 million at the end of 2006, exceeding the volume of loans generating no income by 17%.

At the end of 2006, the biggest amounts of loans had been granted by commercial banks to the following national economy sectors: real estate transactions, financial mediation, manufacturing and trade, which received 30%, 16%, 13% and 12% respectively of the total volume of loans to national economy sectors (24%, 19%, 13% and 14% respectively at the end of 2005).

From the end of 2002 to the end of 2006, the balance of long-term loans increased most rapidly in the sector "Real estate transactions, lease, computer services, science and other commercial services" (13 times), in construction (6.3 times), agriculture and fisheries (3.7 times), financial mediation (3.5 times), and extractive and manufacturing industries (3 times). In 2006, crediting grew fastest in real estate transactions (by 78%) and construction (by 74%) (see Figure 4.34).

Figure 4.34

Balance of Long-Term Loans Granted to Companies in National Economy
(end of year, million LVL)



Responding to the rising domestic demand, the Bank of Latvia has raised the refinancing rate and the reserve requirement several times since March 2004 in order to slow down the rapidly growing lending. However, the efficiency of these measures in Latvia has been limited by the fixed currency exchange rate regime and several specific factors, such as the relatively easy access by banks to foreign resources and

a relatively high share of loans issued in foreign currencies in the total structure of loans.

On March 6, 2007, the Cabinet of Ministers supported the action plan to curb inflation, which, among other things, envisages carrying out several measures to control the growth of crediting. For loans to be granted, it will be required to determine a

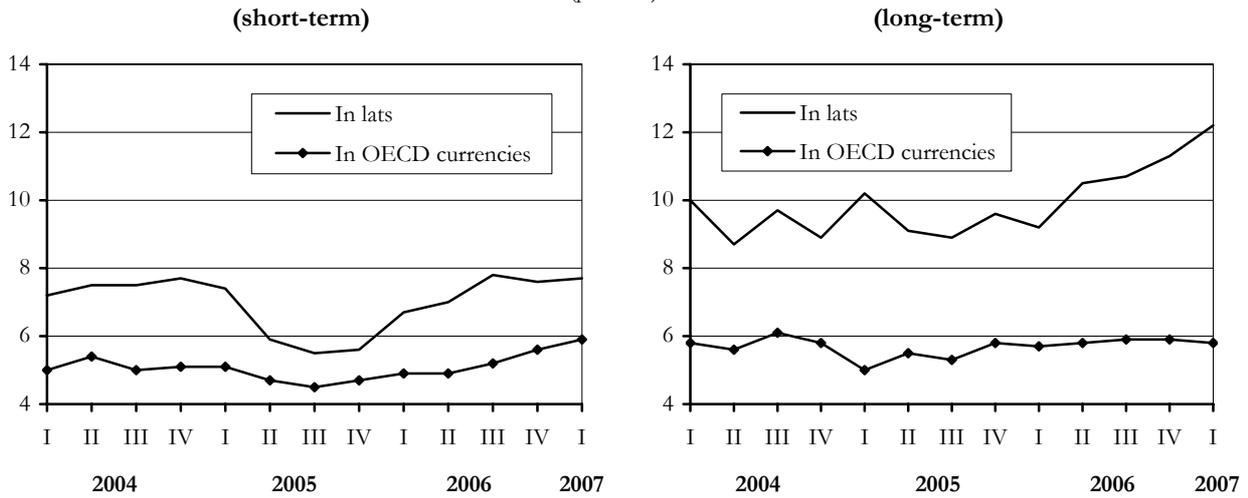
¹ To compare: 0.7% of issued loans were evaluated as generating no income at the end of 2005, 1.1% by the end of 2004, and 1.4% at the end of 2003.

compulsory initial payment in the amount of at least 10-15% of the loan as well as define the maximum volume of the loan against the value of collateral. It is also decided to create a common general register of borrowers, comprising all financial institutions (both the mortgage and consumer loans), so that financial institutions would be aware of the true volume of debts of their customers.

The dynamics of loan interest rates is shown in Figure 4.35.

Figure 4.35

Average Weighted Interest Rates on Loans in Credit Institutions, Quarterly Profile
(per cent)



In the 1st quarter of 2007, the average weighted annual interest rate for short-term loans in lats to companies and individuals was 7.7%, the rate for long-term loans in lats was 12.2%, while the respective rates for loans in OECD currencies were 5.8% and 5.8%¹.

In the 1st quarter of 2007, the average weighted annual interest rate for short-term deposits in lats was 4.3%, the rate for long-term deposits in lats was 5%, while the respective rates for deposits in OECD currencies were 3.3% and 4.3%.

¹ Short-term with floating interest rate.

5. LABOUR MARKET

5.1. Employment and Unemployment

Rapid economic development of Latvia positively influences the situation in the labour market – employment grows, the unemployment rate decreases and the number of economically active persons increases. The number of employed persons has increased by 2.6% on average annually in the last three years (2004-2006), while the unemployment rate has decreased from 10.6% in 2003 to 6.8% in 2006.

In the last three years (2004-2006), the **employment rate** in Latvia has increased by 4.5 percentage points. In 2003 the employment rate in Latvia was by 1.1 percentage points lower than the EU average, while in 2006 it exceeded the EU average by 1.6 percentage points.

The Lisbon Strategy has set a target to achieve the average EU employment rate of 70% by 2010. This target is already achieved by Denmark, Sweden, Netherlands, Austria and the United Kingdom. The employment target of Latvia, set in the National Lisbon Programme of Latvia (see Chapter 6.1) for 2010, is 67%, i.e., by 3 percentage points lower than the Lisbon Strategy target. The rate achieved in 2006 lags behind the set target by mere 0.8 percentage points. It is most likely that the set target rate of employment will be achieved or even exceeded in 2010.

Table 5.1

Key Indicators of Employment and Unemployment*

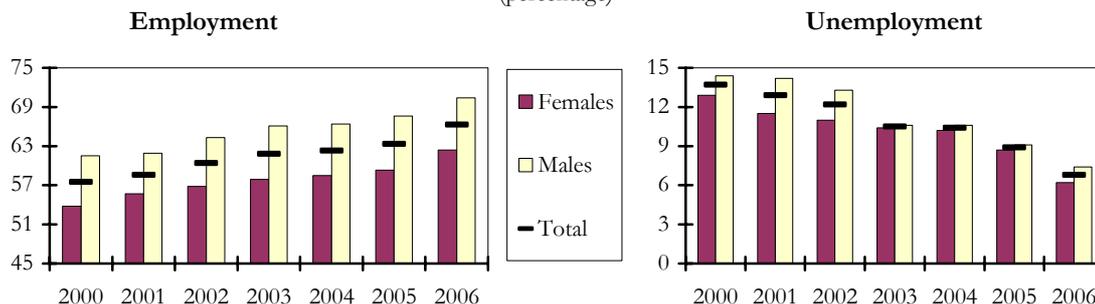
Indicators	2003	2004	2005	2006
Population in the age of 15-64 years (thousand)	1589.3	1587.3	1583.8	1580.4
Economically active persons in the age of 15-64 years (thousand)	1099.6	1105.5	1100.8	1126.1
Employed persons (thousand)	981.5	988.2	1003.6	1047.3
Participation rate (%)	69.2	69.7	69.5	71.3
Employment rate (%)	61.8	62.3	63.4	66.3
Unemployed (job seekers) (thousand)	119.2	118.6	99.1	79.9
Unemployment rate (%)	10.6	10.4	8.7	6.8
Registered unemployed persons (end of period, thousand)	90.6	90.8	78.5	68.9
Registered unemployment rate (end of period, %)**	8.6	8.5	7.4	6.5

* In the table and further in the text, indicators of employment are given for persons in the age of 15-64 years and indicators of unemployment are given for persons in the age of 15-74 years.

** Share of registered unemployed persons in the economically active population from 2002 is according to the new methodology.

Figure 5.1

Employment and Unemployment in Latvia
(percentage)



Source: Eurostat, Structural Indicators, 01.06.2007.

Female employment in Latvia is higher than the EU average and this difference tends to grow, as the female employment rate in Latvia exceeded the EU average by 2.9 percentage points in 2003 and by 5.1 percentage points in 2006. Male employment in Latvia tends to increase every year, but still lags behind the average EU level (by 4.7 percentage points in 2003 and by 1.6 percentage points in 2006).

Despite the fact that employment in 2006 increased in comparison with 2005 in the whole Latvia, employment rates in Latvian regions are still very different¹. For instance, employment rate in Rīga

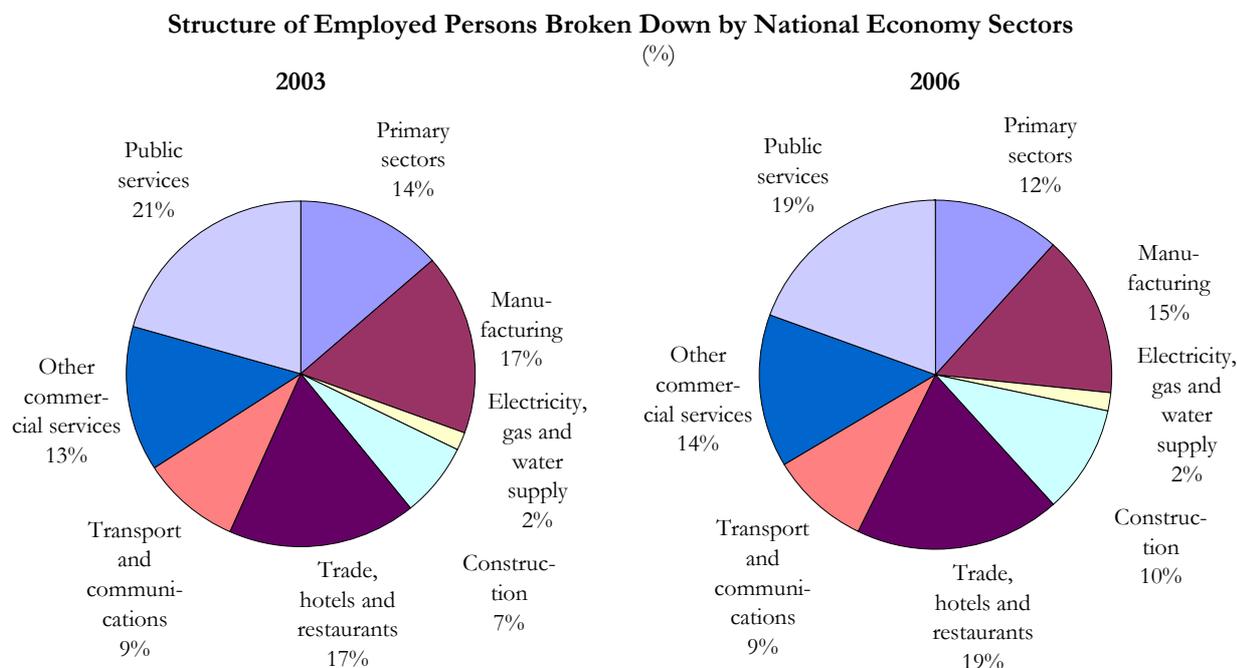
¹ In accordance with the Cabinet of Ministers Instruction No. 271 (issued on April 28, 2004), new statistical regions (Rīga, Pierīga, Vidzeme, Kurzeme, Zemgale, and Latgale) are in force as from May 1, 2005. Compared with the previous division, the territories included in the regions did not change only in Kurzeme and Latgale, but the structure of other regions changed.

was 72%, while employment rate in Latgale amounted to mere 56.8%.

Of all employed persons in 2006, 71% were employed in cities and 29% were employed in the countryside. It has to be noted that the share of employed persons in cities grows every year, but the share of employed persons in the countryside decreases.

The structure of employed persons broken down by national economy sectors has slightly changed in 2006 compared to 2003 (see Figure 5.2). The number of employed persons in service sectors has increased faster, especially the number of employed in trade and communications, while the number of employed persons in agriculture and industry has decreased.

Figure 5.2



Source: Eurostat

In 2006 Latvia took the 13th place among the EU-27 countries in terms of the employment rate, while the position of Latvia in terms of the unemployment rate (the 12th place among the EU-27 countries) has considerably improved in comparison with the previous years. Slovenia, Estonia, Lithuania, United Kingdom, Austria, Luxembourg, Cyprus, Ireland, Netherlands and Denmark had lower unemployment rates than Latvia.

The rate of *registered unemployment* in Latvia was 8.5% at the end of 2004 and 7.4% at the end of 2005, while in 2006 it was by 1.1 percentage points lower than in the preceding year and amounted to 6.5%.

The highest unemployment still remains in Latgale region. At the end of 2006, it was 14.4% and in two districts of Latgale it exceeded 20%: Ludza (23%) and Rēzekne (22.6%) districts. The high unemployment is determined by poorly developed business activity, poor self-employment and insufficient traffic infrastructure.

The lowest rates of unemployment are in Rīga city and Jelgava city, and in Rīga, Ogre, Saldus and Tukums districts (3.8%, 4.9%, 4.8%, 5.0%, 5.2% and 5.2% respectively).

The share of long-term unemployed persons (who have not been able to find a job during one year) in the total number of unemployed persons was 37.8% in 2006 and 45.5% in 2005.

The majority of all unemployed persons are representatives of simple low-skilled professions, while the highest employment rate is among persons with higher education (86.9% of persons with higher education were employed in 2006).

The majority of the unemployed in 2006 were among persons in the age of 35-54 years. The share of the pre-pension age unemployed in the total number of unemployed persons increases every year, which is greatly due to the increase of pension age according to the law on pensions.

The number of unemployed persons decreases not only due to increased employment rate. Since Latvia's accession to the EU in 2004, labour outflow takes place to some old EU member states where labour markets are open to citizens of the new EU member states. Therefore, shortage of labour force in several sectors has developed in Latvian labour market.

5.2. Labour Costs

Labour costs per production unit (ULC) constitute one of the indicators characterising competitiveness (both for the country on the whole and for separate sectors). Although productivity growth rates in Latvia in the recent years are among the highest between the EU member states, labour costs¹ (both the real and the nominal² ones) grow faster than productivity and labour costs per production unit increase.

Eurostat data show that, in the period from 2004 to 2006, ULC – real in EU member states has decreased by 2.5% on average, while it increased by 7% in Latvia. This indicates that the position of Latvia among EU member states in terms of price competitiveness deteriorates.

It should be noted that annual fluctuations of labour costs per production unit are rather high. Short-term fluctuations of ULC are greatly determined by conjuncture changes in the markets of goods and by adaptation of the labour market to these changes, which usually happens with a certain lag. Long-term fluctuations of ULC are related to structural changes in economy, which substantially change producer costs and their competitiveness.

In the current stage of development, quite substantial structural changes take place in Latvian economy, which are characterised by three main directions:

- general economic growth that is mainly based on the growth of productivity and, in the last three years, also on the growth of employment;
- rise of the general level of prices, which is greatly related to the convergence of prices;

- increase of wages (wage convergence), which is greatly affected by the growing competition in Latvian labour market after accession to the EU.

Figure 5.3

Labour Costs
(percentage changes against the preceding year)

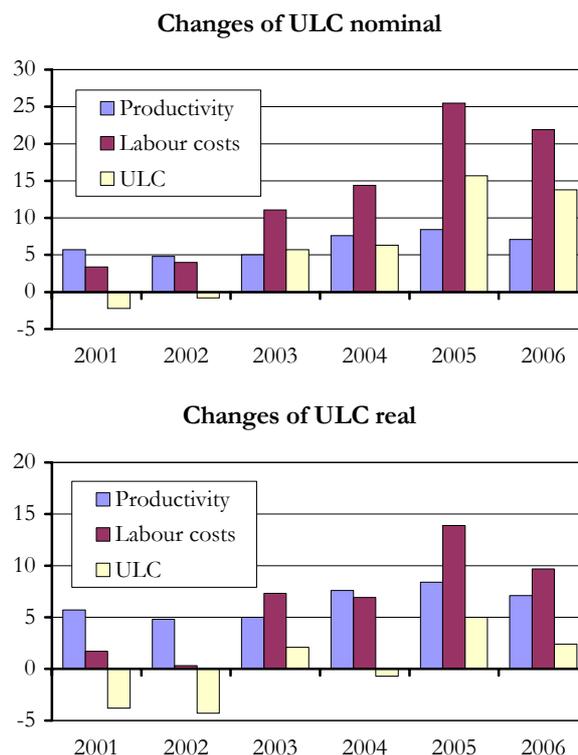
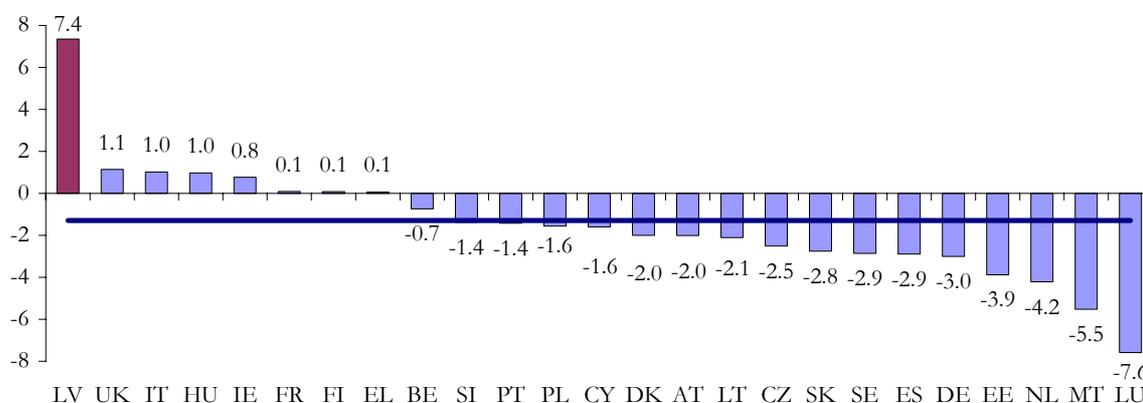


Figure 5.4

Changes of ULC – Real in EU Member States
(2006 in comparison with 2004, %)



AT – Austria, BE – Belgium, BG – Bulgaria, CZ – Czech Republic, CY – Cyprus, DE – Germany, DK – Denmark, EE – Estonia, EL – Greece, ES – Spain, EU – EU-27, FI – Finland, FR – France, HU – Hungary, IE – Ireland, IT – Italy, LT – Lithuania, LU – Luxembourg, LV – Latvia, MT – Malta, NL – Netherlands, PL – Poland, PT – Portugal, RO – Romania, SE – Sweden, SI – Slovenia, SK – Slovakia, UK – United Kingdom

Source: *Eurostat*

¹ corrected by producer price index or deflator

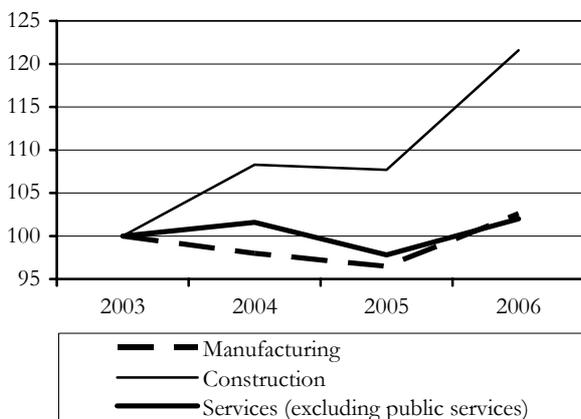
² not corrected by producer price index or deflator

The mentioned factors affect labour costs per production unit differently. The growth of productivity reduces labour costs per production unit, but the increase of wages raises these costs.

The rapid growth of nominal labour costs per production unit in the recent years was mainly determined by the rapid increase of wages. As statistical data show, the dynamics of wages was rather moderate until 2003, but wages increased fast since 2004 and have grown by 43% in the last three years (2004-2006). The growth of wages since 2004 was affected by two main conditions. Firstly, the demand for labour force increased due to the rapid economic growth, and, secondly, opening of labour market in such highly developed countries as Ireland and the United Kingdom increased competition in Latvian labour market (labour supply decreased due to growing emigration), which created a big pressure on wages. Besides, wages of the employed in Latvia were very low in comparison with the EU average level. In majority of sectors, these wages made 15-20% of the EU average. Therefore, increase of wages objectively may occur faster than dynamics of the productivity and price convergence processes.

Figure 5.5

Changes of ULC – Real by Sectors
(percentage changes against 2002)



Source: Eurostat

Dynamics of labour costs per production unit differ by sectors. As it can be seen, labour costs per production unit in 2006 only minimally exceeded the level of 2003 in almost all sectors, with the exception of construction. In construction, they were by 21.6% higher than in 2003.

Increase of wages in manufacturing in 2004 and 2005 was compensated by growth of productivity, and

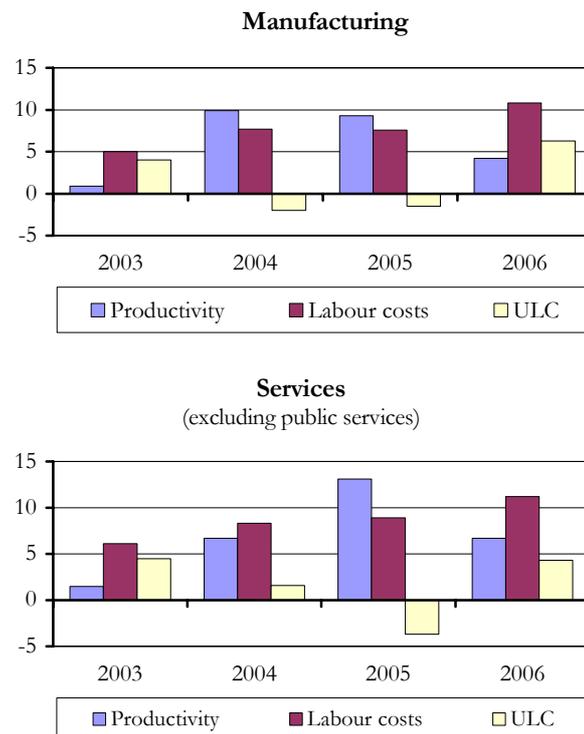
5.3. Employment Policy

Latvian employment policy is based on the EU employment strategy and the long-term employment targets formulated by the European Council in Lisbon: to reach an overall employment rate of 70% in the EU

labour costs per production unit are decreasing. Such compensation is not so typical in service sectors and labour costs per production unit have increased, with the exception of 2005. ULC – real increased both in manufacturing and in service sectors in 2006. During the last three years, labour costs per production unit have increased by 2.6% in manufacturing and by 2% in service sectors. The most rapid increases of ULC – real in 2004-2006 were in construction (by 21.5%) and in transport and communications (by 14.3%).

Figure 5.6

Changes of Labour Costs, Productivity and ULC – Real by Sectors
(percentage against the preceding year)



On the whole, one may conclude that fluctuations of labour costs per production unit are determined by fast growth of wages, which is greatly affected by the convergence process. Convergence of wages is an objective process and should be taken into consideration in the future. The main question is how it will be harmonised with the productivity growth, especially in trading sectors (export sectors). Due to the inevitable wage convergence, it is possible to maintain price competitiveness in international markets in conditions of fixed currency exchange rate only by raising the productivity in export sectors.

by 2010 (including 60% for women and 50% for pre-pension age population of 55-64 years).

In order to achieve fulfilment of the main targets of the European employment strategy, in July 2005 the

European Council accepted the Integrated Guidelines package, where three priority lines of action are formulated:

- attract and retain more people in employment, increase labour supply and modernise social protection systems;
- improve adaptability of workers and enterprises;
- increase investment in human capital through better education and skills.

According to situation, these lines of action are specified in the National Reform Programmes of the member states.

National Lisbon Programme of Latvia for 2005-2008 (hereinafter Programme) (see Chapter 6.1) sets the following priorities of Latvia's employment policy:

- promote an inclusive labour market by expanding the range of active employment measures;
- stimulate economic activities in the least developed regions;
- address the issue of undeclared work more intensively and stimulate the population to engage in the formal economy, by increasing net wages for low-paid employees and strengthening both the state control institutions and associations of social partners (trade unions, employee associations, etc.);
- expand opportunities of education and training.

The Programme envisages to reach or substantially approach the targets formulated in the European Employment Strategy and achieve the employment rate of 67% in 2010 (62% for women and 50% for persons in the age of 55-64 years).

During the last years, indicators of labour market in Latvia considerably improved due to rapid economic development, improvement and diversification of active labour market measures, and other factors. All most important employment policy targets for 2008 and partly for 2010 planned in the Programme (employment rate for women and persons in the age of 55-64 years) were already reached in 2006. However, the employment rate (66.3% in 2006), participation of population (70.3%) and other indicators of labour market still lag behind the level reached in several EU member states. The rate of job seekers (6.8%) is also rather high. At the same time, several national economy sectors start experiencing shortage of workers due to emigration of the labour force.

In order to employ the current resources of labour more completely, public institutions in co-operation with local governments and social partners expand **active employment measures**. State policy in the areas of reduction of unemployment and support to unemployed persons and job seekers is implemented by the State Employment Agency (SEA). Employer

surveys in the framework of short-term forecasting of labour market are conducted twice a year on a regular basis, professional training, retraining and raising skills of the unemployed in accordance with employer demands are organised, and other active employment measures are carried out.

Attracting also co-financing from the European Social Fund, the SEA implements the following measures of active employment policy for reduction of unemployment:

- professional training, retraining and raising skills of the unemployed;
- measures to raise competitiveness;
- measures for certain groups of persons.

The total number of employed persons involved in active employment measures financed by the state rises constantly: 38.2 thousand in 2000, 54.6 thousand in 2003 and 166.4 thousand in 2006¹, mainly due to increased competitiveness of measures (145.7 thousand job seekers in 2006).

8.6 thousand unemployed persons were involved in professional training, retraining and raising skills, 9.6 thousand were involved in paid temporary jobs, and 2.4 thousand were involved in measures for certain groups of persons (MCGP) in 2006. 797 subsidised workplaces were created by the measure "Subsidised employment of unemployed persons from target groups" implemented in the framework of MCGP. 302 workplaces were created by the measure "Subsidised employment of disabled unemployed persons" in 2006. A new active employment measure "Acquirement of working skills" is implemented this year with a goal to offer the unemployed persons an opportunity to test their professional adequacy in a particular workplace during 3 months as well as acquire the necessary skills that would facilitate finding regular work. SEA effects payment for work in the amount of minimum monthly wage, while the employer covers social security payments and may make additional payments to wages.

In order to improve competitiveness of population in the labour market, SEA plans to offer training not only to the unemployed, but also to the employed and self-employed persons since 2008 in addition to the organised active employment measures. It will be possible for entrepreneurs and branch associations to apply for co-financing from the European Social Fund for training of their employees. Also for persons who want to start their small business, the necessary training as well as subsidies and loans for the first steps in business will be available.

In order to promote provision of labour force for national economy, amendments to the Unemployed and Job Seekers Support Law have been worked out, so that SEA, with attraction of co-financing from the European Social Fund, could involve more actively the economically inactive population of working age

¹ One unemployed person may be involved in several activities.

(persons taking care of family members, disabled persons, persons with low motivation level, etc.) into active employment measures and unemployment reduction measures (career consultations, promotion of regional mobility) as from 2008, thereby promotion competitiveness of these persons and their inclusion in the labour market.

In order to raise employment rate of young people, the Professional Career Counselling State Agency (PCCSA) gives individual and group consultations in the choice of education and profession, determination of professional suitability, and career planning. In order to solve the current problems of unemployed young people with integration in the labour market, young people are prioritarily involved in active employment measures organised by SEA.

Several projects of the European Social Fund are being implemented, whose implementation increases opportunities of young people to get included in the labour market, e.g., the project "Ensuring Work Practices for Unemployed Young People".

The project "Employment Measure During Summer Holidays for Persons Acquiring Education in General, Special or Professional Education Establishments" started in previous years is continued. The aim of this measure is to promote summer employment of schoolchildren and create opportunity for them to acquire work experience. In the project, SEA finances schoolchildren's wages from state budget resources in the amount of 50% of the minimum monthly wage determined in the country and covers expenses for the manager of the work practice. Expenses of employers were constituted by schoolchildren's wages in the amount of at least 50% of the minimum monthly wage, tax payments, bonuses, lunches, etc. Approximately 12 thousand schoolchildren were involved in this measure in 2006, which is almost four times more than in 2004 (3.2 thousand).

Latvia still has considerable reserves for **inclusion of women into employment**. Women often leave work or cannot start working due to inflexible work organisation, lack of childcare institutions or other reasons. Survey conducted by the Central Statistical Bureau indicates that 43% of women, who have a child in the age under six years, did not work. Considerable difference between female and male employment rates still exists. At the same time, it has to be noted that a marked difference between female and male wages also exists. Labour force surveys carried out by CSB at the beginning of 2006 indicate that 42.4% of women were employed in low-paid work (under LVL 100, after taxes), which is 1.7 times more than among the employed men.

Due to demographic crisis, more and more attention is paid to processes of **labour force ageing**.

Forecast calculations¹ done by CSB indicate that the number of people older than 65 years will increase in 2005-2030 and their share in the total population will grow from 16.8% in 2006 to 21.3% in 2030. Projects for retaining or attraction of older people in employment are already being implemented.

In 2006, SEA started implementation of special employment measure "Prolongation of active life for seniors" for job seekers in the pre-pension and pension age. Nine new training modules are offered in its framework. Training groups consist of 6-12 job seekers, and the training is no longer than 150 academic hours. Training in provision of housekeeping services, babysitting, catering issues, etc., as well as in mastering foreign languages, information technology issues, project management, etc. are offered to retired job seekers.

With improvement of business environment in the country, growing support to **development of regions** and diversification of regional economy, employment rates in regions have considerably increased in the last years. So, the employment rate in Pierīga region has increased by 4.9 percentage points in 2006 compared to 2005 and reached 70.2%, while the employment rate in Zemgale has grown by 4.4 percentage points to 65.5%. Employment rates have considerably increased in other regions as well, but these rates are lower than in the abovementioned regions. For instance, the employment rate in Latgale has increased by 3.8 percentage points during one year, reaching mere 56.8%, while the employment rate in Kurzeme went up by 1.6 percentage points to 63.6%. Faster development in these regions is hindered by slow administrative territorial reform, shortage of skilled labour force, deterioration of road network, access to financial resources, etc.

In the planning period of 2007-2013, increase of the ESF and state financing will greatly promote improvement of situation in all regions. Activity "Support to implementation of local employment promotion plans" is envisaged, and preference to local governments with high unemployment will be given in its implementation.

Due to the growing globalisation of economy, rapid development of technologies and negative demographic processes, an increasingly bigger attention to **issues of flexicurity** (labour market flexibility and employment security) is paid in the European employment strategy. In this regard, in March 2006 the European Council asked member states to pay bigger attention to implementation of reforms in labour market and social security policies. It is necessary to achieve that labour legislation and agreements are sufficiently flexible and correspond to interests of both the employer and the employee. Operational programmes for 2007-2013 envisage activity for application of labour relations and labour

¹ Collection of CSB statistical data "Demogrāfija" ("Demography"), 2006, page 121.

safety legislation to the new situation in the labour market. It will encourage introduction of labour relations and labour safety legislation in enterprises, improvement of labour environment and rise satisfaction of the employees with working conditions, and will foster reduction of illegal employment. In case of necessity, active employment policy measures have to prepare transition of employees from one workplace to another or from the status of unemployed person to employment.

Improvement of normative regulations is taking place in Latvia in order to ensure their accordance with the current economic and social situation. The Ministry of Welfare has established a working group, which also includes social partners, for development of new proposals for amendments to the Labour Law and other normative acts.

At the same time, it is necessary to improve the lifelong learning systems that would enable employee to maintain and rise skills through all time of capacity for work, and create a modern social security system that would render adequate assistance to the population in case of unemployment as well as would promote mobility and faster return to the labour market.

It is important for entrepreneurs to ensure modernisation of work organisation, balance of the work and out-of-work life opportunities of employees, safety at work, gender equality, etc. At present, the level of labour quality in Latvia considerably lags behind the situation in EU member states in many aspects. The number of people injured in accidents at work is still high (136 cases per 100 000 employed) and is still the highest among EU member states. It is partly due to the long working week that amounts to 42.8 hours on average. It is slightly longer in the other four member states. Number of persons suffering from occupational diseases tends to grow. Data of the State Social Insurance Agency show that the number of disability cases and the total length of disability periods rapidly increase in Latvia in the last years. However, it has to be noted that trade unions, strengthening their influence in the sphere of labour protection and safe working environment, keep increasing the number of trustees on labour protection issues.

Latvia has a relatively high **rate of undeclared employment**, especially in construction, manufacturing, agriculture and transport services, which reduces social security benefits and does not allow to diminish the burden of labour taxes. In order to address this problem more intensively and stimulate population to be engaged in the formal economy, net wages for low-paid workers are being increased, raising the minimum wage and increasing the amount of non-taxable minimum, state control institutions are being strengthened and co-operation with social partners (trade unions and employer associations) is being activated. For reduction of illegal employment, the Ministry of Welfare has developed the *Action Plan*

for 2005-2009, which is approved by the Cabinet of Ministers. It envisages actions in three main directions:

- raising administrative capacity of the State Labour Inspectorate and improvement of control;
- improvement of co-operation between control institutions;
- carrying out measures for informing the society and promotion of legal culture.

The European employment strategy pays a big attention to **improvement of education and industrial training**. Investment in human capital is a determinant factor for increase of the productive capacity in order to promote transition to knowledge-intensive economy. This investment has to ensure substantial improvements in adaptability of the educational system to the changing requirements of the labour market, improve availability of education at all levels, increase participation and responsibility of regional governments and employers in ensuring availability of professional education, and create an efficient lifelong learning system.

The Lisbon Strategy envisages that at least 85% of young people in the age of 20-24 years will complete secondary education by 2010. In 2005 this indicator was 79.9% and is forecasted to exceed 85% in 2010.

The Programme for 2005-2008 envisages improving the adaptability of the educational system and students to the changing requirements of the labour market. For this purpose, the material and technical provision of professional education establishments is being modernised and a set of measures to ensure practice for students is established, using also financing from EU funds.

At the same time, gradual improvement of availability of education at all levels is taking place and measures to reduce the number of students who do not graduate or do not achieve professional education are being implemented, creating pedagogical correction programmes, applying educational services to socially excluded population groups, etc.

Lifelong learning system develops slowly. Only 7.6% of the employed in the age of 25-64 years participated in professional training activities or attended some educational establishment in 2005. A Lisbon target is to achieve involvement of at least 12.5% of employees into lifelong learning by 2010. *Lifelong Learning Policy Guidelines for 2007-2013* have been developed and accepted by the Cabinet of Ministers in February 2007. This document formulates the basic principles, objectives, directions and plan of action of lifelong learning policy.

Due to globalisation processes and gradual restructuring of economy, rapid changes in labour demand take place in the country. In order to make it possible to timely balance the demand and supply of the labour market, the Cabinet of Ministers has determined the Ministry of Economics as the responsible institution for co-ordination of medium-term and

long-term forecasting of the labour market in the country as from July 1, 2007. At present, the necessary preliminary work for starting the new function is under way.

The institutional framework to carry out labour market forecasts is being developed. Functions of the state agency “Latvian Institute of Statistics” will be supplemented with medium-term and long-term forecasting of the labour market. On the basis of this, development of the labour market will be analysed and proposals on economic policy issues will be worked out. The Ministry has developed the required draft normative acts and conducted calculations of the necessary funding, they are co-ordinated and submitted to the Cabinet of Ministers for consideration.

Labour market research at the state level is being done by the Ministry of Welfare, mostly in the framework of the ESF National Programme “Labour Market Research”. A preliminary model of labour market forecasting has been worked out. The Cabinet of Ministers has instructed the Ministry of Welfare to hand over results of the research to the Ministry of

Economics after completion of the research by July 1, 2007 at the latest. After assessment of these results, preliminary scenarios of labour market development will be prepared by the end of 2007. At present, options of usage of the model are being explored and its approbation is under way.

The European Commission, assessing the process of implementation of the Programmes of the member states in 2006, noted that, in the further work in Latvia, a bigger stress has to be put on faster increase of labour force in employment and on strengthening of professional skills of employees. During further implementation of the Programme, it would be important for Latvia to simplify the administrative formalities for hiring and firing of employees, promote education in the field of business, improve and develop active labour market policies, as well as ensure and improve access by parents to childcare institutions.

6. ECONOMIC POLICY AND PRIORITIES OF STRUCTURAL POLICY

6.1. National Lisbon Programme of Latvia for 2005-2008

On October 19, 2005 the Cabinet of Ministers approved the National Lisbon Programme of Latvia for 2005-2008 (hereinafter Programme) aimed at promotion of national growth and employment. The Programme is a policy-planning document that shows how Latvia is going to achieve the Lisbon Strategy goals in 2005-2008 on the basis of the Integrated Guidelines approved by the European Council in July 2005¹.

The Programme is based on the policy-planning documents approved in Latvia and reflects the most essential problems of Latvia for achieving the Lisbon Strategy goals, indicates the main lines of action and activities to solve the problems as well as performance indicators for achieving the goals.

National Lisbon Programme of Latvia for 2005-2008 prescribes that Latvian GDP per capita has to reach 51% of the EU average by 2008 and 54% by 2010. In order to reach this goal, annual GDP growth of 6-8% has to be ensured in 2005-2008.

Progress of implementation of the Programme² indicates that the principal goals set in it are achievable. GDP grew by 10.6% in 2005 and by 11.9% in 2006, which is faster than prescribed by the Programme. According to Eurostat estimate, GDP per capita in Latvia reached 53.4% of the EU-25 average in 2006, which exceeded the Programme's target of 2008 (51%) and is close to the target of 2010 (54%).

Indicators of employment also rapidly improve in Latvia. Employment rate reached 66.3% in 2006, which already exceeded the target rate for 2008 and lags behind the target rate for 2010 by mere 0.7 percentage points.

Latvia has defined 23 performance indicators in total for the medium-term period.

The Programme points out five main economic policy directions to reach the Lisbon goals in Latvia, namely:

- securing macroeconomic stability;
- stimulating knowledge and innovation;
- developing favourable and attractive environment for investment and work;
- fostering employment;
- improving education and skills.

For each of the main economic policy directions, main tasks (priorities) are defined and specific measures with implementation terms are determined and, if the government has decided so, also funding is set. The Programme takes into account the EU approach of the necessity to divide the economic growth from the resource use so that the economic and social progress is not achieved at the expense of excessive use of natural resources and deteriorated environmental quality.

Latvia has a goal to maintain a stable **macroeconomic environment** that is a necessary precondition for ensuring growth and workplaces. The Programme for 2005-2008 defines the following main tasks for maintaining the macroeconomic stability:

- to comply consistently with fulfilment of the Maastricht fiscal criteria in Latvia and ensure gradual reduction of the government budget deficit;
- to introduce medium-term (3-5 years) budget planning and strategic planning in ministries and, in accordance with it, base the budget formation on financing the action policy goals and results;
- to promote coherent increase of wages and labour productivity in order to disallow additional economic instability, at the same time taking into account the consequences of inflation;
- to ensure successful accession of Latvia to the euro zone.

The main activities to be carried out in the area of fiscal policy (see Chapter 4.1), which are envisaged in the Programme in order to fulfil the Maastricht fiscal criteria and ensure efficient budget spending, are being implemented rather successfully. The fiscal consolidation successfully carried out already in the previous years was continued in 2005 and 2006. The level of the general government debt in Latvia keeps remaining among the lowest in the EU and is expected

¹ In March 2000 in Lisbon, the European Council approved the EU strategic development document (Lisbon Strategy), which sets the main goal to achieve that the EU becomes the world's most competitive and dynamic knowledge-based economy in 10 years, which would ensure sustainable economic growth with more and better workplaces and greater social cohesion. In March 2005, the European Council approved the relaunched Lisbon Strategy, envisaging the necessity to focus its policy on growth and employment. It was decided that every member state has to develop a national reform programme for 2005-2008. In July 2005, the European Council approved the Integrated Guidelines for Growth and Jobs, which combine the Broad Economic Policy Guidelines and the Employment Guidelines, and they constitute a base for development of national reform programmes.

² On October 10, 2006 the Cabinet of Ministers supported the *Report on Progress in Implementation of the National Lisbon Programme of Latvia for 2005-2008*, which is developed by the Ministry of Economics and evaluates the progress in achieving the Lisbon Strategy goals.

to remain considerably below the gross government debt volume criterion in the medium-term as defined in the Maastricht Treaty.

In order to ensure purposeful development and efficient spending of the government budget resources, the ministries gradually implement the strategic planning, hence budget formation is based on financing the action policy goals and results.

On August 22, 2006 the Cabinet of Ministers adopted the draft Concept “On Implementation of Strategic Planning and Medium-Term Budget Planning in Public Administration”, which prescribes development of a budget law for one year, at the same time also working out a resource framework for three years. It is expected to introduce medium-term 3-year budget planning, starting with budget planning for 2008.

In order to prevent additional economic instability, the Programme prescribes increase of wages achieved mainly by promoting economic development (growth of entrepreneurship and labour productivity), investing in development of human resources, especially education. The Programme envisages that labour productivity will reach at least half of the EU average in 2008. According to *Eurostat* estimate, labour productivity in Latvia reached 50.5% of the EU-25 average in 2006, which exceeded the target for 2008 (50%).

One of the main goals of the government is introduction of the single EU currency euro in Latvia. Precondition for achievement of this goal is macroeconomic stability that would promote further economic growth. Taking into account that implementation of the goal set by the government to join the euro zone by January 1, 2008 is problematic due to growing inflation, the situation is being assessed and a decision for further action will be taken. In order to curb the domestic demand, on March 6, 2007 the Cabinet of Ministers supported the inflation-reduction measures that are related to budgetary and taxation policies, crediting and other spheres, which may improve the situation in the real estate market, labour market and productivity as well as competition policy.

From the viewpoint of long-term stability, the Programme sets the task to ensure sustainability of public finances as a priority. Assessment of sustainability of Latvian public finances is positive and, according to evaluation by the ECOFIN Council, Latvia is among the countries with a low risk of sustainability of public finances.

Economy based on **knowledge and innovation** is a precondition for development and competitiveness of Latvian national economy. The main tasks of the Programme in 2005-2008 are as follows:

- to increase public investment and foster private investment in research and development;
- to ensure renewal of the intellectual potential in science, improving the system of doctoral grants and modernising the scientific infrastructure;

- to promote transfer of knowledge and technologies in production (including business incubators and technology parks);
- to increase internet availability and introduce electronic signature as well as ensure wider public services in e-environment.

The Programme sets the target that gross domestic expenditures on research and development have to reach 1.5% of GDP in 2010. In order to reach this target, according to the *Law on Scientific Activity* the annual increase of financing for scientific activity in the state budget is prescribed to be at least 0.15% of GDP or by LVL 10-15 million on average annually, at the same time improving the procedure of granting public funding for scientific activity, which is set out by normative acts. Substantial modernisation of scientific infrastructure in research institutes and higher educational establishments and reorganisation of state science institutes are envisaged.

Public financing for research and development amounted to LVL 23.3 million in 2005, which was by LVL 13.6 million more than in 2004. Gross financing for research and development was LVL 50.6 million or 0.57% of GDP. Increase of public financing for research and development was mostly channelled to public research programmes in priority scientific disciplines determined by the Cabinet of Ministers Instruction “On Priority Scientific Disciplines for Financing Fundamental and Applied Research in 2006-2009”, ensuring basic funding for science institutes, and development of scientific activity at higher education establishments.

According to provisions of the Programme, Latvia improves activities of measures related to technology transfer and strengthening co-operation between educational and research institutions and industries (see Chapter 6.5).

In order to encourage private investment in applied research, promote technology transfer and ensure introduction of research results into production, the functions of the Latvian Investment and Development Agency (LIDA) are being expanded. As from June 1, 2006 the Technology Agency is established, which is integrated in LIDA as a separate structural unit. LIDA will administer the corresponding state support programmes, will conduct analysis of the innovation system and instrument efficiency on a regular basis, will promote application of knowledge (especially outside Riga Planning Region), will prepare proposals for new innovation policy support instruments and co-ordinate their development, will prepare, co-ordinate and manage innovation international co-operation projects, etc.

The Programme envisages several measures for improvement of innovation support structures in order to promote transfer of knowledge and technologies and encourage development of new products and technologies. The target is to increase the number of innovative enterprises to 32% of all

enterprises in 2008 and raise the number of national patents to 95, of which 24 are international ones.

In the next financial perspective period (2007-2013), it is planned to implement new programmes (see Chapters 6.2 and 6.3) directed to promotion of co-operation between industries and research institutions, such as:

- support to competence centres;
- development of technology incubators;
- support to innovation incubators;
- continuing implementation of programmes for support to innovation in the private sector.

The government has set several tasks for faster development of the information society. The first thing to be ensured is free competition in the market of information and electronic communication services, and a lot is already done in this regard. Progress is reached in terms of the increase of the number of Internet users. Introducing the current policy, good distribution of telecommunications has been achieved, legal acts related to ICT have been adjusted, main registers and the most essential information systems have been formed, integration of information systems of public administration and formation of online services are being developed (see Chapter 6.6).

The Programme also foresees to encourage widespread use of ICT in public services, SME and households by developing various channels and organisations for provision of services, building the technical and organisational infrastructure for complex provision and convenient use of services, establishing a single state portal, and improving co-operation of public registers.

In order to promote creation of effective and competitive industry with rational sectoral structure correspondent to conditions of Latvia, which would ensure high economic growth rates also in the future, the Programme envisages provision of bigger support to development of clusters. The goal is to stimulate increased competitiveness and productivity of enterprises, promoting their mutual co-operation and collaboration with educational, scientific, research and other related institutions. It is planned to conduct study on the potential of cluster creation and, through a tender procedure, provide support for development of three most perspective clusters.

Conditions for ensuring a **conducive environment for investment and work** improve every year: obstacles to EU internal market freedoms are basically prevented, tax burden is diminished, competition is strengthened, and liberalisation of monopoly sectors has been started.

The Programme sets the following main tasks as priority directions for creation of favourable and attractive environment for investment and jobs in 2005-2008:

- to promote entrepreneurial culture, lessen administrative obstacles and burden, create supportive environment for SME;

- to strengthen supervision of competition and ensure effective competition in public services;
- to improve and develop the transport infrastructure, increase the number of connections with other European infrastructure networks;
- to speed up the administrative territorial reform;
- to ensure effective, safe and sustainable energy supply, supporting decisions of the 2006 Spring European Council.

The Programme foresees to prepare and implement the *Action Plan for Improvement of Business Environment* annually (see Chapter 6.4), including recommendations of entrepreneurs, social partners and the Foreign Investors Council in Latvia (FICIL) into this plan.

Priority in the field of competition protection (see Chapter 6.8) is combating the gravest violations of the Competition Law – conclusion of prohibited agreements and abuse of dominant position. In order to implement this, amendments to the Competition Law have been made and regulations of the Cabinet of Ministers have been approved, envisaging the so-called Tolerance Programme in application of fine. Public funding is granted for measures to ensure efficient implementation of the transposed directives, performing adequate market surveillance, which would create favourable business environment and fair competition and reduce consumer risks of traumas and getting hurt in accidents, using unsafe goods or services.

In order to improve access of SME to funding, more attention is paid to granting funds for business development in early stage (measures for access to seed capital, opportunities to obtain loans on preferential terms) and access to finance in the form of risk capital as well as to co-funding for development projects of entrepreneurs in the territories requiring special assistance (see Chapter 6.7).

Such support programmes as loan and leasing guarantees, export guarantees, heightened-risk loans, fund of venture capital funds, and business angels network are envisaged for the planning period of 2007-2013. Financial support to companies and innovation from the structural funds in the amount of EUR 480 million is planned in the next financial perspective period.

In order to ensure improvement of condition of the state road network and raise the load-carrying capacity of the road surfacing and bridges in accordance with EU requirements, the share of the state budget revenues from the excise tax on oil products channelled to roads is gradually increased (65% in 2007 and 70% in 2008), including increased financing for maintenance and development of 2nd class state roads, in order to promote development of regions.

The Programme pays special attention to quality improvement and development of international transport corridors, including both *Via Baltica* and

East–West road corridors and the East–West railway corridor as well as development and rise of competitiveness of the port infrastructure.

In order to encourage development of local governments, the Programme especially stresses the necessity to carry out the administrative territorial reform of local governments in order to create an optimum administrative and organisational structure of local governments and promote their capacity, which would foster development of regions. Timetable for completion of the reform is set until the local elections in 2009. The Cabinet of Ministers approved draft territorial division of local governments, which serves as a base for implementation of the reform. Several financial support instruments have been created to promote implementation of the reform in accordance with the Law on Administrative Territorial Reform.

In order to ensure formation of strong local governments, it is planned to implement measures for strengthening capacity of local governments in the programming period of 2007-2013 in the framework of the EU Structural Funds' Operational Programme "*Human Resources and Employment*", supporting skills improvement of the current local government employees and ensuring recruitment of skilled specialists to regions and local governments. In order to encourage economic activities in territories requiring special assistance, the grant scheme "Support to Investment in Development of Enterprises in Territories Requiring Special Assistance" has been implemented.

Latvia particularly supports the decision of the Spring European Council meeting regarding the energy policy. It is important to improve security of energy supply and diversify energy sources, thereby reducing dependence of EU member states from one energy supplier. Latvia fully supports the idea to develop a common EU energy policy and use a co-ordinated approach in relations with third countries as well as establish a crisis management system. Latvia is particularly interested in integration of the Baltic States' energy market into the single EU energy market. At present, the energy market of the Baltic States is isolated from the EU energy market. Co-operation projects with the neighbouring countries are being developed or implemented in order to decrease the energetic isolation from other EU member states.

Latvia is in the completion stage of opening the common electricity market for all consumers, envisaging to open it by the mid-2007. It is planned to open the domestic gas market by 2010. In this way, competition in the energy market will be ensured. The government has accepted the Energy Development Guidelines for 2007-2016 that envisage several strategic measures to reduce the energy dependence of the state, among them construction of a new power station in Latvia and increased use of renewable energy resources (especially biomass) in energy production.

Taking into account the policy implemented by the EU in the field of climate change reduction and the energy supply security issue topical for Latvia, sustainable use of energy resources is one of priorities of the state. Therefore the government supports measures aimed at raising the energy efficiency and use of cogeneration and renewable energy resources as well as promotes development of environmental technologies.

Although **employment** in Latvia has increased in the last years, which was affected by the economic growth, there are considerable regional differences in employment and unemployment, incompatibility of employee skills with labour market requirements, relatively high rate of undeclared employment, high unemployment rate among young people, persons after childcare leave, disabled persons, people with insufficient knowledge of Latvian language and other socially excluded risk groups in the labour market.

The Programme for 2005-2008 defines the following main tasks for fostering employment:

- to promote inclusive labour market;
- to encourage economic activities in the least developed regions;
- to reduce the undeclared employment.

Life-cycle approach to employment, improvement and diversification of active employment measures along with development of labour market institutions, employment partnerships and social dialogue are the basic elements that make up the set of employment policy measures of the Programme. Latvia has the target to reach employment rate of 65% in 2008 (including 61% for women and 48% for older people) and 67% (62% and 50%) respectively in 2010.

Development of employment and unemployment indicators in the recent years (see Chapter 5.1), especially in 2006, indicates that Latvia may exceed the targets set in the Programme. During the last three years (2004-2006) the employment rate has increased by 4 percentage points and already exceeded the EU average in 2006.

It is envisaged to make improvements of employment promotion measures and preventive measures of unemployment reduction in the Programme by improving professional training and retraining of the unemployed and raising skills, carrying out measures for the rise of competitiveness (among them teaching of the state language) and diversifying active employment measures in accordance with the needs of the regions.

The Programme particularly focuses on the measures related to inclusion of young people, pre-pension age people and women (especially after childcare leave) as well as the disabled and people from other social exclusion risk groups in the labour market.

Support to development of business activity in territories requiring special assistance is provided both in the framework of national financing (Regional

Fund) and by the use of EU financial resources (European Regional Development Fund), encouraging economic activities in these territories, creating new workplaces and maintaining the current ones.

The growing activity of entrepreneurs and the achieved performance indicators show growth of business activity in territories requiring special assistance. Therefore a new support programme for development of entrepreneurship in territories requiring special assistance is being worked out for the planning period of 2007-2013 in the framework of EU structural funds.

In order to increase economic activities in the least developed regions more effectively, it is envisaged to increase faster the budget expenditures for putting in order the 2nd class roads. LVL 3.5 million were allocated in 2006, while allocation of LVL 12 million is envisaged in the next years.

There is no single particular measure that would guarantee substantial reduction of undeclared employment (shadow economy). Set of measures involving all stakeholders is important. Therefore, the Programme envisages both raising administrative capacities of the State Labour Inspectorate and strengthening the role of the trade and employer unions for solution of the problem as well as stresses the necessity to raise the minimum wage and increase the untaxed minimum in order to reduce the tax burden for persons with low incomes.

The minimum monthly wage was increased from LVL 80 to LVL 90 as from January 1, 2006 and to LVL 120 as from January 1, 2007, the monthly minimum not subjected to personal income tax was raised from LVL 26 to LVL 32 as from January 1, 2006 and to LVL 50% as from January 1, 2007, and the monthly tax allowance for dependent person was increased from LVL 18 to LVL 22 as from January 1, 2006 and to LVL 35 as from January 1, 2007.

Investment in human capital – **improvement of education and skills** – is a decisive factor for raising the productive capacity in order to promote progress towards knowledge-intensive economy.

The Programme envisages the following main tasks for improvement of education and skills in 2005-2008:

- to strengthen co-operation between public administration bodies, education establishments and employers in order to adjust the supply of educational system in accordance with labour market needs;
- to raise cost efficiency at all stages and forms of education;
- to improve availability of education at all levels and reduce the number of those students who do not complete their studies or do not obtain professional qualification;
- to increase availability of life-long learning and motivation of population in this area;

- to raise the overall level of technological skills and natural science knowledge, improve the professional orientation system and ensure availability of professional orientation services for all population in the context of life-long learning.

The Programme sets a goal to raise the education level of young people, which is quantitatively defined for 2010 – the share of young people (20-24 years) with at least a secondary education would reach 85%. This indicator corresponds to the target indicator set by the EU for 2010.

In order to settle these tasks, the Programme pays a big attention to measures for improvement of professional education (both the secondary and the higher), such as modernisation of the material and technical provision and the practical teaching of professional education institutions, and development and implementation of an information campaign in order to raise prestige of engineering sciences, natural sciences, medicine and other fields necessary for development of Latvia.

The Programme stresses the necessity and includes measures to increase availability of higher education and its conformity with labour market needs. For this purpose, the number of study places financed from the state budget has been raised in natural sciences, engineering sciences and environmental sciences, the amount of student loan and funds of grants in higher education institutions have been increased, the set of normative measures to ensure practice for students has been established, etc.

In 2005/2006 academic year, the number of places financed from the state budget was raised in conformity with the labour market needs in such thematic groups of education as engineering sciences and technology, natural sciences and mathematics, health, healthcare and social care. The number of study places financed from the state budget was increased by 553 places in 2006, including by 338 places in engineering sciences and natural sciences. In percentage, the number of study places financed from the state budget in the fields required by the labour market was 44% in 2006 financial year, including 31% in engineering sciences and 13% in natural sciences, mathematics and information technologies.

Lifelong learning system that would provide opportunity for population to adapt to the conditions of the changing labour market is being created. The government has approved the lifelong learning strategy (Lifelong Learning Policy Guidelines for 2007-2013).

Utilisation of structural funds of the European Union facilitates achieving the targets set in the Lisbon Strategy in Latvia. Approximately 67% of financial resources from structural funds in 2004-2006 planning period were channelled for implementation of priorities of the Lisbon Strategy. Priorities of Latvia for work in the next seven years are also clear, namely, raising competitiveness and development of a

knowledge-based national economy. The government has identified three main priorities for further development of the country in the period of 2007-2013, namely, educated and creative person, technological excellence and flexibility of enterprises, development of science and research (National Development Plan of Latvia for 2007-2013).

EUR 4.53 billion in total was allocated to Latvia from the EU structural funds in the new period, of which EUR 2.99 billion are planned to use for three priorities:

- development and efficient use of human resources (education, health and employment, EUR 1.139 billion in total);
- increase of competitiveness and progress towards knowledge-intensive economy (science, innovation, competitiveness, EUR 718 million in total);
- improvement of public services and infrastructure (tourism, regional development, energy efficiency of housing, environment, transport, EUR 1.132 billion in total).

EUR 1.539 billion is constituted by the financing from the Cohesion Fund, which is envisaged for projects of transport and environmental infrastructure as well as for energy efficiency and promoting use of renewable resources.

Consistently implemented economic policy directed towards the establishment of a new knowledge-based economy and fostering employment provides an opportunity for Latvia to achieve the targets set in the Lisbon Strategy.

In order to provide **co-ordination and supervision of implementation of the Lisbon Strategy**, the government has developed the mechanism for monitoring of the implementation in Latvia and has established:

- the Supervisory Board of the Lisbon Strategy, in order to ensure fulfilment of the tasks set in the Lisbon Strategy in Latvia. The Board is chaired by the Minister of Economics approved by the Cabinet of Ministers as the co-ordinator of the Lisbon Strategy's implementation and supervision. Ministers and representatives of the Saeima, local governments and social partners, who are linked to the Lisbon process, are included in the Board. Tasks of the Board are to co-ordinate development of the National Lisbon Programme of Latvia and involve public bodies, the Saeima, local governments and social partners in development of the Programme as well as supervise fulfilment of the Programme and inform the society about fulfilment of its tasks;
- the Advisory Working Group of the Lisbon Strategy, in order to ensure development of the National Lisbon Programme of Latvia and its implementation at the inter-

institutional level. The Working Group is chaired by the State Secretary of the Ministry of Economics. Senior officials of the ministries linked to the Lisbon process are included in the Working Group.

Meetings of the Supervisory Board of the Lisbon Strategy and of the Advisory Working Group of the Lisbon Strategy are held at least once per quarter.

Social dialogue is important for achieving the goals of the National Lisbon Programme of Latvia for 2005-2008. That is why the Programme foresees several measures for improvement of the social dialogue both at the national and the regional levels. Institutions involved in the employment partnership, among them the Employers' Confederation of Latvia and the Free Trade Union Confederation of Latvia, will be strengthened in the framework of the national programme "Support to capacity-building for implementation of the labour market and gender equality policies in the responsible institutions, distribution of information and raising awareness" co-financed from ESF. In the framework of the Programme, also capacities of Latvian local and regional governments and the Latvian Association of Local and Regional Governments are being built in order to ensure development of employment partnership and social dialogue at the local and regional government level.

Since September 2005, the Programme was presented and discussed:

- at the European Affairs Commission of the Saeima;
- at the Sub-commission on Latvia's Future Development of the Education, Culture and Science Commission of the Saeima;
- at the National Economy Council;
- at the Latvian Council of the Small and Medium-Sized Enterprises and Crafts;
- at the Free Trade Union Confederation of Latvia;
- in the framework of the seminar "Building the institutional capacity in Kurzeme region";
- at the Intelligence Conference of Latvia, etc.

The EU Information Agency organises discussions on Lisbon Strategy issues on a regular basis.

On December 12, 2006, the European Commission published the annual Progress Report that assesses the progress in implementation of the Lisbon Strategy in the EU and EU member states. In this annual progress report, the European Commission came forward with recommendations for every EU member state, which were adopted (with small corrections after discussions at various EU institutions) by the Spring European Council on March 8-9, 2007. Assessment of implementation of the Programme and recommendations for Latvia by the European Commission are reflected in Box 6.1.

Box 6.1**Assessment of implementation of the Programme and recommendations for Latvia by the European Commission**

The European Commission believes that the main challenges for Latvian economic policy are as follows:

- development of more concrete measures to secure macroeconomic stability and prevent the overheating of the economy;
- further development of the research and development (R&D) strategy to improve prioritisation and increase private sector involvement;
- implementation of stronger measures to increase labour supply and strengthen skills of the labour force.

Recommendations of the European Commission to Latvia are as follows:

- maintain economic and budgetary sustainability by pursuing a more restrictive fiscal policy, so as to contribute to the prevention of overheating, and a careful prioritisation of expenditure;
- make faster progress in the implementation of the research and innovation policy reforms, in order to meet effectively the ambitious targets defined in the National Lisbon Programme of Latvia for 2005-2008. This concerns especially the promotion of co-operation between research and education institutions and businesses;
- intensify efforts to increase labour supply and productivity by improving regional mobility, enhancing the responsiveness of education and training systems to labour market demands and putting in place a lifelong learning system.

In addition, Latvia has to focus more on:

- establishing a single contact point for the administrative formalities involved in hiring the first employee;
- promoting entrepreneurship education;
- pursuing active labour market policies and improving access to childcare services.

In order to successfully fulfil the recommendations and suggestions of the European Commission and start implementing the new initiatives, a meeting of the Supervisory Board of the Lisbon Strategy was called on January 24, 2007. During this meeting, discussions about measures directed to fulfilment of recommendations and

suggestions of the European Commission and implementation of the new initiatives took place.

Specific proposals for fulfilment of the European Commission recommendations are being worked out, which will be included in the 2007 *Report on Progress in Implementation of the National Lisbon Programme of Latvia for 2005-2008*.

6.2. Integration of Latvia in the Economic and Structural Policy of the EU

6.2.1. Utilisation of the European Union Structural Funds and Cohesion Fund

Absorption of the European Union Structural Funds

Latvia as EU member state has access to the financial support from the EU Structural Funds, which is an instrument for implementation of the EU regional cohesion policy.

The goals regarding the planned use by Latvia of the support from the Structural Funds are set out under the Development Plan or the Single Programming Document (SPD). The Single Programming Document for the Structural Funds Objective 1 programme 2004-2006 for Latvia was approved by June 17, 2004 decision of the European Commission C(2004) 2121 (see Box 6.2).

Box 6.2**Priorities of the Development Plan**

Financing from the Structural Funds will be granted for implementation of priorities set out under the Development Plan:

Priority 1 – promotion of balanced development (EUR 269 million), which includes the following measures:

- 1.1. improvement of environmental and tourism infrastructure;
- 1.2. development of accessibility and transport system;
- 1.3. development of information and communication technologies;
- 1.4. development of education, healthcare and social infrastructure.

Priority 2 – promotion of business activity and innovations (EUR 209 million), which includes the following measures:

- 2.1. support to development of innovations;
- 2.2. business infrastructure development;
- 2.3. enhancing business support measures for small and medium-sized enterprises;
- 2.4. access to financing for small and medium-sized enterprises;
- 2.5. support to public research.

Priority 3 – development of human resources and promotion of employment (EUR 175 million), which includes the following measures:

- 3.1. promotion of employment;
- 3.2. development of education and continuing education;
- 3.3. eradication of social exclusion.

Box 6.2. continued

Priority 4 – promotion of development of agriculture and fisheries (EUR 170 million), which includes the following sub-priorities:

Sub-priority 4.1 – promotion of development of agriculture and rural areas, which includes the following measures:

- 4.1.1. investment in agricultural enterprises;
- 4.1.2. support for young farmers;
- 4.1.3. improvement of processing and marketing of agricultural products;
- 4.1.4. enhancing development and adaptation of rural areas;
- 4.1.5. forestry development;
- 4.1.6. development of local capacity by providing support to sustainable rural communities (LEADER + measure);
- 4.1.7. training;

Sub-priority 4.2 – promotion of sustainable development of fisheries, which includes the following measures:

- 4.2.1. balancing fishing intensity;
- 4.2.2. fleet renewal and modernisation of fishing vessels;
- 4.2.3. improvement of processing and marketing of fishery and aquaculture products, development of fishing port facilities and infrastructure;
- 4.2.4. development of coastal fishery, socio-economic measures, promotion of conquering new market outlets and support to producer organisations.

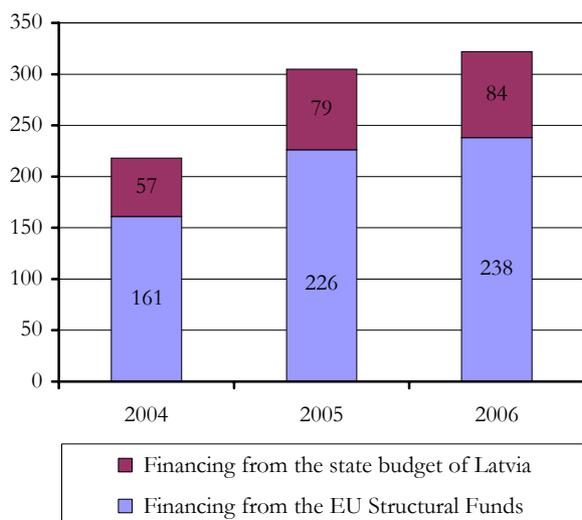
Priority 5 – technical assistance (EUR 22 million).

Total funds accessible in the Structural Funds framework, to which the beneficiaries could apply, were made up of financing from the EU Structural Funds and the national financing (co-financing from the state budget and budgets of local governments of the Republic of Latvia). The financing amount from the EU Structural Funds is 75%, while 25% is financed from the state budget and budgets of local governments. In order to apply for support from the Structural Funds, the beneficiary has to provide its own co-financing.

Total financing accessible to Latvia in the framework of Structural Funds programmes in 2004–2006 amounts to EUR 845 million (EUR 625 million from the EU Structural Funds and EUR 220 million from the state budget of the Republic of Latvia) (see Figure 6.1).

Figure 6.1

Financing from Structural Funds to which Latvia has Access
(million EUR)



Financing of EUR 625 million from the EU Structural Funds is made up of resources from the following funds:

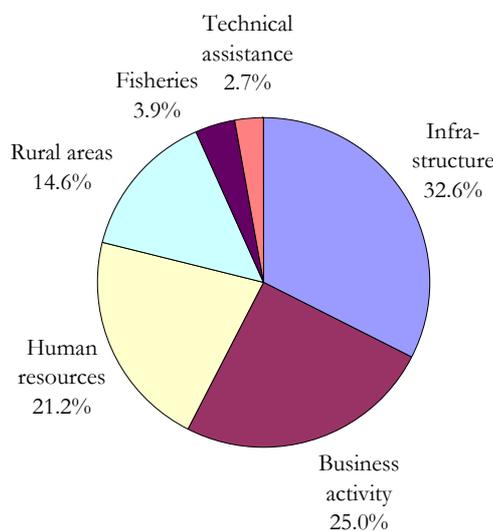
- European Regional Development Fund (EUR 369 million);

- European Social Fund (EUR 139 million);
- Guidance Section of the European Agricultural Guidance and Guarantee Fund (EUR 93 million);
- Financial Instrument for Fisheries Guidance (EUR 24 million).

Breakdown of support from the Structural Funds by sectors shows that the biggest part of the financing (32.6%) is envisaged for infrastructure projects and projects for promotion of business development (25%) (see Figure 6.2).

Figure 6.2

Breakdown of Support from the Structural Funds by Sectors for 2004–2006



According to the informative report of the Minister for Special Assignments in Managing EU Resources¹ on implementation of activities of the Single Programming Document and use of financing,

¹ Informative report “On absorption of the European Union financial resources (Structural Funds and Cohesion Fund)” of the Minister for Special Assignments in Managing EU Resources, May 15, 2007

absorption of EU financial resources proceeds successfully in Latvia.

In the biggest part of support programmes, absorption of resources from the EU Structural Funds had to be completed by December 31, 2006 – conclusion of agreements with the end beneficiaries had to be completed in order to ensure implementation of projects and payment of financing by the end of 2008. Projects for total available financing (100%) from the SF have been co-ordinated in Structural Funds Steering committees by March 31, 2007. Projects were approved for 101.17% of the available financing in the framework of the European Regional Development Fund (ERDF), for 98.39% in the framework of the European Social Fund (ESF), for 100.45% in the framework of the Guidance Section of the European Agricultural Guidance and Guarantee Fund (EAGGF) and for 99.55% of the available financing in the framework of the Financial Instrument for Fisheries Guidance (FIFG). In order to ensure the use of resources as successful and complete as possible, every responsible ministry, for implementation of activities in its sphere of competence in accordance with instructions of the Cabinet of Ministers, envisages assuming surplus obligations (state budget resources that do not exceed 10% of the total available financing). Hence, projects in the framework of ERDF and EAGGF are approved within the mentioned surplus obligations.

35.83 % of the total available Structural Funds financing has been paid to beneficiaries of SF financing or project implementers by the end of the 1st quarter of 2007, hence this indicator has increased by 20.83 percentage points in comparison with results in the previous report. Resources were paid most successfully in the projects co-financed by EAGGF and FIFG, where 77.12% and 71.02% respectively of the available Structural Funds financing was paid. In comparison with the indicators in the previous report, progress was observed by 25.54 percentage points in the EAGGF framework and by 35.84 percentage points in FIFG framework.

Financing paid in ERDF and ESF projects corresponds to 24.43% (progress by 16.99 percentage points in comparison with the previous report) and 33.52% (progress by 26.17 percentage points) respectively of the total resources granted from the respective fund.

By March 31, 2007 refunds of Structural Funds financing have been requested from the European Commission for 28.46% of the total financing granted to the country, which is by 14.51 percentage points more than as of March 31, 2006. By the moment, when the report was prepared, 25% of the total granted financing was received, which is close to the requested amount of refunds. Difference between the ESF resources declared in the European Commission and the refunds paid by the Commission is LVL 15.18 million (see Table 6.1).

Table 6.1

Progress in Absorption of the Structural Funds as of March 31, 2007

Fund	SF financing	Projects co-ordinated in SF management committees		Paid to beneficiaries of SF financing		Payments received from the European Commission	
	million LVL	million LVL	% of financing	million LVL	% of financing	million LVL	% of financing
ERDF	268.50	271.66	101.17	65.59	24.43	54.55	20.32
ESF	89.50	88.06	98.39	30.00	33.52	4.89	5.46
EAGGF	64.55	64.84	100.45	49.78	77.12	42.09	65.20
FIFG	17.10	17.03	99.55	12.15	71.02	8.37	48.93
Total	439.65	441.58	100.44	157.52	35.83	109.90	25.00

Implementation of ERDF activities on the whole is assessed as satisfactory. Part of the projects has been completed, and all open tenders of project applications and the biggest part of support programmes have been completed as well, which means that a big part of the projects will be completed by the end of 2007.

Financial progress of Structural Funds is assessed positively in terms of the financing attracted for projects. Considerable difference between the financing attracted for projects and the paid refunds for project implementers still remains in the case of ERDF (76.7%) and ESF (64.9%), which is unsatisfactory. In order to quicken up payments for

project implementers, amendments to respective regulations of the Cabinet of Ministers were made in January 2007. It also has to be noted that the process of making amendments to the current agreements as well as implementation of already approved projects are continuing. Hence it is expected that the indicators of Structural Funds use and of making payments will improve.

Measures and priorities of the Development Plan, which are under management of the Ministry of Economics, are characterised in Box 6.3 and Tables 6.3 and 6.4.

Box 6.3**Measures and priorities provided by the Development Plan, which are under management of the Ministry of Economics**

Being one of the branch ministries, the Ministry of Economics is responsible for management of measures and activities that are in its area of responsibility. The following measures and activities are under management of the Ministry of Economics:

Activities of Measure 1 “Environmental and tourism infrastructure development” under Priority 1 “Promotion of balanced development”:

- development of heat supply systems;
- improvement of heat supply system by lowering the content of sulphur in heating fuel;
- creation of tourism products and improvement of tourism infrastructure as well as preservation of cultural heritage and expansion of its economic potential;

Measures under Priority 2 “Promotion of business activity and innovations”:

- support to development of innovations;
- development of business infrastructure;
- strengthening the measures to support the small and medium-sized business activity;
- access to financing for small and medium-sized enterprises;

Activities of Measure 1 “Promotion of employment” under Priority 3 “Development of human resources and promotion of employment”:

- enhancing improvement of the retraining of employees;
- providing required training and consultations for launching a business.

In 2006, almost all open tenders under competence of the Ministry of Economics were completed and support programmes were implemented.

Administrative assessment of the open tender “Efficient use of cultural and historical heritage in tourism” was completed on February 28, 2006. 85 of 112 received projects were submitted to the Ministry of Economics for their further assessment according to qualitative and specific assessment criteria. 10 projects with the total support in the amount of LVL 7.62 million were approved by the ERDF Steering Committee in August 2006. Agreements with recipients of support for implementation of projects with co-financing from the Structural Funds were concluded by January 31, 2007.

In March 2006, assessment of administrative conformity of project applications in the open tender of projects “Modernisation of heat supply systems in accordance with environmental requirements and rise of energy efficiency both on the production and distribution side of the heat supply system and on the end consumer side” was completed and 64 of 87 received project applications were submitted to the project assessment commission established by the Ministry of Economics for assessment according to qualitative and specific assessment criteria. 29 projects with the total support in the amount of LVL 8.76 million were approved by the ERDF Steering Committee on November 22, 2006. Agreements with recipients of support for implementation of projects with co-financing from the Structural Funds were concluded by March 31, 2007.

6 projects with total support in the amount of LVL 3.51 million were approved in the framework of the national programme “Improvement of heat supply systems by lowering the content of sulphur in heating fuel”.

All projects of the public sector will be completed by August 31, 2008.

Measures and activities of the Development Plan’s Priorities 2 and 3, falling under responsibility of the Ministry of Economics, are aimed at provision of support to non-agricultural business activity. Resources within these priorities were allocated through state support programmes in accordance with provisions of the “Law on Control of Aid for Commercial Activity”.

Regarding the progress in implementation of ESF activities under responsibility of the Ministry of Economics, in the 1st quarter of 2006, a decision was taken to implement also the ESF national programme for the initially planned grant scheme in the activity “Support to raising skills, retraining and further education of employees”, hence ensuring at least partial absorption of resources of the activity “Enhancing skills and retraining of employed persons” falling under responsibility of the Ministry of Economics. Implementation of the national programme was approved and started on July 1, 2006.

In addition, the ESF national programme for the second Ministry of Economics activity “Training and consultations for beginners of commercial activity and self-employment” considered problematic previously was co-ordinated in the 1st quarter of 2006. The programme envisages promotion of access to training and consultation services for beginners of commercial activity as well as their access to financial resources that are necessary for launching a successful commercial activity or self-employment. The programme is being implemented by SJSC “Latvijas Hipotēku un zemes banka” (Mortgage and Land Bank of Latvia). In the framework of the programme, support is given to people willing to start their commercial activity. Organisation of training courses about start-up and development of commercial activity was started at the end of 2006. Completing the training, a participant has to prepare a business plan for launching a commercial activity, which is assessed by experts of the Mortgage and Land Bank of Latvia. In case of a positive decision, the participant of the programme gets financing for implementation of the business plan (payment for mentor services, grants for start-up of company operation, loan up to LVL 18 thousand).

As from August 12, 2004 the Latvian Investment and Development Agency (hereinafter – LIDA) has carried out reception of project applications for receipt of co-financing from the EU Structural Funds in the following state support programmes and sub-programmes:

1. support for modernisation of the business infrastructure:
 - 1.1. support to infrastructure development: connection and reconstruction (submission of project applications ended in July 2006);
 - 1.2. support to shared infrastructure development (submission of applications ended in August 2006);
 - 1.3. improvement of commercial activity according to the requirements of international standards (submission of applications ended in May 2006);
2. support to development of new products and technologies (submission of applications ended in July 2006);
3. support to consultations and participation of commercial companies in international exhibitions and trade missions:
 - 3.1. consultation services (submission of applications ended in July 2006);
 - 3.2. participation of commercial companies in international exhibitions, fairs and trade missions (submission of applications ended in November 2006).

As from November 1, 2004 LIDA accepted project applications from companies for co-financing from the EU Structural Funds in the state support programme (SSP) “Support for training, retraining and further education of the employed”. After March 27, 2006 the projects were accepted according to the new rules that envisage the simplified procedure for submission of the project.

Box 6.3. continued

1272 projects have been submitted to LIDA by December 31, 2006, of which the biggest part is made by 520 projects for receipt of support in the framework of the support programme "Support to consultations and participation of commercial companies in international exhibitions" and 401 projects in the framework of the support programme "Support for modernisation of the business infrastructure".

In the support programmes for the private sector administered by the Ministry of Economics, agreements have been concluded with the total support in the amount of LVL 134.73 million. 771 commercial companies were supported, providing support for implementation of 1028 projects. Activity of applicants and breakdown of financing by regions would be assessed as equal. 21% of all resources are channelled to projects that are being implemented in Rīga, 19% – in Rīga region, 17% – in Kurzeme and Zemgale regions, 14% – in Vidzeme and 12% – in Latgale region.

Improving the state support programme "Support for modernisation of the business infrastructure" before repeated opening of this grant scheme on March 20, 2006 one of the tasks was to achieve bigger activity of entrepreneurs from regions. Assessment of the activity of applicants leads to a conclusion that the task is fulfilled successfully, because the breakdown of the required support volume by regions was not considerably different (Lielrīga – 28%, Kurzeme – 16%, Zemgale – 17%, Vidzeme – 23%, and Latgale – 16% of the total required support volume).

Table 6.2

Breakdown of Support Provided in the Framework of Support Programmes Administered by the Ministry of Economics and the Number of Approved Project Applications by National Economy Sectors

National economy sector	Total provided support		Number of project applications	
	million LVL	%		million LVL
Agriculture	0.3	0.2	1	0.1
Textile processing	0.5	3.6	25	2.4
Logging/woodworking	24.7	18.3	153	14.9
Chemical industry	13.7	10.2	62	6.0
Metal working	17.7	13.2	85	8.3
Production of electronic equipment	4.2	3.1	36	3.5
Mining industry, Production of building materials, Construction services	27.2	20.2	130	12.7
Services	10.0	7.4	226	22.0
Food industry	6.7	5.0	33	3.2
Printing and publishing industry	8.3	6.1	36	3.5
Transport	3.9	2.9	28	2.7
Energy	1.2	0.9	3	0.3
Trade	2.0	1.5	105	10.2
Processing of raw materials	2.8	2.0	7	0.7
Healthcare	1.7	1.3	8	0.8
Recreation/Tourism and hotel services	5.5	4.1	81	7.9
Other sectors	0.9	0.1	9	0.9
TOTAL:	134.7	100	1028	100

Table 6.3

Breakdown of Support Provided in the Framework of Support Programmes Administered by the Ministry of Economics and the Number of Approved Project Applications by Support Programmes

State support programme	Total provided support		Number of project applications	
	million LVL	%	number	%
SSP 2.0 "Support to development of new products and technologies"	4.0	3.0	45	4.4
SSP 1.2 "Improvement of commercial activity according to the requirements of international standards"	102.7	76.2	258	25.1
SSP 1.3 "Support to shared infrastructure development"	6.4	4.7	15	1.5
SSP 1.1 "Support to infrastructure development: connection and reconstruction"	5.0	3.7	26	2.5
SSP 3.2 "Participation in international exhibitions and trade missions"	1.2	0.9	94	9.1
SSP 3.1 "Consultation services"	2.8	2.1	300	29.2
SSP 4.0 "Support for training, retraining and further education of the employed"	2.4	1.8	157	15.3
"Loans (incl. microcredits) for launching commercial activity"	6.7	5.0	84	8.2
"Development of loan guarantee system"	3.6	2.7	49	4.8
TOTAL:	134.7	100	1028	100

Absorption of the Cohesion Fund

In order to level out differences between EU member states, Latvia after accession to the EU has access to resources from the **Cohesion Fund**, which replaces the ISPA funds that were available for Latvia before the accession. Support from the Cohesion Fund is available to those EU member states, where GDP per capita is below 90% of the EU average. The main goals of the Cohesion Fund are to provide support to environmental protection measures and improvement of transport infrastructure.

Like as with the Structural Funds, resources from the Cohesion Fund are only granted as a co-financing for measures supported financially by the member state. The EU co-financing from this fund has been set at 80-85%. Furthermore, the contribution from the EU may even reach up to 90% of the total project costs if financing is received from the Structural Funds as well. The total project costs have to reach at least LVL 7 million (EUR 10 million).

Utilisation of resources from the Cohesion Fund is set out under the Reference Framework Document co-ordinated with the European Commission in December 2003. In contrast to the Single Programming Document that only sets out priority areas of support, the Reference Framework

Document defines specific projects, to which the financing will be granted. The Cohesion Fund has broader range of financing as compared to ISPA:

- transport sector – roads, railways, ports, airports, public transport;
- environmental sector – management of household waste (regional waste landfill sites), sewage treatment, drinking water supply.

The total financing from the Cohesion Fund available for Latvia in the period of 2000-2006 amounts to EUR 710 million, of which EUR 310 million comprise the financing for projects started before accession to the EU (former ISPA projects), EUR 230 million are earmarked for the Cohesion Fund project applications of 2004, and EUR 170 million comprise the financing for the Cohesion Fund (CF) project applications to be submitted in 2005 and 2006.

Projects for all available Cohesion Fund financing in the amount of EUR 710.77 million have been approved by March 31, 2007. EUR 298.80 million (42.04% of the approved CF financing for Latvia in 2000-2006) were received from the European Commission, while EUR 232.10 million (32.65% of the financing) were paid to executors in the framework of the concluded contracts (see Table 6.4).

Table 6.4

Progress in Absorption of the Cohesion Fund as of March 31, 2007

	CF financing	Projects approved by the European Commission		Paid to beneficiaries of CF financing		Payments received from the European Commission	
	million EUR	million EUR	% of available financing	million EUR	% of approved projects	million EUR	% of approved projects
Ministry of Environment		353.20	49.69	86.16	24.39	110.52	31.29
Ministry of Transport and Communications		353.90	49.79	145.22	41.03	187.15	52.88
Ministry of Finance		3.67	0.52	0.72	19.59	1.13	30.90
Total	710.77	710.77	100.00	232.10	32.65	298.80	42.04

Implementation of Cohesion Fund projects takes place steadily. Part of the projects is completed, but implementation of several projects has been delayed in regard to the planned time schedule. Implementation of some CF projects by 2008-2009 is foreseen in accordance with EC decisions or financial memoranda. The main problems in implementation of projects in the environmental and transport sectors are still created by considerable rise of prices in the construction sector, which has increased costs of a majority of projects that were planned and started in the previous years. This substantial rise of prices is explained by the rapid increase in prices of both fuel and construction materials as well as by increased labour costs determined by the total increase of demand in the construction sector.

The project "Technical assistance for the leading institution of the Cohesion Fund in Latvia" has been worked out. Communication strategy of the Cohesion Fund for 2007-2009 will be developed in the framework of the project. The aim of the strategy is to create an action plan that would allow promotion of a purposeful communication about goals of CF financing. The strategy will include analysis of the internal and external communication regarding the Cohesion Fund up to now, proposals for improvement of the communication, and the action plan for communication, implementation of which is planned from the 2nd quarter of 2007.

Financial perspective period of 2007- 2013

The abovementioned amount of financial resources was available to Latvia in the period of 2004-2006.

This multi-annual budget-planning period (also called financial perspective), lasting from 2000 till 2006 for the old EU member states, expired in 2006 and so the plans for EU expenditures, legislation and other documents determining the use of EU financial resources are no longer applicable for distribution and absorption of the new funding after the end of 2006. The period of financial perspective usually lasts five to seven years. Planning of EU expenditures and preparation of documents for the next period of 2007-2013 was started in 2006.

In order to ensure high-quality absorption of the Structural Funds and the Cohesion Fund, all necessary planning documents and normative acts that would ensure starting absorption of SF and CF in 2007 should have been prepared by 2007.

In order to start efficient absorption of SF and CF resources, programming is being carried out at 3 levels in accordance with the general regulation: the EU level strategy or the Community Strategic Guidelines, the strategy of member states or the National Strategic Reference Framework Document, and the Operational Programmes (hereinafter – OPs) of the member states.

The National Strategic Reference Framework Document for the period of 2007-2013 (hereinafter – NSRFD) is the main SF and CF planning document at the level of Latvia, which ensures the linkage of the cohesion policy with national priorities and substantiates the choice of these priorities as well as determines the funds absorption strategy and the management network and ensures co-ordination between OPs and other financial instruments.

NSRFD was prepared, taking into account the goals and lines of action set in the National Development Plan (the Ministry of Regional Development and Local Government is responsible for development of this plan) and in the National Lisbon Programme of Latvia (see Chapter 6.1, the Ministry of Economics is responsible for development of this programme) as well as considering provisions of the long-term conceptual document “The Growth Model for Latvia: People First” approved by the Saeima. Draft NSRFD was approved by the Cabinet of Ministers on October 3, 2006. After reception of opinion of the European Commission on December 6, 2006 NSRFD was specified, and the Cabinet of Ministers approved it on January 31, 2007.

NSRFD stresses that the most important task of the period of 2007-2013 (to be fulfilled with the help of SF and CF) is to create the necessary preconditions and directly achieve changes that would ensure formation of knowledge-intensive economy in the country. Hence, for SF and CF investments in 2007-2013 in Latvia, the main emphasis has to be put on those measures that develop knowledge as the main resource of growth and create favourable conditions of life for human being as the holder of this resource.

In order to reach this goal, SF and CF investments are planned in accordance with three thematic axes:

- development and efficient use of human resources;
- increase of competitiveness and progress towards knowledge-intensive economy;
- improvements of public services and infrastructure as precondition to balanced development of the country and its territory.

Balanced development of the territory, macro-economic stability, equal opportunities, sustainable development and information society are determined as horizontal priorities.

The Ministry of Finance is appointed the institution responsible for implementation of NSRFD. As from 2007, the ministry has to submit informative reports on implementation of NSRFD to the Cabinet of Ministers quarterly.

The Cabinet of Ministers has approved breakdown of the assignment from the EU Structural Funds and the Cohesion Fund by thematic axes and measures of NSRFD, which was recalculated in current prices at the end of 2006, increasing the total financing from EU funds in 2007-2013 by EUR 0.5 billion. Hence, Latvia has access to EUR 4.5 billion from the EU SF and CF in the period of 2007-2013.

In order to achieve the goals, it is planned to manage SF and CF investments, using three operational programmes:

- 1st OP “Human Resources and Employment”, OP of the European Social Fund;
- 2nd OP “Enterprise and Innovation”, OP of the European Regional Development Fund;
- 3rd OP “Infrastructure and Services”, OP of the European Regional Development Fund and the Cohesion Fund.

In the Structural Funds programming period of 2007-2013, the Ministry of Economics will be an intermediary institution for activities in all three operational programmes: activities for promotion of employment and attraction of high-quality human resources of the 1st OP “Human Resources and Employment”, provision of support to development of entrepreneurship in the framework of the 2nd OP “Enterprise and Innovation”, and provision of support to the sectors of tourism and energy in the framework of the 3rd OP “Infrastructure and Services”.

In order to reach goals set by OP “Human Resources and Employment”, the Ministry of Economics plans to carry out 3 activities for provision of training to the employed and attraction of high-quality labour force to commercial companies. Total financing available for implementation of these activities amounts to EUR 163.98 million.

Indicative financing in the amount of EUR 473.12 million was granted to entrepreneurship support activities of the EU Structural Funds planning period of 2007-2013 offered by the Ministry of Economics

in the framework of the 2nd OP “Enterprise and Innovation”. In this operational programme, Measure 1.2 “Innovation” as well as Priority 2 „Availability of finances” and Priority 3 “Increasing activity and competitiveness of entrepreneurship” are under supervision of the Ministry of Economics.

The innovation promotion measure with the biggest proportional share of financing (42.89% of the financing available to the Ministry of Economics for development of entrepreneurship) was set in order to foster competitiveness of economy and encourage business activity with higher value-added and is directly linked with the Lisbon goal to become a knowledge-based economy. The priority will solve several problems, e.g., insufficient activity of enterprises in sectors with high value-added and capacity of labour and natural resources as minimal as possible. The expected directions of support within the priority will foster development and production of new products and technologies as well as promotion of co-operation between research and entrepreneurship.

The goal of Priority 2 “Availability of finances” is to facilitate access to financing for development of entrepreneurship, at the same time lessening the negative influence of direct state support on the market competition and using state support resources more efficiently, using them repeatedly (as in the case of risk capital and loans) or applying multiplier (as in the case of loan and leasing guarantees). 35.85% of the available financing for development of entrepreneurship are envisaged for this priority.

Priority 3 “Increasing activity and competitiveness of entrepreneurship” consists of two problems to be solved (the low number of enterprises, and increasing their competitiveness) and 21.26% of the available financing for development of entrepreneurship are envisaged for this priority. The problem of low activity of entrepreneurship was not solved substantially in the period of 2004-2006. Taking into account the low number of enterprises and businessmen per 1000 inhabitants and the comparatively low employment rate, both abovementioned problems will be solved through promotion of establishment of new enterprises.

EUR 42.37 million were granted for promotion of tourism in the planning period of 2007-2013.

The goal of measures planned in the energy sphere is to promote availability of housing as well as its sustainability and efficiency and lessen the social tension in local government areas, investing in measures of renovation and energy efficiency of housing (granting EUR 29.97 million for this measure), as well as foster achievement of goals set in the EU and Latvian policies of energy efficiency, use of renewable energy resources and increase of energy supply safety. EUR 132.4 million from the available Cohesion Fund financing are granted for this measure.

The general management framework and planning documents of SF and CF are being developed, mutually co-ordinating them with institutions involved in management of EU funds and consulting with partners (social partners, representatives of the

regions, NGOs) about a wording acceptable for all parties. Approximately 132 sectoral regulations of the Cabinet of Ministers on implementation of EU funds activities have to be worked out and approved for implementation of activities of the new period: about 46 normative acts for implementation of the 1st OP “Human Resources and Employment”, approximately 20 normative acts for the implementation of the 2nd OP “Enterprise and Innovation”, and about 66 normative acts for the implementation of the 3rd OP “Infrastructure and Services”.

Development of the Law “On the Management of the European Union Structural Funds and Cohesion Fund” would be mentioned as an important step for timely and successful absorption of the financing. This law came into force on March 1, 2007.

Sources of financing of the OP are the European Regional Development Fund (53.50% of the total assignment from SF and CF), the European Social Fund (12.15% of the total assignment), and the Cohesion Fund (33.99% of the total assignment). Along this, the financing from the state budget and the private co-financing have to be ensured.

6.2.2. Foreign Trade Policy

Common trade policy is implemented within the EU, where the European Commission negotiates bilaterally and multilaterally on behalf of 27 EU member states. The European Commission voices a common position that is co-ordinated with member states in the Article 133 Committee of the EU Council. The European Union is the biggest exporter of goods and services and the biggest investor abroad as well as one of the main partners in the negotiations of the World Trade Organisation (WTO).

The renewed Lisbon Strategy of 2005 (see Chapter 6.1) envisages measures promoting growth and employment in all EU member states. In addition to this internal agenda, measures aimed at improvement of the external competitiveness of the EU in the world were approved at the beginning of 2007. Using trade policy instruments and the opportunities created by international trade liberalisation for facilitated access to markets of goods and services, several initiatives were determined, which would ensure adjustment of the European trade policy to competitiveness challenges in the future.

Multilateral relations

Strengthening the multilateral trade system is a priority of the EU trade policy. Besides, the most efficient way how to ensure and promote world trade, also fostering the economic development and welfare, is development and implementation of multilateral trade rules. WTO is the only multilateral organisation based on international regulations and agreements with the main task to provide non-discriminatory and predictable trade flows in the global space.

In 2001 in the Qatar's capital Doha, WTO member states started a regular round of multilateral trade liberalisation talks (so-called Doha Development Agenda (DDA)). Development, reduction of poverty in the world and lifting trade restrictions are set as the target of this round. Successful integration of developing countries into international trading system by ensuring balanced redistribution of gains from global trade were set as the key task for reduction of poverty. In the framework of DDA, WTO member states have agreed on granting preferences to the least developed countries, so they will not have to undertake new commitments of trade liberalisation.

In December 2005 in Hong Kong, trade ministers of WTO member states decided that a comprehensive agreement in the main areas of negotiations is necessary, among them substantial reduction of state support measures for agricultural production, reduction of import duties in trade in agricultural and industrial goods and working out preferential conditions for trade in services.

However, coming to agreement in multilateral talks is difficult, considering that all WTO member states with different economic interests have to agree on DDA package of common issues. At the end of July 2006, when WTO member states could not come to agreement on mutual conditions for trade in agricultural goods and on the state support, DDA negotiations were suspended. In view of the seriousness of the situation, WTO member states showed readiness for compromise already at the end of the previous year and negotiations were resumed in February 2007 in the hope of concluding the round started in 2001 by the end of the year. The main problems in the process of multilateral trade liberalisation are the inability of EU member states to harmonise their different approaches regarding reduction of the internal support of industrially developed countries to agriculture, lessening restrictions to accessibility of agricultural products market and diminishing restrictions of developing countries to accessibility of industrial goods.

With successful conclusion of the round, Latvia would benefit from liberalisation of the multilateral trading system by getting freer access to goods and services markets of third countries due to reduction of tariff and non-tariff barriers and to more transparent setting of customs procedures and other procedures (rules of origin, import licensing procedures, investment restrictions, determination of customs value of goods, etc.). It is expected that freer access to markets of other countries will encourage expansion of export markets of Latvia and further growth of economy of the country.

Bilateral relations in the framework of the EU common trade policy

Since May 1, 2004 trade relations of Latvia with third countries are regulated by agreements concluded by the EU. Bulgaria and Romania joined the European Union on May 1, 2007 increasing the EU internal market, where capital and persons may freely move, to

490 million consumers. The increased market of goods and services opens new opportunities for Latvian exporters.

EU has concluded several agreements prescribing conditions of free trade with third countries:

- European Economic Area agreements with Iceland, Liechtenstein and Norway;
- Free trade agreements with Faeroe Islands, Switzerland and Mexico;
- Association Agreements with Chile, Mediterranean countries (Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestinian Authority, Syria and Tunisia) and several overseas countries and territories;
- Customs unions with Turkey and Andorra;
- Stabilisation and Association Agreements with Macedonia and Croatia;
- Trade, Development and Co-operation Agreement with South Africa.

EU also works to expand economic co-operation with Russia, Ukraine, USA, China, India, Republic of Korea, and countries of the Association of Southeast Asian Nations (ASEAN), the African, Caribbean and Pacific Group of States (ACP), Western Balkan countries, the Andean Community and Central American States.

EU member states, including Latvia, support entry of **Russia (Russian Federation)** in the WTO as soon as possible, but results of negotiations are more important than the speed of the entry. Russia still has not solved several issues, e.g., the ones concerning sanitary and phytosanitary measures, technical barriers to trade, rail tariffs, agriculture, etc.

The EU-Russia economic co-operation (see Box 6.4) is regulated by the Partnership and Cooperation Agreement (PCA) that is due to expire on November 30, 2007. Development of a new framework agreement between the EU and Russian Federation is under way.

During the 17th EU-Russia summit on May 25, 2006 the parties agreed to keep the PCA in force after 2007, if the new agreement does not come into force by that time. Most recent meeting of the highest-level representatives took place in the framework of the EU-Russia summit in Samara on May 18, 2007. Talks on the new co-operation agreement took place and issues of creation of the Four Common Spaces, investment climate and co-operation in energy sector were discussed during the summit.

Entry of **Ukraine** in the WTO is significant for Latvia as it is expected that this will deepen the commercial and economic co-operation between the EU and Ukraine. Latvia has special economic interests in conclusion of the EU Free Trade Agreement with Ukraine, taking into account that such agreement with Ukraine existed before Latvia's accession to the EU and encouraged development of transit and international trade.

Latvia is especially interested in considerable reduction of bureaucratic requirements and elimination of other non-tariff barriers to access the Ukrainian market.

Relations between the EU and Ukraine (see Box 6.4) are currently determined by a Partnership and Co-operation Agreement that will expire in 2008 and will be replaced by an Enhanced Agreement. Talks on conclusion of the Enhanced Agreement between the EU and Ukraine started on March 5, 2007.

Economic co-operation between the EU and **US** takes place in the framework of the Transatlantic Economic Initiative. In order to deepen the transatlantic economic relations, the EU-US initiative to enhance economic integration and growth was accepted at the EU-US summit on June 20, 2005. The initiative envisages to promote co-operation between high-level regulators, build more open and competitive financial markets, encourage investment for long-term development, co-operate in protection of intellectual property (including third countries), support and spur innovation and technological development, enhance security of trade not limiting the trade flow and applying visa-free regime to all EU member states, carry out negotiations in aviation sphere on conclusion of a new agreement, strengthen co-operation in the sector of services, and ensure bilateral access to public procurement markets.

A new document "Framework for Advancing Transatlantic Economic Integration between the EU and the USA" was adopted at the EU-US summit in Washington on April 30, 2007. The mentioned document identifies specific co-operation framework in the form of a political agreement as well as mechanisms for its implementation and sets the priority spheres for co-operation and the targets to be achieved. The document envisages promotion of co-operation in such spheres as intellectual property, security of trade, financial markets, innovation and technologies, and investment. It is also envisaged to establish the Transatlantic Economic Council that will supervise and promote implementation of co-operation.

Latvia will continue supporting implementation of the initiative, paying attention to foreign trade promotion, investment and co-operation of entrepreneurs.

Economic dialogue between the EU and **China** is based on the EU-China Trade and Economic Co-operation Agreement concluded in 1985. Joint Committee for Trade is set up in its framework.

In order to support the economic and trade reforms of China and its integration in the world trading system, the EU-China co-operation programme that is the most comprehensive WTO programme of such kind in China was started in 2004. The programme consists of such elements as: customs and import/export regulatory systems, agriculture, technical barriers to trade, services, legislative aspects, protection of intellectual property rights as well as policy development, co-operation and transparency.

Agreement to start talks on conclusion of a new Partnership and Co-operation Agreement was reached during the EU-China summit in September 2006. Talks were started in January 2007.

EU has started talks on conclusion of Free Trade Agreements (FTAs) with **India, Republic of Korea**, and countries of the **Association of Southeast Asian Nations (ASEAN)**. The goal of FTA is to bilaterally improve conditions of access to markets of goods and services, comprising practically all aspects related to trade, among them trade in goods and services, public procurement, competition, intellectual property rights, movement of capital, customs, regulatory transparency, etc.

Talks on conclusion of FTAs between the EU and the **African, Caribbean and Pacific Group of States (ACP)** were started in 2002. Since October 2003, talks take place on a regional level with each of 6 regions of ACP separately: West Africa, Central Africa, East and Southern Africa, Southern Africa Development Community, The Caribbean, and the Pacific. The goal of the FTA talks is gradual integration of ACP countries in the global economy. In addition to talks, assistance related to trade is provided to ACP countries, which would promote trade capacity and regional integration of these countries.

Economic co-operation policy between the EU and **Western Balkan countries** is formed in the framework of the Stabilisation and Association Agreement. This agreement sets the most favourable terms for various products imported from countries that are participants of this agreement (Albania, Bosnia and Herzegovina, Montenegro, Croatia, Macedonia, Serbia). In February 2007, the EC distributed a proposal (in the process of talks) that envisages introduction of emergency measures in trade with Balkan countries participating in the stabilisation and association process. This proposal would change the current system of trade preferences, as it set quotas for several fishery products, wines and sugar of Balkan countries.

Talks on conclusion of Association Agreements between the EU and the **Andean Community** and between the EU and the **Central American States** were started in 2006. Both Association Agreements would include a political dialogue, co-operation programmes and a free trade agreement.

Economic relations with third countries: economic co-operation agreements of Latvia

In order to continue and activate bilateral economic co-operation after accession to the EU, Latvia has concluded bilateral economic co-operation agreements with **Russia, China, Belarus, Ukraine, Kazakhstan, Azerbaijan, Georgia, Moldova** and **Uzbekistan**.

These agreements are the most important umbrella agreements that regulate bilateral economic co-operation and comprise co-operation in industry, tourism, transport, pharmaceuticals, agriculture, financial services, communications, professional training, investment policy, technologies and innovation and other fields, thereby promoting development of economic co-operation.

Conclusion of economic co-operation agreements with **Armenia** and **India** is being prepared.

Economic co-operation agreements concluded between Latvia and third countries envisage establishment of Intergovernmental Commission and/or Joint Committee, which in turn ensure supervision of validity of these agreements and opportunities of analysis how to improve further co-operation.

The 1st meeting of the **Latvia–Azerbaijan** Intergovernmental Commission on Economic, Scientific, Technical and Cultural Co-operation took place in Baku (Azerbaijan) on March 1-3, 2007. Opportunities of further bilateral co-operation in sectors of economy, standardisation, metrology and conformity assessment, industry, transport and transit, banking, tourism and culture, education, communications and information technologies were discussed at this meeting.

The 1st meeting of **Latvia–Ukraine** Intergovernmental Commission on Economic, Scientific, Industrial and Technical Co-operation took place in Riga on May 10-11, 2007. Co-operation in such fields as transport, fuel-energy complex, industry, agriculture, tourism and scientific technical co-operation as well as other perspective areas for development of further commercial and economic development were discussed at this meeting.

In relations with **Moldova**, the Agreement between the Government of the Republic of Latvia and the Government of the Republic of Moldova on Economic, Industrial, Scientific and Technical Co-operation was concluded on May 11, 2007 and an Intergovernmental Commission will be established in its framework.

Meetings of Intergovernmental Commission and/or Joint Committee of several concluded economic co-operation agreements with **China, Belarus and Georgia** are planned in the autumn of 2007.

System of General Preferences (SGP) with the aim to promote sustainable development of developing countries, granting preferential access to markets of EU member states and reducing the import duty or fully abolishing it for certain products, is also applied in international trade. Application of SGP is suspended if the World Bank has classified for three consecutive years that the beneficiary country has achieved a high income level and the imports of its five most important groups of goods to the EU constitutes less than 75% of the total imports of the mentioned country to the EU in the framework of the SGP regime. At present, this system is attributed to 175 countries. The most important import partners of Latvia in the SGP framework are Russia, Belarus and Ukraine.

Box 6.4

The new legal framework of EU-Russia and EU-Ukraine economic relations

The **EU-Russia** economic co-operation is currently regulated by a Partnership and Co-operation Agreement (PCA) that will expire on November 30, 2007. Active development of a new EU-Russia framework agreement is taking place.

It is expected that the new co-operation document will constitute the legal base for relations between the EU and Russia and will comprise all spheres of co-operation, including those not included in the current PCA.

The agreement will to a great extent contain the structure and issues of the roadmap for the Four Common Spaces (the 1st – Common Economic Space; the 2nd – Common Space of Freedom, Security and Justice; the 3rd – Common Space on External Security; the 4th – Common Space on Research, Education, Culture) and will envisage opportunities for conclusion of separate sectoral agreements.

Creation of the Four Common Spaces of the EU and Russia, including establishment of the Common European Economic Space (CEES), is crucially important in order to promote and diversify trade between the EU and Russia, provide new opportunities for economic integration and convergence, and encourage access to market and development of infrastructure.

In the trade aspects, the aim of the agreement is to achieve gradual integration of EU and Russian economies, preventing barriers to investment and trade as well as carrying out convergence of regulators and approximation of legal norms and promotion of trade. Provisions of the agreement will be developed on the basis of provisions of the current Partnership and Co-operation Agreement and of the Action Plan for the Common Economic Space.

After entry of Russia in the WTO, the EU and Russia may start negotiations on conclusion of deepened and ambitious Free Trade Agreement (FTA). Special interests of Latvia in the framework of the Free Trade Agreement are: considerable reduction of non-tariff trade barriers, national regime for public procurement, improvement of investment climate, incl. liberalisation of land market, annulment of export restrictions, standstill clause preventing introduction of new trade restrictions, efficient procedure for settlement of disputes, considerable liberalisation of the market of services (incl. transport), promotion of trade, co-operation in customs sphere, protection of investment and free movement of capital.

EU-Ukraine relations are currently determined by a PCA that will expire in 2008. This agreement will be replaced by an Enhanced Agreement. In comparison with the PCA, the Enhanced Agreement may contain several new elements, e.g., section on deepened space of free trade, expanded section on the rule of law, freedom and safety, as well as develop further the already existing economic and political co-operation.

The agreement's section on trade and related issues will concern co-operation in spheres of technical regulations, standards, conformity assessment procedures, sanitary and phytosanitary measures, trade promotion, customs, trade in services, intellectual property rights and public procurement. The agreement will determine transparency of regulations. The co-operation will be directed to development of Ukrainian sanitary and phytosanitary regulations and infrastructure and their gradual harmonisation with EU standards, building capacity of Ukrainian customs administration and other border institutions, and promoting compatibility of EU and Ukrainian transit systems. It is expected that the agreement will contain a protocol about mutual assistance in customs matters.

Latvia is especially interested to eliminate the current trade barriers and restrictions and conclude a free trade agreement with Ukraine in order to ensure conditions for export of Latvian goods as favourable as possible. The widest possible co-operation between the EU and Ukraine is important for Latvia. Latvia is interested in provision of technical regulations with regard to industrial goods, standards, sanitary and phytosanitary measures, freedom of trade in services and commercial activity, trade promotion and customs operation reforms, regulation of public procurement, conditions of competition policy as well as other measures in the agreement. It is important that the new agreement would provide for wide co-operation in spheres of transport, logistics and energy. The process of negotiations is expected after entry of Ukraine in the WTO.

A decision to start examination against Belarus was adopted on December 29, 2003. Following the results of examination about violations of the freedom of association in Belarus, EC Regulation No. 1933/2006 temporarily withdrawing SGP from Belarus as from June 21, 2007 was adopted on December 21, 2006.

If Belarus carried out sufficient measures for prevention of the violations, the EU may take decision about non-withdrawal of SGP for Belarus. Taking into account that Belarusian export products are mostly used as raw materials or intermediate consumption goods and are not produced in Latvia (or are produced in insufficient amount), withdrawal of SGP may raise costs of end products.

EU sectoral agreements

Steel

Steel is one of the most widespread raw materials in the world due to its diverse applications in various sectors and its processing capacity. Steel sector takes a special place in international trade. In 2006, steel production in the world increased by 9.7% in comparison with 2005. Asian countries were the most active producers of steel, and the leader position was taken by China that increased its steel production by 20%, while steel production in the EU increased by 5.9% in the mentioned period. In 2006, steel exports of the EU decreased by 1%, while the growth of imports made up 46%.

EU and Latvia as EU member state apply provisions of the double control system with quantitative restrictions to import of several steel products from those countries that are not WTO members (Russia, Kazakhstan and Ukraine), and adequate agreements on steel trade are concluded with these countries. Currently it is planned to sign agreements for 2007 and the period of further years. Provisions of agreements will be maintained as in the current agreements and they prescribe setting amounts of quotas adequate for trends of the EU steel market demand. The agreements will lapse automatically, when Russia, Kazakhstan and Ukraine will enter the WTO. It is expected that WTO entry procedures with Russia and Ukraine will be completed in 2007.

Extension of the agreements provides to entrepreneurs the guarantees of predictable development as well as ensures continuity and growth of the traditional trade flow.

Double checking system without quantitative restrictions is applied to imports of particular steel products from Macedonia.

Prior surveillance system is applied to imports of several steel products from all third countries.

Textiles

Textile sector is characterised by intensive use of labour force, high number of employees and considerable place in international trade. During the last years, the role of several third countries (such as

China, India and Pakistan) in textile trade has grown particularly. In the European Union, trade policy issues related to development of this sector are considered by working groups of the Article 133 Committee/Textile of the EU Council of Ministers.

Since January 1, 2005 no quantitative restrictions are applied between WTO member states. EU and Latvia as EU member state apply the double control system with quantitative restrictions to imports of textile products from those countries that are not WTO members (Belarus, Montenegro and North Korea), while the double checking system without quantitative restrictions is applied to imports of textiles originated in Uzbekistan.

In accordance with the agreement on textile trade until 2008, concluded between the EU and China on June 10, 2005 import restrictions are prescribed for 10 categories of goods of Chinese origin. Approximately 45 000 companies are involved and 3.7 million people are employed in Chinese clothing industry sector. Exports of textiles and clothing of Chinese origin reached about USD 147 billion in 2006. Imports of those categories of Chinese origin textiles, which are exempted from quantitative restrictions since 2005, kept growing in the EU in the previous year, while imports of the textile products subjected to quantitative restrictions have decreased.

High-level working group of the EC was set up in February 2004 (including representatives of the government and industry), which developed the EU action plan for promotion of development and competitiveness of the sector and defined the following principal lines of action: research and development, education, access to market of third countries, structural funds, deepened regional integration with Mediterranean countries, protection of intellectual property, and strengthening the dialogue between China and the EU. Revision of results of the abovementioned action plan is planned in the 2nd half of 2007.

Potassium chloride

The Commission Regulation (EC) No. 1818/2006 of December 11, 2006 on the implementation of the management system of the quantitative ceiling of potassium chloride in relation with anti-dumping measures on imports of potassium chloride originating in Belarus, which prescribes import licensing for the mentioned product (CN codes: 3104 20 50 and 3104 20 90), came into force on January 1, 2007.

Imports of potassium chloride in Latvia amounted to 5667 tons in 2006, which is by 34% less than in 2005. Quantitative ceiling (quota) of potassium chloride in 2007, which applies to all EU member states, amounts to 700 thousand tons. Entrepreneurs may import the mentioned amount within the year without paying customs duty and antidumping duty. According to data of the European Commission, member states have used 55.7% of the total amount of quota as of May 8, 2007. In case of exhaustion of the

quota, anti-dumping duty in the amount of 27.5% will be applied to imports of potassium chloride originating in Belarus.

Trade defence instruments

The system of trade defence instruments (hereinafter TDI) works in the EU as well as in the greatest part of economies of other countries that import goods and services. EU uses these instruments in accordance with WTO rules that are worked out as a component of the multilateral trading system and sets their working principles. EU has unilaterally, on grounds of WTO rules, determined stricter criteria in application of TDI, hence establishing a system that is more open and balanced than TDI system of other WTO member states.

TDI (anti-dumping, anti-subsidy, and safeguard measures) in the European Community are applied in accordance with unified principles, as TDI are a constituent part of the common trade policy of the European Community. EU member states represent their interests regarding TDI in advisory committees of the European Commission, namely, the Anti-dumping and Anti-subsidy Committee and the Safeguard Committee. Interests of Latvia in these advisory committees are represented by the Ministry of Economics.

Anti-dumping and anti-subsidy measures are aimed at protection of local producers of the European Union against losses caused by unfair competition of third countries companies or government subsidies. Determinant for application of the safeguard measures is such import growth that causes losses for local producers, but does not constitute an unfair competition.

130 anti-dumping and 12 anti-subsidy measures against various goods in the European Community were in force as of March 31, 2007. European Commission examines 81 cases at present.

In Latvia, there are both producers and consumers of the goods affected by TDI procedures, but the most essential interests of Latvia involve import and industrial usage of the goods subjected to TDI. The following trade defence cases are most essential for Latvia from the standpoint of import and user interests:

- anti-dumping proceeding concerning imports of potassium chloride originating in Belarus and Russia;
- anti-dumping proceeding concerning imports of ammonium nitrate originating in Russia and Ukraine;
- anti-dumping proceeding concerning imports of certain footwear with uppers of leather originating in China and Vietnam;
- anti-dumping proceeding concerning imports of, inter alia, silicon manganese originating in Ukraine.

So that interests of companies would be considered as effectively as possible in proceedings carried out by the Commission¹, also the interested parties in Latvia (producers, importers, exporters and consumers) have to inform the Commission and the Ministry of Economics about their interests. The Commission is the most important institution in these procedures, and all proofs and arguments in TDI procedures are to be submitted first to the Commission, but it is also important for the Ministry of Economics to know problems and interests of Latvian companies. They will be taken into account not only by working out the national position of Latvia, but also by practically defending state interests in TDI proceedings carried out by the European Commission. Only through co-operation and active participation in the proceedings carried out by the Commission, it is possible to achieve more effective protection of their interests.

As EU applies trade defence measures, also other third countries may apply some defence mechanism both against all exporters of the respective EU product (e.g., safeguard measures) and against exporters of the specific product of some EU member state (e.g., anti-dumping measures). If application of TDI by some third country affects interests of Latvian companies in the markets of the respective countries, Latvia tries to solve the emerged problem both at the level of bilateral relations and at the EU level. EU consults member states on how to represent their interests more efficiently in trade defence instrument proceedings carried out by third countries, as well as supervises whether bilaterally concluded agreements and WTO rules are observed in these proceedings. The most essential case, where a Latvian company incurs losses in a market of a third country, is the anti-dumping measures against imports of steel bars from Latvia, which are in force in the US. Request to start consultations regarding the compliance of the US practice in carrying out anti-dumping proceedings with WTO norms, which, among other things, affects a Latvian company, was submitted by the EU to the Dispute Settlement Body of the WTO on September 22, 2006.

In the autumn of 2006, the EU Commission came forward with a new political strategy aimed at strengthening EU competitiveness in the global economy market, which is characterised by increasingly bigger fragmentation and complexity of production processes and supply chains and emergence of new important participants in the market, especially in Asia. Integral component of the new strategy is reflection process about potential reform of the trade defence instruments that are in force. As a result, the Commission published the “Green Book” on December 6, 2006 starting one of

¹ Information on TDI procedures carried out by the Commission is available on the EC website: http://ec.europa.eu/comm/trade/issues/respectrules/anti_dumping/stats.htm

the biggest public discussions of the TDI sphere in the EU history. Its goal is to clarify how the Community trade defence instruments operate in conditions of the global economy. First conclusions on the launched discussion are expected in the autumn 2007.

Latvia as a small and open economy tends towards a more liberal model of foreign trade. The traditional Latvian trade partners that face trade defence proceedings most often are Belarus, Russia, China, Ukraine, etc. If anti-dumping measures were not introduced against these countries concerning imports of particular goods (leather footwear (China, Vietnam), potassium chloride (Russia, Belarus), ammonium nitrate (Belarus, Russia, Ukraine), steel bars and pipes (Ukraine, Croatia, Romania), etc.), Latvia could import many goods and raw materials without additional anti-dumping duty and hence could acquire cheaper resources.

Latvia disapproves unfair trade and acknowledges the necessity to turn against it. However, the legislation in force is frequently used for protection of Community producers, thus reducing in the EU internal market.

6.2.3. EU Internal Market

On May 1, 2004 Latvia became a participant in one of the biggest internal markets of the world, which includes 30 countries at present (EU member states plus European Economic Area countries – Norway, Iceland and Liechtenstein) with more than 480 million consumers. The European Union policy is aimed at development of the single internal market, where free movement of the factors of production (goods, services, persons and capital) is ensured in order to promote sustainable and stable development of EU economy and prosperity of EU population.

In Latvia, the process of implementation of the principles of the free movement of goods and services and the right of establishment, which are set out in Articles 28-30 and Articles 43-55 of the Treaty establishing the European Community, is supervised and co-ordinated by the Ministry of Economics, by constantly identifying the norms that may potentially or actually hinder implementation of the freedoms behind the EU internal market, inter alia, by assessing normative acts still being in a draft stage.

In the framework of the procedure established for notifying draft technical regulations (Directives 98/34/EC and 98/48/EC), which prescribes obligation of EU member states to submit draft technical regulations to the European Commission and other EU member states and European Economic Area countries (Norway, Iceland and Liechtenstein) for further assessment in order to preventively assess and avert inclusion of such requirements into national law, which have the potential to create barriers to the free movement of goods as well as to the freedom to provide information society services, Latvia submitted 1 draft regulation of the Cabinet of Ministers to the

European Commission in the 1st half of 2007. From May 1, 2004 till May 1, 2007 Latvia informed the European Commission about 43 draft technical regulations and received detailed opinions of the European Commission in 8 cases. In most cases, the detailed opinions of the EC related to the fact that draft normative acts did not include the principle of mutual recognition, which prescribes that products legally manufactured or put into the market in some EU member state or Turkey or legally manufactured in some European Free Trade Association country, which is a contractor of the European Economic Area Treaty, should be allowed free access to the Latvian market by national authorities.

The principle of mutual recognition is actually the sole legal instrument in the non-harmonised sphere of application of national technical regulations and standards.

The European Commission, acknowledging the problems existing in application of the principle of mutual recognition, in February 2007 came forward with a Proposal for a Regulation of the European Parliament and of the Council, which will set procedures for application of national technical regulations to products legally sold in other member state. The aim of the regulation is to improve the way how the principle of mutual recognition works in practice as well as provide for public institutions the necessary instruments for correct introduction of the principle into daily practice and enable representatives of business to use advantages given by the principle of mutual recognition. The Regulation will not be applied to goods of Iceland, Norway, Liechtenstein and Turkey.

As from the 2nd half of 2005, Latvia has considerably improved the statistics of implementation of internal market directives. 99.5% of internal market directives were transposed into national legislation as of February 1, 2007, which fully ensures reaching the Lisbon goal to transpose at least 98.5% of directives or to allow the deficit of transposition of directives in the amount of 1.5%. Since Latvia's accession to the European Union on May 1, 2004, a total of 16 violation procedures have been brought against Latvia for inadequate application of internal market legislation acts (*Internal Market Scoreboard* Nr. 15 bis, February 2007).

In order to encourage business activity and innovations, one of the priorities of Latvia in the European Union is to promote the free movement of services. Among initiatives of EU legal acts, the directive of the European Parliament and of the Council related to services in the internal market and adopted on December 27, 2006 is the most essential for Latvia. The directive is aimed at creation of the legal regulation necessary to promote implementation of the right of establishment and free movement of services in the EU internal market. Member states have to implement this directive in 3 years. The directive will make a positive contribution in the

context of provision of cross-border services and in improvement of business environment, especially in reduction of administrative obstacles. The directive envisages such measures for prevention of administrative obstacles as creation of single contact points (“one-stop shops”), opportunities to carry out administrative procedures electronically, unified requirements for issuance of licences, as well as obligation of EU member states to submit information about the current restrictions in provision of services, etc. to the European Commission that will assess validity of the restrictions and indicate the necessary improvements.

Informative campaign about the SOLVIT network, which operates as an alternative mechanism to solve internal market problems of the European Economic Area, was carried out actively in 2006. The idea of SOLVIT operation is to find a fast and real solution to the internal market problems that have arisen as a result of incorrect application of EU legal norms by public bodies. SOLVIT centres solve problems both of residents and of entrepreneurs and SOLVIT services are free of charge.

As a result of the informative campaign, the number of complaints at Latvian SOLVIT centre has increased again. Latvian SOLVIT centre sent 4 cases to centres of other member states and received 5 cases

to be solved in 2004, the number of sent and received cases increased to 9 cases and 12 cases respectively in 2005. In 2006, Latvian SOLVIT centre reviewed 13 cases and sent 13 cases for solution to SOLVIT centres of other member states.

As a solution found by SOLVIT network (unlike a court decision) is not binding for the public body that violates EU normative acts, the proportion of successfully solved cases is an essential indicator. The proportion of successfully solved cases was 67% in 2005 and kept growing to 79% in 2006, which indicates ever-growing professionalism of employees of the SOLVIT centre and authority of Latvian SOLVIT centre among public institutions.

Up to now, residents have complained most frequently about border control, visas, state fees related to entry and stay in Latvia and other EU member states, registration of vehicles, and raising different requirements in recognition of professional qualification (e.g., dentist’s diploma of a Latvian citizen is not recognised by the Portuguese Dental Association). The main subject of complaints by companies is violations of free movement of goods (e.g., disregard of the CE conformity marking) and inclusion of discriminatory conditions in public procurement tenders.

6.3. Sector-Specific Development Policies

6.3.1. Industrial Policy

One of the main goals of the national economy development in Latvia is to create an efficient and competitive industry that would ensure high and stable growth. Industrial policy in Latvia is being shaped in accordance with the policy development directions of the European Union, at the same time identifying and solving issues that are urgent for local industrial enterprises in co-operation with organisations that represent industrial enterprises. Industrial policy is closely connected with innovation, business activity, education and other policies. The most substantial documents formulating industrial policy in Latvia are as follows:

- Single Strategy of National Economy (approved by the Cabinet of Ministers on August 17, 2004);
- National Lisbon Programme of Latvia for 2005-2008 (approved by the Cabinet of Ministers on October 19, 2005);
- Long-term Economic Strategy of Latvia (accepted by the Cabinet of Ministers on July 17, 2001);
- Industrial Development Guidelines of Latvia for 2004-2013 (accepted by the Cabinet of Ministers on February 24, 2004).

The Entrepreneurship Competitiveness and Innovation Promotion Programme for 2007-2013 was developed, co-ordinated with ministries and submitted to the Council of Ministers in 2007. The Programme includes measures for promotion of development of innovation, business, small and medium-sized enterprises and industries. The Programme is developed in order to achieve bigger co-ordination of the economic policy of Latvia in this strategically important policy direction, which up to now was included in the framework of the National Innovation Programme for 2003-2006, Programme on Development of Small and Medium-Sized Enterprises of Latvia in 2004-2006 and Industrial Development Guidelines of Latvia. The time period for implementation of the Programme allows to successfully co-ordinate it with the measures included in the National Development Plan of Latvia and with the structural funds utilisation opportunities offered by the EU Financial Perspective for 2007-2013.

The study “Prospects and possible restructuring of manufacturing sectors by 2020” commissioned by the Ministry of Economics and started in 2006 was completed in February 2007. The common goal of the study was to forecast development of manufacturing as well as problems and potential improvements in manufacturing by 2020. The study included analysis of statistics and creation of the regression model thereby

providing a base for numerical sectoral forecasts, and two round-table discussions with representatives of industries were organised, which creates a base for future planning and common awareness of principal trends and problem factors. After completion of the study, the Ministry of Economics plans to continue the started discussion with representatives of the most important manufacturing industries, holding an annual expert forum that would include forming and maintaining a common vision on issues essential for development of industries in medium-term and long-term.

Support for development of enterprise clusters is one of the ways widely applied in the world practice and included in strategic documents of Latvian government to promote development of industries. In 2007 the Ministry of Economics in co-operation with industry associations has started the work on analysing prospects of cluster development in several industrial sectors. Support for awareness and motivation of enterprises and working out cluster development strategies is envisaged, initially focussing on nine industry sectors. Results concerning cluster development prospects and the developed initial cluster strategies will be discussed and presented at the end of 2007. It is planned to start the State Support Programme for Cluster Development co-financed from the EU Structural Funds in 2008.

Co-operation started between Nordic and Baltic Sea countries in the sphere of innovation and industrial policy continues in 2007. Inter-state co-operation project BSR InnoNet (Baltic Sea Region Innovation Network) was officially started in September 2006. The project *BSR InnoNet* is financed from the 6th Framework Programme of the European Union and is oriented on co-operation in the field of creation of the cluster policy, promotion of contacts, exchange of information and co-operation between clusters, as well as analysis of clusters in the region. The Nordic Innovation Centre is proposed as the institution co-ordinating the project, the Latvian Investment and Development Agency and the Ministry of Economics represent Latvia in the project, involving also representatives of other public institutions and the private sector into various activities of the project. Results of national consultations were summarised in the beginning of 2007. The visits, interviews and collecting information in all countries involved in the project took place in its framework. Summary of national consultations includes the current and planned activities in the area of cluster promotion in every country, the institutional system and priority fields where countries see opportunities of closer co-operation in the Baltic Sea region. The Europe Cluster Conference at ministerial level will take place in Stockholm in January 2008, and adoption of the European Cluster Memorandum is planned in its framework. The document is foreseen to be a declaration stressing the importance of clusters in development of innovation in Europe, calling EU

member states at the national and regional levels as well as EU institutions at the EU level to promote development of clusters, and giving recommendations for implementation of cluster support initiatives.

Since 2005, when the European Commission published its Communication “Implementing the Community Lisbon Programme: A policy framework to strengthen EU manufacturing – towards a more integrated approach for industrial policy”, paid attention to industry competitiveness issues in the European Union. The role of strong and competitive manufacturing industry in economic and technological growth of the EU is stressed. Although industrial policy is basically horizontal, analysis of sector-specific issues and implementation of respective measures is named as an important aspect at the same time. The Communication of the European Commission published in 2005 defined several horizontal and sector-specific policy initiatives. Assessment of several launched policy initiatives was carried out in 2007 and the Council conclusions about industrial policy were adopted in May 2007. The Council conclusions contain assessment of progress in implementation of horizontal industrial policy initiatives and particular sectoral policy initiatives:

- Automotive industry (CARS 21 initiative);
- Biotechnologies (medium-term assessment of the strategy of biotechnology and life sciences);
- Information technologies (recommendations of the ICT Task Force);
- Shipbuilding (progress communication on the LeaderSHIP 2015 initiative of the shipbuilding sector).

The Council conclusions and discussions of the EU member states on the whole approve the horizontal and sectoral initiatives started by the Commission and offer the opinion that the initiated work would be continued.

6.3.2. Energy Policy

The Cabinet of Ministers approved the Guidelines for Development of Energy Sector for 2007-2016 on June 27, 2006. The guidelines include the governmental policy, development targets and priorities in the energy sector both in the medium term and long term.

Main directions of the energy policy are promotion of competition, raising the level of energetic independence, increasing the security of energy supply, encouraging the use of renewable and local energy resources, diversification of usable energy resources and environmental protection.

In **electricity supply**, more than 90% of all electricity generated in Latvia is generated by the JSC “Latvenergo” that also ensures import of electricity and its supply to consumers. As from September 1, 2005 all functions of electricity transmission system

operator are performed by JSC “Augstsprieguma tīkls” fully owned by the state JSC “Latvenergo”. As from July 1, 2007 all functions of electricity distribution system operator will be taken over by the JSC “Sadales tīkls” fully owned by the JSC “Latvenergo”. In addition, more than 100 small power plants and 15 licensed electricity distribution and sale companies operate in Latvia.

Latvia, as EU member state, has to ensure compliance with the unified requirements set in EU

legal acts concerning the energy sector (see Box 6.5). In electricity supply, it means that the electricity market in Latvia is being opened gradually and has to operate in accordance with provisions of Directive 2003/54/EC of June 26, 2003 concerning common rules for the internal market in electricity. In accordance with this directive, as from July 1, 2007 every electricity user is entitled to choose their supplier of electricity.

Box 6.5

Harmonisation of normative acts with EU directives

The key fields in harmonisation of legal acts with EU legislation are oil and oil product reserves, security of supply, energy efficiency, and continued introduction of market principles in the energy sector:

- **security of supply and creation of oil product reserves.** The Concept of the State Oil Product Reserve was approved on June 27, 2006. On June 27, 2006 the Cabinet of Ministers accepted its Regulation No. 541 “Procedure for the Establishment and Storage of Petroleum Product Reserve”, which regulates the procedure for oil product reserves to be established by merchants;
- **electricity sector.** On May 5, 2005 the Saeima passed the Electricity Market Law (in force as from June 8, 2005) with the aim to create preconditions for operation of efficiently functioning electricity market, so that electricity would be supplied to all electricity users safely, qualitatively and for justified prices, ensure all electricity users’ rights to choose electricity merchant freely and promote electricity generation by use of renewable energy resources. On March 17, 2005 the Saeima passed the Law “Amendments to the Energy Law” (in force as from April 15, 2005), by which the previous electricity sector regulation was excluded from the law and Article 20.¹ of the Energy Law was expressed in a new wording according to the market requirements. On June 13, 2006 the Cabinet of Ministers accepted the “Regulations on the Special Connection to Electricity Transmission System” that define the procedure for establishment of special connection to electricity transmission system or increasing the capacity of a current connection. On April 25, 2006 the Cabinet of Ministers adopted Regulation No. 322 “Regulations on Annual Assessment Report of Transmission Operator” that determines the procedure by which a transmission system operator develops and submits the assessment report to the Ministry of Economics and the Public Utilities Commission, as well as requirements regarding the content of the assessment report. Cabinet of Ministers Regulation No. 695 “Regulations on Permits for Increase of Electricity Generation Capacities or Introduction of New Generation Facilities” are in force as from August 29, 2006, which sets the requirements to be fulfilled so that electricity producer would get a permit for increase of electricity generation capacities or introduction of new generation facilities. On November 6, 2006 the Cabinet of Ministers adopted Regulation No. 921 “Regulations on Electricity Production from Cogeneration” that sets the criteria by which cogeneration power stations are qualified for getting rights to sell the produced electricity within compulsory procurement;
- **gas sector.** On May 26, 2005 the Saeima passed the Law “Amendments to the Energy Law” (in force as from June 29, 2005) that determines principles for operation of the natural gas market. The aim of the law is to create conditions for competition in the natural gas market in Latvia as well as harmonise regulatory normative acts with requirements of EU legislation. Transitional provisions of the law prescribe that time and procedure for coming into force of the legal norms, which regulate principles for operation of the natural gas market, are determined by a special law. On June 20, 2006 the Cabinet of Ministers accepted the regulation “Regulations on Annual Assessment Report of Natural Gas Transmission Operator” that determines the procedure by which a natural gas transmission system operator develops and submits the assessment report to the Ministry of Economics and the Public Utilities Commission, as well as requirements regarding the content of the assessment report.

On July 23, 2004 the Cabinet of Ministers accepted the draft policy-planning document “Guidelines for Creation of Preconditions for Electricity Market in Latvia” prepared by the Ministry of Economics. It defines the basic principles for the model of opening the electricity market in Latvia, necessary preconditions for the market opening, market participators and their basic functions, duties and rights, and principles of perspective structure and regulation of the sector. It also formulates the problems that currently hinder opening the Latvian electricity market and implementation of electricity users’ rights of choice. The draft guidelines have been prepared, taking into account Directive 2003/54/EC of the European Parliament and of the Council concerning common rules for the internal market in electricity. In order to create legal environment for efficiently functioning and competitive electricity

market, based on the guidelines, the Saeima passed the Electricity Market Law on May 5, 2005.

The most important precondition for creation of market relations in the electricity supply sector is the changes in the sector’s structure, hence separating elements of a natural monopoly (transmission and distribution services) from competing elements (generation and trade). Creation of the sector’s organisational structure correspondent to market conditions takes place in accordance with requirements of the new wording of Article 20.¹ of the Energy Law and requirements of the Electricity Market Law.

Creation of mechanisms for market operation in the electricity sector is necessary and constitutes one of the government’s priorities. Provisions of legal acts prescribe equal rights for all electricity users in Latvia to freely choose their electricity supplier and be qualitatively and

securely supplied with energy in the necessary amount. In turn, electricity producers and merchants are endowed with rights to use transmission and distribution services.

At present, JSC "Latvijas Gāze" is the only merchant in the **natural gas market** in Latvia. In compliance with licences issued by the Public Utilities Commission, "Latvijas Gāze" carries out transmission, distribution, storage and sale of natural gas. Approximately 70 companies compete in supply of liquefied petroleum gas.

Amendments to the Energy Law made on May 26, 2005 prescribe main conditions for opening the natural gas market and were developed, taking into account Directive 2003/55/EC of the European Parliament and of the Council concerning common rules for the internal market in natural gas. The law includes issues concerning operation of systems, duties and rights of market participants, as well as competition opportunities in the natural gas market. The Saeima has passed a special law prescribing that these amendments will come into force on January 1, 2010.

By choosing a regulated procedure of access, member states carry out the necessary measures to confer rights or accessing the system to natural gas companies and qualified users inside or outside the area, which contains an interconnected system, on the basis of published tariffs and other conditions and obligations that are to be complied with, when the system is used.

In order to update regulation in **heat supply**, on November 30, 2006 the Cabinet of Ministers adopted Regulation No.971 "Regulations for Supply and Use of Thermal Energy" that sets the procedure by which an energy supply merchant supplies thermal energy and a thermal energy user uses it, and the procedure by which a supplier is authorised to cease supply of thermal energy to a user, who has not paid for received thermal energy or has not fulfilled other obligations to the supplier.

Investment in the energy sector

State support in the energy sector is only given to projects that are linked to adjustment of heat supply systems.

In the framework of utilisation of the EU Structural Funds (see Chapter 6.2.1), support to public and non-governmental sectors is envisaged. The priorities for the use of the Structural Funds are listed in the SPD, these priorities are sub-divided into measures, which in turn are sub-divided into activities. Priority 1 (Promotion of territorial cohesion) includes Measure 1 (Improvement of environment and infrastructure and promotion of tourism), which includes several activities that are in the competence of the Ministry of Economics. One of these activities is aimed at provision of support to public sector institutions for modernisation of heat supply systems according to environmental requirements and improvement of energy efficiency of heat supply systems both in production and distribution and for the end

consumers. In the framework of the EU Structural Funds for 2004-2006, LVL 11.6 million have been allocated for the mentioned projects. It is planned to allocate approximately EUR 132.4 million in the energy sector from the Cohesion Fund during the next Structural Funds utilisation period of 2007-2013. This amount will be distributed to measures for increase of efficiency of district heating systems and for development of cogeneration plants that use biomass.

87 project applications were submitted and assessed in the framework of the open tender of project applications "Modernisation of heat supply systems in accordance with environmental requirements and rise of energy efficiency both on the production and distribution side as well as the end consumer side of the heat supply system" of SPD Sub-Activity 1.1.4.2. Co-financing from the European Regional Development Fund (ERDF) was granted for 29 project applications. The projects envisage modernisation of heat supply systems according to environmental requirements and improvement of energy efficiency both on the production and distribution side as well as the end consumer side of the heat supply system. 6 project applications were approved and are being implemented in the framework of the national programme "Improvement of heat supply systems by reducing the content of sulphur in fuel" of SPD Sub-Activity 1.1.4.1.

Supporting reconstruction of district heating systems, construction of heat sub-distribution units and other heat regulation equipment and reduction of heat losses in buildings, the Minister of Economics Regulation No. 192 "On Energy Efficiency Programme of Local Governments" of April 23, 2007 was issued. Through it, utilisation of appropriation in the amount of LVL 5 million, granted in the form of earmarked subsidy to local governments by the Law "On the State Budget for 2007" in the Ministry of Economics Programme 29.00.00 "Energy Policy", was ensured in the framework of an open tender of local government projects.

6.3.3. Construction Policy

The goal of the state policy in construction is creation of conditions to meet the demand of the national economy for environmentally friendly, healthy, energy-saving and resources-saving, aesthetic and modern buildings.

By planning the development of construction in the Republic of Latvia, the Cabinet of Ministers has accepted the following political documents:

- the Concept for State Strategy in Construction on November 5, 1996;
- the Concept for Strategy on Terms for Converting the Former USSR Technical Norms of Construction and on Financing on September 28, 1999, and
- the National Programme on Construction on August 30, 2002.

In the *Declaration of the Intended Activities of the Cabinet of Ministers of November 7, 2006*, defining education, knowledge and competitiveness as the basis for growth in basic principles for development of sectors, the government has set the following tasks for development of the construction sector:

“1. Ensuring of development and implementation of the single construction policy, inter alia, eliminating the fragmentation and functional overlapping of involved institutions and by creating a co-ordinated and integrated construction management and control system.

2. Modernisation of the Latvian system of construction standards by laying down minimum requirements for functionality of buildings; improvement of the national building standardisation and supervision system.

3. Reduction of administrative obstacles in construction and simultaneously improving quality control in construction and observation of environmental requirements; elimination of bureaucratic obstacles in performing repair works of buildings and destruction of illegally constructed buildings.

4. Providing construction branch players with access to building standards, local government construction regulations and issued building permissions.

5. Promoting of construction that is safe to public, friendly to environment and human health and also energy-efficient; improvement of the system of legal acts in the construction sector.”

National Programme on Construction is the integrated target programme for the development of the construction sector for 2002-2012, and its main goal is to achieve development of competitive construction by providing Latvian construction sector with a technical and organisational normative base harmonised with EU legislation, encouraging high-quality and energy-efficient construction, obtaining increased competitiveness of construction specialists and promoting development of Latvian construction science. Action plan for implementation of this programme is updated every year in accordance with the situation in the sector, and all ministries, Latvian Association of Local and Regional Governments, and non-governmental organisations of the construction sector are involved in this process by giving and evaluating proposals on activities before their inclusion into the plan.

In 2007 the *Action Plan for Implementation of the National Programme on Construction* was supplemented with a draft of new policy document (Construction Guidelines), drafts of normative acts for introduction of the Construction Information System, amendments to several normative acts, harmonising them with EU legislation, drafts of National Annexes to Eurocode standards, measures for alignment of business environment, promotion of fair competition in

construction procurement, rise of competitiveness of local construction companies, improvement of skills of construction specialists, reduction of illegal employment in the sector, as well as the draft Programme for Promotion of Renovation of Apartment Houses, the draft Concept for Development of Social Dwellings and other measures important for construction and renovation of housing.

In order to implement the set tasks improvement of the normative base of construction by including norms that meet the economic and latest technological requirements which are harmonised with EU positions into normative acts, by adaptation and introduction of European standards, as well as work to ensure construction supervision and control, to improve quality of services provided by state and local government bodies, to reduce administrative obstacles and to ensure public access to information important for the society, should be continued.

The state legislatively regulates only those requirements in construction, non-observance of which may affect human life, health, environment or interests of all society. It has also a task to reduce administrative barriers to construction contractors. The amendments to the *General Construction Regulations* prepared by the Ministry of Economics and submitted to the Cabinet of Ministers on May 18, 2007 define a new form of construction process (combined planning and building operations), determine a simplified procedure for connections of existing buildings to existing networks, as well as pay greater attention to fire security. It will actually diminish the time of construction and will allow saving resources. However, this process will be successful only if it will comply with the set requirements. In order to ensure this, a responsibility limit is set for every participant of the construction process.

The new Latvian construction norm LBN 501-06 “Procedure for Determining Construction Costs” will make considerably easier for both central and local government institutions and for construction contractors to prepare for public construction procurement and carry it out with a good quality.

In order to ensure transparency of the construction process and to reduce administrative obstacles as well as to improve construction management and control functions, amendments to Article 4 of the *Construction Law* and Cabinet of Ministers Regulation No. 983 of December 5, 2006 “Regulations of Construction Information System” (CIS) created a base for establishment of the single system in the country, which would include the information about every building from the moment of intention until its commissioning, inter alia, about decisions taken by local governments in the field of construction. A pilot project was worked out and preparatory work for a tender for introduction of CIS is under way. It is planned to fully introduce the system by 2010 ensuring accumulation of construction information as well as electronic exchange of

information among construction management and control institutions and participants of construction. Beginning of CIS is constituted by two already introduced databases – Register of Construction Businesses and Register of Certified Specialists, which provide an opportunity to efficiently check legality of operations both of companies and specialists.

In accordance with Article 10 of the *Construction Law* and Cabinet of Ministers Regulation No. 453 of June 28, 2005 “Regulation on Registration of Construction Businesses”, businesses are being registered in the Register of Construction Businesses. The number of documents to be submitted and the time for consideration of application and making decision have been reduced to a minimum, daily reception of documents at the Customer Service Centre is prescribed and, for businessmen’s convenience, certificates are being issued throughout the workday.

As of May 1, 2007 the register contains information on 4865 construction businesses, staff employed by companies, persons with rights of permanent practice in accordance with Article 8 of the *Construction Law*, data characterising company operation, information on violations in construction and violations of rules of the register. Register of Construction Businesses is publicly available with the exception of the data, the availability of which is limited in accordance with the normative acts regarding business secret and data protection.

Conformity assessment of specialists in various spheres of construction, granting a certificate of

construction practice or architectural practice in the respective sphere, is carried out by 8 building specialist certification centres of non-governmental professional organisations, which are accredited by the Latvian National Accreditation Bureau (LATAK) and by the Latvian Architects Society.

The joint register of certified specialists, which is maintained by the Ministry of Economics, contains information on 8388 practice certificates, of which 7448 are construction practice certificates in various fields of construction and 940 are architectural practice certificates. Of the total, Latvian Architects Society has issued 940 architectural practice certificates, Certification Centre of Construction Specialists of Latvian Association of Civil Engineers – 3819 construction practice certificates, Certification Centre of Association of Heat, Gas and Water Technology Engineers of Latvia – 1900, Certification Centre of Hydroamelioration Construction Specialists of Latvian Land Reclamation Specialists Society – 235, Certification Centre of Latvian Railwaymen Society – 258, Certification Centre of Latvian Shipping Association – 55, Certification Department of Latvia’s Electricians’ Brotherhood – 178, Certification Centre of Latvian Association of Energy Construction – 447, and Certification Bureau of Latvian Electricians’ Society – 556 construction practice certificates.

Construction is among the national economy sectors that develop most rapidly in Latvia (see Box 6.6).

Box 6.6

Development of construction in 2006

Data of the Central Statistical Bureau indicate that 2006 has been a special year. Average annual growth rate of construction in Latvia was 10.9% in the period from 2000 until 2004, while the volumes of construction reached LVL 1131.6 million in 2006 or by 14.4% more (in constant prices) than in 2005, exceeding the results of 1999 almost three times. The volume of building work performed abroad has also increased, indicating growth of competitiveness of Latvian construction contractors. Since 2000, exports of construction services in total have increased imports by 2.1 times.

Volumes of new construction (in constant prices) in the country have increased by 22.2% or LVL 106.8 million, while volumes of repair and reconstruction work have grown by 7.1% and LVL 36.0 million respectively. In comparison with the previous year, volumes have increased by 2.1 times in construction of bridges, by 1.4 times in construction of educational institution buildings, industrial production buildings and warehouses, and by 1.2 times in construction of administrative buildings and living houses.

The rapid growth of construction was greatly due to the growing domestic demand that is based both on increase of wages, on increased crediting and on ever growing investment. Increasingly bigger attention paid to reduction of administrative obstacles and availability of current information on the Internet are also of some importance.

Along with growth of construction rates, demand for building materials has increased and manufacturing of local construction products has become topical. New production units are developing successfully by introducing new technologies for development of up-to-date materials.

With rapid increase of prices for resources and construction products, costs of construction in 2006 rose by 20.9% on average in comparison with 2005, which is the largest increase of construction costs during one year since 1995. The issue of how to reduce costs, not deteriorating the quality of construction work and observing principles of

sustainable development, is topical. As a result of the study “Opportunities of reduction of construction costs in Latvia”, proposals about opportunities to use instruments at disposal of state institutions and the Bank of Latvia for this purpose have been prepared.

Although the sector develops rapidly and total volumes of construction keep growing, the territorial distribution of investment and construction activities in the country is still very uneven. In the previous year, the total number of commissioned buildings was 9077, of which 4162 were commissioned in Rīga and Rīga district, 990 – in Valmiera district, 931 – in Ventspils district, 830 – in Jelgava district, 704 – in Liepāja

district, 611 – in Daugavpils district, 483 – in Madona district, and 366 – in Rēzekne district.

Similar situation will continue, as indicated by the number of issued building permits for new construction: 6060 in Rīga and Rīga district, 1011 – in Jelgava district, 857 – in Valmiera district, 792 – in Ventspils district, 583 – in Daugavpils district, 508 – in Liepāja district, 336 – in Madona district, and 277 – in Rēzekne district.

In order to ensure state control functions in construction, improvement of the structure of the State Construction Inspection, development of human resources, assessment and motivation of employees are necessary.

Number of construction violations and level of corruption possibility in local governments are still comparatively high, development rates of scientific potential in the sector are insufficient and the growing demand for skilled specialists in construction is not fully met.

Functions of the organisational structure of the sector are still divided: general supervision and co-ordination of construction in the country is carried out by the Ministry of Economics, while the supervision of particular areas is under competence of other ministries. The competence of the Ministry of Transport and Communications includes road construction (Road Directorate of Latvia), railways, ports and telecommunications, while territorial planning is within the scope of competence of the Ministry of Regional Development and Local Government. Ministry of Welfare, Ministry of Justice, Ministry of the Interior, Ministry of Environment, Ministry of Health and Ministry of Agriculture determine particular requirements for buildings or their construction. State Inspection for Heritage Protection that is subordinated to the Ministry of Culture sets requirements for reconstruction and restoration of cultural monuments.

Direct supervision of construction in their administrative territories is carried out by 553 local governments (7 cities, 53 towns, 35 amalgamated local governments (provinces) and 432 rural municipalities) that have established their construction boards for this purpose or have delegated their supervision powers to other construction boards. 147 construction boards (boards of cities, towns, districts, amalgamated local governments, rural municipalities or united boards) and 99 building inspectors operate in Latvia.

Data summarised by the State Construction Inspection indicate a small trend to decrease in violations of requirements of normative acts. 1148 builders were brought to administrative responsibility for the violations, the claimed amount of fines was LVL 256 249 and construction was suspended in 253 cases.

During the examinations the indications of insecurity in several objects of construction were established, which are due to a low-quality

construction plan or insufficient assessment of technical condition of a current building.

In order to reduce violations and application of the *Code of Administrative Violations* in construction, informative work with construction boards of local governments has to be done more actively.

Website of the Ministry of Economics provides current information about novelties in construction and informative measures as well as access to policy and normative documents of construction sector, procedure of construction process, responsibilities of producer and the procedure of conformity assessment of construction products, information on public procurement in construction, procedure for conferring and renewing rights of construction and control of environmental accessibility, procedure for registration of construction businesses, as well as the required application forms.

As the situation in the sector changes, it is necessary to increase administrative capacity of institutions involved in development and implementation of construction policy as well as to improve the construction control system. As the first accomplishment, which can be mentioned is the re-division of functions between ministries at the beginning of 2007, when the Housing Policy Department and the Housing Agency were included in the structure of the Ministry of Economics. This considerably increases the current capacity of the ministry, and management as well as implementation of the projects related to the issues of operation, reconstruction and energy-efficiency of buildings (all of them are construction issues to the great extent) will become more determined.

In order to carry out purposeful development of construction, the main action priorities are:

- development of a new political document – Construction Guidelines – and a programme for its implementation;
- optimisation of the institutional structure of construction;
- improvement of construction control system.

The urgent tasks are as follows:

- improvement of the conformity assessment system and market supervision of construction products;
- promotion of development of scientific disciplines related to construction;
- development of production of domestic building materials;
- improvement of educational system for training of highly skilled construction specialists.

The fact that non-governmental professional organisations of the sector work more and more actively, giving proposals and actively involving themselves in preparation of important decisions and processes of drafting of policy-planning documents

and legal acts, is of certain importance in fulfilment of the tasks. The following active social partners involved in formation of the construction policy and in its implementation that should be mentioned are: Latvian Architects Society, Latvian Association of Civil Engineers, Latvian Construction Contractors Association, Latvian Building Inspectors and Supervisors Association, Association of Heat, Gas and Water Technology Engineers of Latvia, Latvian Building Materials Producers' Association, Latvian Window and Door Manufacturers' Association, Latvian Building Materials Traders' Association, Latvian Builders' Trade Union, Technical Experts Association, Latvian Association of Local and Regional Governments, Association of Road Builders of Latvia, Latvian Land Reclamation Specialists Society, Latvian Shipping Association, Latvian Railwaymen Society, Latvian Geotechnical Union, Latvian Association of Energy Construction, Latvia's Electricians' Brotherhood, Latvian Electricians' Society, Latvian Consulting Engineers' Association, as well as Society of People with Disabilities and their Friends "Apeiron".

6.3.4. Tourism Policy

The main goal of Latvian state tourism policy is to improve competitiveness of the tourism sector and,

through promotion of sustainable growth of tourism, encourage balanced development of regions, preserve cultural and natural heritage and foster social integration of the society.

In order to determine and implement state tourism development policy, a system of tourism policy planning documents and normative acts (see Box 6.7) is created and is being improved on a regular basis in Latvia. Guidelines of Tourism Development Policy of Latvia (hereinafter – Guidelines) approved by the Cabinet of Ministers in 2004 (Cabinet of Ministers Instruction No. 559 of August 11, 2004) define basic principles of tourism development policy, set goals of tourism development and identify main lines of action for achievement of these goals: positioning of Latvia as a distinctive, safe and recognised tourist destination; development of incoming and domestic tourism; promotion of co-operation.

In order to ensure achievement of objectives set in the Guidelines, the Tourism Development Programme of Latvia for 2006-2008 was worked out (approved by the Cabinet of Ministers Instruction No. 505 of July 5, 2006, hereinafter – Programme). The Programme is a medium-term policy-planning document developed for 3 years and includes horizontal activities of tourism development (see Box 6.8).

Box 6.7

Changes in normative acts

On grounds of the delegation given by the Law "Amendments to the Tourism Law" adopted by the Saeima on February 16, 2006, the Cabinet of Ministers has approved three Cabinet of Ministers Regulations worked out by the Ministry of Economics:

- Cabinet of Ministers Regulation No. 1017 of December 19, 2006 "Regulations regarding a Database of Tourism Services Providers" (in the framework of implementation of this regulation, a connection of the database of tourism services providers with the Integrated State Information System will be established in 2007, thereby providing a base for single information system about tourism services providers in Latvia);
- Cabinet of Ministers Regulation No. 67 of January 23, 2007 "Regulations regarding the Procedures for the Preparation and Implementation of a Package Tourism Service, Information to Be Provided to a Client, and the Rights and Duties of a Package Tourism Service Provider and a Client";
- Cabinet of Ministers Regulation No. 226 of April 3, 2007 "Regulations regarding the Procedures for Filling, Keeping and Submitting a Foreigner's Declaration" (the regulation pertains to the planned Latvia's joining the Convention Implementing the Schengen Agreement); the Cabinet of Ministers has also accepted the draft law "Amendments to the Administrative Violations Code of Latvia" that prescribes administrative penalties for non-observance of these regulations.

Amendments to the Tourism Law also prescribe that, as from January 1, 2008, tourist guide services in Latvia will be only provided by persons with a certificate of professional qualification. In order to meet the mentioned requirements, the Saeima passed the Law "Amendments to the Law on Regulated Professions and Recognition of Professional Qualifications" on November 2, 2006. Ministry of Economics, on the basis of analysis of conditions for provision of tourist guide services in other EU member states and their conformity with EU legal norms, and in co-operation with both Latvian tourist guide associations and other concerned parties, continues working out draft Cabinet of Ministers regulation regarding the procedures for certification of a tourist guide and provision of tourist guide services.

Box 6.8

Tourism Development Programme of Latvia for 2006-2008

The main goal of the Programme is to ensure annual increase of the value-added of the tourism sector by 10-15% and growth of the share of the tourism sector in GDP by 20% annually (at current prices).

Sub-goals of the Programme are as follows:

- promote recognition of Latvia as a tourist destination, increasing the market share of Latvian tourism in tourism markets of Latvia and achieving repeated return of travellers (tourists) to Latvia;
- encourage development of commercial activity of tourism, achieving balanced development of tourism infrastructure, tourism services and tourism products, which would correspond to tourism demand;
- foster development of co-operation in the field of tourism, attaining improved capacity of public institutions in the tourism sector as well as local governments and non-governmental organisations.

Specific activities promoting tourism development in the framework of the allocated state budget are determined in the annual action plan. Action Plan of Latvian Tourism Development for 2007 was approved by the Cabinet of Ministers Regulation No. 425 on June 6, 2007. The mentioned programme and plan include horizontal activities for tourism development, which are implemented by the Ministry of Economics, Latvian Tourism Development Agency, other ministries and public institutions in co-operation

with local governments, the private sector and non-governmental organisations.

LVL 1.3 million were allocated to the state budget programme “Implementation of the Tourism Policy” in 2007. In accordance with the set priorities, these finances are directed to strengthening positions of Latvia as a tourist destination, improvement of tourism infrastructure, promoting development of new tourism products and expanding co-operation.

Rapid growth of the tourism sector in Latvia on the whole continued in 2006 (see Box 6.9).

Box 6.9

Indicators of Latvian tourism development in 2006

In 2006 the share of the tourism sector in Latvian GDP was 2.0% (preliminary results), compared with 1.8% in 2005. In the period from 2000 to 2003 a stable increase in the incoming tourism had taken place – by 9.5% on average annually. The tourist flow to Latvia increased rapidly after Latvia’s accession to the European Union: in 2004–2006, the average increase was by 23.4% annually. Number of foreign travellers in Latvia reached 4.645 million in 2006 (increase by 23.1% in comparison with 2005). Expenses of foreign travellers in Latvia amounted to LVL 266.2 million in 2006 (increase by 40.1% in comparison with 2005). However, in spite of these positive trends, the indicators of tourism balance of payments are still negative – expenses of Latvian residents during their trips abroad in 2006 exceeded expenses of foreign travellers in Latvia by LVL 138.4 million.

The number of hotels and other tourist accommodation establishments amounted to 393 in 2006 (decrease by 6% in comparison with 2005), while the number of beds reached 24 489 (increase by 1.8% in comparison with 2005). The number of nights spent in hotels and other tourist accommodation establishments has risen, and the number of foreign guests served has reached 816 297 (growth by 11.8% in comparison with 2005).

Results of a survey of Latvian residents about domestic travels indicate that 1.2469 million people went on one-day recreation trips in 2006 (increase by 2.8% in comparison with 2005), while 751.1 thousand people went on short trips with staying overnight (1–3 nights) (growth by 3.8% in comparison with 2005). Expenses of domestic travellers on recreation and business trips amounted to LVL 214.4 million (increase by 35.5% in comparison with 2005), making 44.6% of the total expenses of foreign and domestic travellers, and show the economic importance of the local tourism.

Growth of the tourism sector in 2006 was mostly promoted by the following factors:

- strengthening of Latvia as new tourist destination after accession to the European Union;
- measures of Latvian tourism marketing implemented in high-priority, priority and perspective markets of tourism;
- World Hockey Championship in Rīga;
- increased number of direct flights;
- expansion of low-cost airline services;
- increased number of tourist class hotels.

The rapid development of tourism also in 2006 has made even more acute the issue of non-conformity of the supply of provided services with the demand, and, as a result, the competition and the quality of provided services have decreased. High inflation in the country has caused rise of prices for tourism services, thereby deteriorating correspondence of the value of provided services with the price, which until now was one of the biggest factors of attractiveness of Latvia from the viewpoint of foreign tourists. Unlawful actions against tourists or their property also continue, undermining the positive image of the state. Solving this problem and taking care of the safety of tourists, the Tourist Hotline 22033000 is introduced in Latvia. It enables those tourists who need help in various complicated situations to get informative support.

According to the set priorities, measures supporting tourism development in the previous period were aimed at improvement of tourism infrastructure, promotion of development of new tourism products and services, and strengthening positions of Latvia as a tourist destination.

For promotion of recognition of Latvia’s tourism image and popularisation of Latvia as a tourist destination in the international tourism market, the

Latvian Tourism Development Agency has carried out several large-scale marketing measures in the 1st half of 2007. In February, an international working seminar for tourism professionals “Buy Latvia, Buy the Baltics” took place in Latvia. In its framework, foreign participants could meet and make contacts with representatives of Latvia as well as acquaint themselves with a wide supply of tourism products not only at presentations, but also by personal presence, going on various tours throughout Latvia.

With the goal to awake interest of potential European travellers in Latvia before the beginning of the new tourism season, a wide advertising campaign “You Won’t Believe It Until You See It” was launched. In its framework, advertising movies about Latvia were broadcasted on several international TV networks, advertising flags were placed on the biggest internet portals of Latvia’s priority target market countries, and posters were set up at underground train stations of London.

Latvian Tourism Development Agency continues carrying out annual marketing activities (take part in international tourism fairs, publish informative materials of tourism, organise working seminars and visits of foreign media representatives and tour

operators to Latvia), especially focussing on Latvia's high-priority target markets (Estonia, Russia, United Kingdom, Lithuania, Finland, Germany, Sweden) and directing particular marketing activities to the prospective distant tourism markets (USA and Japan).

In order to improve awareness of professionals of the tourism sector about topicalities in the sector, in addition to the previously held tourism information days, the Latvian Tourism Development Agency has started publication of a new free periodical "Tūrisms" ("Tourism").

Continuing development of a high-quality tourism infrastructure and a single tourism information system, the Latvian Tourism Development Agency has involved in implementation of the INTERREG project "Creation of a New Tourist Destination by Combining Supplies of Latgale and Rytu Aukstaitija border regions", thereby encouraging growth of the tourist flow in the region and promoting recognition of this region as a joint tourist destination – Baltic Land of Lakes.

In order to ensure further international integration of Latvian tourism sector, representation of state interests and acquiring better practice, international co-operation is developed by taking part in the work of the UN World Tourism Organisation and the European Travel Commission as well as in the work of the Tourism Advisory Committee and the Tourism Sustainability Group of the European Commission. Latvian Tourism Development Agency also implements Latvia's participation in the pilot project of the European Commission "European Destinations of Excellence" (the theme of 2006 was "Best Emerging Rural Tourism Destinations"), which has the aim to draw attention to the diversity, different and shared values of European tourist destinations and to promote destinations where the economic growth is ensured by sustainable tourism development. Latvia will also participate in the next phase of the project (the theme of 2007 will be "Tourism and Local Intangible Heritage"). At the Baltic Sea region level, by participating in the work of Baltic 21 Tourism Task Force and in the INTERREG III B project "AGORA – Network of Sustainable Tourism Development in the Baltic Sea Region", the Ministry of Economics has conducted the study "Tourism for all" as well as organises the seminar "Sustainable Development – Opportunity for Growth of a Competitive Tourism Sector" in June 2007 and will draft the national Agenda for the 21st century (Agenda 21) of the tourism sector.

Latvia will be the presiding country of the Council of the Baltic Sea States from July 2007 to June 2008. Promotion of a sustainable tourism development

network in the Baltic Sea region will be among Latvia's priorities of action during its presidency.

Promoting co-operation between Baltic States in creation and popularisation of joint tourism products, national tourism organisations of Baltic States organise the "Baltic Travel Marathon" this year on the basis of the "Latvian Travel Marathon" successfully carried out by the Latvian Tourism Development Agency in the previous year. This project is being implemented with a goal both to encourage development of domestic tourism and enable residents of Baltic States to acquaint with tourism opportunities in all region.

From the standpoint of Latvian tourism development perspective, the most important work for the Ministry of Economics in 2007 relates to drafting the required normative acts for receipt and absorption of resources from the European Regional Development Fund (EUR 42.3 million) in 2007-2013 for Measure 4.2 "Tourism" of Priority 4 "Quality Environment for Life and Economic Activity" of the 3rd Operational Programme "Infrastructure and Services". The objective of this measure is to strengthen the position of Latvia as a tourist destination and increase its competitiveness, creating favourable conditions for complex development of tourism products of national importance. Two activities are planned: 4.2.1 "Development of Tourism Product of National Importance" and 4.2.2 "Development of Tourism Information System". Activity 4.2.1 "Development of Tourism Product of National Importance" is divided into 3 sub-activities: 4.2.1.1 "Conservation and Renovation of Urban Planning Monuments of State Importance and Adjustment of Infrastructure to Development of Tourism Product", 4.2.1.2 "Development of Bicycle Tourism Product of National Importance" and 4.2.1.3 "Development of Cultural, Active, Health and Recreation Tourism Product of National Importance".

Latvia as EU member state will pay special attention to further integration of the renewed EU tourism policy into state tourism policy and its implementation (Communication from the European Commission "A Renewed EU Tourism Policy: Towards a Stronger Partnership for European Tourism").

Evaluating the current situation and trends of tourism development, the following main priorities are set for the further period:

- promote competition in the tourism sector and improve competitiveness of tourism companies;
- develop Latvian tourism product and tourism information system;
- encourage compliance with sustainable development principles in planning and implementation of the tourism policy.

6.4. Business Environment

Business environment in Latvia is being consistently improved through development of the legal framework, harmonising it with EU requirements and monitoring the effects of administrative procedures on business activity. Considerable reforms and improvements have been achieved in registration of enterprises, taxation policy, customs legislation and procedures and border crossing, construction, real estate development and other areas.

Reforms for improvement of business environment are estimated positively in various surveys, for example, in the survey “*Doing Business in 2007: How to reform*”¹ conducted by the World Bank Group, business environment of Latvia takes the 24th place among 175 countries, which is by 7 positions higher in comparison with the previous year (in “*Doing Business in 2006*”, Latvia took the 31st place among 155 countries). The higher place was got due to achievements in the spheres of taxation, licensing and liquidation of enterprises. Latvia also has a high place (11th) in the topic “*Enforcing Contracts*”, and starting a business is also made simpler. Latvia is placed among 15 countries where reforms favourable to business activity proceed most rapidly. Business environment is evaluated in 19 aspects, and Latvia is estimated as follows:

- 11th place – in enforcing contracts;
- 13th place – in getting credit;
- 25th place – in starting a business;
- 28th place – in trading across borders;
- 46th place – in protecting investors;
- 52nd place – in paying taxes;
- 62nd place – in closing a business;
- 65th place – in dealing with licenses;
- 82nd place – in registering property;
- 123rd place – in employing workers.

Action Plan for Improvement of Business Environment is worked out annually since 1999. The *Action Plan* is an inter-ministry policy planning document setting out directions of activity for implementation of business environment policy as well as tasks, measures to be carried out, responsible institutions, indicators for assessment of how the tasks have been accomplished and their accomplishment terms. Problems included in the *Action Plan* and their solutions are identified through close co-operation with organisations representing entrepreneurs (Council of the Small and Medium-Sized Enterprises and Crafts, National Economy Council, Foreign Investors Council in Latvia) as well as through assessment of problems identified in business environment surveys. The *Action Plan* covers amendments to legal acts,

revision and simplification of procedures, improvement of co-ordination between various bodies, preparation and publication of information, as well as training employees of public institutions.

Directions and tasks of the *Action Plan* cover such spheres as taxation policy and tax administration, improvement of legal environment for business activity, reduction of the number of procedures and the required time, and improvement of access to information.

The *Action Plan* for 2007 includes 27 measures. Its goals are directed to raising quality of business environment, improvement of taxation policy and tax administration, solution of problems of the construction sector, access to information and promoting co-operation between businesses and public administration bodies, reduction of administrative barriers for entrepreneurs, and fostering economic activity and establishment of new companies.

The most essential measures of the *Action Plan* are:

- improvement of medium-term and long-term forecasting of the labour market;
- efficient settlement of labour disputes;
- bringing into effect the real estate registration system and simplification of registration procedures;
- application of uniform normative acts in local governments in the sphere of planning and construction;
- improvement of the process of acquisition of statistic data, etc.

Meetings of the **Foreign Investors Council in Latvia (FICIL)** with higher government officials are held annually. Prime Minister, Minister of Economics, Minister of Foreign Affairs, Minister of Finance and other government officials take part in the high-level meetings. They meet with leaders of bigger international investor companies and other higher officials that represent various sectors and countries. Since the 2nd High-Level Meeting, recommendations of FICIL are included in the *Action Plan*. The 11th high-level meeting of Latvian government and FICIL took place on May 31 and June 1, 2007. The most important issues discussed were:

- potential improvements of taxation policy and tax administration;
- issues of transport infrastructure;
- issues of public private partnership;
- development of Latvian economy and business environment.

In 2007 the Ministry of Economics conducts the regular (already the 4th) **survey to assess measures for improvement of business environment**. The

¹ Source: www.doingbusiness.org

survey consists of three main elements: *business survey*, *self-appraisal* of the influence on business environment exerted by *national and local government institutions*, and *report of policy recommendations*. 700 company managers in Latvian cities and regions will be interviewed in the survey. About 50% of respondents will be interviewed in Riga, 10% – in Pierīga (vicinity of Rīga), 10% – in Vidzeme, 8% – in Kurzeme, 13% – in Zemgale, and 10% – in Latgale; of them, approximately 18% of respondents will be interviewed in Daugavpils, Liepāja, Jelgava, Ventspils, Jūrmala and Rēzekne, about 9% of respondents – in other district towns, approximately 16% – in other towns, and 9% of respondents – in the countryside. The companies to be interviewed will be selected so that they would correspond to the criteria of sphere of action, legal form, age, property rights and size of companies.

The survey is expected to cover such spheres as starting a business, licensing, environmental requirements, foreign trade, observance of working regulations, inspection activities, tax administration, state assistance to business activity and electronic services. The survey will contain questions about administrative costs and time spent fulfilling requirements of supervision institutions during entrepreneurs' daily business activities in phases of start-up, choice of location, and operation.

Results of the survey conducted in 2007 will be available at the end of this year.

The survey allows to compare development trends of business environment and to identify spheres where new reform programmes are required as well as to

measure effectiveness of various activities for improvement of business environment. The survey helps both to develop measures of assistance to small and medium-sized enterprises and to find out the opinion of entrepreneurs about operation of state and local government bodies.

Panel of private sector experts and representatives of entrepreneur associations is established for independent supervision of the survey and determination of entrepreneur priorities. Representatives of non-governmental organisations (National Economy Council, Council of the Small and Medium-Sized Enterprises and Crafts, Foreign Investors Council in Latvia, Employers' Confederation of Latvia, Latvian Chamber of Commerce and Industry, Latvian Association of Certified Auditors, Foundation for Representation of Taxpayers' Rights and Interests, Association of Mechanical Engineering and Metalworking Industries of Latvia, Latvian Association of Business Consultants, Logistics and Customs Brokers Association, Latvian Real Estate Association) as well as independent experts are represented in the expert panel.

It is planned to hold a conference at the end of this year in order to discuss results of the survey and recommendations for improvement of business environment with officials of the responsible institutions and involved entrepreneurs.

Several amendments to **legal acts** were made in 2006 and the 1st half of 2007, that facilitates business activities (see Box 6.10).

Box 6.10

Amendments to legal acts in 2006-2007

Amendments were made to the Cabinet of Ministers Regulation No.44 of January 20, 2004 "Regulations Regarding Work Permits for Aliens", crossing out the requirement for employers to submit to the State Employment Agency a note of the State Revenue Service for confirmation of a work invitation.

Spheres where an employer may employ a person, concluding an agreement for a definite time, as well as list of seasonal works were expanded.

Work group of the Ministry of Interior develops a migration concept which envisages that, after making the respective amendments to normative acts, employers will have to submit an invitation for alien only to the Office of Citizenship and Migration Affairs and will not have to pay a state fee for consideration of documents.

Amendments regarding financial statements of businesses were approved, throwing more light on the contents of balance and reports of receipts and expenses as well as the procedure of preparation and submission for individual businessmen whose turnover from economic activity transactions in the previous year exceeds LVL 200 000.

Amendments to the Law "On Taxes and Fees" are developed, which prescribe introduction of a system of flexible and incentive tax penalties, observing the principle of proportionality.

As from March 20, 2007 taxpayers which have concluded agreement with SRS regarding signing of electronic documents with electronic signature granted by SRS have an opportunity to receive a new form of service online, namely, information about the taxpayer's state of tax payment i.e. overpayment of taxes or tax debts, including principal debt and penalty for delayed payment.

In 2007 the Ministry of Economics has started a new project, namely, conducting pilot projects of administrative burden measurement for entrepreneurs. This year, it is envisaged to carry out pilot projects in the areas of taxes, construction, real estates, fuel circulation, and labour legislation. The Standard Cost Model methodology used in several EU member states will be applied for the pilot projects so that the data acquired would be comparable with results of other

countries. Taking into account the results of the pilot projects, accordance of the used methodology with Latvian situation will be assessed so that it would be possible to carry out measurements in other areas as well as repeated measurements for evaluation of effectiveness of the performed changes also in further years. Results of the pilot projects are expected at the end of this year and will be discussed at the planned business conference.

6.5. Innovation and New Technologies

National innovation system of Latvia is poorly developed at present and considerably lags behind the average level of EU member states. Although a growth of the number of active companies has been observed in the sphere of innovation, especially in the sector of services, results of the Central Statistical Bureau's survey for 2005 show that mere 17.5% on average of all companies in Latvia are innovative, at the same time this indicator is 45% on average in EU member states.

National Lisbon Programme of Latvia 2005-2008 (see Chapter 6.1) sets innovation among the main priorities. In order to foster increase of national innovation capacity, the following tasks are set:

- to create favourable institutional environment for innovative activity;
- to promote co-operation of science, education and the private sector;
- to support transfer of knowledge and technologies;
- to encourage development of new products and technologies, including promotion of entrepreneurs' awareness of the intellectual property and its protection.

In order to fulfil tasks set in the national Lisbon programme, the planned activities for promotion of industrial research and for development of new products and their introduction into market were continued and several new activities were launched in 2007.

Commercial companies have an opportunity to submit projects to the Ministry of Education and Science in order to get support for implementation of projects in the framework of **EUREKA Programme**. EUREKA Programme is an EU programme for promotion of commercial activities and international co-operation of scientific institutions in order to foster development of high technologies, new competitive products and services. Commercial companies may receive up to LVL 91 000 for implementation of collaborative research project and the aid intensity may constitute 75% of costs for conduction of industrial research and 50% of costs for planning work. LVL 400 000 were granted to the Ministry of Education and Science in 2007 for implementation of this initiative.

Ministry of Education and Science continues implementing the **Market-Oriented Research Programme**. In its framework, the research projects aimed at promotion of integration of science and production are supported. Scientific institutions registered in the Register of Scientific Institutions can receive financing in the amount of 70% of the attributable costs but the remaining 30% have to be attracted from commercial companies. In the framework of the programme, 27 projects were supported in 2006 and 15 projects were supported in 5 months of 2007.

In order to promote transfer of technologies and knowledge, in 2007 the Ministry of Economics continued supporting operation of **technology transfer contact points** at the University of Latvia, Riga Technical University, Latvia University of Agriculture, Rēzekne Higher Education Institution and Ventspils University College. The goal of technology transfer contact points is to encourage co-operation of scientists and entrepreneurs and ensure efficient introduction of research results of state research institutions into production. LVL 202 000 were granted for implementation of the projects in 2007. In the framework of technology transfer contact points, 63 commercialisation offers were prepared, at least 13 co-operation agreements with entrepreneurs were initiated and 26 patent applications (among them 7 international patent applications) were prepared in 2006.

Latvian Technological Centre continues ensuring operation of the **Innovation Relay Centre (IRC)** with the support from the Ministry of Economics and the Ministry of Education and Science. IRC Latvia is one of 71 European IRC network centres that operate in conjunction with a joint programme, and the goal of these centres is to ensure unified and efficient operation of the EU technology transfer network and, with its help, promote and support competitiveness of EU member states on a global scale. In the framework of the centre, support is given to Latvian entrepreneurs, encouraging transfer of innovative technologies from Latvia to Europe or from European countries to Latvia. 11 technological audits were conducted, 6 informative seminars in Latvian regions were organised and conclusion of 4 technology transfer agreements with the total economic effect after implementation in the amount of approximately LVL 2.4 million was stirred in the framework of the centre in the 1st half of 2007.

In 2007, the Ministry of Economics started implementing the **Programme for Development of Innovation Centres and Business Incubators** that has a goal to promote upgrading of innovation infrastructure, support innovation centres and establishment and operation of business incubators as well as provision of services to start-ups by innovation centres and business incubators, thereby facilitating establishment and development of new innovative companies. 11 projects of innovation centres and business incubators have been supported in the framework of the programme:

- “Ventspils Business Incubator – centre of development of innovative companies” of Ventspils University College;
- “Establishment of innovation incubator in the Biomaterials Innovation and Development Centre of Riga” of Riga Technical University;

- "Establishment of innovation centre of Rēzekne Higher Education Institution" of Rēzekne Higher Education Institution;
- "Establishment of business and technology incubator of Science and Technology Park VALDEKA" of Latvia University of Agriculture;
- "Project of establishment of Medical Equipment Production Innovation Centre" of Riga Stradiņš University;
- "Līvāni business incubator – for development of innovative business activity" of Līvāni province council;
- "Establishment of business incubator of new companies in Ventspils" of Ventspils city council;
- "Establishment of Tukums business incubator" of Tukums town council;
- "Project of establishment of Valmiera Business and Innovation Incubator" of Valmiera town local government;
- "Project of development of Ogre Business and Innovation Incubator" of Ogre province council;
- "Establishment of business incubator" of Jelgava city council.

LVL 1 628 212 have been granted for operation of the centres and incubators in 2007 and LVL 1 641 594 have been granted for their operation in 2008. Implementation of the programme will be completed in 2009-2013 as well, attracting approximately LVL 18.2 million from the European Regional Development Fund and from the state budget.

It is planned to implement the state support programme "**Competence Centres**", attracting the financing from the EU structural funds as from 2008. Competence centre is a company that is formed with a goal to establish a stable long-term partnership between the scientific and the private sector through collective industrial research with commercially applicable results. In order to promote formation of potential competence centres and support the initiative of state scientific institutes and public higher education institutions to co-operate with commercial companies, the Latvian Investment and Development Agency announced the project tender "Planned development of the strategy of competence centres" in June 2007. The goal of the

tender is to support development of operation strategies of competence centres, which would define the principles of centre's operation, main planned projects of industrial research, potential for commercialisation of research results and the necessary resources. It is planned to support development of operation strategies of 10-12 competence centres.

In order to encourage spirit of entrepreneurship and involvement of young people in business activities, in 2006 the Latvian Investment and Development Agency carried out the pilot project for senior students "**Training Course for Authors of Business Ideas**", that will be continued in 2007. In the framework of the project, 4 intensive training courses were organised and 81 students from various Latvian districts were trained within them. 22 perspective business ideas were chosen, of which 5 are implemented in companies. Continuing this initiative in 2007, the competition of business plans "Cup of Ideas" was started in co-operation with Riga city council, JSC "Hansabanka" and JSC "Ekoinvestors"; the goal of this competition is to promote creation of new companies, give an opportunity for every young resident of Latvia to implement his business idea and provide the knowledge, contacts and financing necessary for starting business.

In order to promote wider awareness of society about the role of innovation in development of national economy, one of the main measures in 2007 is the innovation week of the Baltic Sea region "**Innovation Circus**" planned on September 9-13. The aim of the measure is to popularise the role of innovation, demonstrating the most successful Latvian and Baltic innovation in the private, public and educational sectors. It is envisaged to actively involve all visitors into the measure, giving them opportunity to get direct information from managers of innovative companies and scientists about the role of knowledge in creation of new products, meaning of products with high value-added and opportunities for practical application of newly created knowledge. It is planned to complete the innovation week with an international conference "Baltic Dynamics'07" that will be dedicated to innovation and innovative business activity and will take place in the hotel "Reval Latvija" on September 12-14, 2007.

6.6. Information Society

Information society is a social development phase based on free mutual exchange of information and developing a knowledge-based economy. Information society consists of the technological base (infrastructure, software), range of information services available to the society, and the level of individual skills and knowledge. As a result of

development of information and telecommunications technologies, information and knowledge are more and more widely used in work and labour relations, education and everyday life.

With Latvia's accession to the EU, the European Union initiatives with regard to building the information society (see Box 6.11) became binding for Latvia.

Box 6.11**European Union initiatives in building the information society**

In December 1999, the European Union launched the initiative “*eEurope – an Information Society for All*”. In June 2000, the initiative was harmonised with Lisbon Strategy objectives and the *eEurope 2002 Action Plan* was carried out. The main three goals of this action plan were:

- cheaper, faster, secure Internet;
- investing in people and skills;
- stimulate use of the Internet.

As a result of implementation of the action plan in EU member states, in 2002 more than 90% of schools and companies had Internet connection and more than half of all population used Internet on a regular basis. However, the majority of individual users used dial-up access that is an Internet connection with small speed. Therefore, the main goal in the *eEurope 2005 Action Plan* is a wide distribution of broadband data transfer in networks, which by 2010 should embrace at least 50% of all networks.

To boost development of digital economy, on June 1, 2005 the European Commission launched a new initiative “*i2010: European Information Society 2010*”, which is a strategy for the next 5 years. Its goal is to foster growth and jobs in the information society and media industries. 3 policy priorities are outlined in the initiative:

- to create an open and competitive single market for information society and media services within the EU;
- to increase EU investment in research on information and communication technologies by 80%;
- to promote an inclusive European information society.

On April 25, 2006, the European Commission communicated the action plan “*i2010. eGovernment Action Plan: Accelerating eGovernment in Europe for the Benefit of All*” that corresponds to the initiative “*i2010*” and is focussed on such important eGovernment goals for the period by 2010 as inclusion of all EU population in the use of information, provision of access to a wide range of informative services, creation of an electronic public procurement system, achieving conclusion of 50% of transactions electronically and ensuring availability of all information about all public procurement, etc.

Declaration of the Intended Activities of the Cabinet of Ministers headed by the Prime Minister emphasises the tasks for ensuring publicly accessible information services: increasing the role of traditional and electronic libraries and the information network that connects them for receiving information: construction of the Latvian National Library and its development as the central point and co-ordinator of the network of libraries; creation of a Single State Archive Information System; and improvement of the National Ordering System for public broadcasters.

In order to ensure access to information, the following tasks for development of ICT infrastructure and services have been set: ensuring that all people and entities in every part of Latvia have the possibility to receive electronic communications services, including broadband Internet services; development of publicly available Internet access points; implementation of the terrestrial digital television broadcasting; efficient use of limited national resources (radio frequency spectrum, numeration); creation of a single national emergency medical and crisis situation management structure; and increasing the range of electronic mail services.

In order to promote development of eGovernment and eServices, the following activities are envisaged: capacity building of public administration and expansion of the range of e-services and availability of information; development of various channels for delivery of state and local government services (Internet, telephones and cell phones, radio and TV broadcasts); development of ICT infrastructure and services at the national and local government level by extensive use of external services; provision of a complete processing cycle of electronic documents in all national, local and judicial authorities; improvement of data quality in the national and local government information systems, their security,

integration and linkage; introduction of uniform identification cards of Latvia’s residents; formation of a common geospatial information infrastructure; improvement of the state electronic procurement system; improvement of the procedures and systems for collection and processing of statistical data; establishment of an e-election system; enhancement of general IT-related skills among Latvia’s residents.

Building the information society is set as a priority in the National Lisbon Programme of Latvia for 2005-2008 (see Chapter 6.1). The main planned activities for promotion of ICT and building the information society are the following:

- to encourage widespread use of ICT in public services, SME and households (see Box 6.12);
- to ensure the security of networks and information, as well as convergence and interoperability in order to establish an information area without frontiers;
- to encourage development of broadband networks, including the poorly served regions, in order to develop the knowledge economy.

On July 18, 2006 the Cabinet of Ministers approved the *Guidelines for the Development of the Information Society for 2006-2013*, setting lines of action for building the information society in Latvia.

Short-term priority tasks are:

- to develop territorial coverage of ICT access infrastructure;
- to make ICT more accessible financially for households and SME;
- to provide basic skills of ICT usage to individuals and motivate them to use ICT;
- to create electronic services of public administration and use ICT in order to optimise administrative functions; ensure access to public information for local govern-

- ments and entrepreneurs for provision of services and develop centres for provision of public administration services;
- to introduce e-signature and develop infrastructure for its usage;
- to support creation of online services and innovative, knowledge-intensive and environmentally friendly products.

Lines of long-term action for development of information society are:

- to expand the access infrastructure and promote ICT accessibility;
- to develop knowledge and skills of users;
- to develop services and content;
- to develop ICT usage in commercial companies and innovation;
- to develop ICT science and research;
- to promote creation of export-capable ICT products and services.

Box 6.12

Computer and Internet usage in Latvia

According to the data of the CSB survey "Computer and Internet Usage in Households", 41% of all households (households where at least one person in the age of 16-74 years lives) had computers and 42% of households had Internet connection in 2006. 60% of inhabitants had ever used a computer and 56% of inhabitants had ever used Internet. 49% of inhabitants (inhabitants in the age of 16-74 years) used computer on a regular basis and 46% of inhabitants used Internet on a regular basis. 23% of all households had broadband Internet connection.

At the beginning of 2006, 59% of all companies had computers, 46% of companies had Internet connection, and 15% of companies had their own Internet website. 28% of all employees of companies used computer on a regular basis, while Internet was used regularly by 22% of employees.

At the beginning of 2005-2006 academic year, the number of computers per 100 full-time students at higher educational establishments and colleges was 10.7 (7.5 at professional education institutions and 6.2 at comprehensive schools). 100% of higher education institutions and colleges, 87.4% of professional education institutions and 95% of comprehensive schools had Internet connection.

Financing from the EU structural funds and resources from the state and local government budgets will be used for implementation of the development programme.

Action Strategy of the Secretariat of the Special Tasks Minister for eGovernment Affairs for 2007-2009 was approved by the Cabinet of Ministers Instruction No. 954 of December 13, 2006. The strategy comprises lines of action and spheres of competence of the secretariat. Measures and the funding planned for them are formulated in accordance with the principle of development of budget programmes. In the framework of budget programmes, the following new policy initiatives are set in priority sequence:

- management of projects of the operational programme measure "Infrastructure and Services of Information and Communication Technologies for 2007-2013";
- increasing the number of the secretariat's employees and harmonisation of the pay for work;
- improvement of human resources of ERDF technical assistance;
- introduction of a safe electronic signature in Latvia;
- management of maintenance of centralised state information systems;
- management of other projects financed by the EU;
- conducting studies on e-services, state information systems, etc;
- improvement of human resources of electronic procurement agency;

- establishment of contact points of the national e-access network and maintenance of National Contact Points of the *eContent plus* programme of the European Commission.

Through implementation of the new policy initiatives, the Secretariat of the Special Tasks Minister for eGovernment Affairs has developed several policy documents and normative acts in 2007:

- procedure by which institutions publish information on the Internet (Cabinet of Ministers Regulation No. 171 of March 6, 2007);
- procedure by which exclusive rights to repeated use of information are granted and information on granting such rights is made public (Cabinet of Ministers Regulation No. 338 of May 22, 2007);
- amendments to the e-Government Development Programme for 2005-2009 (Cabinet of Ministers Instruction No. 257 of May 9, 2007).

On May 26, 2006 the Electronic Procurement State Agency started its operation. The agency took over functions of system maintenance and ensuring of procurement as well as computers, software and accumulated data from the Procurement Supervision Bureau and started centralised procurement.

According to the data of the Electronic Procurement State Agency, the total volume of procurement of general agreements was LVL 495 717.63 in 2006 and LVL 767 299.73 in the

1st half of 2007, of which the greatest part was made by procurement of computer hardware and printers.

Conference “Information and Communication Technologies for Inclusive Society” took place in Riga on June 11-13, 2006. Ministerial Declaration was signed during the conference, which is a joint political agreement of 34 countries to implement e-inclusion goals: to solve the needs of aged employees and other aged people, reduce the geographic digital divide, improve access to electronic services and promote the ICT usability, improve ICT usage skills and competence of the population, and encourage cultural diversity and development of inclusive electronic government. The first meeting of the e-inclusion subgroup of the EU initiative “i2010 – a European Information Society for Growth and Employment” also took place during the conference.

On June 15, 2007 the Cabinet of Ministers accepted Instruction No. 372 “Programme for Communication with Society on European Union Issues for 2007-2011”. This programme is aimed at increasing knowledge of Latvian population about opportunities, rights and duties in the European Union and the sense of belonging to it. The programme has the following sub-goals:

- to provide society on the whole and particular target groups with a sufficient, successive, comprehensive, objective, topical and simply understandable information, improve and increase the involvement of society, strengthen the feedback for participation of Latvia in the European Union, facilitating adoption of decisions;
- to integrate communication in formation of the European Union policy, so that communication would be an integral component of this process, and establish an efficient co-ordination mechanism for communication of the government with society on European Union issues;
- to create developed, strong and knowledgeable information mediators provided with informative and technical resources, promote harmonisation and co-ordination of activities of information mediators, especially at the regional level. To encourage informal education on European Union issues in the comprehensive education system (European dimension).

In September 2006, the state JSC “Latvijas Pasts” introduced the service of e-signature, and issuance of e-signatures was started. By the end of April 2007, the state and local government bodies had submitted applications to issue e-signatures to 20 448 employees.

In order to achieve increase of the number of users of safe e-signature and promote usage of safe e-signature, the concept “On Financing of Safe

Electronic Signature in Particular Target Groups of Population” was drafted.

The programme “*Information and Communication Technologies for Education Quality*” for 2007-2013 was approved by the Cabinet of Ministers Instruction No. 812 of October 20, 2006.

The strategic goal of the programme is to promote formation of educated and creative personality by raising knowledge, abilities and skills of educatees in the use of information and communication technologies. The programme has the following sub-goals:

- to achieve high-quality acquirement of information literacy and computer literacy;
- to use ICT in the learning process widely by developing electronic teaching materials, improving the content of educational programme for improvement of education quality and attraction, creating and using various services to raise education quality;
- to increase ICT knowledge and skills of teachers and education employees by raising the qualification level and work efficiency of teachers/lecturers;
- to establish an efficient information system of education by ensuring availability of electronic teaching materials and raising efficiency of management of education system;
- to create corresponding to its tasks, cost-efficient, safe and reliable ICT infrastructure in all stages and forms of education institutions and education administration bodies.

In order to achieve the goal and sub-goals of the programme, the following lines of action are set:

- formation of electronic teaching resources;
- establishment of education information system;
- raising ICT competence of the teaching staff;
- modernisation and maintenance of ICT infrastructure of education system.

The required financing for implementation of the programme amounts to LVL 130.1 million, the envisaged sources of financing are the EU structural funds, state and local government budgets, and the private capital. It is envisaged to work out the action plan of the programme for 2007-2009 in the 1st half of 2007.

E-Commerce

E-commerce in Latvia develops rather slowly at present. 6% of companies made purchases over the Internet in 2005 (27% of companies in the EU on average in 2006), while mere 1.7% of companies received orders by using opportunities provided by the Internet (15% of companies in the EU on average in 2006).

¹ Source for Latvian data: CSB; source for EU data: Eurostat

In 2005, the turnover of goods and services purchased over the Internet made up 1.4% of the total turnover of companies in Latvia, while the turnover of goods sold over the Internet constituted 1% of the total volume of sales turnover (turnover of e-commerce in the EU on average made up 12% in 2006).

In the last 3 months of 2006, purchases over the Internet were made by 9.2% of Latvian population and by 20% of population in the EU on average.

In order to explore the experience of EU member states in formation and efficient introduction of the e-commerce development policy, the Ministry of Economics worked out the EU PHARE Twinning Light 2003 project LV 2003/IB/EC-06TL “*Strengthening of the E-Commerce Environment*” and successfully implemented it in co-operation with German experts in 2006. In the framework of this project, the experience of other

EU member states in formation of efficient e-commerce policy was explored. German experts developed proposals for the action plan for introduction of efficient e-commerce policy in Latvia. In the framework of the project, also supervision bodies were informed about the best practice of EU member states in organising and ensuring efficient supervision in the sphere of information society services, paying special attention to provision of efficient supervision over unsolicited electronic commercial messages.

Taking into account the information, knowledge and expert recommendations acquired in the framework of the project, the activities to be carried out for promotion of e-commerce development in Latvia were worked into the draft *Entrepreneurship Competitiveness and Innovation Promotion Programme for 2007-2013*.

6.7. Small and Medium-Sized Enterprises

Small and medium-sized enterprises (SME) comprise a major part of the national economy and play a significant role in GDP growth and employment in Latvia like elsewhere in Europe (see Box 6.13).

Assistance to SME in Latvia is regulated by the Law on Control of Aid to Commercial Activity, which is in force as from January 1, 2003.

Box 6.13

The number of small and medium-sized enterprises in Latvia

According to provisional data, there were 58 406 economically active businessmen and commercial companies in Latvia in 2006 (excluding agricultural and fishing farms and self-employed persons, which perform economic activity), of which more than 99.9% (58 400) fell in the category of SME. The distribution of economically active SME in Latvia according to their size is similar to the one in EU member states: micro enterprises – 75%, small enterprises – 20%, medium-sized enterprises – 4%, large enterprises – 1%. 69.9% of private sector employees in the country are employed in SME, which create 63.2% of GDP.

Important indicator characterising economic activity is the number of economically active businessmen and commercial companies per 1000 inhabitants. This indicator in Latvia has grown constantly in the last 5 years from 17 in 2001 to 24 in 2005.

It is of the same importance to accentuate the number of performers of individual piecework (self-employed persons), which amounted to 40 327 in 2005 (17 per 1000 inhabitants), and the number of agricultural and fishing farms, which equalled to 13 269 in 2005 (6 per 1000 inhabitants). Taking into account the fact that there is no single methodological practice among EU member states for calculation of such indicator characterising economic activity as the number of enterprises per 1000 inhabitants, it is difficult to conduct objective comparative analysis of this indicator. The current practice of the responsible EU institutions shows that calculation of the number of enterprises per 1000 inhabitants includes not only businessmen and commercial companies but also performers of individual piecework, agricultural and fishing farms, etc. Accordingly applying an analogous practice, Latvia had 47 performers of economic activity per 1000 inhabitants in 2005, which is close to the EU average.

Statistical data of the recent years indicate positive trends in growth of the number of newly founded enterprises. According to statistical data calculated by Lursoft in co-operation with the Register of Enterprises of the Republic of Latvia, 13 404 businessmen and commercial companies were registered in 2006, which is the biggest number of newly registered entities conducting commercial activity in the last 12 years. This is by 22.63% more than in 2005 (10 927). Growth of the number of newly founded enterprises continued in the first 4 months of 2007 as well. In this period, 5146 new commercial companies and businessmen were registered, which is the highest indicator in the last 13 years and by 17.76% more than in the respective period of the previous year (4370). This, on the whole, may indicate efficiency of the measures conducted to ensure improvement of business environment and promotion of business development.

However, it is important not to forget that constant natural growth is inevitable in any free market conditions under certain objective positive circumstances as in the case of Latvia, where favourable conditions for equable growth of the number of newly founded enterprises are already ensured with accession to the EU and substantially increased opportunities of local enterprises. Nevertheless, promoting establishment of newly founded enterprises does not suffice to ensure sustainable development. In order to ensure the rise of competitiveness, these newly founded enterprises have to be viable. Statistical data show that the total number of enterprises increases by approximately half of the growth of the number of newly founded enterprises, hence indirectly indicating problems in regard to their viability.

Box 6.14**Definition of SME**

The **Law on Control of Aid to Commercial Activity** lays down the definition of small and medium-sized enterprises (according to the European Commission Regulation No. 70/2001 and amendments to the European Commission Regulation No. 364/2004, and according to the European Commission Recommendation No. 361 of May 6, 2003):

Medium-sized enterprises:

- number of employees from 50 to 249;
- annual turnover does not exceed EUR 50 million;
- total balance sheet value is under EUR 43 million.

Small enterprises:

- number of employees from 10 to 49;
- annual turnover does not exceed EUR 10 million;
- total balance sheet value is under EUR 10 million.

Micro enterprises:

- number of employees from 1 to 9;
- annual turnover does not exceed EUR 2 million;
- total balance sheet value is under EUR 2 million.

Although an active policy for improvement of business environment has been implemented and activities to support small and medium-sized business have been carried out in the previous years, development of the SME sector in Latvia is still hindered by several essential problems:

- shortage of human resources and their skills, which creates problems in the choice of personnel and in introduction of new business management methods and innovation as well as in usage of the relevant instruments of the state and EU support. 15% of the commercial companies surveyed in the annual “World Development Report”¹ of the World Bank have acknowledged shortage of skilled labour force as an essential factor affecting business environment. The current programmes for training of employees are assessed by entrepreneurs and experts as inefficient and such that insufficiently encourage people to become employees and employers.
- insufficient capacity and intensity of the sector support policy implemented by the state;
- inaccessibility of financing because the guarantee and investment funds are insufficiently developed at present;
- insufficiently intensive informative link about Latvian and EU support instruments in development of the small and medium-sized business sector;
- complexity of the administrative environment that is a precondition to successful functioning of the competition market system. It has been calculated that, after restoration of Latvia’s independence, 250 new laws and 350 new normative documents on average were adopted every year. This, unequivocally, has created problems for SME that face disproportionately high costs. Almost 30% of Latvian entrepreneurs have

asked public institutions to explain application of normative acts in the last two years. 36% of entrepreneurs disagree with a view that access to information on changes of normative acts is good.

- inflexible system of taxes and its interpretation. Although Latvian system of taxes may be assessed as rather favourable and Latvian rates of direct taxes are among the lowest in the EU member states, Latvian entrepreneurs note that tax legislation is mostly hard to understand and observe without a help of tax consultant, sometimes legal norms are contradictory and their interpretation not always seems to be clear;
- insufficient provision of information. Access to information is usually associated with the effect of the scale of costs, as small enterprises have bigger difficulties with access to information than big companies (it is especially topical in the spheres that are related to internal and external business regulation norms and export markets). For instance, internet is used for electronic submission of documents to various public institutions (SRS, customs, etc.) by mere 12% of all Latvian entrepreneurs. The opportunity to electronically submit reports to the Central Statistical Bureau was used by mere 8% of entrepreneurs, while only 5% on entrepreneurs used the opportunity to electronically submit tax declarations to the SRS;
- incomplete territorial planning. Lack of territorial planning and zoning of towns and other settlements heightens risks and costs of entrepreneurs. Unbalanced access to infrastructure between Rīga and other regions; networks of public services are insufficiently developed outside Rīga.

On January 27, 2004, the Cabinet of Ministers approved the **“Basic Guidelines of the Small and Medium-Sized Enterprises’ Development Policy in**

¹ „World Development Report 2005: A Better Investment Climate for Everyone”, World Bank, Washington DC, www.worldbank.org.

Latvia". This document lays down the basic principles of activity of the government, long-term objectives and tasks, as well as the main directions of the SME development policy. The goal of the *Basic Guidelines* is to ensure promotion of favourable environment for business activity, spur initiative of entrepreneurs and lessen the total risk, prevent obstacles to business activity, and foster stability and efficiency of the financial system and capital market in order to improve competitiveness of enterprises in the market.

The *Basic Guidelines* foresee implementation of a policy based on the best practices of companies of the developed countries in accordance with the activities outlined in the European Charter for Small Enterprises, at the same time also taking into account the specifics of SME development problems in Latvia.

For implementation of the *Basic Guidelines*, the Cabinet of Ministers approved the **"Programme on Development of Small and Medium-Sized Enterprises of Latvia in 2004-2006"** (hereinafter Programme) on May 25, 2004, in order to facilitate achievement of SME development policy goals. 2006 was the last year for implementation of the Programme, so the Ministry of Economics in co-operation with institutions responsible for implementation of measures of the Programme has prepared and submitted to the Cabinet of Ministers two informative reports on measures implemented by the reference year of Programme's operation and one informative report on the process of implementation of the Guidelines and on actual results and performance indicators of implementation of the Programme (for the time period since 2004) (see Box 6.15).

Box 6.15

Programme on Development of Small and Medium-Sized Enterprises of Latvia in 2004-2006, "Basic Guidelines of the Small and Medium-Sized Enterprises' Development Policy in Latvia"

The key measures implemented in the framework of the Guidelines and the Programme in accordance with their main actions are:

For creation of favourable environment for business activity, especially in relation to SME:

- The Council of the Small and Medium-Sized Enterprises and Crafts (CSMEC) was established in 2004, which consists of representatives delegated by 27 organisations. CSMEC meetings have been held on a regular basis since 2004. Key issues were reviewed and proposals for amendments to legal acts and changes in SME development and taxation policy and regarding the key issues affecting SME interests were given at these meetings.
- In order to eliminate administrative obstacles to business development, annual Action Plan for Improvement of Business Environment was prepared in co-operation with organisations representing entrepreneurs and submitted to the Cabinet of Ministers every year.
- In order to encourage more active involvement of entrepreneurs in solving issues of improvement of business environment, the Ministry of Economics in co-operation with the Latvian Investment and Development Agency held the conference "Better Regulation Initiative to raise competitiveness of business environment in Latvia and Europe" on June 30, 2006.
- The Ministry of Economics has envisaged to carry out 4-5 pilot projects in 2007, in the framework of which it is planned to calculate what administrative burden is put on entrepreneur in meeting provisions of normative acts as well as clarify who puts this burden and what opportunities exist for its reduction.

For promotion of availability of finances for development of small and medium-sized business:

- In order to improve accessibility of preferential loans, the Mortgage and Land Bank of Latvia (MLBL) has granted loans for development of SME in the framework of the first phase (2000-2009) and second phase (2003-2012) of the Programme of Crediting Latvian SME Development.
- A separate structural unit, the Administration of Support Programmes ALTUM, was established at the beginning of 2005 in the framework of MLBL operation for consolidation and growth of business support functions. ALTUM implements support programmes financed by the state and the EU.
- In the framework of the national programme "Development of the Loan Guarantee System", the Latvian Guarantee Agency issued 31 guarantees for the total amount of LVL 2 306 954 to enterprises during 2006, which enabled entrepreneurs to attract investments in the form of credit resources for the total amount of LVL 5 970 271.
- In the framework of the state support programme "Support to the Risk Capital of Small and Medium-Sized Commercial Companies", 3 risk capital funds co-financed by the state (LLC "Zaļās gaismas investīcijas", JSC "Eko Investors" and LLC "TechVentures Fondu Vadības Kompānija") have been established. The funds have attracted the necessary private investors (among them JSC "Atklātais pensiju fonds SEB Unipensija" and JSC "Pirmais Slēgtais Pensiju Fonds") in 2006. The total volume of the capital available for investment projects is LVL 21.8 million. 3 investments are already carried out by the 1st quarter of 2007.

For development of human resources and new business initiative:

- The Ministry of Economics and LIDA have organised seminars for entrepreneurs on a regular basis in relation to information and consultations on absorption of the EU Structural Funds (inter alia, about technical issues of drawing up project applications). Support was provided to entrepreneurs of Latgale in preparation of project applications for submission.
- Conferences for promotion of activities related to business were organised, namely, "Latvian Entrepreneur – EU Entrepreneur", the 2nd conference of Latvian entrepreneurs "State Support to Entrepreneurship", "Days of Knowledge for Entrepreneurs", and the International Quality Management Conference. Seminars were organised, namely, entrepreneur motivation seminars, seminars on application of EU legislation requirements in Latvian enterprises, business forums on opportunities of application of EU funds for in-service training of employees and improvement of technology processes in enterprises, as well as regional seminars on financial instrument and topicalities in the state support programmes for availability of finances.
- In order to ensure receipt of information to entrepreneurs according to the *one-stop-shop principle*, LIDA has rendered consultations to entrepreneurs on a regular basis, providing information and references, distributing their business offers, searching information about co-operation partners, requirements of EU legislation, national legislation, opportunities of joint projects, etc.

Box 6.15 continued**Promotion of competitiveness of small enterprises:**

- LIDA has organised business forums and meetings with directors of Latvian foreign economic representative offices for entrepreneurs, provided consultations and organised seminars on finding (searching) potential co-operation partners, export opportunities, fields of operation of foreign companies in Latvia, participation in international exhibitions and contact exchanges, development of branch catalogues, customs procedures, restrictions and quotas.
- For promotion of export, the portal of entrepreneurs www.exim.lv was created, where business offers and information about exhibitions and activities are published.
- For promotion of competitiveness of SME, provision of support to participation of commercial companies in international exhibitions, fairs and trade missions, promotion of development of new products, technologies, design, etc., attraction of infrastructure (co)financing support to SME, attraction of co-financing from the EU Structural Funds has provided Latvian entrepreneurs with opportunity to submit their projects to the following state support programmes administered by LIDA for 2004-2006:
 - support to consultations and participation of commercial companies in international exhibitions, fairs and trade missions;
 - support to development of new products and technologies;
 - support to modernisation of business infrastructure;
 - support to raising qualification of employees, their retraining and further education.

SME support policy is set in Chapter 2.2.4 of the **National Lisbon Programme of Latvia for 2005-2008** (see Chapter 6.1), defining the main directions of governmental policy to promote SME development, which are:

- promotion of availability of finances, including funds for development of an idea (seed capital);
- ensuring informative and consultative support;
- raising competitiveness through support to introduction of new technologies and modernisation of production.

The Mortgage and Land Bank of Latvia (MLBL) plays an important role in the **SME support system**. Since 2000 MLBL helps to introduce and implement the “Programme of Crediting Latvian SME Development”. The insofar implementation of the programme has substantially promoted accessibility of capital to SME and has encouraged more active involvement of commercial banks in offering loans to SME. On November 26, 2002 the Cabinet of Ministers approved the Programme of Crediting Latvian SME Development (second phase) for the next three years, foreseeing state guarantees in the amount of LVL 20 million to MLBL in order to enable the bank to borrow the necessary resources for crediting SME in the financial market. On January 21, 2004 MLBL started crediting in the framework of the Programme of Crediting Latvian SME Development (second phase). Funding projects of specific SME (business beginners, rapidly growing SME, SME in regions requiring special assistance, and female SME) supported in the framework of EU programmes is continued in the framework of the Programme of Crediting Latvian SME Development (second phase).

In 2006, in the framework of the Programme of Crediting Latvian SME Development (first phase), MLBL has granted 998 loans for the total amount of EUR 48.5 million, which promoted creation of

approximately 2800 new jobs. In the framework of the second phase of the SME crediting programme, MLBL has granted 990 loans for the total amount of LVL 53.43 million, hence promoting creation of 3136 new jobs and establishment of 146 new enterprises.

A separate structural unit, the Administration of Support Programmes ALTUM, was established at the beginning of 2005 in the framework of MLBL operation for consolidation and growth of business support functions. ALTUM implements support programmes financed by the state and the EU, granting high-risk loans to viable and perspective projects of SME and business beginners, which are not financed by commercial banks due to insufficient collateral and other risks of the project. ALTUM also implements other support programmes, among them the programme of training and consultations for business beginners and the housing guarantee programme. Crediting Programme for Beginners, which is co-financed from resources of the state and EU Structural Funds, was started in 2006. So far, LVL 5 million from the state budget have been granted for implementation of the programme. Loans for the total amount of LVL 4.6 million (75 loans) have been granted in the framework of the programme by January 1, 2007. Special assistance loans in the framework of special programmes have been granted to 530 SME for the total amount of approximately LVL 25.2 million by January 1, 2007. Most of special assistance loans were granted to SME in the regions requiring special assistance (approximately LVL 10.4 million), business beginners (about LVL 4.8 million), female enterprises (approximately LVL 3.7 million) and rapidly growing SME (about LVL 6.3 million).

On grounds of the agreement concluded by the Mortgage Bank, the Ministry of Economics and the State Employment Agency (SEA) on May 8, 2006, ALTUM implements the Programme of Training and Consultations and Financial Support for Business Beginners co-financed from the European

Social Fund (ESF). Support to people willing to start their business is envisaged in the framework of the programme. Participants of the programme have to complete the training course and, on its completion, prepare a business plan for starting a business activity. The business plan is examined by experts. If they take a positive decision, the participant of the programme receives funding for implementation of the project (payment for mentor services, grants for starting operation of enterprise, loan in the amount of up to LVL 18 thousand).

Providers of the training in regions of Latvia are: in Kurzeme region – LLC “Comperio”, in Vidzeme region – LLC “Zygon Baltic Consulting”, in Rīga region – LLC “Nordic Training International”, in Latgale region – LLC “VIP konsultācijas”, and in Zemgale region – LLC “DEA Baltika”, which were selected through a tender. Training takes place from January 2007 to December 2007. Training is organised in groups of 20 people. If the number of applicants exceeds the number of places in the group, the educational institution is entitled to carry out the test of preliminary qualification of programme applicants, which will allow to complete every group of the programme more successfully.

The Latvian Guarantee Agency (LGA) is a state-supported institution with a goal to support development of business activities of small and medium-sized enterprises (commercial companies) registered in Latvia, by issuing:

- loan guarantees to small and medium-sized commercial companies of Latvia, solving the problem of insufficient collateral to get loan from a commercial bank;
- financial leasing guarantees to small and medium-sized commercial companies of Latvia in industrial leasing transactions;
- and by operating as a fund of funds in the risk capital sector, taking part with its financing in creation and operation of new risk capital funds.

In 2006, the Latvian Guarantee Agency took part in 57 informative seminars (1700 participants in total) in order to inform both the entrepreneurs and the credit structures about guarantee products and the procedure for receiving them. In 2006, LGA issued 31 guarantees to enterprises for the total amount of LVL 2 306 954, which enabled entrepreneurs to attract investment in the form of credit resources for the total amount of LVL 5 970 271. Since December 2006, LGA started offering new guarantee products: circulating capital guarantees and financial leasing guarantees.

In 2005, the European Commission (EC) approved the State Support Programme (SSP) for development of risk capital, which was worked out by the Ministry of Economics. In 2005, LGA announced a tender for selection of risk capital fund management companies in the framework of

the SSP “*Support to Risk Capital of Small and Medium-Sized Commercial Companies*”. 8 applications for establishment of risk capital fund management companies were received, which several times exceeds the number of funds to be established (three funds), 3 winners of the tender were chosen and contracts were concluded with them, and 3 risk capital funds co-financed by the state were established, namely, LLC “Zaļās gaismas investīcijas”, JSC “Eko Investors” and LLC “TechVentures Fondu Vadības Kompānija”. By the end of 2006, the funds attracted the necessary private investors, among them such institutional investors of Latvia as JSC “Atklātais pensiju fonds SEB Unipensija” and JSC “Pirmais Slēgtais Pensiju Fonds”, and the total volume of capital available for investment projects is LVL 21.8 million. As from 2007, the funds have started active investment, and 3 investments were made already in the 1st quarter of 2007.

Taking into account that 2006 was the last year for implementation of the Programme on Development of Small and Medium-Sized Enterprises of Latvia for 2004-2006 and of the National Programme of Innovation 2003-2006, and in accordance with the EC practice to review the entrepreneurial, innovation and industrial development policy planning together, the Ministry of Economics has worked out a new **Programme for Promotion of Business Competitiveness and Innovation in 2007-2013**.

The programme comprises set-ups and action policy of business competitiveness promotion, innovative activity and industrial development, describing the vision of competitiveness promotion as well as development of innovation and industry for the next 7 years. Main goals of the programme are: to provide favourable conditions for development of business; promote increase of capacity and efficiency of the National Innovation System; achieve substantial growth of competitiveness and productivity in industry, fostering increased volumes of manufacturing products with a high value added.

The programme defines specified measures to be carried out for improvement of business environment, promotion of availability of finances, development of new entrepreneurship initiatives and fostering their competitiveness, promoting awareness of society on the role of innovation in competitiveness promotion, for contribution to co-operation of industrial, educational and science sectors, transfer and commercialisation of knowledge, as well as for promotion of development of industries and raising their productivity.

The measures reflected in the action plan for implementation of the programme are financed in the framework of the budget of the Ministry of Economics and other involved ministries in 2007.

In the period of 2008-2013, the action plan includes programmes co-financed from the EU Structural Funds, activities planned in the framework of the budget of the Ministry of Economics and other involved ministries, as well as the necessary additional budget. The action plan does not include the measures that are included in action plans for implementation of other programmes. Management, co-ordination, supervision and assessment of implementation of the programme will be carried out by the Ministry of Economics.

EU member states approved the **European Charter for Small Enterprises** at the European

Council meeting in Feira on June 19-20, 2000. This is one of the most important political documents of the EU for achievement of the Lisbon goals. It recognises the great role of small enterprises in development of competitiveness, innovation and employment spheres, and they also constitute the driving force for social and local integration in Europe and the base of national economy growth. Latvia joined the Charter on April 23, 2002 by signing the Maribor Declaration in Slovenia together with other EU candidate countries, thereby pledging to work in accordance with 10 lines of action of the Charter (see Box 6.16).

Box 6.16

European Charter for Small Enterprises

Ten lines of action of the Charter:

1. education and training for entrepreneurship;
2. cheaper and faster establishment of enterprises;
3. more efficient legislation and regulation;
4. availability of training;
5. improving Internet access;
6. gaining more out of the Single Market;
7. taxation and financial matters;
8. strengthening the technological capacity of small enterprises;
9. making use of successful e-business models and developing top-class small business support;
10. developing stronger, more effective representation of the interests of small enterprises at the EU and national level.

In April 2005, the European Commission came forward with a legislative initiative, by which the **Competitiveness and Innovation Framework Programme (2007-2013)** would be established (see Box 6.17). The programme was officially adopted by the Transport, Telecommunications and Energy Council of Ministers on October 12, 2006. It is

intended as a continuation of the Multiannual Programme for Enterprise and Entrepreneurship, in Particular for Small and Medium-Sized Enterprises (2001-2006) and would be organised in the framework of the next EU financial perspective (2007-2013).

Box 6.17

Competitiveness and Innovation Framework Programme (2007-2013)

The programme has 3 separate subprogrammes or pillars:

- the Entrepreneurship and Innovation Programme;
- the ICT Policy Support Programme;
- the Intelligent Energy – European programme.

In the framework of the **first pillar**, the following financial instruments will be developed:

- the High Growth and Innovative SME Facility (GIF) – actually, the development of risk capital, dividing it into GIF 1 (seed and startup stage of SME) and GIF 2 (SME expansion stage investments);
- the SME Guarantee Facility;
- the Capacity Building Scheme – is designed to improve the capacity of institutions investing in innovative SME.

The **second pillar** is established in order to support the information and communication policy and achieve more investment in this sector. It is envisaged to ensure the support by:

- developing a single European information space and strengthening information products and services of the Internal Market;
- stimulating innovation and its implementation and investment in information and communication technologies;
- developing an inclusive information society and effective services in the interest of the society, as well as improving the quality of life.

In the framework of the **third pillar**, the Intelligent Energy – European programme for 2003-2006 will be continued and expanded. It was established by merging the following 4 programmes:

- SAVE programme: in its framework, norms and standards for rise of efficiency of heat insulation of buildings were developed;
- in the framework of ALTENER programme, projects for more efficient use of renewable energy resources in heat supply and electricity generation were implemented;
- in STEER programme, projects related to the rise of energy efficiency in transport and to the promotion of the use of renewable energy resources (among them biofuel) in transport were implemented;
- COOPENER programme envisaged to develop energy policy and market conditions.

6.8. Competition Policy

The aim of competition policy is to promote competitiveness of Latvian national economy by creating such business environment, in whose framework companies are enabled to compete and develop freely, and which makes companies continuously increase efficiency of their operation and look for ways how to decrease prices, improve quality and offer new goods and services. Competition is a mechanism of the market economy, which ensures efficiency and development, that is the main precondition to welfare of society in long term. Under the influence of competition, prices decrease, quality of goods and services improves, and choice opportunities of consumers increase. The Competition Council (hereinafter CC) is responsible for development and implementation of competition policy in the country.

The goal of activity of the CC is to promote situation where the market works in consumer interests and strong competition between fairly operating companies exists.

The CC acts in accordance with the Competition Law and other normative acts as well as with the action strategy of the CC for 2007-2009 approved by the Cabinet of Ministers on August 29, 2006. The strategy sets three directions of activity to fulfil functions delegated by the CC and its tasks:

- protection of competition;
- promotion of competition;
- strengthening the role of the Competition Council in development and implementation of EU legal acts and in international organisations and networks.

Protection of competition

The strategic direction of protection of competition comprises activities directed to such violations of the Competition Law as prohibited agreements, abuse of dominant position, unfair competition, and to control over merger of companies.

Prohibited agreements are such agreements between market participants, which have as their purpose or consequence the hindrance, restriction or distortion of competition in the Latvian market. The Competition Law stipulates that such agreements are prohibited and null and void from the moment of being entered into. Not only contracts drawn up in writing but also verbal agreements, concerted practices and decisions taken by associations of market participants are regarded as agreements. Of all forms of agreements, prohibited agreements between competitors regarding prices and division of “spheres of influence” or cartels do the biggest harm to competition. The highest fines up to 10% of company’s turnover are provided for such agreements. However, imposition of fine not always is the most important for the CC, when cases of prohibited agreements (among them cartels) are examined and violations of the Competition Law are established. The process and result of a particular case quite often may be a lesson for market participants who might face a similar situation in the future. CC has examined several such cases and taken decisions in them in 2007. For example, violation of prohibited agreement was established in activities of the Latvian Architects Society (hereinafter LAS) and of the Latvian Association of Civil Engineers (hereinafter LACE) (see Box 6.18).

Box 6.18

The CC establishes prohibited agreements in activities of LAS and LACE

On February 14, 2007 the CC adopted decision on establishment of violation of prohibited agreement in activities of LAS. LAS had approved the bylaws on payment for designer work and services in construction and the Architect Code of Ethics, which prescribed that members of LAS may be removed from membership for non-observance of the bylaws.

There was a similar situation in the case on prohibited agreement in activities of LACE. The CC adopted decision thereof on April 25, 2007. This non-governmental organisation, at its congresses, has adopted decisions on the minimum payment to be received by certified civil engineers for their services.

By adoption of the mentioned decisions, these professional associations distorted, hindered and restricted competition, because opportunities of their members to compete on prices in the market were restricted, which is especially prohibited in compliance with Article 81 (1) of the Treaty establishing the European Community.

It must be noted that, in compliance with Latvian and EU competition law norms and practice, if an agreement aimed at hindrance, restriction and distortion of competition has been established, a competition supervision authority may not assess consequences of the agreement, as the activity itself is prohibited already.

Both cases were examined almost at the same time and, in both cases, the CC was of the opinion that it was not necessary to impose fine on the violators, taking into account that both professional associations had admitted their violation and had ceased it, repealing the adopted decisions, before the CC took its decision. In the CC practice, these were the first examined cases and adopted decisions on establishment of violation on the subject of non-compliance of decisions taken by associations of representatives of liberal professions (professional services – in accordance with explanation of terms included in normative acts of the Republic of Latvia, the notion “professional services” includes independent scientific, literary, artistic, educational or pedagogic activity as well as independent activity of physician, lawyer, engineer, architect, dentist or accountant) with norms of the Competition Law. CC was of the opinion that, in these two cases, it was important to adopt an administrative act indicating the unlawful activity of LAS and LACE and stressing the harm of the violation to competition, which might deter other market participants from similar activities in the future.

Abuse of dominant position may manifest itself in various forms: as directly or indirectly imposed unfair prices or other trade conditions, application of dissimilar conditions in equivalent cases, requirement to assume supplementary obligations beside the subject of the particular agreement in conclusion of agreements. The Competition Law stipulates that any market participant who is in a dominant position is prohibited from abusing such dominant position in any manner.

Verdict of the Supreme Court Senate of the Republic of Latvia of April 23, 2007, by which the CC decision of 1999, that established violation of abuse of a dominant position of the SJSC to be privatised “Rīgas Starptautiskā autoosta” (Riga International Bus Station), was acknowledged as well-grounded and non-appealable, is important in the practice of the Competition Council. Dispute between the CC and the SJSC to be privatised “Rīgas Starptautiskā autoosta” lasted 8 years, and each concerned party tried to make out its case in continuous contention. The process of hearing the dispute case lasted very long, because court rulings were appealed several times. The case was initially heard in the Vidzeme Suburb Court of Rīga (in 2003) and in the Rīga Regional Court (in 2004), and both courts ruled to repeal the CC decision. In 2005, the CC appealed to the Administrative Cases Department of the Supreme Court Senate, which decided to repeal the ruling of the Rīga Regional Court and sent the case for hearing to the Administrative Regional Court that took decision in favour of the CC, recognising its decision of 1999 as well-grounded. The CC decision was taken by establishing the fact that “Rīgas Starptautiskā autoosta”, who is in a dominant position, has indirectly imposed unfair trade conditions to passenger carriers of regular international bus routes by setting different tariffs for the same service – the bus station set 10 times higher price for usage of infrastructure (i.e., usage of the boarding/disembarkation platform) for those passenger carriers that did not sell their tickets in booking-offices of the SJSC to the privatised “Rīgas Starptautiskā autoosta”.

In order to promote progress in the process of hearing the case in the future and ensure that similar disputes would be considered in much shorter period of time, the CC participated in drafting the concept for bringing into effect the administrative process in institution and court, which envisages improvement of the administrative process both in institution and in court, including reduction of terms for hearing cases on violations of competition law.

As regards **regulation of mergers of companies**, the Competition Law stipulates that market participants shall, prior to merger, submit a notification of such merger to the CC if the combined turnover of the participants in the merger during the previous financial year was not less than LVL 25 million or the combined market share of the market participants in the merger in this relevant market is more than 40%. As a merger of companies, one would regard the joining of one market participant to another one, the merging of two or more market participants in order to become one market participant, the acquisition of assets of other market participant, or acquisition of direct or indirect decisive influence over another market participant. If a notification of merger has not been submitted in the cases prescribed by the Law or market participants do not meet the binding merger regulations set by the competition supervision body, the CC may take a decision regarding the imposition of a fine of up to LVL 1000 for each day, counting from the day when the notification should have been submitted, on the market participant.

The number of company merger cases to be examined by the CC has increased lately. In 2007 the CC has taken decisions to allow mergers of companies in the medicine retail market, the building materials production market and the forestry sector market. Several applications expressing willingness to merge in the fuel retail market were examined. The merger case of JSC “Virši-A” and LLC “Passim” could be mentioned as an example (see Box 6.19).

Box 6.19

CC allows JSC “Virši-A” to acquire two fuel filling stations of LLC “Passim” in Ludza district

The CC, through assessment of situation in the market, came to a conclusion that the merger will not create unfavourable competition conditions and market concentration in Ludza district and the neighbourhood because, in accordance with the Competition Law, a merger may be prohibited if, as a result of this merger, a dominant position (market share of at least 40%) of market participant is created or strengthened, or which significantly hinders, restricts or distorts competition in the market. Both fuel filling stations are situated next to town borders (one is approximately one kilometre from Ludza, while the other is located immediately at the administrative border of Kārsava). Each of these fuel retail outlets of LLC “Passim” is the only one in the respective rural municipality. In the administrative area of Ludza town, two market participants (LLC “Avin” and LLC “Latvijas nafta”) operate in the petrol and diesel fuel retail market. In the administrative area of Kārsava town, LLC “Avin” is the sole market participant. Taking into account the abovementioned, the CC acknowledged that there is no ground to restrict the merger transaction of JSC “Virši-A” and LLC “Passim” because, as a result of it, a dominant position of JSC “Virši-A” will not be created in the petrol retail market and the diesel fuel retail market in Ludza district and its neighbourhood as well as significant hindrance, restriction or distortion of competition will not take place. Such mergers of companies, when big businesses are willing to acquire small fuel filling stations, may create a situation in the future, when positions of Latvian fuel traders will be consolidated among the main fuel market competitors, hence improving the competition situation in the market.

Promotion of competition

This direction of activity includes supervision of market sectors and formation of competition culture in society. The CC has the task to ensure purposeful

collection and analysis of comprehensive information about competition situation in various markets, promote competition in those markets where no competition exists or competition is insufficient, and

improve awareness of society about the positive impact of competition on welfare in society.

The CC has envisaged performing supervision in several market sectors, such as autogas market, insurance of land transport, etc. in 2007. Supervision

of the market of goods and services in such market sectors as cement production, telecommunications and retail trade of automotive fuels has been completed this year (see Box 6.20).

Box 6.20

Competition situation and trends in retail trade of automotive fuels

In the framework of market surveillance, the CC acquired and analysed information on fuel purchases and their structure, volumes and directions of sales, and storage of fuels. In the framework of market surveillance, it was established that merger processes of fuel market participants have grown rapidly since 2006, where bigger market participants take over or rent enterprises of smaller market participants. As a result of these processes, three biggest fuel retailers have essentially increased their market shares, the market share of the fourth biggest retailer JSC “Virši-A” has increased as well, while the total number of market participants has decreased. Approximately one half of the market shares is concentrated by three leaders – LLC “Latvija Statoil”, LLC “Neste Latvija” and LLC “Lukoil Baltija R”. However, the actual competition situation in the fuel retail market in Latvia mostly depends on situation in particular specific geographic (regional) markets. Also in the biggest part of Latvian regional markets, LLC “Latvija Statoil” is an incontestable leader, followed by LLC “Neste Latvija” and LLC “Lukoil Baltija R”. On the whole, a rapid increase of market shares of the three main market participants as well as their entry in new markets took place.

Opportunities of the small and medium-sized fuel retailers to independently import fuel in Latvia are very limited. The number of fuel importers tends to decrease. The main obstacles are the lack of financial resources for rent, possession or construction of terminals, and the considerable volumes of operation necessary for achieving economy from purchase of a big amount of fuel abroad and its storage in terminals. The co-operation opportunities of small fuel traders for import of fuel into Latvia are made difficult by requirements of normative acts, mutual competition of fuel traders, as well as the small economic effect provided by fuel purchases abroad.

In the situation when big fuel market participants attract customers with special offers and discounts, also small fuel traders mutually co-operate more, concluding co-operation agreements on mutual servicing of fuel cards and coupons, which promotes attraction of customers and increases survival and development opportunities of small market participants in conditions of pressure by big competitors. This trend in the fuel market should be appreciated and is desirable if the norms of the Competition Law are not being violated, especially on the issue of price determination, adjustment of prices and exchange of information about prices.

One of the tasks of the CC in promotion of competition is to encourage awareness of society about the positive impact of competition on welfare in society as well as formation of dialogue with various target audiences, hence performing the informative and educational function. Through discussions about the role and importance of competition, the CC can more successfully solve conflict situations in their initial stage as well as timely prevent them.

On February 13, 2007 the CC met with Latvian Press Publishers Association in order to discuss uncertain issues in relation to the CC authority and practice by assessing exchange of information between entrepreneurs, including in the professional associations. Several issues were talked over during the discussions, e.g., on exchange of information between members of the association and publishers, directly focussing on the information content, what information the members of association are allowed to exchange with, so that the Competition Law would not be violated, respectively, so that the particular exchange of information would not be regarded as a prohibited agreement.

Representatives of the International Monetary Fund, who had arrived in Latvia to evaluate development of the country and its implemented economic, monetary and financial policies, met also with representatives of the CC in order to acquaint both with competition policy issues of our country and with administrative activity of the CC.

CC officials had a meeting with representatives of the Corruption Prevention and Combating Bureau (CPCB). The main issue of this discussion was the signs of cartels' existence and their detection,

respectively, it was discussed how CPCB officials, by examining particular cases, may establish signs of a cartel as successfully and accurately as possible and inform the CC about them.

In the framework of measures for informing society, CC representatives gave broad information on the CC practice in relation to prohibited agreements between entrepreneurs, types of penalties and potential exemptions in a seminar on competition issues organised for tourist agencies.

Significant meeting was held between representatives of the CC and of law offices. Its goal was discussions on amendments to the Competition Law and formation of competition environment in Latvia. Also such issues as development trends of competition policy in the European Union and Latvia, mergers and concentration of companies, authority of the Competition Council and the process of examination of cases, etc. were discussed.

The CC has conducted assessment of draft normative acts and policy documents in the aspect of protection and development of competition. Assessing several draft regulations of the Cabinet of Ministers, among them “Regulations for Natural Gas Supply and Use”, the CC established that several norms are imprecisely formulated or contain conditions that may cause such behaviour of market participants, which might be treated as an abuse of a dominant position. In this regard, the CC prepared respective proposals for specification of the mentioned draft legal act.

In March 2007, the CC assessed the draft Cabinet of Ministers Regulation “Regulations Regarding the Price-List of Paid Service of the State Agency “New Three Brothers”” as well as the draft Cabinet of

Ministers Regulation “Amendment to the Cabinet of Ministers Regulation No. 249 of April 12, 2005 “Statute of the State Agency “New Three Brothers”” and objected to further advancement of them, because these regulations are contradictory in the aspect of implementation of equal competition. By implementing these regulations, the agency might cause negative consequences in respect of competition in the market of construction and planning services.

The CC voiced similar objections, assessing the draft Cabinet of Ministers Regulation “Regulations Regarding the Price-List of Paid Services Provided by the State Police”. The draft envisaged setting price for services that may also be provided by private companies. The CC believes that the State Police, by providing such paid services, may cause negative consequences in respect of competition in the market of security services, and recommended not to include them in the mentioned regulations.

Strengthening the role of the Competition Council in development and implementation of EU legal acts and in international organisations and networks

The CC, through participation in various working groups, co-operates with the European Commission and competition bodies of other European countries in development of various legal acts and mutual exchange of information.

In the framework of a working group, the CC participated in development of proposals for transposition of Directive 2005/29/EC on Unfair Commercial Practices into national legislation and implementation of Regulation (EC) No. 2006/2004 on Consumer Protection Co-operation.

The CC continues participating in working groups of the European Competition Network, e.g., Working Group on Pharmacy and Sub-Group on Banks and

Payments. Their main tasks are mutual exchange of information and discussions on application of normative acts regulating competition to each of the mentioned sectors.

CC representatives participate in Working Group on Penalty Imposition Issues of the European Competition Authorities, which has an aim to summarise penalty imposition rules of competition bodies and practice of their enforcement, explore their common and different traits as well as problems that may be created by differences of penal systems. In the framework of Air Traffic Working Group of the European Competition Authorities, the CC participates in discussion of documents on competition in airports.

In 2007, the CC plans to start implementation of the Twinning Light Project “Further Strengthening of the Economic Research and Analysis Capacity of the Competition Council” financed from the EU Transition Facility Programme. The main goal of the project is to strengthen the economic analysis capacity of national competition body as an instrument for increase of competitiveness of national economy in the framework of Lisbon Strategy targets.

The specified aims of the project are related to development of a system of measurable indicators for long-term assessment of competition policy results in Latvia and the capacity to work out guidelines and methodology for efficient research and analysis of economic sectors and particular markets, development of analytical capacity of the Competition Council, ability to skilfully use the research methodology and results, as well as development of co-operation with other public and private institutions, companies, non-governmental organisations, professional associations, research and academic education institutions, in order to promote efficient acquisition and application of the necessary analytical information.

6.9. Regulation of Public Utilities

According to the Law “On Regulators of Public Utilities”, a two-tier regulation system of public utilities is established in Latvia and the sectors regulated at the state level are separated from the sectors regulated at the local government level.

The Public Utilities Commission (hereinafter Commission) regulates public utilities at the state level, while the local government regulators regulate providers of services in the respective municipal territories and supervise sectors of municipal waste management (with the exception of municipal waste processing), water supply, sewage, and heat supply (except combined heat and power). It has to be noted that the Commission does not supervise the local government regulators and is not authorised to influence their operation.

The Commission is a multi-sector regulator performing regulation functions in the sectors of energy, electronic communications, postal services and railway transport. The task of the Commission is to ensure to all users the opportunity to receive uninterrupted and safe services for economically reasonable prices and to ensure to businesses providing public utilities the possibility to develop with profitability according to the economic situation. An important part of the Commission’s work is promotion of competition in the regulated sectors. The Commission adopts its decisions independently and is not subject to decisions of the government or other state institutions. Members of the Commission’s Board are appointed by the Saeima, and only a court may declare decisions taken by the Commission substantively unlawful and repeal them. Activities of the Commission are financed

from the duty paid by businesses on the basis of the annual net turnover of regulated public utilities.

Functions of the Commission include regulation of the regulated sectors and businesses that operate in them, protecting interests of users and fostering development of public utility providers, setting tariff calculation methodologies and approving tariffs in

accordance with laws of every sector, issuing licenses and registering general authorisations, promoting competition in the regulated sectors, carrying out extra-judicial settlement of disputes, and supervising compliance of the provided utilities with license conditions and specified quality requirements.

Box 6.21

Current developments in normative acts pertaining to regulation of public utilities

On March 6, 2007 the Cabinet of Ministers approved the Report on Development of Consumer Price Inflation and Proposals for its Reduction, which reconfirmed the necessity to change over to a unified system for regulation of public utilities, by delegating the functions of local government regulators to the Public Utilities Commission in order to ensure professional, effective and uniform evaluation and approval of prices for regulated services.

On May 7, 2007 a committee of the Cabinet of Ministers considered the informative report on the universal service fund or other financing mechanism for compensation of net costs of universal service obligations, which suggested to establish a work group tasked to develop a model of financing of universal service for all regulated sectors with a single administration of universal service financing by March 1, 2008. The work group will also have to determine the amount of financing of net costs created due to execution of universal service obligations for every regulated sector and the sources of financing for provision of universal service.

Characteristics and policies of the regulated sectors

Energy sector

In the energy sector, electricity supply and gas supply are regulated by the state. The dominant role in the electricity supply is played by the JSC “Latvenergo” that generates more than 90% of the electricity generated in Latvia and ensures import of electricity, its distribution and delivery to users. As from September 1, 2005 all functions of electricity transmission system operator are carried out by JSC “Augstsprieguma tīkls” fully owned by the JSC “Latvenergo”. On February 21, 2007 a license was issued to the distribution system operator JSC “Sadales tīkls” that starts operation on July 1, 2007 completely taking over all distribution system operator functions from the JSC “Latvenergo”.

Electricity is also generated by about 150 small hydropower stations with the total capacity of 25 MW, 14 wind power stations with the total capacity of 25.2 MW, and 39 cogeneration plants with the total capacity of 137 MW. Twelve other licensed businesses carry out distribution or sale of electricity.

Supply of natural gas in Latvia is ensured by vertically integrated JSC “Latvijas Gāze”, while about 50 companies compete in the supply of liquefied gas.

As from July 1, 2007 all users in the electricity market of Latvia have the opportunity to choose a supplier. Until now, the opportunity to choose was given to all electricity users with the exception of households. The users’ opportunity to choose alternative suppliers of electricity is directly linked with the supply of sellers and producers in the electricity market, and it is expected that the users will take the opportunity to change their suppliers of electricity.

New electricity tariffs came into force on January 1, 2007. The tariffs increased by 6% on average for households and by 18% on average for other users. The tariff increase was determined by increased amount of imported energy and price rise for imported energy as well as increased natural gas tariffs and tariffs for network

services. In March 2007 the JSC “Augstsprieguma tīkls” submitted draft tariffs for electricity transmission system services to the Commission, and this draft is currently evaluated. It is expected that the JSC “Sadales tīkls”, starting its operation, will submit new draft tariffs for distribution system services. Although electricity tariffs grow every year on a regular basis, electricity tariffs on the whole are still among the lowest in the European Union.

Taking into account the rise of natural gas tariffs of the JSC “Latvijas Gāze” as from May 1, 2007 it is expected that new draft tariffs for electricity will be submitted in the 2nd half of 2007. On March 28, 2007 the Commission approved new natural gas tariffs that came into force on May 1, 2007. Natural gas supply tariffs rose by 17% on average for households and by 33% for other users. The main reason for the rise of natural gas supply tariffs is the price increase for the natural gas purchased from the Russian gas holding company “Gazprom” from January 1, 2007.

Electronic communications and post

The biggest market participants in the sector of electronic communications are the fixed network operator LLC “Lattelecom” and mobile communication operators LLC “LMT” and LLC “Tele2”. A total of 476 companies were registered in the sector of electronic communications at the beginning of May 2007.

On May 3, 2007 the Saeima adopted amendments to the Law on Electronic Communications, that envisage to adjust the legal regulation related to installment and construction of electronic communication networks, specify imperfections detected in the course of application of the law (especially on issues concerning number portability services, provision of universal service, and mechanism for financing of universal service) and determine more accurate transposition of European Union directives.

The Commission has basically completed the market analysis in all electronic communication markets in 2006. The work for carrying out the next round of market analysis was started in 2007. Regulations on the Amount of Information Required for Market Analysis and the

Procedure of its Submission were reviewed in accordance with the experience accumulated in the course of market analysis, and the forms for information submission were sent to businesses. The priority task of the Commission in 2007, in relation to market analysis, is to carry out reinforced supervision of observance of obligations set for businesses with substantial power in the market.

In the postal sector, the state JSC “Latvijas Pasts” provides general postal services, while approximately 40 service providers operate actively in the sector of express mail.

During the quality measurements of a general postal service (ordinary letter) of the state JSC “Latvijas Pasts”, carried out by the Commission, a non-compliance with quality requirements of general postal services set by Cabinet of Ministers regulations was detected in 2006. In order to improve the time for letter forwarding and to prevent uncertainties of mail delivery terms, the Commission proposed to make amendments to the Postal Regulations, envisaging that a provider of general postal services ensures delivery of mail to addressee on the same day when the mail was received at a postal delivery office.

Railway

In the railway sector, the state JSC “Latvijas Dzelzceļš” ensures maintenance of public railway infrastructure as well as carries out cargo transportation and international passenger transportation. Domestic

passenger transportation is carried out by JSC “Pasažieru vilciens” and LLC “Gulbenes-Alūksnes bānītis”. In the sector of cargo transportation, there are also several operators independent from the state JSC “Latvijas Dzelzceļš”.

On April 25, 2007 the Commission set the fee for the use of public usage railway infrastructure for transportation during the 2007/2008 period of train traffic timetable. Total costs of infrastructure manager for the 2007/2008 period of train traffic timetable are planned by about 15% higher than in the calculation of cost price submitted a year ago, while the volume of transportation is planned by approximately 5% lower than in this calculation. As a result, the calculated cost price of public usage railway infrastructure increases by about 20%. The most substantial position of the increase in costs are wages and social payments.

Discussing the draft fee for public usage railway infrastructure, representatives of the railway transport sector agreed that the costs for maintenance of railway infrastructure have increased and setting a higher fee is legitimate. However, they expressed opinion that the application of such infrastructure fee will make it difficult for carriers to work successfully. The persons concerned expressed opinion that a financial support from the state is necessary for the railway transport sector on the whole.

6.10. Export Promotion Policy

With the objective to actively promote international competitiveness of Latvian companies and foster entry into new markets and consolidation in the current ones, the **Latvian Export Promotion Programme for 2005-2009 (LEPP)** is being implemented.

The Programme is being implemented in the framework of annual action plans that contain co-ordinated work of several public institutions. The LEPP Action Plan for 2007 prescribes several measures in the four main lines of action:

- development of institutional base for export promotion;
- promotion of international competitiveness of Latvian companies and development of export capability;
- support in export marketing and in the entry into new markets;
- financial instruments for export promotion.

In the framework of the LEPP Action Plan, consultations on issues involving exports are given to entrepreneurs, export skills seminars and pilot programmes on starting exports for entrepreneurs are organised, market survey in priority sectors in target countries is conducted, support is given for participation of Latvian exporters in international exhibitions and trade missions, measures of external

marketing are implemented and information on the potential of Latvian sectors, product groups and particular companies is distributed abroad, programmes for finding co-operation partners are implemented, visits of entrepreneurs abroad in the framework of visits of highest-ranking state officials are organised, business days, trade missions and contact exchanges of entrepreneurs are organised.

The Export Promotion Council chaired by the Minister of Economics supervises implementation of LEPP. The Council is made up of representatives of public institutions and industry associations as well as social partners.

Work is being done to introduce the system of export credit guarantees with an aim to increase access to markets with a higher degree of risk and promote export of goods and services of Latvian origin outside the European Union. In addition to the Law on Guaranteeing Export Credits adopted in the previous year, two regulations of the Cabinet of Ministers were approved in 2007, which determine the procedure for issuance of export credit guarantees and exchange of information with the European Commission and other EU member states.

Chapter “Entry in Foreign Markets” of the operational plan “Enterprise and Innovation” for

absorption of the EU Structural Funds for 2007-2013 (see Chapter 6.2.1) is worked out. Unlike the previous state support programme, much wider opportunities and activities are envisaged, where the state support will be available, and procedures for receipt of financing will be substantially facilitated. For the next planning period of 2007-2013, it is envisaged to provide support to entrepreneurs for participation in international exhibitions and missions, organisation of seminars and conferences, acquisition of market surveys and finding the strategic partner. Support will also be given to various trainings for promotion of international competitiveness and export capacity of Latvian companies.

Link to the **Development Concept of Foreign Economic Representative Offices of Latvia** is essential for LEPP. Implementation of the Concept substantially contributes to strengthened competitiveness of Latvian entrepreneurs in the global market. Foreign economic representative offices of Latvia constitute one of the most efficient instruments for export promotion and attraction of foreign investment.

10 foreign economic representative offices of Latvia – in Germany, United Kingdom, Sweden, France, Russia, Kazakhstan, Netherlands, Norway, Denmark and USA – are operating abroad at present. The representative offices operate in three main directions: identification and channelling of the potential investment and export projects, provision of services for Latvian companies, and distribution of information to foreign companies on the economic situation and business environment of Latvia.

In accordance with LEPP, it is planned to open 2 new foreign economic representative offices of Latvia abroad every year.

The Ministry of Economics and LIDA organise forums for Latvian entrepreneurs twice a year. In the framework of these forums, Latvian entrepreneurs are acquainted with the foreign markets where representative offices operate, and bilateral meetings of companies with leaders of representative offices are organised in order to discuss interests of companies and their business opportunities. This activity took place in Daugavpils on June 21, 2007, and, in its framework, entrepreneurs of Latgale region were acquainted with services provided by LIDA as well as with projects successfully implemented with support of foreign economic representative offices of Latvia.

External marketing is one of the main export promotion instruments. The Ministry of Economics carries out several external marketing measures in co-operation with LIDA and other institutions. Foreign visits of state officials with participation of Latvian business delegations constitute one of these measures. Business seminars, contact exchanges and visits to companies in accordance with enterprise interests are held in the framework of these visits. Several visits to the Russian Federation (Kaliningrad,

Komi Republic), visit of the Minister of Economics to Düsseldorf in Germany, as well as visit of the President of State to Morocco and Cyprus took place in 2007. More than 100 company representatives in total have participated in these visits.

In 5 months of 2007, Latvian entrepreneurs have participated in joint stands organised by LIDA at three exhibitions in Netherlands (food) and Germany (food, biomedicine). Participation of companies at 4 important international exhibitions was also supported, providing marketing of companies before the exhibitions, inviting foreign companies to the stands and working in the stands together with Latvian companies, in Germany (wood processing, machine building), Norway (structures of horizontal logs), and Australia (wood processing). 44 companies in total took part at these exhibitions. Contact exchange of companies was additionally organised in the framework of “Hannover Messe 2007”. In the framework of the food exhibition in Netherlands, wide degustation of products was organised, which got a great response and was highly appreciated both by professional Dutch food buyers and by journalists.

Several trade missions of Latvian companies were organised abroad in 2007. Individual business programme was prepared for each entrepreneur in the framework of these missions.

Customer Service Department of LIDA continues operation in 2007, providing consultations on issues involving foreign trade, selection of business partners, external marketing activities proposed by LIDA, state support programmes, and other issues.

Information on external markets is also being prepared electronically. In the 1st half of 2007, information is prepared and updated for 22 country profiles (Israel, Austria, USA, Moldova, Japan, Finland, etc.) placed on the LIDA website in the section “Foreign markets”.

Among the most important projects in 2007, one would note the festival “French Spring”. In its framework, a business conference took place on March 22. About 200 participants attended the conference, of which more than 90 represented French entrepreneurs as well as state and local government officials. In parallel to the conference, a contact exchange took place, attended by 20 French companies.

3 seminars on specific foreign trade issues (Seminar for Latvian textile companies on opportunities and conditions for entry in Swedish and Danish markets; Opportunities in the Danish construction market; Seminar for entrepreneurs of the metal working sector on requirements of the Russian market) were held in 2007. Cycle of seminars on export skills as well as five seminars on external markets are planned in the 2nd half of the year.

In order to provide to Latvian entrepreneurs those services they are most interested in, LIDA has developed a new co-operation model between a company, LIDA project manager and employee of representative office, considering that the Latvian company is a primary LIDA customer, but offers and requests of foreign companies are subordinate to it.

6.11. Protection of Consumer Rights and Market Surveillance

Supervision of consumer rights

The Consumer Rights Protection Centre (hereinafter CRPC) under supervision of the Ministry of Economics is the main co-ordinating institution that supervises observance of the normative acts of consumer rights protection¹. CRPC reviews applications and complaints of consumers about non-compliance of purchased goods or services with agreement terms, gives practical help to consumers in cases of solving conflict situations, protects consumer rights in legal proceedings, represents interests of consumers in the process of drafting normative acts, gives consultations on consumer rights protection legislation and compliance of goods, and co-operates with international consumer rights protection bodies and national institutions of consumer rights protection of other countries.

In accordance with the Cabinet of Ministers Regulation No. 631 “Procedure for Submission and Review of Consumer Claims Concerning Goods or Services Non-compliant with Agreement Terms”, the CRPC created and placed on its website a database of examiners (where 11 examiners are registered) in August. However, a bigger diversity for examination of various goods and services would be desirable.

In order to settle consumer complaints more effectively as well as arrange and provide protection of consumer interests in various spheres, the CRPC has co-operated with several business associations. CRPC co-operates with the Leasing and Factoring Committee of the Association of Latvian Commercial Banks,

working out the Code of Good Practice of Leasing and Factoring Companies. Meetings with representatives of Latvian Real Estate Developers Association as well as with Association of Latvian Travel Agents were organised in order to discuss the assessed agreements and ensure observance of consumer rights in them.

CRPC continues co-operation with other central and local government bodies as well. Employees of the CRPC have participated in working groups organised by the state agency “Housing Agency”, where “Example of Agreement for Management and Administration of Newly-Built Housing and Rules for Use and Management of Apartment House and Underground Parking Lot” was developed. Agreement with the management of the State Agency of Health Statistics and Medical Technologies on exchange of information regarding traumas got by inhabitants through the use of unsafe goods has been achieved.

A meeting of the Consumer Advisory Council on the planned activities in the framework of the Consumer Programme for 2008-2010 took place in May 2007. The Consumer Advisory Council was established in April 2006. Its main goals are to promote development of consumer protection policy and rise of the consumer rights protection level, ensuring and encouraging dialogue and exchange of information in the field of consumer rights protection between public institutions as well as associations and foundations of consumer rights protection and entrepreneurs.

Box 6.22

Operation of the CRPC in 2007

In 4 months of 2007, the CRPC:

- carried out 948 inspection visits to trade and service companies (sites),
- provided 1340 consultations to entrepreneurs,
- provided 8548 consultations to consumers;
- reviewed 374 cases of administrative offences in the area of consumer rights protection, and a fine in the amount of LVL 15 505.00 was applied,
- reviewed 648 applications and complaints of consumers.

In comparison with the same reference period in 2006, the number of complaints and applications (hereinafter complaints) has increased by 44% (451 complaints were reviewed in 4 months of 2006, 334 complaints were reviewed in 4 months of 2005). The number of complaints still tends to grow in the last years, which may be explained by greater awareness of consumers about their rights. 214 of the reviewed complaints were settled in favour of consumers (as a result, consumers got refunds of money paid for goods and services not complying with agreement terms, and the total amount of refunded money was LVL 29 452.24), claims in 149 complaints proved to be unfounded, 60 complaints were sent for review to other institutions in accordance with their cognizance. In their complaints, consumers have presented claims about:

- non-observance of the principle of legal equality of contracting parties – in 84 cases,
- provision of incomplete information – 13,
- incorrectly set payment for purchase and weight or measure – 6,
- violations of review of claims – 94,
- non-issuance of documents attesting to the transaction, and other offences – 114,
- services that do not comply with agreement terms – 259,
- goods that do not comply with agreement terms – in 255 cases,
- various other claims – in 37 cases.

¹ Information about consumer rights is available on the CRPC website www.ptac.gov.lv as well as on the website of the non-governmental organisation for consumer protection: www.pateretaja-celvedis.lv.

Box 6.22 continued

Of 255 received complaints about purchased goods that do not comply with agreement terms, the most were related to electrical appliances (58), mobile phones (53) and footwear (41).

The biggest share of all complaints is constituted by complaints about provided services that do not comply with agreement terms (259), of which the most complaints are about construction (58), rent and public utilities (26), electronic communications (23) and tourism (21) services.

With regard to Regulation (EC) No. 261/2004 of the European Parliament and of the Council of February 11, 2004 *Establishing common rules on compensation and assistance to passengers in the event of denied boarding and of cancellation or long delay of flights, and repealing Regulation No. 295/91* (hereinafter Regulation No. 261/2004), air passengers (7) have turned to the CRPC with complaints in order to get help in obtaining compensation and assistance from air carriers. The CRPC, which is responsible for supervision of observation of air transport passenger rights in Latvia, has helped them by explaining their rights and, in cases of necessity, has taken decisions, obligating airlines to meet the legitimate demands of passengers. In order to ensure efficient review of these complaints and legal regulation in protection of air passenger rights, and taking into account a CRPC proposal, a working group was established in 2007. During its work, amendments to Article 88 of the *Law on Aviation* and to Cabinet of Ministers Regulation No. 632 *Bylaw of the Consumer Rights Protection Centre* were developed, as well as proposals for new Cabinet of Ministers regulations were developed, which would determine the procedure, by which co-operation between institutions is ensured in review of cases resulting from violations of Regulation No. 261/2004.

Reviewing consumer complaints, CRPC officials co-operate with other officials from various institutions in Latvia and other European countries. Complaints are reviewed in accordance with legal regulation prescribed by normative acts.

In 4 months of 2007, the CRPC has assessed 3923 advertisements, established 220 violations and received 15 complaints. The biggest number of violations still is in the advertisements where a special offer is made. The number of such advertisements non-compliant with requirements of normative acts, which advertise various health improvement preparations and food supplements, has increased. CRPC also concludes that the number of such advertisements non-compliant with requirements of normative acts, where external normative acts obligate to include specific components in the advertisement, is increasing. For instance, advertisements of alcoholic beverages must obligatorily include a warning to society about the negative effect of alcohol use. The abovementioned obligatory requirements are frequently met only formally in such advertisements, not achieving the meaning set by the law.

Supervision of agreements

By May 2007, the CRPC has issued 26 administrative acts on unfair terms of agreement, demanding to cease fulfilling the unfair terms of agreements concluded with a specific consumer and of agreements concluded with other consumers, as well as demanding to alter draft agreements offered to consumers.

The number of established violations of unfair terms of agreement has increased by more than 50% in comparison with the previous year, which is attributable to the activity of the CRPC in this field and to increased level of consumer knowledge in assumption of contractual obligations. A big part of the administrative acts on unfair terms of agreement pertain to agreements of purchase, development or management of real estate, and this trend becomes increasingly pronounced.

The most frequent unfair terms in agreements with consumers are as follows:

- prescribing settlement of disputes only by the court of arbitration;
- prescribing disproportionately big penalty to be paid by a consumer in case of non-fulfilment or inadequate fulfilment of contractual obligations;
- infringement upon legitimate rights of a consumer;
- prescribing service provider's or vendor's rights to alter terms of agreement unilaterally;
- prescribing service provider's or vendor's rights to unilaterally keep the advance payment paid by a consumer, not providing such opportunity for the consumer.

Decisions have been taken mainly with regard to unfair terms of agreements of consumer crediting, provision of electronic communication services, purchase and management of real estate, purchase of

various goods and provision of various services (e.g., making and putting the windows).

Decisions with regard to collective consumer interests are published since 2007 on the CRPC website www.ptac.gov.lv (in the section "Decisions of the CRPC").

In 2006, the CRPC assessed compliance of 21 tourism services with requirements of Regulation No. 163 of May 2, 2000 "*Regulations on Complex Tourism Services*" as well as called to prevent violations established in them. In 2007, the CRPC conducts tests of draft agreements altered by providers of complex tourism services as well as assesses whether they comply with requirements of Regulation No. 67 of January 23, 2007 "*Regulations on the Procedure of Preparation and Implementation of a Complex Tourism Service, Information Providable to Customer, and Rights and Services of a Complex Tourism Service Provider and of a Customer*".

In 2007, the CRPC employees have also started assessment of guarantee terms offered by vendors, service providers and producers to consumers. Up to date, seven calls to prevent non-compliances of guarantee terms with requirements of normative acts have been sent.

In 2007, the CRPC will continue performing consumer rights supervision in regard to unfair terms of agreement in case when consumer has concluded agreement with producer, vendor or service provider, paying special attention to insurance agreements and agreements on electronic communication services.

Repeated supervision of observance of consumer crediting rules as well as tests of Internet websites will also be carried out.

As from February 2007, employees have been trained to master a computer programme that helps to ensure co-operation of institutions in the framework of Regulation (EC) No. 2006/2004 of the European

Parliament and of the Council of October 27, 2004 on co-operation between national authorities responsible for the enforcement of consumer protection laws. The CRPC has also solved one case of violation of

advertisement rules in accordance with provisions of the mentioned Regulation.

Box 6.23

International co-operation of the CRPC

In 2007, the CRPC participates in the project “Best Practice techniques, Enhancement of market surveillance of Consumer Product Safety within the framework of the General Product Safety Directive (GPSD)” financed by the European Commission and organised by PROSAFE. In the framework of the project, 24 countries have aggregated information about national legislation of market surveillance, its strategy, processes, procedures and publications. Manual on good practice of market surveillance in the EU will be made as a result of the project.

International co-operation network ICPEN

CRPC continues its work in the ICPEN (International Consumer Protection and Enforcement Network) – an international co-operation network where consumer rights protection and fair trade supervision bodies work, encouraging international co-operation in prevention of unfair and misleading marketing activities. In March 2007, the CRPC participated in the ICPEN conference that was held in Krakow, Poland. In the framework of the conference, a plan of ICPEN strategy was approved, which envisages the following main tasks in the further work of ICPEN: efficient determination and promotion of implementation of consumer rights protection measures, exchange of information between member states in relation to the former practice in effective enforcement of legislation as well as on other consumer rights protection activities, participation in prevention of cross-border violations, raising the co-operation level of member states, and promotion of co-operation of cross-border consumer rights protection organisations.

Co-operation of the Baltic States

On June 16, 2005, mutual project in the field of children’s product safety was organised between **market surveillance and consumer rights protection bodies of the Baltic States** in the framework of concluded co-operation agreement. 3 child bicycles were tested in Latvia in 2006, and the test results showed that none of them complied with the set requirements and were to be considered unsafe as they create risk of injury and risk of poisoning. Trade of these goods was stopped and the chain of distribution and placing in the market was explored. As a result, administrative cases were initiated and administrative penalties were imposed for trade of such goods, goods were recalled from consumers, 99 hazardous goods were destroyed and 251 hazardous goods were removed out of Latvia and brought to the importer.

In May 2006, a co-operation agreement was concluded between Latvian CRPC, Lithuanian Consumer Council and Estonian Consumer Protection Council on co-operation in introduction of EU Regulation on administrative co-operation between consumer rights protection institutions. It is envisaged to co-operate in the framework of this agreement in order to prevent various violations of provisions of EU directives more efficiently, especially regarding economic interests of consumers.

Meeting of co-operation partners will take place in June 2007, and issues of joint co-operation projects will be solved during this meeting.

Co-operation network of Baltic Sea region

In 2006, Latvia as one of the **Baltic Sea region co-operation countries** participated actively in network meetings on market surveillance issues and got involved in a joint project on safety of goods. 6 functional electric transformer toys were chosen and sent to a German laboratory for safety tests. Trade of the goods was halted because, as a result of tests, they were acknowledged non-compliant with requirements of normative acts, as non-compliance of adapters was established, and administrative cases on trade of non-compliant goods were initiated.

Cross-border trade

The number of Latvian residents going abroad and the number of tourists visiting Rīga have rapidly increased in the recent time period, thereby the cross-border consumer protection becomes increasingly topical.

The European Consumer Centre of Latvia (ECC Latvia) was established as a separate department of the CRPC, co-financed by the European Commission.

In 4 months of 2007, consumers contacted the ECC Latvia 139 times, of which 121 were a consultation and 18 complaints. 33% of the received complaints pertained to air traffic services, 22% of complaints were related to household appliances, 6% pertained to e-commerce, 6% were related to accessories. 23% of the provided consultations were related to air traffic services, 21% – to household appliances, 12% – to clothing and footwear, 11% – to e-commerce, 2% – to tourism services, and 1% – to accessories, and 30% of consultations were given about EU normative acts and other services.

In 4 months of 2007, minicards with contact information of the ECC Latvia are available in 37 various places visited by foreign tourists (Rīga International

Airport, tourism information centres, hotels, etc.), and information is provided about the cases when a consumer may turn to the ECC Latvia for help.

Due to the successfully started co-operation with the Latvian Tourism Development Agency, the booklet “Shopping in Latvia” in English with information for foreign tourists about Latvia, prepared by the ECC Latvia, was distributed at the International Exhibition Matka 2007, which took place in Helsinki on January 18-21, 2007.

With a goal to inform consumers actively, co-operation with the European Union Information Agency was continued, which helped to distribute the booklets “What is the European Consumer Centre?”, “How to shop more safely at Internet shops in the European Union?”, “Complex tourism service and consumer rights in the European Union!” prepared by the ECC Latvia.

With a goal to provide wider information to consumers on consumer rights in the EU, the ECC Latvia continues adding information to the website www.ecclatvia.lv on a regular basis, so that consumers would get more and more high-quality information

about cross-border purchases and information about how to act in cases when a low-quality commodity or service is purchased. Since the ECC Latvia was opened, its website was visited 3864 times from 36 different countries, among them countries that are not EU member states.

Market surveillance

In order to ensure that only safe goods complying with certain requirements are available in Latvian market, effective market surveillance is necessary.

CRPC has set the priority directions of market surveillance in 2007, which are: children's goods (cots, baby walkers, nappy changing tables), baby-proof lighters, provision of information about commodity in Internet shops and assessment of compliance of guarantee vouchers with requirements of the Consumer Rights Protection Law, and supervision of computer games.

A programme for withdrawal of samples of goods has been worked out, setting children's goods, toys, individual means of protection, etc., as priorities.

Tests of compliance of computer games labeling, provision of information and their content with the set requirements are being carried out together with the Ministry for Children and Family Affairs and other involved institutions.

At the end of 2006, 3 projects of the testing of goods were implemented at the CRPC:

1) toys, 2) electric appliances, 3) individual means of protection.

In the framework of the project of toys, samples of 49 toys were withdrawn (soft, plastic and electric

toys): non-compliance was established for 8 toys, and 41 toys were acknowledged to be unsafe.

Big share of the established unsafe toys is constituted by soft toys with easily detachable small parts and easily accessible packing, that poses a risk of choking and suffocation to a child. One of the most frequent faults of plastic toys is sharp and abrasive edges a child can get easily injured from. Exceptional hazard is posed by toys with batteries not fastened in accordance with requirements, so a child can very easily remove the batteries and swallow them, which may create a very serious hazard to his health.

Information about the unsafe toys is already sent and published in the EU Rapid Exchange of Information System (RAPEX).

In the framework of the project of individual means of protection (IMP), special attention was paid to 2 groups of goods – respiratory protection masks against dust, and various types of protection gloves. 11 samples were withdrawn, non-compliance was established for 4 of them, and 7 were acknowledged to be unsafe. The most frequent non-compliances are: incorrectly defined class of individual means of protection, improper labeling, in some cases the goods are unusable and do not fulfil the functions of IMP, being just simple household goods. Taking into account the construction volumes currently growing in the country, special attention must be paid to this group of goods.

In the framework of the project of electric appliances, 35 samples were withdrawn for testing. 7 of them were acknowledged to be unsafe, and non-compliance was established for 5 samples.

6.12. Quality Assurance

6.12.1. Quality Structural Policy

The main task in the area of quality assurance is to promote observance of requirements of normative acts in the regulated and non-regulated sphere as well as improve the base of normative acts in accordance with EU requirements, taking into account the needs of the national market and national economy, hence ensuring compliance of the products placed in the market and of the provided services and encouraging increased competitiveness of entrepreneurs and reduction of obstacles to inter-state trade.

National quality assurance system in Latvia is regulated by the Law "On Conformity Assessment", the Standardisation Law and the Law "On Uniformity of Measurements" as well as by the Cabinet of Ministers regulations deriving from the mentioned laws.

The main directions of the policy are:

- improvement of the conformity assessment infrastructure (including testing and calibration laboratories, inspection and certification institutions, environmental verifiers) in

accordance with the needs of Latvian national economy in order to protect consumers and environment from low-quality products and services, promote growth of competitiveness of entrepreneurs and reliability of products and services provided by Latvian entrepreneurs;

- improvement of the informative and consultative base in order to inform Latvian population on the recent national requirements and requirements of EU normative acts;
- participation of national institutions of accreditation, standardisation and metrology in international organisations, ensuring their international recognition and compliance of the Latvian quality assurance system with international requirements;
- maintenance and international comparison of the national base of standards in order to ensure the necessary traceability of measurements and protect society from inaccurately conducted measurements;

- encouraging introduction of quality management system, environmental and other voluntary quality systems in enterprises in order to ensure manufacturing of higher-quality products and provision of higher-quality services as well as competitiveness of Latvian companies in international markets.

In order to foster development of Latvian national economy, the following activities were carried out in 5 months of 2007:

- notification of conformity assessment institutions accredited in the regulated sphere to the European Commission and other EU member states in the electronic form was ensured, using the “Nando-input” database. Thus it is possible to notify more operatively information about conformity assessment institutions that have proved their competence in accordance with requirements of the New Approach Directives. Publication of Latvian conformity assessment institutions in the official newspaper “Latvijas Vēstnesis” was also ensured;
- regulation on norms of losses permissible in the process of reloading and storage has been drafted, in order to set unified requirements for norms of losses permissible in the process of reloading and storage of goods;
- meetings of Latvian national accreditation, standardisation and metrology councils have been organised;
- development and representation of Latvia’s position in EU institutions is ensured in regard to the European Commission’s draft Regulation of the European Parliament and of the Council on requirements for accreditation and market surveillance, which pertains to trade of products and proposal for a decision of the European Parliament and of the Council on a unified system of trade of products, by which the up-to-now systems of accreditation and market surveillance will be improved, as well as the New Approach;
- participation in working groups and conferences of international organisations has been ensured in order to shape unified conformity assessment policy throughout the EU, taking into account the interests of Latvia.

In the first 5 months of 2007, the number of the certified enterprises where quality management systems are introduced has reached 659 enterprises, which is by 101 enterprises more than in the first 5 months of 2006.

In order to improve the legislative, informative and consultative base as well as the infrastructure of the conformity assessment system, it is planned to carry out the following activities in 2007:

- to improve the Latvian national metrology system, making proposals on the calibration process of measuring instruments;
- to improve the Latvian National Conformity Assessment System, making proposals for its improvement, in view of the provisions of the “State Administration Structure Law” and the “Administrative Law of Latvia” ;
- to inform society about topicalities in the field of quality assurance on a regular basis in order to raise society’s awareness of quality assurance issues;
- to organise the annual National Accreditation Conference in co-operation with the state agency “Latvian National Accreditation Bureau” in order to promote confidence in accredited institutions of conformity assessment;
- to organise the annual international quality conference and the Latvian Quality Award 2007 in co-operation with the Latvian Association for Quality in order to popularise quality assurance as a way for raising business competitiveness.

6.12.2. Standardisation, Metrology, Accreditation

Standardisation. The limited liability company “Latvijas standarts” (LVS) was founded in 1999 as the national standardisation organisation with a goal to manage and co-ordinate activities of businesses, institutions and organisations of the Republic of Latvia in standardisation, and it operates according to provisions of the *Standardisation Law*. LVS provides standardisation information to Latvian national economy in order to increase competitiveness of Latvian entrepreneurship and industry and integrate Latvia and its entrepreneurship into international economy, and it co-operates with international and European organisations of standardisation.

Since 2004, LVS is a full-fledged member of the European Committee for Standardisation (CEN) and of the European Committee for Electrotechnical Standardisation (CENELEC) as well as a corresponding member of the International Organisation for Standardisation (ISO) and an associate member of the International Electrotechnical Commission (IEC).

The main functions of LVS are to set up Latvian fund of standards, co-operate with international and European organisations of standardisation, and issue Latvian standards.

In order to develop national standards and adapt international and regional standards at the status of Latvian standard, LVS co-ordinates operation of 43 technical committees of standardisation (LVS/STC) in various national economy sectors. New working group of standardisation LVS/DG 03 “Precious metals – their application in jewellery and related products” was founded in 2006.

25 187 standardisation documents were registered by LVS by May 1, 2007, of which 21 584 EU standards were adapted. 478 European standards and 31 international standards were adapted and standardisation information services to 2625 legal and physical persons were provided in 4 months of 2007.

In 2006, LVS:

- adapted 1711 European standards at the status of Latvian standard;
- registered 492 alterations of Latvian standards and other documents;
- reviewed 2158 European standard projects (1.5 times more than in 2005);
- translated standards of the regulated sphere (p.942) in construction, machine safety, and work environment into Latvian.

In 2006, the infrastructure of information technologies of LVS was improved, the system of standard searching was improved and its use was simplified, and the automatic system for electronic notification of information was introduced. On the basis of this system, the LVS Information Fund provides a new free-of-charge service "Monthly Report on the Standards Registered at the Status of Latvian Standard and on Abolished Latvian Standards" to customers in the areas of customers' interest. In 2006, this service was used by 372 permanent customers, and 3792 regular reports were sent to them.

Since the previous year, LVS has joined those national standardisation organisations that undertake to organise meetings of the technical committees (TC) of the European standardisation organisations (see Box 6.24).

Box 6.24

Meetings of the technical committees of the European standardisation organisations in Riga

Up to now, 8 meetings of TC have already taken place in Riga, where representatives of the respective LVS technical committees and of those institutions interested in issues reviewed at the meetings participated from Latvia.

In first months of 2007, two meetings have taken place:

- CEN/TC 250/-/1 CG "Eurocodes of construction".
- ETSI/TC 15 "Legal interception of information".

In April 2007, a meeting of the co-ordination group of CEN/TC 250/-/1 CG "Eurocodes of construction" took place. It was attended by 25 experts from different countries, experts of LVS/STC 30 "Constructions" and of the Ministry of Economics took part in it. A meeting of ETSI/TC 15 "Legal interception of information" also took place and was attended by 64 participants.

At the meetings of the committees, issues on development of new sector standard projects were reviewed, achievements were reported and information on topicalities in the respective sectors was given. More than 400 experts of standardisation work from national standardisation organisations, enterprises and professional organisations of various countries participated in the meetings.

Through involvement in organising meetings of the technical committees of European standardisation organisations in Riga, LVS gives bigger opportunity for Latvian experts to participate and contribute to European standardisation work, expressing their opinions and protecting Latvian economy interests in the processes of development of European standards and acquiring standardisation work experience of experts from other countries. LVS implemented these labour-consuming activities in active co-operation with the respective technical committees of standardisation, professional associations (Latvian Real Estate Association; Latvian Liquefied Petroleum Gas Association) and sectoral ministries (Ministry of the Environment, Ministry of Economics).

Directions of LVS activity in 2007 are:

- involvement of standard users and their means into standardisation processes, co-operating with ministries, associations, and commercial companies;
- introduction of electronic system for selling of standards (e-Shop);
- translation of standards of the regulated sphere into Latvian;
- introduction of requirements of the Law on Supply of Free Mandatory Copies of Printed and Other Publications;
- preparing to participate in ISO at the status of full-fledged member;

- technological mating of European standardisation organisations and LVS databases;
- organising meetings of the technical committees of standardisation of CEN and CENELEC in Latvia.

Metrology. The state agency "Latvian National Metrology Centre" (hereinafter Agency) is an agency under supervision of the Ministry of Economics and operates in accordance with the Law "On Uniformity of Measurements" and the Cabinet of Ministers Regulation No.624 of August 1, 2006 "Bylaw of the State Agency "Latvian National Metrology Centre"". It is the national metrology institution of Latvia.

The goal of the metrology agency is to ensure and develop provision of credibility and traceability of measurements in the country.

The main tasks of the Agency are:

- to ensure the base of measurement standards of physical quantities and reproduction of measurement units;
- to approve the types of measuring instruments and register them in the State Register of Measuring Instruments;
- to provide calibration services;
- to participate in development of normative acts related to regulated metrology;

- to co-operate with metrology organisations of other countries and engage in work of international metrology organisations;
- to organise inter-laboratory comparison and take part in it;
- to organise training in the metrology sphere.

Since the Agency started operating, participation in several inter-laboratory comparison projects have been ensured (e.g., in the sphere of non-automatic weighing instruments), and the Radiation Metrology and Testing Centre (RMTC) has organised comparative measurements of the Baltic Thermoluminescent Dosimetry Laboratory (TDL) for employees of Radiation Safety Centres of Estonia, Latvia and Lithuania.

In the area of electric and time measurements, establishment of the National Time Standard is continued:

1. work for installation of two GPS antennae and determination of co-ordinates was completed in co-operation with the Latvian Geodetic Service;
2. programming of the time server S250 and synchronisation with the Primary Standard and GPS were conducted;
3. primary configuration of the system TTS-3 and its preparation for transmission of time signals were conducted;
4. assembly of the UPS accumulator system and its mating with the diesel generator energy feeding system were conducted.

TC-Q “Quality” of the EUROMET Technical Committee took place in February. During it, the quality system of the Agency was successfully presented. The metrology agency has received

confirmation of its admittance in the newly established European metrology organisation EURAMET.

513 measuring instruments were calibrated in 2006.

Accreditation. The state agency “Latvian National Accreditation Bureau” (hereinafter LATAK) is a public administration institution under supervision of the Ministry of Economics, which ensures operation of the national accreditation system.

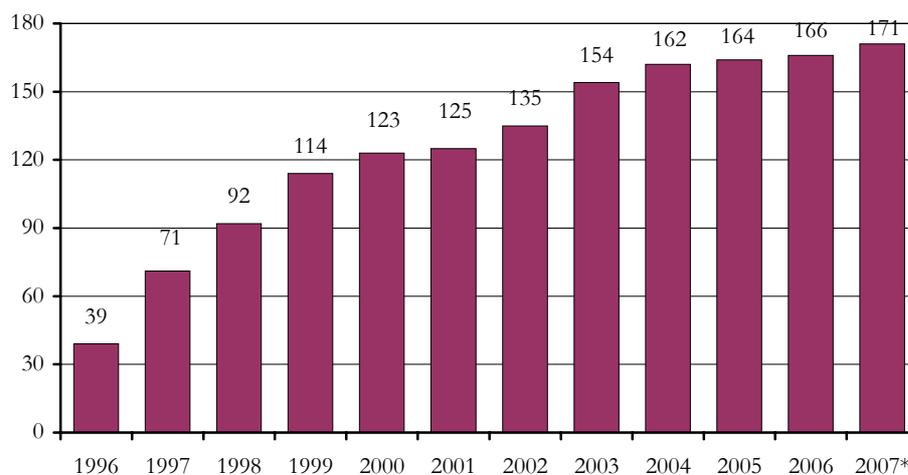
According to the Law “On Conformity Assessment”, the main functions of LATAK are:

- to evaluate, accredit and supervise the testing and calibration laboratories and certification and inspection institutions in conformity with the prescribed requirements of normative acts, Latvian national standards, EU or international standards;
- to organise and co-ordinate inter-laboratory comparative testing in compliance with Latvian, EU and international requirements;
- to represent Latvia in international accreditation organisations;
- to maintain and update the informative base of accredited institutions.

In the first months of 2007, the number of accredited conformity assessment institutions has increased, exceeding the planned one: 171 conformity assessment institutions are maintained in the system as of May 2, 2007 (see Figure 6.3). At present, one conformity assessment institution is evaluated in terms of compliance with requirements of Good Laboratory Practice (GLP), considering the Cabinet of Ministers Regulation No. 398 of September 3, 2002 “Requirements for Work Quality of Laboratories and Inspection of Laboratories”.

Figure 6.3

Development Dynamics of the National Accreditation System



* number of institutions as of May 3, 2007

LATAK also provides accreditation services in Ukraine where 2 conformity assessment institutions are accredited.

Fulfilling functions of methodological management of assessors, LATAK organised 4 training seminars for assessors and experts in 2007, where 35 participants took part. LATAK organised a training

seminar for the laboratories that organise inter-laboratory comparative testing programmes. The seminar was attended by 49 listeners.

LATAK participates in the European Co-operation for Accreditation (EA) in the framework of the Multilateral Recognition Agreement (MLA) in 6 accreditation spheres.

6.13. Privatisation

The goal of privatisation is, by changing ownership of a state or local government property, to create a favourable environment for operation of the private capital in interests of development of Latvian economy and scale down the activity carried out by the state and local governments as businesses.

As the goal of the mass privatisation implemented in Latvia is basically achieved, the Saeima adopted the Law on Completion of the State and Local Government Property Privatisation and Use of Privatisation Certificates (hereinafter – Privatisation Completion Law) that came into force on September 1, 2005 and prescribes how to complete the privatisation process and land reforms and ensure completion of the use of privatisation certificates.

The Privatisation Completion Law prescribes:

- the term of August 31, 2006 by which every legal or physical person may propose to bring any state or local government property to privatisation;
- the procedure by which a privatisation proposal submitted by a person is reviewed and decision is adopted to bring the state or local government property to privatisation;
- that privatisation may be denied and the property maintained in possession of the state or local government if the property is necessary to carry out public administration functions or commercial activity of the state or local government;
- that the Cabinet of Ministers or a local government could take decisions on bringing the state or local government property to privatisation by February 28, 2007;
- that the state joint stock companies “Latvenergo”, “Latvijas pasts”, “Starptautiskā lidosta „Rīga””, “Latvijas dzelzceļš”, “Latvijas gaisa satiksme” and “Latvijas valsts meži” will not be privatised or alienated;
- the terms by which the persons willing to redeem land allocated for permanent use have to submit land redemption application (August 31, 2006) or by which the land boundary plan or confirmation of the land redemption payment done in privatisation certificates before conclusion of the land redemption contract has to be submitted to the State Land Service (September 1, 2008);

In 2007, LATAK participated in several committees: session of Multilateral Recognition Agreement (EA MLA) committee, EA Inspection – Certification Committee (EA IC / CC), EA Laboratory Committee (EA LC), and EUROMET-EUROCHEM Technical Committee.

- that privatisation certificates do not have an expiry term, but may be only used in the framework of the privatisation process;
- the procedure of ending the issuance of privatisation certificates. The final term of April 28, 2006 is set for persons, by which they can submit application for privatisation certificates.

In order to ensure successful and open progress of privatisation completion processes, the Cabinet of Ministers has set the procedure of how the institutions conducting privatisation and land reform have to establish publicly available registers of privatisation proposals and land redemption.

In the framework of application of norms of the Privatisation Completion Law, problems of interpretation and implementation of several norms arose. In order not to jeopardize completion of privatisation and land reform, the Cabinet of Ministers, in accordance with Article 81 of the Constitution, opened the Privatisation Completion Law for solution of the following problems:

- particular terms were specified;
- application of particular norms was specified, inter alia, in further handling of properties, bringing of which to privatisation is denied;
- to extend the term for review of privatisation proposal and its consequences;
- the procedure of land reform completion was specified, expanding regulation both in land redemption and in dealing by the state and local governments with land that will not be redeemed as well as in restoration of land ownership rights for former owners;
- to specify particular terms in granting and use of privatisation certificates, inter alia, extend the opportunity for a person to transfer privatisation certificates granted to the person to the account of a credit institution;
- specific conditions were set, which must be observed in settlement of disputes that arise in the framework of privatisation and land reform.

Privatisation of state property

Privatisation of state-owned property units or land is carried out and privatisation proposals are summed up by the state joint stock company “Privatizācijas

aģentūra” (hereinafter – Privatisation Agency) under the Law “On Privatisation of Property Units Owned by the State and Local Governments”.

Decision to bring a state-owned property unit (including capital shares) or vacant land plot to privatisation is taken by the Cabinet of Ministers, while a decision to bring a built-up land plot (on which there are buildings owned by other person) to privatisation is taken by the Privatisation Agency. The decision is taken on the basis of a privatisation proposal submitted by any physical or legal person.

616 proposals for privatisation of real estate, 57 proposals for privatisation of state capital shares and 4085 proposals for privatisation of land plots have been registered by the Register of Privatisation Proposals of the Privatisation Agency from September 1, 2005 (when the Privatisation Completion Law came into force) till April 1, 2007. After August 31, 2006, the Register of Privatisation Proposals registered those privatisation proposals that were submitted by mistake to other state and local government institutions by this date and transferred by cognisance to the Privatisation Agency later.

A physical or legal person eligible to acquire a movable or immovable property in Latvia can be the subject in privatisation of state-owned property (real estate, capital shares, land). Payments for the property units have to be done in lats (LVL) and/or privatisation certificates.

In accordance with the Privatisation Completion Law, the Cabinet of Ministers has taken decisions on bringing 127 properties to privatisation and denials of bringing to privatisation for 56 properties by April 1, 2007.

From April 17, 1994 till April 1, 2007, privatisation rules have been approved in the statutory procedure for 2225 state property units (except land). 94 companies were transformed to public joint stock companies, putting 439.14 million shares into public circulation. From April 17, 1994 till April 1, 2007 incomes from privatisation of state property units (with the exception of land, selling of shares emerged as a result of capitalisation of debts and alienation of capital shares) amounted to LVL 1.644 billion, of which LVL 328.286 million in cash and LVL 1.262 billion in privatisation certificates. New owners took over obligations of privatised state companies (enterprises) for more than LVL 185.2 million. The amount of the specified investments was LVL 130.7 million, while the amount of investments actually invested reached LVL 253.8 million.

Privatisation Agency carries out privatisation of state-owned lands since 1997. 4181 state-owned land plots with the total area of 6477.8 hectares were privatised (purchase agreements signed) by April 1, 2007. Total sale price for the privatised state lands reached LVL 141.71 million, of which LVL 49.60 million in cash and LVL 92.11 million in property compensation certificates. As of April 1, 2007, incomes from privatisation of these land plots amounted to LVL 136.98 million, of which

LVL 47.73 million in cash and LVL 89.25 million in property compensation certificates.

Privatisation of local government property

Decision concerning real estate owned by a local government is taken by the council of the local government (city, province, rural municipality). The decision is taken on the basis of a privatisation proposal submitted by any physical or legal person.

A physical or legal person eligible to acquire a movable or immovable property in Latvia can be the subject in privatisation of local government property (real estate, capital shares, land). Payments for the property units have to be done in lats (LVL) and/or privatisation certificates.

Privatisation of local government property in the local government area is ensured by property privatisation commission of the respective local government (rural municipality, city, district, novads).

Compliance of privatisation projects, rules and announcements approved by a local government with provisions of the Law “On Privatisation of Property Units Owned by the State and Local Governments” and the Privatisation Completion Law is ensured by the Ministry of Economics.

From February 17, 1994 till April 1, 2007, the Ministry of Economics has reviewed and accepted for information privatisation projects for the total relative price of LVL 99.7 million (including payments in certificates for the nominal value of LVL 56.2 million).

From January 1, 1997 till April 1, 2007, the Ministry of Economics has reviewed and accepted privatisation rules in respect of 1568 built-up and vacant local government lands (announcements of privatisation of built-up land plots separately as from September 1, 2005) with the total value of land plots in the amount of LVL 20.1 million (of which LVL 12.6 million to be paid in property compensation certificates).

Pursuant to Item 7 of Article 5 of the Privatisation Completion Law, after August 31, 2006, local governments shall quarterly submit data to the Ministry of Economics, regarding the received privatisation proposals for municipal property units and built-up and vacant land plots, decisions on bringing these property units and land plots to privatisation, the sale price and the amount of privatisation certificates to be used for payment.

Privatisation of apartment houses

Privatisation of apartment houses in Latvia was started in 1995. The Central Apartment Houses Privatisation Commission (renamed as the state agency “Mājokļu aģentūra” (Housing Agency) as from January 1, 2004) and apartment privatisation commissions of the respective local governments have prepared and put up for privatisation in the procedure laid down in the Law “On Privatisation of State and Local Government Apartment Houses” 28 830 state and local government apartment houses with 496 965 apartments or 99.46% of the total number of apartments (499 688) by March

31, 2007. 194 347 apartments have been handed over to private owners by a resolution preceding privatisation of the apartment house.

There are 426 412 state and local government apartments privatised (purchase agreements signed, or handed over to private owners preceding privatisation of the apartment house) in Latvia by April 1, 2007, making up 85.34% of the total number of apartments. So far, apartment owners have taken over management of 9045 apartment houses, among them 5565 local government apartment houses and 3480 state-owned apartment houses, where more than 50% of apartment properties have been privatised.

Owners of privatised apartments can decide themselves on the most acceptable form for management and maintenance of their apartment house: either organise a co-operative society of apartment owners (CSAO) or sign an authorisation agreement for management of the house. As a result of this process, 392 CSAOs have been founded in Latvia, among them 284 in seven biggest cities and 108 in districts of Latvia. The biggest number of CSAOs has been founded in cities of Riga, Liepāja and Ventspils and in Kuldīga and Valmiera districts. Authorisation agreements for house management have been signed for 2735 apartment houses.

Land reform

The principal goal of land reform is to change over the legal, social and economic relations of land use and ownership from the command economy to the market economy.

State land reform includes allocation of free land cognisable to the state for permanent use, restoration of ownership rights, redemption of the land allocated for permanent use, and privatisation (alienation) of land owned by the state or local government. Redemption of land allocated for permanent use is being carried out in relation to the rural and urban land reform that is under way in the country. According to data of the information system of the Real Estate State Cadastre, 960 755 land units are registered in the country as of April 1, 2007, of which 670 955 land units or 69.9% are recorded in the Land Register.

Allocation of urban land for the use to apartment house owners or orchard users, who received the land for laying out an orchard with building rights is over, and urban land commissions have reviewed conclusions concerning rights to acquire ownership of land for payment but, in accordance with the conclusions made, conclusion of purchase agreements is continuing in compliance with the Cabinet of Ministers Regulation No. 171 of May 6, 1997 “On Calculation of Compensation for Former Landowners or their Heirs and on Setting Fee for Urban Land Given into Ownership”. SJSC “Latvijas Hipotēku un zemes banka” (Mortgage and Land Bank of Latvia) has signed a total of 70 193 agreements, of which 437 agreements were signed in the 1st quarter of 2007.

Allocation of free (unclaimed) rural land cognisable to the state for permanent use, i.e. until June 1, 2006, and

submission of redemption claims to the State Land Service for redemption of rural land allocated for permanent use, i.e. until August 31, 2006, have been finished. After submission of a redemption claim, the State Land Service verified the claimant’s rights to acquire ownership of land. If the claimant was entitled to redeem land, the State Land Service included this land redemption claim into the Rural Land Redemption Register. Claimants included in this register have to submit a land border plan registered in the information system of the Real Estate State Cadastre or, in the procedure set by the Cabinet of Ministers, a confirmation of land redemption payment in privatisation certificates before conclusion of land redemption agreement to the respective regional bureau of the State Land Service by September 1, 2008. State Land Service included the cadastrally surveyed land units allocated for permanent use, which were not claimed for redemption by their permanent users by August 31, 2006 into the Rural Land Redemption Register, on grounds of a land border plan registered in the information system of the Real Estate State Cadastre.

State Land Service has received 53 738 claims in total for 86 327 land units with the total area of more than 348 600 hectares. Review of the submitted claims is completed and decisions on the rights to redeem land were adopted for 77 462 land units or 89.7% of the claimed land units with the total area of more than 311 200 hectares. Denial of land redemption was adopted for 1401 land units or 1.6% of the claimed land units with the total area of 8700 hectares.

16 279 land units with the total area of 91 500 hectares were included into the Rural Land Redemption Register without person’s land redemption claim, on grounds of a land border plan registered in the information system of the Real Estate State Cadastre. Thereby, permanent users of rural land at present have acquired rights to redeem 93 741 land units with the total area of more than 402 700 hectares. Until review of land redemption claim and adoption of decision and receipt of lacking documents, adoption of decisions is postponed for 6446 land units or 7.5% of the claimed land units with the total area of more than 23 200 hectares.

Transfer of ownership of rural land for pay and conclusion of land purchase agreements with the SJSC “Latvijas Hipotēku un zemes banka” are continued. SJSC “Latvijas Hipotēku un zemes banka” has signed a total of 212 618 agreements (among them 3655 agreements in the 1st quarter of 2007) for sale of 1.585 million hectares of land (of which 18 580 hectares in the 1st quarter of 2007).

Pursuant to Article 16 of the Law “On Completion of Land Reform in Rural Areas”, submission of claims for restoration of ownership rights of former landowners or their heirs for the free (unclaimed) land cognisable to the state to the Central Land Commission is continued. 1633 land units with the total area of 2650 hectares were registered as free (unclaimed) land cognisable to the state in the

information system of the Real Estate State Cadastre as of May 1, 2007.

Privatisation certificates

Privatisation certificate is a state-issued dematerialised security that can be used only once as means of payment for the state or local government property to be privatised.

Privatisation certificates are issued and used according to the Law “On Privatisation Certificates”. By April 1, 2007 a total amount of 103.9 million privatisation certificates have been issued to 2.45 million people for the time they had lived in Latvia, including 794.2 thousand privatisation

certificates granted to 41.3 thousand politically repressed persons. 7.99 million property compensation certificates have been issued to 117.0 thousand former owners or their heirs, including 691.7 thousand certificates for property appropriated for state needs at the privatised specialised state agricultural enterprises, 4 892 thousand for land in rural areas, 960.5 thousand for house ownership, 812.7 thousand for urban land, 461.0 thousand for companies and other property units, 89.8 thousand for property taken away from politically repressed persons and 83.7 thousand for property alienated in illegal manner.

Table 6.5

Use of Privatisation Certificates
(by April 1, 2007)

Type of property	Number	Number of privatisation certificates (million)	incl. property compensation certificates (thousand)
Apartment houses	428 thousand privatised housing units	37.30	589.8
Companies and other properties	accurate data not available	7.15	109.6
Capital shares (stocks) including: in public offering	accurate data not available	44.44	954.0
Land	128.7 million shares 283 thousand land plots	37.14 15.76	820.0 5427.9
Total:		104.65	7081.3
% of total certificates issued		93.5%	88.6%

7.1 thousand property compensation certificates have been granted to 159 former owners or their heirs in the 1st quarter of 2007.

By April 1, 2007 in accordance with the limitation period set in Item 5 of Article 27 of the Law on Completion of the State and Local Government Property Privatisation and Use of Privatisation Certificates, 55.9 thousand persons lost their rights to transfer 1.29 million privatisation certificates to their accounts.

According to the Law “On Privatisation of Land in Rural Areas”, 11 073 decisions have been made by April 1, 2007 about payment of cash compensations for former land ownership in rural areas. Compensations in the total amount of LVL 17.45 million have been paid to 8 412 persons, cancelling 0.62 million property compensation certificates.

Cash compensations in the total amount of LVL 4.39 million were paid to 25.3 thousand politically repressed persons as payment for privatisation certificates by April 1, 2007.

104.65 million privatisation certificates or 93.5% of the total number of issued certificates have been used for privatisation of state and local government property units by April 1, 2007 (see Table 6.5).

2.45 million privatisation certificates or 2.1% of the total number of issued certificates, including 0.19 million compensation certificates, were on accounts of 402 thousand physical persons as of April 1, 2007.

Accounts of legal persons held 2.67 million privatisation certificates or 2.4% of the total number of issued certificates, including 0.04 million property compensation certificates, as of April 1, 2007.

In April 2007, holders of privatisation certificates could use services of 17 licensed intermediary capital companies for transactions in the market of privatisation certificates. Total monthly transactions with privatisation certificates (buying from physical persons and selling), carried out by intermediary capital companies in the 1st quarter of 2007, fluctuated from 0.12 million privatisation certificates in January to 0.14 million privatisation certificates in March.

6.14. Public Private Partnership

In the last 10 years, countries all over the world pay increasingly bigger attention to co-operation between the public and the private sectors, thereby trying to find new solutions for successful provision of public services,

development and maintenance of infrastructure, which would promote economic growth and ensure welfare in society. In the framework of this co-operation, one may also speak about public private partnership (PPP).

European Community law currently provides no special definition of PPP and only gives a general explanation of PPP. The European Commission classifies PPPs¹ as:

- purely contractual PPP (DBFO type contracts and concessions (see Box 6.25)), if co-operation

between the public institution and the private partner is based on a long-term contract;

- institutionalised PPP (joint entities), if co-operation between the public institution and the private partner is carried out within a joint entity.

Box 6.25

Frequently used PPP models are:

- joint contract of design, building, financing and operation or the DBFO type contract – the private partner designs, builds, finances and operates the object or provides service, receiving an annual payment of the public sector for duration of the contract. DBFO type projects may be with various modifications, e.g., BFO type projects (from Build-Finance-Operate) if the public sector has already developed the technical project and the private partner is only attracted to build, finance and operate the object. In the case of RFO type projects (from Renovate-Finance-Operate), the private partner renovates some existing object of the public sector, e.g., a school or kindergarten, finances the renovation and then operates this object while the public sector makes annual or monthly payments.
- concession – the private partner designs, builds, finances and operates the object or provides service, but mainly regains his investments for ensuring the particular service or object with user fee from the end consumer (inhabitants who use the service or object).

However, PPP is most often perceived as long-term contractual relations between a public and a private person in order to ensure performance of function of the public person by building, reconstructing or maintaining a socially important object of infrastructure or providing public service, where the private partner, attracting resources of the private sector, assumes risks related to fulfilment of obligations set in PPP contract or a part of these risks.

Successful operation of PPP requires mutual interest. Implementation of a PPP project should ensure gains not only for the public partner, but also for the private one who must be ready to undertake implementation of the project. From entrepreneur's standpoint, involvement in projects of such type means wider business opportunities and predictable long-term cash flow.

It is important to consider three most essential aspects in implementation of PPP:

- PPP efficiency or ensuring VFM² in the project. It means to choose the most economically advantageous solution, although not always at the lowest costs. Thereby, in the case of every new PPP project, it would be required to conduct financial and economic calculations and, within their framework, to determine, which model of project implementation (i.e., traditional procurement or PPP) will give the biggest value for the invested finances. Similar approach is used in every EU member state that implements sound PPP policy. Thereby, assessment of project's VFM in public investment projects is very essential component of initial assessment of the project. Global practice proves that medium savings through implementation of investment project in PPP form makes up 20%, besides, PPP projects are

more frequently implemented within the planned budget and time;

- Risk management of PPP. In PPP projects, the public partner shares risk with the private partner, who can better manage many substantial project risks;
- Responsibility in observance of budget discipline. In particular cases, implementation of PPP project is linked with long-term obligations of the public person, which in turn are related to observance of fiscal discipline.

Implementation of public private partnership policy

Promotion of PPP in Latvia was already started at the beginning of 2000, when the Saeima adopted the Concessions Law and it came into force. In addition to it, the institutional system (see Box 6.26) for successful implementation of PPP policy and PPP projects was also created.

In order to improve co-operation between institutions involved in the PPP process, the Advisory Council of Public Private Partnership was established in January 2007 with the aim to participate in addressing issues linked to PPP policy and thereby foster creation of favourable environment for implementation of PPP projects and encourage use of the PPP instrument, attracting private capital to build-up of public infrastructure and to public services. Its decisions are of a recommending character for public institutions and local governments (see the chapter about advisory councils of the Ministry of Economics).

The most important normative acts regulating PPP in Latvia are specified in Box 6.27.

In order to align the legislative framework of PPP and harmonise Latvian legislation with the new directives of the European Parliament and of the Council (*Directive 2004/17/EC co-ordinating the procurement procedures on entities operating in the water, energy, transport and postal services sectors*, and *Directive 2004/18/EC on the co-ordination of procedures for the award of public works contracts*,

¹ EC Green Paper on PPPs and Community Law on Public Contracts and Concessions, 30.04.2004

² Value for money

public supply contracts and public service contracts), Public Private Partnership Law is being drafted at present. It is expected that this law would define and regulate the principal PPP issues in models where partnership between the public and the private sectors is based on contractual relations and models, where partnership takes place within a separate company.

In 2007, the Ministry of Economics is planning to:

- create a PPP website destined for provision of maximum information to society about the current and urgent issues, drafted normative acts and reached progress concerning PPP;
- conduct study on analysis of national economy sectors from the aspect of PPP and submit a report to the Cabinet of Ministers, identifying in it the most suitable sectors for running PPP

projects and defining suitability of the PPP model in the context of regional development;

- note the role of recording mechanisms of PPP projects and responsible institutions in this process, submitting to the Cabinet of Ministers a report about influence of PPP projects on the state budget and debt and about promotion of co-ordinated co-operation between institutions involved in the PPP process;
- identify administrative obstacles in implementation of PPP projects as well as imperfections and hindrances in normative acts, which obstruct implementation of such projects;
- publish informative material on the methodological base of PPP.

Box 6.26

Institutions involved in the public private partnership process

The Ministry of Economics is the leading public administration institution that develops the PPP policy and co-ordinates its implementation. Main goals of the Ministry of Economics in PPP sphere are:

- elaborate proposals for improvement of the legal and methodological base of PPP;
- co-operate with Latvian, EU and other international and foreign bodies on PPP policy issues;
- co-ordinate activities of state, local governments and the private sector in the PPP sphere.

Latvian Investment and Development Agency (LIDA) is responsible for fostering implementation of PPP projects, working out proposals for promotion of PPP development and supporting development and implementation of respective projects as well as provision of informative, consultative, legal and other public services on this issue to central and local government bodies as well as natural and legal persons.

Along with the Ministry of Economics and LIDA, there are other institutions, e.g., line ministries and local governments, that are involved in the PPP process and substantially affect opportunities of PPP usage.

Box 6.27

The most important normative acts regulating public private partnership

- Concessions Law (in force as from February 16, 2000);
- Public Procurement Law (in force as from May 1, 2006) prescribing that DBFO and other PPP agreements not regulated by the Concessions Law may be concluded for up to 30 years;
- Cabinet of Ministers Regulation No. 700 of August 10, 2004 “On the Procedure of Registration, Recording and Control of Concession Agreements” (in force as from August 14, 2004), establishing the procedure of registration, recording and control of concession agreements, carried out by the Register of Enterprises;
- “Concept on Promotion of Concessions (Attraction of Private Capital to Perform State Functions)” (approved by the Cabinet of Ministers on April 16, 2002). It envisaged to create the Concessions Division at the Ministry of Economics and to expand the competence of LIDA by including PPP issues;
- Latvian Public Private Partnership Development Guidelines (approved by the Cabinet of Ministers on March 23, 2005). They determine the basic principles and targets of PPP policy and indicators of their attainment;
- Action Plan for Implementation of the Latvian Public Private Partnership Development Guidelines in 2006-2009 (approved by the Cabinet of Ministers on November 16, 2005). It sets the following lines of action for promotion of PPP:
 - co-ordinated activity of institutions and organisations involved in the PPP process (establishment of Advisory Council of PPP, etc.);
 - examination of PPP by sectors (to conduct analysis of national economy sectors from the standpoint of PPP);
 - creation of instruments promoting the PPP process (development of methodology and standardised documentation);
 - alignment of the legislative framework (development of the PPP Law in compliance with requirements of EU directives);
 - improvement of the knowledge and understanding of PPP (creation of PPP website, organisation of informative seminars).

Promotion of public private partnership projects

LIDA gives advisory support to contractors of potential PPP projects, providing them with information on the applicable type of PPP transaction, conduction of a suitable procurement procedure, financial and economic calculations and procedures for performing them, possible legal solutions of the project agreement and other PPP issues, as well as organising informative seminars for public institutions about methodology and standard documents of the management cycle of PPP projects.

All most current information on PPP (topicalities, methodological materials, standardised draft PPP agreements, etc.) is available on websites of the Ministry of Economics and LIDA.

Implementation of the programme “Promotion of Public Private Partnership” co-financed by the bilateral financial instrument of the Norwegian government continues in 2007. The programme is managed by LIDA. The main goal of the programme is to support state and local government institutions in their efforts to implement a consistent and well-founded PPP

approach to development of infrastructure and public services. In the framework of the programme, those activities will be supported, which envisage:

- development of the technical and economic justification of PPP projects (VFM analysis);
- development of documents of competitions for PPP projects, among them drafting PPP agreement for projects that have VFM in case

of PPP co-operation in accordance with the conducted survey.

Co-financing of the programme from the bilateral financial instrument of the Norwegian government is EUR 1.8 million. Two open tenders are planned in the framework of the programme – at the end of 2007 (for the amount of EUR 0.8 million) and in the middle of 2008 (for EUR 1 million). Implementation of the projects has to be completed by April 30, 2011.

Box 6.28

The most topical projects to be implemented by PPP in 2007 are:

- at the meeting of State Secretaries on February 8, 2007, the draft Cabinet of Ministers instruction “On permission for Salaspils province council to conclude service agreement on management of housing to be built” (Protocol No. 6, § 8) developed by the Ministry of Economics was announced, which prescribes to allow Salaspils province council to conduct procurement procedure in the framework of the project “Construction of housing with social apartments”;
- at the meeting of State Secretaries on May 24, 2007 the draft Cabinet of Ministers instruction “On permission for Cēsis town council to conclude procurement agreement on construction and management of pre-school education establishment on Ata Kronvalda St. 35, Cēsis” (Protocol No. 20, § 5) developed by the Ministry of Economics was announced, which prescribes to allow Cēsis town council to conduct procurement procedure in the framework of the project “Construction of new pre-school education establishment in Cēsis”;
- the Ministry of Economics has developed and, on February 16, 2007, sent to ministries for co-ordination the draft protocol decision of the Cabinet of Ministers session, concerning implementation of the Rīga Northern transport corridor project, as well as the informative report approved by Rīga city council, concerning implementation of Rīga Northern transport corridor project, which is drawn up in order to inform the Cabinet of Ministers about the Rīga Northern transport corridor project and necessary preconditions for its implementation, as well as to promote fulfilment of these preconditions. The draft protocol decision is being specified according to objections and proposals given in conclusions of ministries;
- Cabinet of Ministers Instruction No. 816 of October 20, 2006 “On the Concept “Construction of a motorway in the segment Rīga ringroad-Sēnīte of the main state road A2 on the E77 route”” approved the proposals submitted by the Ministry of Transport and Communications on the first construction of a motorway in this segment by usage of PPP model. The Ministry of Transport and Communications is developing the legal documentation of this project. Implementation of four similar projects in the transport sector by 2013 is planned in accordance with the PPP programme for 2007-2013 developed by the Ministry of Transport and Communications.

6.15. Advisory Councils of the Ministry of Economics

6.15.1. National Economy Council

Founders of the National Economy Council (hereinafter – NEC) of the Ministry of Economics are the Ministry of Economics, Latvian Chamber of Commerce and Industry, Latvian Association of Local and Regional Governments, Free Trade Union Confederation of Latvia, and Employers’ Confederation of Latvia. NEC operates in accordance with Sub-paragraph 6.11 and Sub-paragraph 7.2 of the Cabinet of Ministers Regulation No. 238 of April 29, 2003 “Statute of the Ministry of Economics”, “Agreement on Co-operation in the National Economy Council” concluded on February 17, 1999 and Bylaws No. 8400-31-1 of NEC of the Ministry of Economics of May 14, 2007.

NEC is an advisory institution that participates in settlement of issues pertaining to business policy. The objective of its operation is to promote establishment and implementation of policy of favourable environment for business activity in Latvia as well as foster introduction of principles of sustainable national economy development in the country and encourage the process of sustainable development of the country and participation of society in it, as well as facilitate fulfilment of the goals set by Lisbon Strategy in Latvia

and involve public institutions, local governments and social partners in fulfilment of these goals.

NEC reviews and monitors settlement of issues and development of draft normative documents, national economy development concepts, state budget and other documents that are important for development of Latvian national economy. NEC prepares proposals and adopts recommending decisions on these issues. NEC carries out a dialogue between entrepreneurs and the Ministry of Economics, Single Economic Strategy and Development Council, as well as other public institutions and non-governmental organisations.

Decisions taken by the NEC have a recommending character.

Composition of the NEC is approved by the Minister of Economics on grounds of a decision of the NEC Steering Committee.

NEC Steering Committee is a consulting and co-ordinating institution that takes part in settlement of issues pertaining to business policy and is responsible for assessment and approval of issues in the agenda of the NEC action plan and NEC meetings as well as for ensuring and improvement of efficiency of NEC operation.

Composition of the NEC Steering Committee is approved by the Minister of Economics. Steering

Committee consists of five representatives of NEC founders, who are NEC members at the same time.

NEC consists of 21 experts designated by the NEC Steering Committee, among them the Minister of Economics, NEC chairman and representatives of entrepreneur organisations, public bodies and other organisations of the Republic of Latvia.

Representatives of the Council of the Small and Medium Sized Enterprises and Crafts of the Ministry of Economics (see Chapter 6.15.2) and of the Foreign Investors Council in Latvia participate in NEC meetings in the status of observers.

Decisions on changes or additions to composition of the NEC are taken by NEC founders in meetings of the NEC Steering Committee.

NEC is chaired by the Chairman elected by members of the NEC Steering Committee from among members in the rotation order for a term of office of one year.

NEC meetings are held once per month on average.

In 2007, the Chairman of the Free Trade Union Confederation of Latvia is elected the Chairman of the NEC.

Work of the NEC is organised by the Secretariat of the National Economy Council.

In between NEC meetings, recommending decisions of the NEC are taken by the NEC Steering Committee.

NEC co-operates with the Saeima, ministries and other public bodies in order to incorporate NEC's proposals necessary for improvement of business environment into normative acts prepared by the responsible bodies.

In order to ensure professional representation of the interests of industries in effective dialogue with the Ministry of Economics, NEC and other business organisations and public institutions, the Ministry of Economics has set up a model of co-operation with industries.

The Ministry of Economics and the NEC have concluded a protocol of agreement on co-operation with the following councils of experts (CE) of industries: CE of Machine Building and Metal Processing Industry, CE of Chemical and Pharmaceutical Industry, CE of Light Industry, CE of Construction Materials Producers, CE of Timber Industry, CE of Food Industry, CE of Construction Industry, CE of Passenger Carrier Industry, CE of Business Education and Management Advisers, CE of Tourism Industry, and CE of Printing and Publishing Industry.

On signing the protocol of agreement, the parties agreed to unite their resources for development of programmatic documents, take measures towards implementation of the economic development and business environment improvement programmes adopted as part of the governmental declaration, and that the councils of experts will assess draft legislative acts worked out by ministries and will issue their opinion thereof.

Box 6.29

Proposals of the NEC for improvement of business environment

NEC holds a view that work to ensure stable macroeconomic environment in Latvia has to be continued. In order to maintain stable macroeconomic environment and promote competition in Latvia, a balanced budget has to be drawn up, competition supervision has to be strengthened and development of competition in all national economy sectors has to be fostered for public benefit, timely identifying the risk sectors, where violations of competition law are possible and limiting administrative and other obstacles to competition.

Normative acts have to be assessed already during their development in order to identify and prevent possible violations of competition law, technical barriers to trade and discriminatory conditions in the field of free movement of goods and services and entrepreneurship law. Supervision of state support and procurement has to be improved, achieving high transparency for state support projects.

In order to create favourable conditions for business activity, simplification of legislative processes has to be carried out, thereby lessening the burden of legislation in business activity. Implementation of the European Union initiative on "better regulation" has to be ensured in Latvia.

Management system of EU funds' projects has to be improved, thereby ensuring high-quality and efficient absorption of the Structural Funds and the Cohesion Fund. Introduction of the public private partnership mechanism has to be encouraged, especially in absorption of EU structural resources.

Creation of efficient and competitive sectoral structure has to be fostered. Research and development and innovation must be encouraged, especially in the private sector. Measures that would promote co-operation of educational, research and national economy sectors, ensuring transfer of knowledge and technologies, have to be worked out and implemented.

In order to improve access of small and medium-sized enterprises to finances, more attention must be paid to allocation of funding for development of business in early stage and to accessibility of finances in the form of risk capital as well as to co-financing for business development projects in areas requiring special assistance.

It is necessary to raise efficiency of the education and training system, its quality and compliance with long-term labour market demands in the country. Co-operation between public administration bodies, education institutions and employers in correction of the supply of education system in accordance with labour market requirements must be strengthened. Carrying out changes in education system, the principle of accessibility of education must be observed in order to ensure it in the context of life-long learning.

Entry in new export markets and consolidation in the current ones must be fostered. Institutional base of export promotion and raising its capacity, development of foreign economic representative offices, access to financial instruments and support to companies in export marketing have to be ensured.

In order to promote employment, structural problems of employment must be solved, supporting the opportunity to acquire adequate higher qualification in accordance with labour market requirements and facilitating the labour mobility, especially by improving the transport infrastructure.

Box 6.29 continued

Undeclared employment must be reduced in the country, which may be achieved by the following measures:

- by raising the minimum wage and increasing the non-taxable minimum in order to lessen the tax burden for persons with low incomes;
- by increasing the administrative capacity of the State Labour Inspectorate through attraction of additional staff, improvement of control of observance of labour law norms and raising awareness of society on labour law issues;
- by strengthening the role of trade unions and employer associations in entrepreneurship through promotion of consolidation of entrepreneurs in business organisations;
- by creating a favourable environment to increase reputation of socially responsible business activity.

NEC holds a view that it is necessary to encourage business activity in Latvia even more by improving business environment, reducing administrative obstacles and stimulating initiative of entrepreneurs.

Competitiveness of the country, its opportunities to create new workplaces and ability to ensure welfare for its residents are greatly determined by establishment of efficient business policy and provision of entrepreneurship regulation processes – simpler entrepreneurship procedures, easier access to information, lower costs, and more comprehensible official requirements.

NEC has unambiguously expressed the opinion that successful absorption of the EU Structural Funds requires creation of procedures as simple as possible so that maximum number of projects submitted by small and medium-sized commercial companies of Latvia would be implemented.

Entrepreneurs are among the most important “users” of legal acts and most directly face the controlling influence of legislation in their daily work, so it is necessary to popularise work of business associations as partners in development of legal acts and help raise the capacity of business associations.

NEC holds a view that it is necessary to improve administrative procedures in Latvia, because, after Latvia’s accession to the EU, a lot of time should be spent, when entrepreneurs solve issues related to regulating requirements and administrative procedures of central and local governments and acquire new administrative procedures related to application of EU legal acts as well as acquaint themselves with frequently voluminous EU legal acts that often are to be applied directly.

NEC notes the positive trend that the business environment in Latvia is favourable on the whole and the governmental policy of promotion and support to business activity has to be evaluated positively. This is indicated by the rapid development of Latvian economy in the recent years, growth of GDP and increased economic activity in all sectors, however, it is necessary to improve it further, because business activity must be a priority for every government and it constitutes the backbone and driving force of all national economy. Owing to business activity, state budgets get revenues to maintain the state machinery, pay retirement pensions, allowances and grants, ensure health and social care and finance all activities necessary for all society.

NEC members and experts work in the following councils, committees and working groups:

- Consultative Board for Development Co-operation Policy Issues at the Ministry of Foreign Affairs;
- Supervisory Board of the Lisbon Strategy at the Ministry of Economics;
- Construction Council at the Ministry of Economics;
- Latvian Tourism Advisory Council at the Ministry of Economics;
- Export Promotion Council at the Ministry of Economics;
- National Standardisation Council at the Ministry of Economics;

European Union Structural Funds Supervision Committee at the Ministry of Finance;

- Working Group of the European Union Structural Funds Steering Committee at the Ministry of Finance;
- Working Group for National Taxation Policy Assessment at the Ministry of Finance;
- Information Society National Council of Special Assignments Minister for Electronic Government Affairs;
- Advisory Council of the Latvian Investment and Development Agency.

Box 6.30

Meetings of the NEC in the 1st half of 2007

Four meetings of the NEC were held in the 1st half of 2007.

During the NEC meeting on January 25, 2007 situation in the following national economy sectors was analysed:

- machine building and metal processing industry;
- wood industry;
- light industry.

The second NEC meeting was called on March 1, 2007. At this meeting, the issue of situation in the construction sector in Latvia was considered.

The third NEC meeting took place on March 29, 2007, where the issue of real estate tax was considered. The report prepared by the Ministry of Finance on development of consumer price inflation and opportunities to reduce it was assessed as the second issue at this meeting.

At the NEC meeting on May 25, 2007, cadastral value of land was discussed. The report “On development of European Union Structural Funds programmes for 2007-2013 planning period, planned programmes and their main conditions” prepared by responsible officials of the Ministry of Economics was assessed as the second issue.

6.15.2. Council of the Small and Medium-Sized Enterprises and Crafts

The Council of the Small and Medium-Sized Enterprises and Crafts is an advisory institution of the Ministry of Economics.

The Council of the Small and Medium-Sized Enterprises and Crafts (CSMEC) consists of representatives delegated by non-governmental organisations representing small and medium-sized enterprises (SME) and businessmen (organisations of various sectors of national economy and regional organisations of SME). The Ministry of Economics has the status of observer.

The composition and statute of the CSMEC were approved by the Ministry of Economics Regulation No.49 of February 16, 2004.

The activity of the CSMEC has an aim to involve the non-governmental organisations of SME and the industry associations into development and implementation of favourable SME business environment policy as well as promote SME development, co-operation and competitiveness of Latvian businessmen in the European Union.

The key functions of the CSMEC are: to review and follow settlement of such issues (draft normative documents, national economy development concepts, state budget, and other documents) that are important for development and implementation of favourable SME business environment policy and would promote SME development, as well as prepare proposals and make recommending decisions on these issues; to carry out dialogue between entrepreneurs, the Ministry of Economics, other public bodies and non-governmental organisations as well as international organisations, which affect operation and development of SME.

Meetings of the CSMEC are held once per month on average. Work of the Council of the Small and Medium-Sized Enterprises and Crafts is led by the Chairman elected by the Council. In between the meetings of the Council, the recommending decisions are taken by the CSMEC Steering Committee that consists of five CSMEC members nominated by participating organisations of the Council.

The Ministry of Economics ensures work of the Council and performs the functions of its secretariat.

In the 1st half of 2007, four meetings of the Council of the Small and Medium-Sized Enterprises and Crafts have taken place, where the following most important issues were considered:

- Changes in application of the real estate tax in 2007;
- Development of consumer price inflation and proposals for its reduction;
- Draft “Law on State Support Guarantees to Small and Medium-Sized Businesses” developed by the Ministry of Economics;
- Draft programme for promotion of business competitiveness and innovation for

2007-2013 developed by the Ministry of Economics and the action plan for its implementation;

- Draft concept “Necessity of legal regulation for lobbying in Latvia” developed by the Corruption Prevention and Combating Bureau, etc.

The Council has continued the launched positive and efficient dialogue with institutions representing businessmen as well as with the Ministry of Economics and the public institutions responsible for improvement of Latvian business environment.

A positive trend to be noted is that, through co-operative efforts with the Ministry of Economics, businessmen are invited on a regular basis to assess SME development issues and the draft programming documents shaping SME development policy before their adoption by the government. Proposals for various legal acts, for the draft programme for promotion of business competitiveness and innovation for 2007-2013 and the action plan for its implementation, and for the draft concept “Necessity of legal regulation for lobbying in Latvia” have been developed at the meetings and submitted to the responsible ministries.

Representatives of participating organisations of the Council have taken part in development of documents pertaining to preparation of project applications of entrepreneurs and receipt of financing from the EU Structural Funds, namely, grant scheme guidelines to get support from the EU SF, administrative and specific criteria to state support programmes for receipt of the EU SF, on carrying out the supply and service procurement, and on agreement of the grant schemes manager (LIDA) and recipient of the financing.

On initiative of the CSMEC, an Internet portal www.mazaisbizness.lv is set up for small and medium-sized entrepreneurs, which serves as a manual and provides practical information for people willing to launch business activity as well as information necessary for small and medium-sized entrepreneurs about legislative acts and various legal and financial issues and latest developments.

For more detailed acquaintance with business environment in Latvian regions, the CSMEC organises visiting sessions. During these sessions, meetings with local government leaders and experts and businessmen of the respective region are held, problems and needs of entrepreneurs are explored and solutions to them are searched collectively.

In the visiting sessions, the main topics of discussion are business environment and development prospects in the respective region, municipal support to entrepreneurs, opportunities for entrepreneurs to use financing from the EU Structural Funds and hindering factors.

In order to strengthen the role of the Council of the Small and Medium-Sized Enterprises and Crafts in improvement of business environment and ensure that

the non-governmental sector is competently represented in absorption of the EU Structural Funds and support programmes, the CSMEC members and representatives of its participating organisations are delegated to take part in the following councils and committees:

- EU Structural Funds Supervision Committee at the Ministry of Finance;
- Working group of the EU Structural Funds Steering Committee at the Ministry of Finance;
- Information Society National Council;
- Export Promotion Council at the Ministry of Economics;
- Advisory Council of the Latvian Investment and Development Agency;
- Working group for national taxation policy assessment at the Ministry of Finance;
- Entrepreneurs/experts panel of the Latvian Investment and Development Agency;
- Commercial Activity Development Council of the Rīga City Council, etc.

Through participation in entrepreneur delegations outside Latvia, co-operation agreements between the Council and similar organisations of the Republic of Azerbaijan and the State of Israel were concluded and talks with representatives of the Republic of Moldova were started.

The Council of the Small and Medium-Sized Enterprises and Crafts plans to solve the following issues at meetings in the nearest future:

- CSMEC, in co-operation with sectoral ministries, plans to hold a conference on opportunities of EU funds' absorption for 2007-2013;
- improvement of the legal environment for entrepreneurship;
- amount of the entrepreneurship risk state fee and part of the fee to be included into the employee claim guarantee fund;
- changes of employee structure in the public and private sectors, dynamics of the number of state-paid employees;
- waste management reform planned by the Rīga City Council, etc.

6.15.3. Advisory Council of Public Private Partnership

Advisory Council of Public Private Partnership (Advisory Council of PPP) is a consulting and co-ordinating institution established by the Ministry of Economics, with the aim to participate in addressing issues related to PPP policy and thereby foster creation of favourable environment for implementation of PPP projects and encourage use of the PPP instrument, attracting private capital to build-up of public infrastructure and to public services. Its decisions are

of a recommending character for public institutions and local governments.

By the Ministry of Economics Regulation No. 23 of January 19, 2007 "On Establishment of the Advisory Council of Public Private Partnership", the composition of the Advisory Council of PPP was approved. It consists of representatives of the Economic Affairs Committee of the Saeima, Ministry of Economics, Ministry of Finance, Treasury, Ministry of Education and Science, Ministry of Culture, Ministry of Welfare, Ministry of Regional Development and Local Government, Ministry of Transport and Communications, Ministry of Justice, Ministry of Health, Ministry of the Environment, Latvian Association of Local and Regional Governments, Rīga City Council, Latvian Investment and Development Agency, State Regional Development Agency, Association of Latvian Commercial Banks, Public Private Partnership Association, Latvian Builders Association, Association of Latvian Cities, National Economy Council, Latvian Chamber of Commerce and Industry, and Employers' Confederation of Latvia, and is chaired by the Minister of Economics.

By the Ministry of Economics Regulation No. 59 of February 8, 2007 "On the Statute of the Advisory Council of Public Private Partnership", the statute of the Advisory Council of PPP was approved. It approves functions, tasks and rights of the Advisory Council of PPP as well as organisation of its work, determining that the Department of National Economy Structural Policy of the Ministry of Economics performs functions of the Secretariat of the Advisory Council of PPP and organises its work.

The first meeting of the Advisory Council of PPP took place on January 25, 2007 (it is planned that meetings of the Advisory Council of PPP will be held at least once in three months), where the attending persons were informed on the current situation in the field of PPP, opportunities to implement PPP projects and the work done by the Ministry of Economics, LIDA and other public institutions for development of PPP. Assessment of the draft Concessions Law developed by the Ministry of Economics was set as the main issue of the meeting, as this draft law does not fully solve the problematics of those issues with regard to this field.

On grounds of decisions taken at the first meeting of the Advisory Council of PPP, additional discussions about the legislative framework regulating PPP took place on February 8, 2007 and February 20, 2007, where proposals submitted by ministries and other institutions for amendments to the draft Concessions Law developed by the Ministry of Economics were considered.

7. Recommendations

In order to ensure sustainable development, it is necessary to limit the domestic consumption in Latvia and implement such structural policy that promotes business activity and competitiveness of national economy – improvement of business environment, export promotion, efficient and sustainable energy supply and liberalisation of energy market, and supervision of competition. The measures that increase the productive capacity of national economy, i.e., promotion of knowledge and innovation, are especially important.

In our opinion, the most important and urgent objectives of the economic policy are as follows:

in order to maintain stable macroeconomic environment and promote competition, it is necessary:

- **to consistently implement the inflation-reduction plan approved by the government in March 2007** and assess the opportunity to supplement it with new measures limiting the domestic consumption, e.g., introduction of consumer credit tax, and measures (among them taxes) that may stimulate companies to invest in production and raise productivity, etc.;
- **to create state budget with a surplus in 2008 and the following years. It is necessary to consistently introduce the strategic planning in ministries and the medium-term budget planning**, thereby promoting purposeful, far-sighted, co-ordinated, transparent and result-oriented use of available resources and a link of strategic plans of ministries with the budget. The planned big investment projects of the central and local governments must be included in a medium-term budget and the priority sequence of their implementation has to be determined, taking into account the fiscal limitations and restrictions of construction capacities of the budget;
- **to ensure efficient unified and independent system of public utilities regulation**, incorporating the regulated sectors of local governments into the *Public Utilities Commission*. In order to avoid a rapid growth of inflation, not only specific criteria and methodology for review of prices have to be in place, which ensure compliance of tariffs with economically justified costs, but also a system must be developed, which

would allow to forecast the potential impact of measures for raising all administratively regulated prices, among them prices of public utilities regulated at local government level, on the total inflation in certain period of time;

- by transposing EU requirements on further opening of energy and electronic communication and postal markets, it is important to promote real competition and ensure that the implemented changes are in consumer interests. Availability and adequacy of energy have to be ensured by improving the energy supply infrastructure and widely implementing energy efficiency measures in the consumer sector as well as increasing efficient use of renewable energy resources and generation of energy in the co-generation process. **The market liberalisation process has to be harmonised with application of flexible regulation principles and further improvement of commercial activity principles of energy companies;**
- **to strengthen supervision of competition and encourage development of competition to public benefit in all national economy sectors**, timely identifying the risk sectors where violations of competition law are possible, limiting administrative and other obstacles to competition. More active fight against the gravest violations of competition law is needed, such as abuse of dominant position and cartel agreements, introducing more efficient investigation instruments and sanction policy. Along the *ex post* application of competition protection instruments, when market distortions are identified and investigation is under way in the framework of particular cases, it is necessary to focus more actively on the use of *ex ante* preventive measures in order to disallow a possibility of such distortions;
- **to assess normative acts already during their drafting** in order to identify and prevent unsubstantiated restrictions of competition by reducing a negative impact on competition, technical barriers to trade and discriminatory conditions (legal and administrative barriers) in the area of free

circulation of goods and services and business law;

- **to continue fight against corruption and money laundering and opportunities to operate in shadow economy.** Supervision of state support and procurement has to be improved, achieving high level of transparency for state support projects as well as following the changes in EU normative acts and implementing preconditions for electronisation of the procurement process. Opportunities to prevent money laundering, which are prescribed in normative acts, must be used more efficiently. It is essential to ensure availability of information about implementation and legal control of public administration functions delegated to commercial companies. This should promote more efficient use of resources and lessen opportunities of corruption;

in order to create conditions favourable for functioning of business activity and promote functioning of the domestic market, it is necessary:

- **to ease the legislative burden on business activity** by promoting simplification, clarity, mutual harmonisation and transparency of the legislative process. *Action Plan for Improvement of Business Environment* has to be updated and implemented on a regular basis, including in it the recommendations of the *National Economy Council of the Ministry of Economics, Council of the Small and Medium-Sized Enterprises and Crafts, Foreign Investors Council in Latvia* and *Foreign Investment Advisory Service of the World Bank* and maintaining a constant dialogue with social partners;
- **to ensure implementation of the EU initiative on better regulation in Latvia**, determining the institution responsible for this initiative and developing the strategy of its implementation;
- to encourage development of local governments and ensure rise of their capacity. **The administrative territorial reform has to be completed before the local elections of 2009** in order to establish optimum administrative and organisational structure of local governments and promote their capacity; **special attention has to be paid to incentives for development of less developed regions.** Real levers and instruments have to be created in order to stimulate entrepreneurs to invest into depressive regions;
- in order to ensure high-quality efficient absorption of the Structural Funds and the

Cohesion Fund, **the system for introduction of EU funds has to be improved** by simplifying procedures and institutional system for granting resources from EU funds and control their utilisation;

- **to improve the energy supply safety and diversify energy sources**, hence reducing Latvia's dependence on a single supplier of energy. The main tasks at present are to liberalise the electricity market and develop interconnections between electrical networks of the Baltic States and Nordic countries and electrical networks of Central European countries. In order to ensure sustainable use of energy resources, **a substantial role is played by the support to energy efficiency raising measures, use of co-generation and renewable energy resources, and promotion of development of environmental technologies;**
- **to promote implementation of public private partnership projects**, assessing those plans and programmes of public investment (of local governments, the state and the European Union), in the framework of which, particular projects suitable for PPP would be identified. It is also **necessary to improve the mechanism for recording PPP projects, defining the role of responsible institutions in this process**, so that it would be possible to determine the influence of such projects on the fiscal policy of the state timely, when PPP projects are still being planned. With the start of drafting the Public Private Partnership Law and after its coming into force, **promotion of society's understanding of PPP has to be continued;**
- **to provide efficient management of state-owned properties** by promoting expropriation of state-owned real estates and capital shares that are not needed for public administration functions, among other things, promoting privatisation of state-owned entities, improving and centralising the state-owned real estate management system. Legal improvement and consolidation must be made to the management of state-owned corporate enterprises and the mechanism for application of national interests in the state-controlled corporate and other enterprises;
- **to strengthen supervision of consumer rights** through continued improvement of supervision methods for normative acts,

especially by creating an efficient market surveillance system and a mechanism for protection of collective interests of consumers as well as ensuring a successful review of consumer complaints. Special attention has to be focussed on safety of children's goods and safety of services as well as on supervision of observance of economic interests of consumers. **Informing and educating consumers and entrepreneurs has to be strengthened**, hence promoting prevention of consumer rights violations before they appear;

- **to promote observance of consumer rights in the cross-border context and prevention of cross-border violations**, ensuring implementation of the EU Regulation on co-operation between national authorities responsible for consumer protection as well as efficiently co-operating with consumer rights protection authorities of the Baltic States;

in order to promote creation of efficient and competitive sectoral structure, it is necessary:

- **to promote research and development (R&D) and innovation, especially in the private sector**. Measures have to be developed and carried out to foster co-operation between educational, research and national economy sectors, ensuring transfer of knowledge and technologies. National research programmes and principles for financing grants need to be improved. State aid must be provided to innovative enterprises and infrastructure for development of technology transfer contact points, business incubators and knowledge-intensive technology enterprises;
- **to enhance society's awareness about the essence of innovation and its necessity**, especially in Latvian regions;
- **to promote development of the information society more actively** by raising availability of Internet and introducing the e-government. **It is necessary to develop the e-services more actively**, e.g., to introduce the electronic declaration of taxes, improving the communication regime between a taxpayer and the State Revenue Service;
- in order to improve access to financing for SME, **more attention has to be paid to allocation of finances for business development in early stage** (measures for availability of pre-seed and seed capital, opportunities to receive preferential loans) and access to finances in the form of risk

capital as well as to co-funding for business development projects in areas requiring special assistance. **Informative and advisory support to SME and business beginners has to be ensured**;

- **to conduct analysis and forecasting of the labour market on a regular basis**, which will promote ensuring mutual correspondence of labour supply and labour demand and will provide the required information on introduction of the changes necessary for public administration bodies in training of the labour force;
- **to improve efficiency, capacity and quality of the educational and training system and its compliance with long-term labour market demands**. Co-operation between public administration bodies, educational establishments and employers in correction of the educational system supply in accordance with labour market needs has to be strengthened, and cost efficiency in all stages and forms of education has to be raised. Implementing changes in the educational system, the principle of access to education must be observed in order to ensure it in the context of life-long learning;
- **to improve the motivation system for doctoral students** in order to restore the potential of science and research, and **raise the level of technological skills and knowledge of natural sciences on the whole** by improving the system of professional orientation and ensuring availability of professional orientation services for all population in the context of life-long learning;
- **to foster expansion into new export markets and consolidation in the current ones**. It is essential to provide the institutional base of export promotion and rise of its capacity, development of the network of foreign economic representative offices, access to financial instruments and support to companies in the export marketing. In order to strengthen the international competitiveness of Latvian companies, it is necessary to ensure that border-crossing procedures (tariff and non-tariff barriers) do not raise unjustifiably the costs of raw materials and inter-consumption goods and services for Latvian companies and to promote bigger market access for exporters in third countries, especially in rapidly growing markets (Russia, China, India);

- **to foster introduction of quality assurance systems.** Introduction of such quality management systems as environmental management systems, labour protection and safety management systems, food quality assurance systems and other quality management systems must be supported and fostered in order to promote upgrading of companies and hence the growth of competitiveness;
- **to improve conformity assessment system** by co-ordinating the standardisation policy at the national level, ensuring international traceability of conducted measurements and encouraging the use of adequate measuring instruments, as well as promoting accreditation of conformity assessment institutions in the regulated and non-regulated spheres. Applying these conformity assessment instruments, Latvian entrepreneurs and their products/services will have additional credibility also in other EU member states;
- **to improve the current state aid programmes** by making them an effective instrument to strengthen long-term competitiveness of Latvian entrepreneurs. The state aid granting system must be improved, focussing the state aid on the projects that will make the biggest contribution to development of national economy in the future. Impact of the current state aid programmes on competitiveness of Latvia has to be assessed and state aid programme priorities for the next planning period must be defined, changes in aid granting conditions have to be done in order to channel resources to activities where state aid will be needed the most for strengthening of the long-term competitiveness of Latvian entrepreneurs;

promotion of employment requires:

- **to solve structural problems of employment** by supporting efforts to get adequate and higher skills in accordance with labour market requirements and facilitating the labour mobility, especially through improvement of transport infrastructure;
- **to facilitate work of young people** in order to provide an opportunity to employ young people more flexibly, **promote employment of young people with special needs** by keeping the benefits also

when the young person works, and foster **more flexible return of new mothers to work.** It is advisable to entitle the employer to opt for a shorter trial period but to determine the maximum trial period of 6 months by the law. It is desirable to establish labour courts, which would provide an opportunity to settle labour disputes more efficiently and faster. It is advisable not to obligate the employer to cover expenses related to leave for studies and examinations, as these expenses would be covered by state budget resources;

- **to reduce undeclared employment** by raising the minimum wage and increasing the non-taxable minimum in order to lessen the tax burden on people with low income, and raising administrative capacities of the State Labour Inspectorate, attracting additional personnel, improving control over observance of labour law norms, raising the level of society's awareness about labour law issues, strengthening the role of trade unions and employer associations in business activity, encouraging entrepreneurs to unite in business organisations in order to create a favourable environment for increased reputation of socially responsible business activity;
- **to revise the system of taxes and benefits so that the work would pay off,** increase the efficiency of social expenditures and raise the non-taxable minimum.

In order to achieve strategic goals of Latvia, **it is essential to continue improving co-ordination of economic policy in the country and continue the reform of public administration** by introducing, among other things, a uniform system of wages and strengthening the current public administration bodies.

Consistently implemented economic policy will promote the convergence process and increased standard of living of the population. Successful development and economic growth of Latvia will depend not only on the work of public institutions but also on everyone's personal initiative everywhere in Latvia under the conditions of mutual understanding and dialogue within the society.