

**Ministry of Economics  
Republic of Latvia**

**ECONOMIC  
DEVELOPMENT  
OF LATVIA**

**REPORT**

**RIGA  
DECEMBER 2007**

Commentaries, questions or proposals are to be sent to:

Ministry of Economics, Republic of Latvia  
Brīvības ielā 55, Rīga, LV-1519

Phone: 371-67013119

Fax: 371-67280882

E-mail: [macro@em.gov.lv](mailto:macro@em.gov.lv)

Homepage: <http://www.em.gov.lv>

The Report was prepared by: O.Barānovs (overall compiling, 1., 4.1.1., 4.4., 6.1.), G.Piņķe (3.1., 3.2.1., 3.2.2., 3.3.1., 3.3.2., 3.5., 4.1.2., 4.1.3., 4.3.1., 4.3.2., 5.1.), E.Gergelevičs (2., 3.2.4.), A.Bessonovs (3.2.1., 3.2.2., 3.4.), M.Kubliņš (3.3.1., 3.3.2.), I.Skribāne (3.2.3., 4.3.3., 5.2.), D.Dravnieks (3.3.3., 6.3.2.), J.Salmiņš (4.1.2., 4.1.3.), I.Šnīdere (4.2., 4.3.1., 4.3.2.), Č.Gržibovskis (5.1.), J.Ušpelis (5.3.), I.Šulcs, G.Silovs (6.2.1.), A.Gulbis, D.Klinsone, L.Stauvere, S.Pizika, M.Paņkova, G.Ābele, (6.2.2.), D.Matulis, R.Bērziņš (6.2.3.), T.Grīnfelds, E. Skribnovska (6.3.1.), D.Merirands, D.Eberšteina (6.3.2.), A.Liepa (6.3.3.), A.Andriksone, I.Mežecka, I.Grīnberga (6.3.4.), I.Beināre, I.Benga (6.4.), I.Stikāne, U.Vanaga (6.5.), L.Neiders, I.Eglītis (6.6.), K.Šuste (6.7.), M.Stenders, I.Tarvāne, R.Vīksne (6.8.), M.Purviņa (6.9.), I.Ozoliņa (6.10.), L.Zemīte, B.Vītoļa (6.11.), R.Ansone, E.Beļskis, J.Maurāns, V.Zvejs (6.12.), D.Jirgena, N.Kovolenko, K.Lore, G.Vigupe (6.13.), I.Lipovska (6.14.), I.Bērziņa (6.14., 6.15.3.) Z.Kubuliņa (6.15.1.), I.Galiņa (6.15.2.). Translated by A.Liepiņš.

All the numerical information and data unless otherwise indicated were provided by the Central Statistical Bureau of the Republic of Latvia. Data of the Bank of Latvia and the Financial and Capital Market Commission have been used in characteristics of the Balance of Payments and the banking and monetary indicators of Latvia. The Treasury of the Republic of Latvia data is used in the characteristics of financial indicators of Latvia.

Cover design: Ingmārs Usas

Printed:

SIA „ABC JUMS”

Rūpniecības iela 3, Aizkraukle, LV-5101

Phone: 371-65122888, phone/fax: 371-67142383

**ISSN 1407-4109**

© Ministry of Economics, Republic of Latvia, 2007

**Reference mandatory in case of reprinting and quoting.**

**Dear reader,**

We offer for your attention the 27th **Report on Economic Development of Latvia** prepared by experts of the Ministry of Economics. The first Report was published in September 1994 and the following ones since 1995 were published traditionally twice a year in June and December. The present Report, like the previous ones, evaluates the economic situation in Latvia and progress of reforms, as well as offers economic development forecasts.

Fast economic growth has already been observed in Latvia for several years. GDP growth was also considerable in 2007 (according to our estimations – by 10.6%). The rapid GDP growth indisputably reduces backwardness of our country from the old EU member states.

We are satisfied with our success, but also are clearly aware of the existing problems and are developing appropriate policies to solve them. Along with the fast growth, economic disproportions (essential rise of inflation rate and large current account deficit of the balance of payments) developed and intensified.

One of the main tasks in 2008 will be improvement of the macroeconomic situation of Latvian economy as fast as possible. The Ministry of Economics in co-operation with the Ministry of Finance has worked out several measures for stabilisation of the economic situation for the next 2 years, aimed at promotion of economic growth that will result in stability of national economy in the long term.

The priority tasks of the Ministry of Economics in 2008 are as follows:

- develop the annual *Action Plan for Improvement of Business Environment*, including also the measures for reduction of the administrative burden;
- prepare the *Informative Report on Situation in the Labour Market and Medium-Term Forecasts for Conformity of Labour Demand and Supply*;
- prepare also the *Informative Report on Work Efficiency of Representative Offices of the Latvian Investment and Development Agency and Latvian Tourism Development Agency* and offer concrete proposals for further development of the network of economic representative offices;
- ensure active participation in adoption by the Saeima the draft laws “Amendments to the Competition Law” and “Amendments to the Energy Law”.

In order to achieve 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 both on the development of main economic and social indicators, growth of national economy sectors and external economic environment, and on the government’s economic policy for promotion of growth and employment, foreign trade policy, utilisation of the EU Structural Funds and the Cohesion Fund, innovation and entrepreneurship 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.

December 2007



**Kaspars Gerhards**  
Minister of Economics

# CONTENTS

Abbreviations .....	6
<b>1. Economic Situation: Brief Overview .....</b>	<b>8</b>
<b>2. Development of World Economy .....</b>	<b>12</b>
<b>3. Growth and Productivity .....</b>	<b>15</b>
3.1. GDP Dynamics and Productivity .....	15
3.2. GDP Expenditure .....	16
3.2.1. Aggregate Demand .....	16
3.2.2. Private and Public Consumption .....	17
3.2.3. Investment .....	18
3.2.4. Exports and Imports .....	21
3.3. Contribution of Sectors .....	25
3.3.1. Structure and Dynamics of the Economy .....	25
3.3.2. Manufacturing .....	26
3.3.3. Energy Sector .....	38
3.4. Development of Regions .....	40
3.5. Forecasts .....	43
<b>4. Macroeconomic Stability .....</b>	<b>45</b>
4.1. State Finances .....	45
4.1.1. Fiscal Policy and Public Debt .....	45
4.1.2. Budget Revenues .....	49
4.1.3. Budget Expenditures .....	54
4.2. Prices .....	56
4.2.1. Consumer Prices .....	56
4.2.2. Producer Prices .....	60
4.3. Balance of Payments .....	61
4.3.1. Current Account .....	61
4.3.2. Financial Flows .....	63
4.3.3. Foreign Direct Investment .....	64
4.4. Financial and Capital Markets .....	68
4.4.1. Monetary Policy and the Exchange Rate .....	69
4.4.2. Market Structure and Development .....	69
4.4.3. Deposits and Loans .....	70
<b>5. Labour Market .....</b>	<b>76</b>
5.1. Employment and Unemployment .....	76
5.2. Labour Costs .....	77
5.3. Employment Policy .....	80

<b>6. Economic Policy and Priorities of Structural Policy .....</b>	<b>84</b>
6.1. National Lisbon Programme of Latvia for 2005-2008 .....	84
6.2. Integration of Latvia in the Economic and Structural Policy of the EU .....	90
6.2.1. Utilisation of the European Union Structural Funds and Cohesion Fund .....	90
6.2.2. Foreign Trade Policy .....	97
6.2.3. EU Internal Market .....	104
6.3. Sector-Specific Development Policies .....	105
6.3.1. Industrial Policy .....	105
6.3.2. Energy Policy .....	107
6.3.3. Construction Policy .....	109
6.3.4. Tourism Policy .....	112
6.4. Business Environment .....	116
6.5. Innovation and New Technologies .....	118
6.6. Information Society .....	121
6.7. Small and Medium-Sized Enterprises .....	123
6.8. Competition Policy .....	128
6.9. Regulation of Public Utilities .....	132
6.10. Export Promotion Policy .....	134
6.11. Protection of Consumer Interests and Market Surveillance .....	136
6.12. Quality Assurance .....	142
6.12.1. Quality Structural Policy .....	142
6.12.2. Standardisation, Metrology, Accreditation .....	143
6.13. Privatisation .....	145
6.14. Public Private Partnership .....	150
6.15. Advisory Councils of the Ministry of Economics .....	153
6.15.1. National Economy Council .....	153
6.15.2. Council of the Small and Medium-Sized Enterprises and Crafts .....	155
6.15.3. Advisory Council of Public Private Partnership .....	156
<b>7. Recommendations .....</b>	<b>158</b>

## ABBREVIATIONS

### Abbreviations

CEE	Central and Eastern Europe	IMF	International Monetary Fund
CF	Cohesion Fund	ISPA	Instrument for the Structural Policies for Pre-accession
CHP	Thermal power station	IT	Information technologies
CIS	Commonwealth of Independent States	IUVI	Import unit value index
CRPC	Consumer Rights Protection Centre	JSC	Joint stock company
CSB	Central Statistical Bureau	LEPP	Latvian Export Promotion Programme
CSMEC	Council of the Small and Medium-Sized Enterprises and Crafts	LGA	Latvian Guarantee Agency
DDA	Doha Development Agenda	LIDA	Latvian Investment and Development Agency
DPI	Producer price index for products sold in the domestic market	LLC	Limited liability company
EAGGF	European Agricultural Guidance and Guarantee Fund	LVS	Limited liability company "Latvijas standartis"
EC	European Commission	ME	Ministry of Economics of Latvia
ECB	European Central Bank	NATO	North Atlantic Treaty Organisation
EEA	European Economic Area	NEC	National Economy Council
EMU	Economic and Monetary Union	NPP	Nuclear Power Plant
ERDF	European Regional Development Fund	PHARE	The Economic assistance programme of European Union for countries of Central and Eastern Europe
ERM II	European currency rate mechanism	PPI	Producer price index
ESA	European System of National Accounts	PPP	Public and private partnership
ESF	European Social Fund	RSE	Riga Stock Exchange
EU	European Union	SJSC	State Joint Stock Company
EU-15	European Union before enlargement on May 1, 2004	SME	Small and medium-sized enterprises
EU-25	European Union after enlargement on May 1, 2004	SOLVIT	Efficient Solving of Internal Market Problems
EU SF	European Union Structural Funds	SPD	Single Programming Document
FCMC	Financial and Capital Market Commission	SRS	State Revenue Service
FDI	Foreign Direct Investment	TDI	trade defence instruments
FIAS	Foreign Investment Advisory Service	TEN-T	Trans-European Transport Network
FIFG	Financial Instrument for Fisheries Guidance	UN	United Nations
FTA	Free Trade Agreement	USA	United States of America
GDP	Gross domestic product	WTO	World Trade Organisation
HPS	Hydroelectric power station	XPI	Producer price index for exported products
ICT	Information and communication technologies		

### State Abbreviations

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

### Measures

EUR, EURO	Euro, single currency of the EMU	SDR	Special drawing rights, IMF approved currency
LVL	Latvian lats (national currency of Latvia)		

### 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 positive impact on economic development of the country.** GDP grew by 10.4% on average annually in the period of 2004-2006 and by 11% in the first 3 quarters of 2007. The Ministry of Economics estimates that GDP has increased by 10.6% in 2007 in total.

**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 the NATO and EU, and formation of positive future expectations. Both, private consumption and investment have increased considerably in the last years. Expansion of export opportunities plays a smaller role in the growth. Contribution of net exports to the growth is negative in the last four years.

Growth of domestic demand in 2007 was slightly more moderate than in 2006. *Plan of Measures Aimed at Curbing Inflation* adopted by the Cabinet of Ministers on March 6, 2007 has slowed down the rapid growth of crediting, which, in turn, has reduced the growth rate of private consumption. The pace of export growth in 2007 was slightly faster than in 2006, but slower than the pace of import growth.

**The biggest contribution to the growth is made by service sectors** in the recent years. Increased domestic demand especially fosters development of trade, hotels and restaurants, which in total has grown by 15.5% on average annually over the period of 2004-2006 and by 14.4% in the first 3 quarters of 2007. Financial intermediation and real estate transactions, rent, computer services and other commercial services in total grew by 12.1% on average annually over the above-mentioned period and by 13.3% in the first 3 quarters of 2007.

Increased household income and distribution 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.

**The rapid rise of investments has a favourable influence on development of construction.** Output in construction has grown by 14.1% on average every year over the period of 2004-2006 and by 15.1% in the first 3 quarters of 2007. Construction of streets and roads, residential and commercial buildings, hotels, industrial and other objects has grown fast in the recent years. Real estate boom is expected to cool down. However, sufficiently high construction development rates are expected also in the future due to implementation of projects financed from EU funds.

**Contribution of manufacturing to the growth is more moderate.** Output of manufacturing grew by 6.2% on average every year over the period of 2004-2006 and by mere 0.7% in the first 3 quarters of 2007. The slow growth of manufacturing in the first 3 quarters of 2007 was greatly determined by the decrease of production output by 7.1% during this period in wood processing, which is one of the biggest industrial sub-sectors. At the same time, the rapid growth of other export-oriented industries should be noted: production of metal and metalwork increased by 7%, production of electronic and optical appliances – by 9.5%, and chemical industry and related industries – by 6.7%.

Slower growth of manufacturing relates to restructuring of several sectors, mainly wood processing enterprises, which will ensure growth of competitiveness of companies in foreign markets and bigger contribution to GDP formation in the future.

**Growth rates in agriculture lag behind the overall growth rates of national economy.** Output of the sector decreased by 2.8% in 2006 due to unfavourable weather, but increased by 9.1% in the first 3 quarters of 2007. Further development of agricultural sector will depend on readjustment 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 can be explained 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% on average annually over the period of 2004-2006 and by 9.2% in the first 3 quarters of 2007. After accession to the EU, cargo transportation increased especially rapidly and passenger transport services grew, among them air transport services.

Table 1.1

## Latvia: Key Indicators of Economic Development

	2004	2005	2006	2007	2008 f
	(growth compared with preceding year, per cent)				
Gross domestic product	8.7	10.6	11.9	10.6 e	7.0
Private consumption	9.5	11.5	19.8	15.0 e	6.5
Public consumption	2.1	2.7	4.0	3.5 e	3.5
Gross fixed capital formation	23.8	23.6	18.3	13.5 e	7.5
Exports	9.4	20.3	5.3	9.4 e	10.0
Imports	16.6	14.8	17.5	20.0 e	12.2
Consumer prices	6.2	6.7	6.5	10.1	13.0
	(per cent of GDP, unless indicated otherwise)				
Central government budget fiscal balance	-1.0	-0.4	-0.3	0.8 e	1.0
Central government debt	14.5	12.5	10.6	9.0 e	9.2
Current account balance	-12.8	-12.5	-22.3	-23.0 e	-22.0
Foreign direct investments (flows)	4.6	4.5	8.1	7.0 e	8.0
Employment rate	62.3	63.3	66.3	67.0 e	68.0
Unemployment rate (15-74 years)	10.4	8.7	6.8	6.0 e	5.7

e – estimation, f – forecast

**Central government budget balance tends to improve;** deficit in the central government budget amounted to 1.6% of GDP in 2003 and, due to gradual improvement of financial situation, constituted only 0.3% of GDP in 2006.

The Saeima approved the state budget for 2007 with a financial deficit in the amount of 1.3% of GDP. However, the Saeima made amendments to the Law “On the State Budget for 2007” in September of this year, envisaging a surplus in the amount of 0.4% of GDP. Provisional data show that 2007 was concluded with a budget surplus of LVL 94 million or 0.8% of GDP.

The Saeima has approved the budget for 2008 with a surplus in the amount of LVL 163 million or 1% of GDP<sup>1</sup>. Budget surplus is also planned for the following years – in the amount of 1.2% of GDP in 2009 and 1.5% of GDP in 2010.

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 the high inflation rate and the high current account deficit** caused by high domestic demand.

Inflation rate has been exceeding the mark of 6% since 2004. In 2007, price growth rates increased and average annual inflation rate reached 10.1%. Latvian inflation rate is determined by many, sometimes mutually unrelated factors, among them structural changes related to membership in the EU, rise of

world prices for energy resources, changes of administratively regulated prices, etc. However, the most important factor is the rapidly growing domestic demand stimulated both by essential rise of employee wages and by growing volume of crediting.

Relatively high inflation rate is also expected in 2008, because an essential increase of administratively regulated prices and raising the excise tax rates on tobacco products and fuel are envisaged. The Ministry of Economics forecasts that the average level of prices in 2008 will exceed the respective indicator of 2007 by 13%. Inflation will decrease gradually in medium-term period, as the influence of the mentioned price-increase factors will go down and the government will implement inflation reduction measures.

Relatively high current account deficit has already been characteristic for Latvia over several years. Up to now, it has not affected the stability of economy, because the deficit is greatly covered by annual increase of non-debt flows and reserve assets of the Bank of Latvia. The current account deficit in 2006 amounted to 21.1% of GDP. The increase in the negative balance of current account in 2006 was caused by deterioration of both – the balance of goods and income and the balance of services and current transfers.

Small improvement of the current account was observed at the beginning of 2007 and was related to the decrease of foreign trade deficit. However, data of the 3<sup>rd</sup> quarter indicate that the current account deficit increases again, as the trade deficit and debt flows grow. In the first 3 quarters of 2007, the current account deficit of the balance of payments was 24.8% of GDP (20.3% in the respective period of the

<sup>1</sup> Combined budget deficit according to the cash principle.

preceding year), as the negative balance of goods increased and the positive balance of current transfers decreased. 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.

Gradual decrease of the current account deficit in the 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 receptiveness.

#### **EU is the main trading partner of Latvia.**

Foreign trade with EU member states has been constantly expanding since restoration of Latvia's independence, and currently 77% of Latvian exports and imports are linked to the EU. In January–November 2007, most of Latvia's foreign trade turnover was made up by trade with Lithuania (14% of the total amount), Germany (13%), Estonia (10%), Russia (9%), Poland (6%) and Sweden (6%).

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 has increased by three times in comparison with the period before the accession to the EU.

Over the period of January–November 2007, the value of exported products (in current prices) exceeded the level of the respective period of 2006 by 23%, while imports increased by 23%. In 2007, exports to CIS countries increased fastest and their value was by one-third higher than in the previous year, with substantial increases in exports of machinery, metalwork and food products. Exports to EU member states grew by 24% and the biggest contribution to this growth was made by increased exports of wood and metal-working products.

**Along with the economic growth, income of population is also growing.** Despite the considerable rise of prices, the actual income of employees has increased by 29.9% over the period from 2004 to 2006 and by 22% in the first 3 quarters of 2007. Retirement pensions also grow but not as fast as wages.

Increase of wages in Latvia was affected by two principal conditions. Firstly, the demand for labour force increased due to fast economic growth; secondly, opening of labour market in such highly developed countries as Ireland and the United Kingdom increased competition in Latvian labour market (supply of labour force decreases due to the growing emigration), which creates a big pressure on wages. Furthermore, wages of employees in Latvia were very low in comparison with the EU average – 15-20% of the EU average in most sectors until 2006. For this reason, increase of wages is a manifestation of the objective process of convergence.

Following a recommendation of the National Tripartite Co-operation Council, the Cabinet of Ministers has determined that the minimum monthly wage is to be increased to LVL 160 as from January 1, 2008. It should be noted that the minimum wage was increased both in 2006 and in 2007. The last increase of the minimum monthly wage will create an insignificant pressure on the increase of the average wage because, in the current conditions where competition in the labour market has grown considerably, the dynamics of the increase of the average wage is less and less determined by the volume of the minimum monthly wage and the determinant role is played by other factors.

**Economic development in Latvia in the recent years has a positive impact on the situation in the labour market.** Over the period of 2004–2006, the number of the employed grew by 2.6% on average annually, while the unemployment rate went down from 10.6% in 2003 to 6.8% in 2006. In 2007, the number of the employed kept increasing (by 1% in the 3<sup>rd</sup> quarter in comparison with the respective period of the previous year) and the unemployment rate continued to decrease.

At the same time, a great number of vacancies emerges in several sectors (construction, trade, particularly manufacturing sectors). One reason for the loaded labour market is the high emigration rate, as many inhabitants of Latvia have gone to work in the Western Europe, mostly in the United Kingdom and Ireland.

Although the number of population of working age diminishes, the number of economically active residents increases and the employment rate grows. Over the period of 2004–2006, the employment rate has increased by 4.5 percentage points. Employment rate in Latvia was by 1.1 percentage points lower than the EU average in 2003, while it exceeded the EU average by 1.6 percentage points in 2006. Employment rate kept increasing in 2007. In the 3<sup>rd</sup> quarter of 2007, it reached 69% or by 1 percentage points more than in the 3<sup>rd</sup> quarter of the preceding year.

**The economic growth potential is best characterised by the growth of investments.** Investments in fixed assets increased by 81% over the period of 2004–2006 (by 22% on average annually), while they increased by 13.5% in 2007 according to estimation of the Ministry of Economics. Latvia has one of the highest indicators among EU member states regarding the growth of investments and their share in GDP.

Investments are stimulated 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 sales of manufactured products due to the growing demand made a positive impact on

the financial situation of companies thereby increasing opportunities to make investments.

After Latvia's accession to the EU, the volume of incoming foreign direct investments (FDI) has substantially increased. Over the period of 2004-2006, foreign businessmen have made contributions in the form of direct investments to Latvian national economy in the volume almost four times bigger than over the period of 2001-2003. Furthermore, volume of the investments in 2006 was twice bigger than in 2005. The volume of incoming FDI has substantially increased also in 2007 (8.2% of GDP in the first 9 months).

At the end of September 2007, foreign direct investments accumulated in Latvia amounted to LVL 4992 million, which was by 25% more than at the end of 2006. In the sectoral structure of accumulated FDI, investments in service sectors make a bigger share. Almost half of FDI attracted in this period are invested in the sector of commercial services. Three-fourths of FDI are related to EU member states and the biggest investors are entrepreneurs of Sweden, Estonia, Germany and Denmark.

The reforms implemented in the previous decade have strengthened the private sector, conditions favourable for development have been created and business environment is improving. Investments continue to grow rapidly, encouraging modernisation of production and introduction of new, more productive technologies. Accession of Latvia 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, instability of the global financial market and the situation in Latvian export markets. Growth in 2008 is expected to be more moderate than in the previous years. This will be determined by more moderate growth rates of private consumption. The annual GDP growth may be expected to be 6-8% in the medium term.

## 2. DEVELOPMENT OF WORLD ECONOMY<sup>1</sup>

Development of world economy in the 1<sup>st</sup> half of 2007 continued at a rather fast pace, while the 2<sup>nd</sup> half of the year has brought some corrections in the forecasts mainly due to deterioration of situation in financial markets. Although the world growth forecasts in 2007 overall are slightly raised, growth in 2008 is forecasted a little more pessimistically (see Table 2.1).

Table 2.1

GDP Growth (in % compared to the previous year)					
	2002-2004 on average	2005	2006	2007 f	2008 f
World	4.1	4.8	5.4	5.2 ↑	4.8 ↓
USA	2.7	3.1	2.9	1.9 ↓	1.9 ↓
Japan	1.5	1.9	2.2	2.0 ↓	1.7 ↓
EU	1.8	2.0	3.2	3.0 ↑	2.5 ↓
CIS	7.2	6.6	7.7	7.8 ↑	7.0 ↑

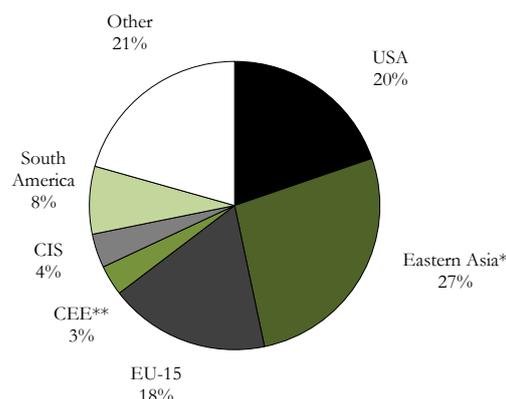
Source: "The World Economic Outlook", October 2007, International Monetary Fund, <http://www.imf.org>  
f – forecast; ↑/↓ trend of changes of forecasts in comparison with the June 2007 report.

Growth in 2008 will be greatly ensured by the growing economies (China, India, etc.). Growth risks will still be related to instability of financial markets, growing impact of inflation, price fluctuations in oil

product markets and, for the growing economies, mostly to rapidly inflowing foreign capital.

Figure 2.1

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



Source: "The World Economic Outlook", October 2007, 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

Table 2.2

**Main Macroeconomic Indicators of Several 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
Euro zone countries of which:	1.5	2.8	2.5	2.1	2.2	2.2	2.0	2.0	0.3	0.0	-0.2	-0.4
Germany	0.8	2.9	2.4	2.0	1.9	1.8	2.1	1.8	4.6	5.0	5.4	5.1
France	1.7	2.0	1.9	2.0	1.9	1.9	1.6	1.8	-1.1	-1.2	-1.6	-1.8
United Kingdom	1.8	2.8	3.1	2.3	2.0	2.3	2.4	2.0	-2.5	-3.2	-3.5	-3.6
USA	3.1	2.9	1.9	1.9	3.4	3.2	2.7	2.3	-6.1	-6.2	-5.7	-5.5
Japan	1.9	2.2	2.0	1.7	-0.3	0.3	0.0	0.5	3.6	3.9	4.5	4.3
China	10.4	11.1	11.5	10.0	1.8	1.5	4.5	3.9	7.2	9.4	11.7	12.2

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

<sup>1</sup> In this chapter, data from "World Economic Outlook", International Monetary Fund, October 2007 were used, unless indicated otherwise.

Economic growth of the **United States** was weak at the beginning of 2007, but the growth accelerated during the 2<sup>nd</sup> half of 2007 and the year was concluded rather successfully. The growth was favourably influenced by rapid development of export, mainly due to decline in the value of the US dollar and by increased private investments. However, the growth was negatively influenced by reduced growth rates of private consumption and decreased investment in housing.

Despite successful development of export, which most likely will continue in 2008 as well, development of US economy is evaluated rather pessimistically mainly due to the abovementioned indicators of instability of financial markets and poor indicators of the housing market.

Economy of **Japan** developed rather slowly during the 1<sup>st</sup> half of 2007, which was mainly influenced by decreased investment and lower growth rates of private consumption, while the growth stabilised in the 2<sup>nd</sup> half of the year. Growth in 2008 will be influenced positively by stable growth of exports, while the growth of private consumption, vulnerability of financial market (mainly related to crisis in the US housing market), decline of global growth rates, growing oil product prices and potential increase in the value of the yen are assessed more negatively.

Fast economic growth in developing countries of the Asian region has been observed in the last years, and indisputable leader in this region is **China**, where growth in 2007 is estimated at 11.5%. Rapid growth of exports and investment should be mentioned as the main factors of development. Due to the rapid increase of exports, the growth is estimated to be very fast also in a couple of the next years although it is foreseen that the growth may slightly stabilise (at 10%). Potential decrease of the global demand (mostly for electronic goods), as well as instability in the global financial markets similarly as in other regions are noted as the principal risks for growth in this region.

Economic growth in the **old EU member states** was rather fast at the beginning of 2007, but slightly slowed down during the 2<sup>nd</sup> and 3<sup>rd</sup> quarters, mostly due to stabilisation of construction rates and decrease of private consumption rates. The growth was influenced favourably by the rather high export rates and increased investments. However, mostly due to the successful start of the year, it is expected that the growth in 2007 on the whole will be slightly above the potential one, but may decrease by approximately 0.5 percentage points in 2008.

Economic growth of **Germany** slightly slowed down in 2007 mainly due to decreased private consumption and export rates. However, the growth was fostered by rising expenses for investments due to increasing demand for machinery and equipment and by rising volumes of construction.

It is expected that growth in the further years will be influenced positively by increase of investments and private consumption.

Growth in **France** in 2007 was slightly lower than forecasted before. It still was supported mainly by the private consumption and was affected negatively by stagnation of the private investments.

Further growth in France is expected to be weaker still than forecasted before and will be slightly below the potential one. It is possible that the main driving force for growth will be a stable domestic demand, including increased private consumption.

Economy in the **United Kingdom** kept developing rather fast in 2007, mainly due to the growing private consumption. Growth in the upcoming years may be affected negatively by the unstable financial market of the world. Economic development of the United Kingdom will also greatly depend on further development of the real estate market.

The high growth rates in the **new EU member states and candidate countries** slightly stabilised in 2007. Expenses for acquisition of new production facilities and development of construction continue supporting rapid growth of investment volumes. Labour market conditions improved; availability of credits increased mostly due to assistance of foreign banks, which in turn promoted growth of private consumption, especially in the Baltic States and Southern European countries. Export was promoted by further integration in Western European markets and by improvement of product quality.

Further growth in the region is expected to stabilise in the nearest future. Domestic demand might be slightly slowed down due to the fiscal and monetary restrictions, but it still will be one of the principal driving forces of development. The growth will also be promoted by the EU Structural Funds.

The current rapid growth in the **Baltic States** is ever more associated with growing concern about expansion of external imbalance and overheating of economy. It was fostered by fast increase of credits, which not only raised the private demand but also encouraged inflation and created the current account deficit. These credits are mostly associated with resources of foreign mother banks and, unlike in other new EU member states, are issued in foreign currencies.

Further growth rate in the Baltic States is forecasted to be a little slower than at present and may be slightly above 6% in 2008, as well as in 2009. Like in the whole group of the new EU member states, the domestic demand is considered the principal driving force of growth, although to a lesser extent than at present.

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
<b>Total</b>	<b>5.6</b>	<b>6.3</b>	<b>5.8</b>	<b>5.2</b>	<b>4.9</b>	<b>5.1</b>	<b>5.1</b>	<b>4.1</b>	<b>-5.2</b>	<b>-6.6</b>	<b>-7.3</b>	<b>-7.5</b>
Estonia	10.2	11.2	8.0	6.0	4.1	4.4	6.0	7.0	-10.0	-15.5	-16.9	-15.9
Latvia	10.6	11.9	10.5	6.2	6.7	6.5	9.0	8.9	-12.6	-21.1	-25.3	-27.3
Lithuania	7.6	7.5	8.0	6.5	2.7	3.8	5.2	4.6	-7.1	-10.9	-14.0	-12.6
Czech Republic	6.5	6.4	5.6	4.6	1.8	2.5	2.9	4.4	-1.6	-3.1	-3.4	-3.5
Hungary	4.2	3.9	2.1	2.7	3.6	3.9	7.6	4.5	-6.8	-6.5	-5.6	-5.1
Poland	3.6	6.1	6.6	5.3	2.1	1.0	2.2	2.7	-1.7	-2.3	-3.7	-5.1
Slovakia	6.0	8.3	8.8	7.3	2.8	4.4	2.4	2.0	-8.6	-8.3	-5.3	-4.5
Slovenia	4.1	5.7	5.4	3.8	2.5	2.5	3.2	2.1	-1.9	-2.5	-3.4	-3.1
Malta	3.3	3.3	3.2	2.6	2.5	2.6	0.6	2.0	-8.0	-6.1	-9.4	-8.2
Cyprus	3.9	3.8	3.8	3.7	2.6	2.5	2.0	2.4	-5.6	-5.9	-5.5	-5.6
Bulgaria	6.2	6.1	6.0	5.9	5.0	7.3	8.2	7.9	-12.0	-15.8	-20.3	-19.0
Romania	4.1	7.7	6.3	6.0	9.0	6.6	4.3	4.8	-8.7	-10.3	-13.8	-13.2
Croatia	4.3	4.8	5.6	4.7	3.3	3.2	2.3	2.8	-6.4	-7.8	-8.4	-8.8
Turkey	7.4	6.1	5.0	5.3	8.2	9.6	8.2	4.6	-6.2	-7.9	-7.5	-7.0

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

The financial markets crisis of 2007 has also affected the group of the **Commonwealth of Independent States (CIS)**. However, it has not delayed the region from rapid development and reaching the highest GDP growth of the recent years (see Table 2.4).

Year 2007 started with a small growth, but it steadily increased since the 2<sup>nd</sup> quarter. Rise of export commodity prices, considerable inflow of capital, as well as growth of productivity have made a big contribution to development of economy of the region. Like in other regions, also the growth of CIS countries is based on increase of private consumption and easy access to credits, which create disproportions of development.

In the nearest years, the growth in this group of countries may decline, as credit conditions and the external demand deteriorate. High prices of goods will still be supported by economies of the big exporting countries, while growth of the biggest exporting countries of the region will be more moderate.

Mainly the unstable financial market of the world, decline of the foreign and domestic financing and the global demand are considered risks to the region's growth.

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	7.8	7.0
of which in Russia	6.4	6.7	7.0	6.5
Consumer prices	12.1	9.4	8.9	8.3
of which in Russia	12.7	9.7	8.1	7.5
Current account balance (% of GDP)	8.8	7.6	4.8	3.1
of which in Russia	11.1	9.7	5.9	3.3

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

Although the IMF has reduced its forecasts of global growth rates in the nearest years due to deterioration of conditions of the unstable global financial markets, these rates may nevertheless remain at a comparatively good level. The biggest influence on the global development is still exerted by the USA, which is associated with big financial deals most of all. Development is also affected unfavourably by financial market conditions in several Western European countries, while developing countries make an ever more positive contribution. Potentially high inflation, growing oil prices and global imbalances are also added to the risks. On the whole, the global growth in 2008 is forecasted in the amount of 4.8%.

## 3. GROWTH AND PRODUCTIVITY

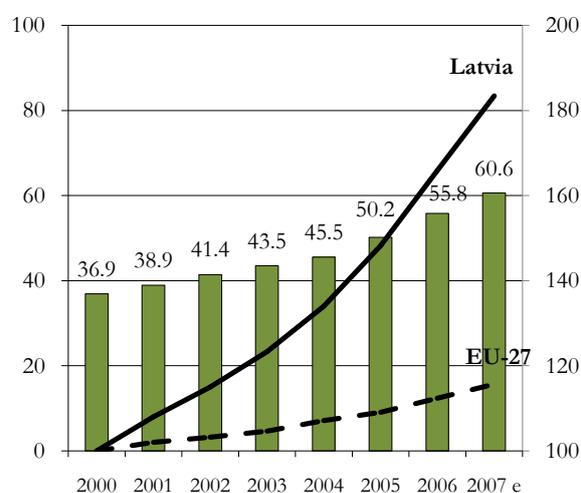
### 3.1. GDP Dynamics and Productivity

Rapid economic growth has been observed in Latvia for several years. Over the last three years (2004-2006), GDP showed average annual increase of 10.4%.

Figure 3.1

#### Dynamics and Level of GDP in Comparison with EU Average (in Purchasing Power Standards)

(2000 = 100%, curves – right axis  
EU-27 = 100, columns – left axis)



Source: Eurostat

e – estimation by the Ministry of Economics

Growth was especially notable in 2005 and 2006 – by 10.6% and 11.9% respectively. The high growth rates were mostly ensured by stable dynamics of the domestic demand.

Also the results of 3 quarters of 2007 indicate a rapid growth by 11% on average but the growth has slightly diminished.

In 2006, Latvian GDP per capita in purchasing power standards was at 55.8% of the EU-27 average (according to the estimation by Eurostat). In comparison with 2004, lagging behind the average EU level decreased by 10.3 percentage points.

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 over the last three years is exceeding the mark of 7%: productivity increased by 7.5% in 2004, 8.7% in 2005, and 7% in 2006.

Figure 3.2

#### GDP Growth in Quarterly Profile (percentage change against the corresponding quarter of the preceding year)

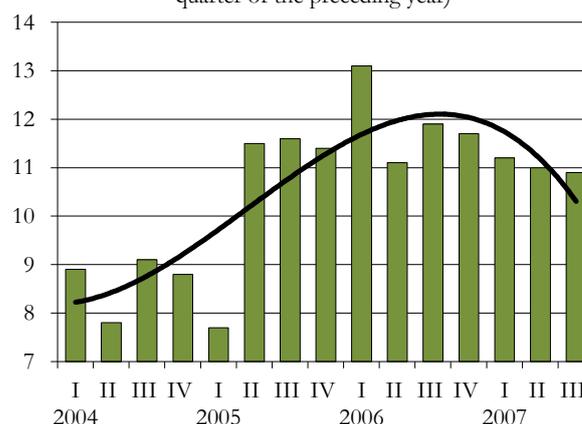


Table 3.1

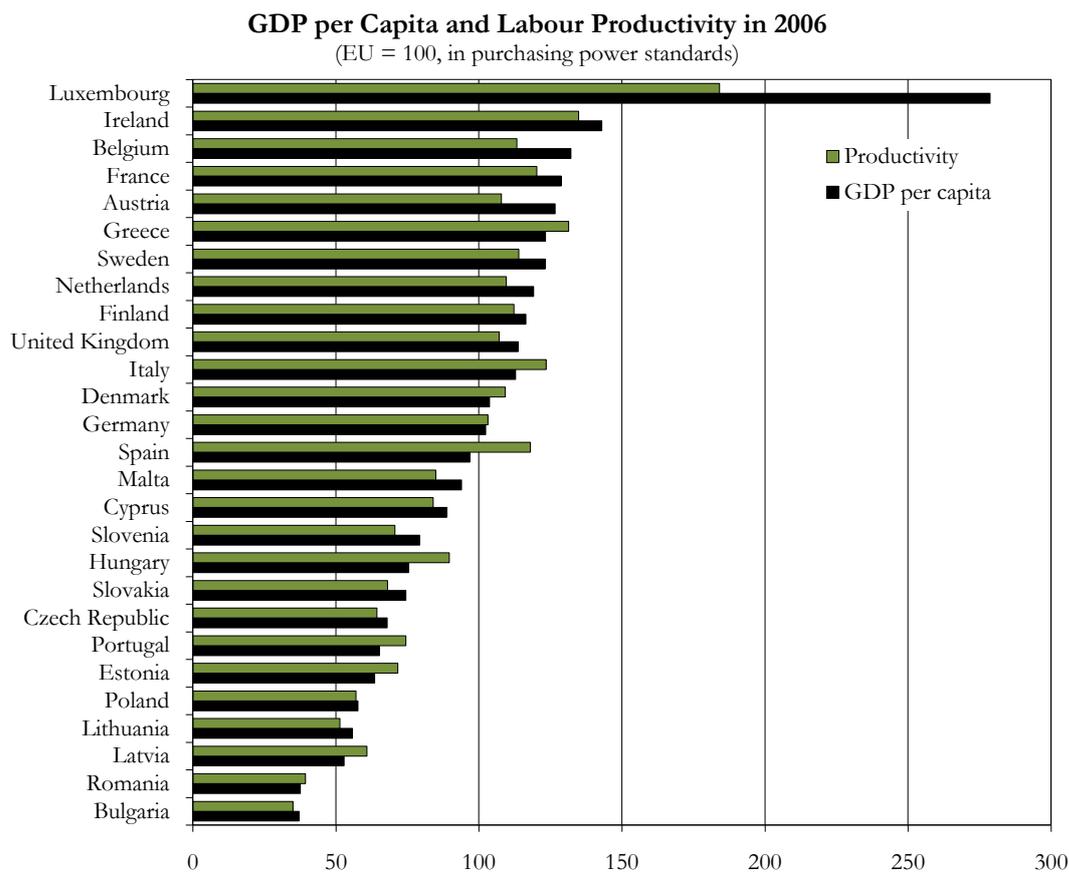
#### Productivity by National Economy Sectors – Value Added per Person Employed

	Annual average real changes in the period of 2004-2006 (%)	Level in current prices in 2006 (LVL per person employed)
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
<b>Total national economy</b>	<b>7.7</b>	<b>9256</b>

\* Public administration with healthcare and education

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

Figure 3.3



Source: Eurostat

## 3.2. GDP Expenditure

### 3.2.1. Aggregate Demand

The main impulse to the fast growth over the last years has been the stable increase of the domestic

demand. Both the private consumption and investments have grown substantially.

Gradual decline of the previously too rapid growth rate of the domestic demand was observed at the beginning of 2007.

Table 3.2

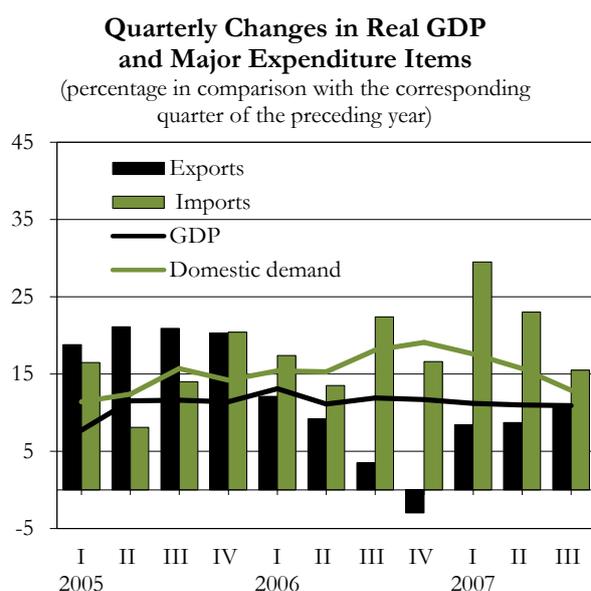
**Expenditure of Latvian GDP**  
(percentage)

	2005			2006			2007 e		
	structure	growth rates	contribution to growth	structure	growth rates	contribution to growth	structure	growth rates	contribution to growth
<b>Gross domestic product</b>	<b>100.0</b>	<b>10.6</b>	<b>10.6</b>	<b>100.0</b>	<b>11.9</b>	<b>11.9</b>	<b>100.0</b>	<b>10.6</b>	<b>10.6</b>
Private consumption	62.5	11.5	7.3	65.2	19.8	12.7	66.4	15.0	10.9
Public consumption	17.4	2.7	0.5	16.9	4.0	0.6	17.7	3.5	0.5
Gross fixed capital formation	30.6	23.6	7.5	34.4	18.3	6.5	35.3	13.5	3.2
Inventories	3.8	-	-4.4	3.7	-	0.2	3.4	-	3.2
Net exports	-14.4	-	-0.2	-20.2	-	-8.1	-22.7	-	-8.6
- exports	47.8	20.3	8.2	44.2	5.3	2.3	42.8	9.4	3.9
- imports	-62.2	14.8	-8.5	-64.4	17.5	-10.4	-65.6	20.0	-12.5

e – estimation by the Ministry of Economics

Growth of the domestic demand in 2007 was more moderate (17.5%) than in the preceding year. The inflation-curbing plan adopted by the Cabinet of Ministers in the middle of 2007 slowed down the rapid expansion of crediting. Opportunities of mortgage lending and lending for individuals decreased in particular, slowing down the growth of private consumption, but the fast growth of employee wages promoted private consumption. Growth rate of exports was slightly faster than in 2006 but slower than the growth rate of imports, hence the export-import balance of Latvia deteriorated.

Figure 3.4



### 3.2.2. Private and Public Consumption

The disposable income of households<sup>1</sup> in Latvia amounts to about 60% of GDP in the last years. The level of private consumption expenditures in comparison with the GDP has increased annually – from 63% in 2004 to 65.2% in 2006 and, by provisional estimation, may even reach 67% in 2007 (see Table 3.3), therefore the net savings of households are negative.

Growth of the disposable income of households in 2007 was slightly faster than the growth of private consumption, therefore the negative balance of the net savings slightly decreased. Furthermore, 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.

<sup>1</sup> Disposable income – income in cash and the cash value of goods and services obtained in kind, received in a 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.

Table 3.3

### Disposable Income and Final Consumption Expenditures of Households, Net Savings

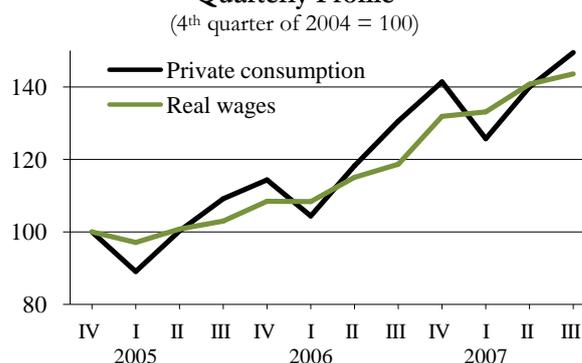
	2004	2005	2006 e	2007 e
Disposable income of households (changes in % in comparison with the preceding year)	17.7	20.3	20.4	30.0
Final consumption expenditures of households (changes in % in comparison with the preceding year)	17.2	21.2	29.7	27.2
Net savings in % of disposable income	-3.0	-3.8	-11.7	-9.4
Net savings in % of GDP	-1.8	-2.3	-6.9	-5.7

e – estimation by the Ministry of Economics

Growth of real wages is slightly slower than the growth of private consumption (see Figure 3.5).

Figure 3.5

### Growth of Real Wages and Private Consumption, Quarterly Profile



Consumption expenditures of households per household member in the country increased in 2006 by 21% on average in comparison with 2005 and constituted LVL 155 per month. Considering growth of the price index, real consumption expenditures increased by 14%.

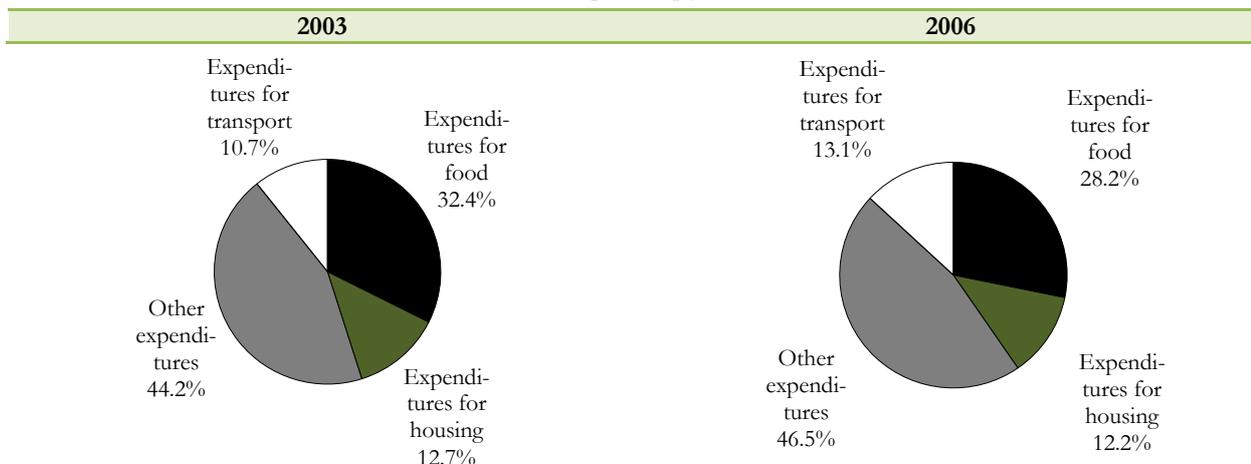
In the structure of household consumption in 2006, expenditures for food (including non-alcoholic beverages) made 28.2% of consumption expenditures in comparison with 32.4% in 2003. Expenditures for transport reached 13.1% of the total volume of consumption expenditures.

In 2006 compared with 2005, expenditures for transport, recreation and cultural activities, maintenance and cleanup of housing increased the most (by 36.9%, 35.2%, and 24.7% respectively). The trends are rather similar both in cities and in rural areas, which indicates certain growth of the level of material welfare<sup>2</sup>.

<sup>2</sup> According to data of the budget survey of households.

Figure 3.6

**Structure of Household Consumption Expenditures**  
(percentage)



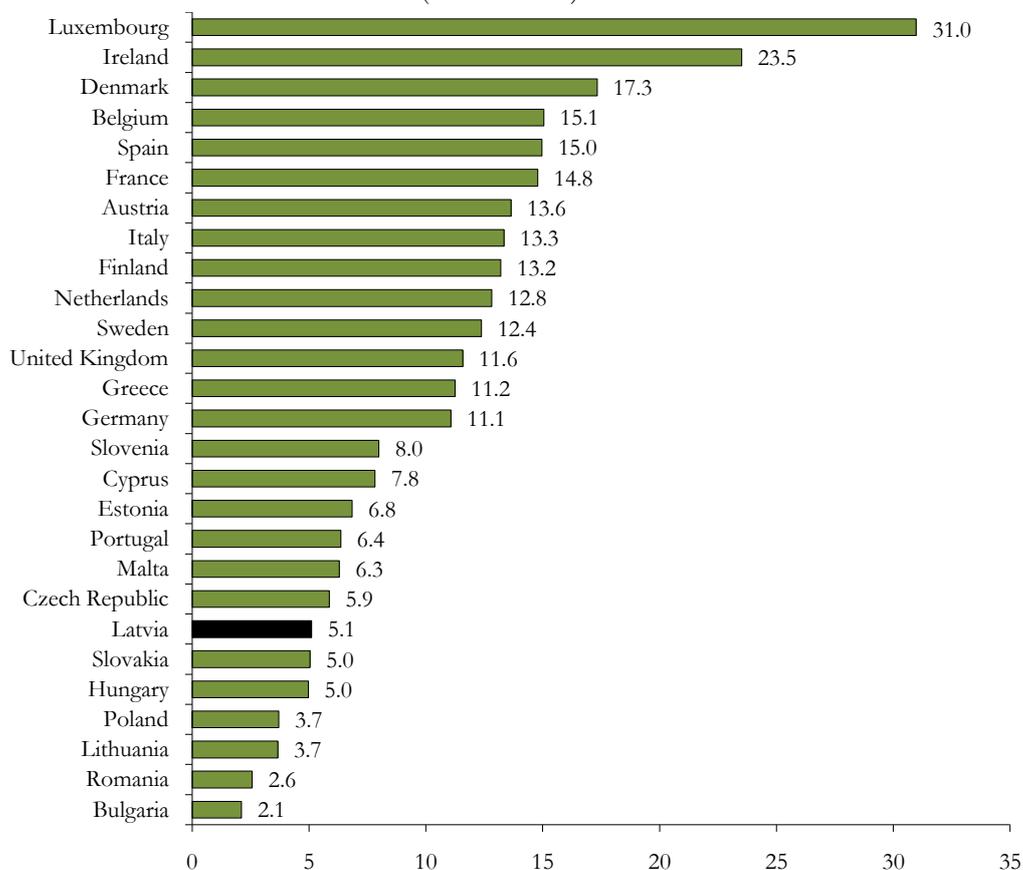
**3.2.3. Investments**

Latvia in the last years. Investments increased by 81.1% in 2004-2006 (by 22% on average annually).

Rapid dynamics of investments<sup>1</sup> and a significant share of investments in GDP are characteristic to

Figure 3.7

**Volume of Investments per Person Employed in EU Member States in 2004-2006**  
(thousand euros)



Source: Eurostat

<sup>1</sup> Gross fixed capital formation or investment in fixed assets

As indicated by *Eurostat* data, average annual growth rates of investments in Latvian economy exceed the average annual investment growth rates in EU member states almost six times. However, it should be noted that Latvia lags behind the EU average indicators almost two times in respect to the volume of investments per person employed.

The rapid investment dynamics is based on the access to cheap financial resources, which was determined firstly by the intensified inflow of foreign capital since Latvia's accession to the EU and, secondly, by improvement of financial situation of companies due to relatively low tax burden and high domestic demand. Results of a conjuncture survey indicate that entrepreneurs assess the financial situation of companies positively overall, however, the balance of assessment of the financial situation of companies in 2007 is by a few percentage points lower than in the previous periods.

Investments increased by 18.3% in 2006. As a favourable business environment remains, investments kept growing fast also in 2007. Volume of investment in 9 months of 2007 was bigger by 14.6% than in the corresponding period of the preceding year, and the share of investments in GDP reached 32.5%.

Table 3.4

#### Gross Capital Formation

	2004-2006 (average per year)	2006	2007 I-IX
Real growth in per cent			
<b>GDP</b>	<b>10.4</b>	<b>11.9</b>	<b>11.0</b>
Gross capital formation	16.6	18.9	21.6
– gross fixed capital formation	21.9	18.3	14.6
% of GDP			
<b>Gross capital formation</b>	<b>35.6</b>	<b>37.9</b>	<b>37.1</b>
– gross fixed capital formation	31.3	34.4	32.5
– changes in inventories	4.3	3.5	4.5

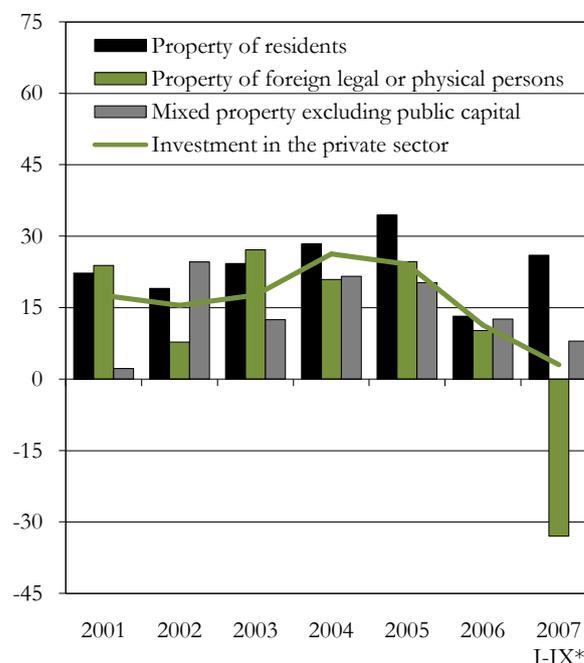
Investment growth rates have been increasing both in the public sector<sup>1</sup> and in the private sector since 2004. It should be noted that the average annual investment volumes have increased almost 1.5 times in the public sector and almost two times in the private sector over the period of 2004-2006 in comparison with the pre-accession period of 2001-2003.

Investments in the public sector grew especially rapidly in 2007 (investment volumes in 9 months of this year were by 42% bigger than in the respective

period of the preceding year). Investments in the private sector increased faster in 2005 and 2006.

Figure 3.8

#### Fixed Investment Dynamics in the Private Sector by Property Forms (percentage in comparison with the preceding year)



\* estimated using the quarterly data

Investments in companies owned by residents has been growing especially rapidly: by almost 25% annually since 2004, i.e., almost 1.5 times faster than the investments in companies owned by non-residents. Overall, it can be concluded that investment growth rates remain rather high and are increasing every year. Investments in the private sector grew by 26.3% in 2004, 24.1% in 2005, and by 11.3% in 2006. According to provisional data, investments in the private sector in 9 months of 2007 were by 3% greater than in the respective period of 2006.

**Sectoral structure of investments<sup>2</sup>.** Along with the rapid growth of investments, also certain changes in the sectoral structure of investments could be observed. 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.

During three years since Latvia's accession to the EU (2004-2006), volumes of investments increased by 61% in the production sphere and by 64% in the services sphere. Provisional data of 9 months of 2007 indicate that investments grow most rapidly in production sectors, especially in the energy sector and construction.

<sup>1</sup> The public sector includes enterprises and organisations of the central and local governments, business companies with the share of the central or local governments or their enterprises in equity capital in amount of 50% or more, social and religious organisations and enterprises owned by them, and budgetary institutions.

<sup>2</sup> Investment in breakdown by sectors is presented according to the non-financial investment statistics that do not include all investment in fixed assets.

Table 3.5

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

	Growth			Structure		
	Average 2004-2006	2006	9 months of 2007*	Average 2004-2006	2006	9 months of 2007*
Primary sectors	17.6	-4.1	13.8	4.8	4.6	4.0
Manufacturing	20.5	9.4	7.0	16.4	16.7	16.5
Electricity, gas, and water supply	2.7	-14.4	39.0	7.7	6.1	11.3
Construction	33.7	18.4	32.0	4.2	4.6	5.0
Trade	13.3	4.6	1.8	14.7	14.0	13.0
Transport and communications	10.1	11.5	12.0	14.4	14.5	13.2
Other commercial services	25.3	22.4	-1.7	22.9	25.1	20.1
Public services	20.5	5.3	72.0	14.9	14.4	15.7
<b>Total</b>	<b>17.7</b>	<b>9.1</b>	<b>14.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

\* estimated using the quarterly data

In the services sphere, growth of investment in 2004-2006 was especially fast in such sectors as hotels and restaurants, real estate transactions and education. In 9 months of 2007, investments in health protection rose substantially (3.5 times more than in 9 months of 2006), while investments in real estate were slightly less significant (by 17%) than in 9 months of 2006, which is explained by implementation of measures of the inflation-curbing plan.

Since Latvia's accession to the EU, annual growth rates of investments have become almost twice higher also in manufacturing, where the average annual investment volumes have increased by almost 70%.

In terms of investment volumes, production of other non-metallic products, chemical industry, production of electric and optical equipment, and

production of transport vehicles were the sectors that are the most attractive for the investors. Average annual investment volumes in these sectors in three years (2004-2006) have increased more than twice in comparison with three years before accession to the EU, of which in production of other non-metallic products – almost five times.

Volumes of investments for the light manufacturing have declined considerably. Investments in the light manufacturing accounted for 7.1% of the total investment volume in manufacturing in 2003 and mere 2.4% in 2006. In 9 months of 2007, investments in this sector decreased by 36%. Such dynamics of investment indicates essential decrease of competitiveness of the light manufacturing.

Table 3.6

**Dynamics and Structure of Investment in Manufacturing**  
(%)

	Growth rates			Structure		
	Average 2004-2006	2006	9 months of 2007*	Average 2004-2006	2006	9 months of 2007*
Food industry	10.4	-11.0	2.0	25.9	21.9	21.7
Light industry	-16.4	-26.6	-27.2	3.1	2.4	3.0
Wood processing	17.9	18.6	-41.9	25.4	26.3	19.2
Paper industry and publishing	25.8	14.9	34.4	7.2	7.7	10.3
Chemical industry and related industries	33.1	74.2	116.4	7.3	8.9	10.7
Production of other non-metallic mineral products	84.3	103.1	106.2	10.7	14.6	13.7
Production of metals and metal articles	12.9	-18.5	46.6	6.7	5.9	7.3
Production of machines and equipment	2.5	-38.8	68.6	2.2	1.6	2.6
Production of electric and optical equipment	16.0	-31.7	23.3	2.8	2.4	2.0
Production of transport vehicles	32.1	-25.8	-48.2	2.4	2.1	1.8
Other industries	50.4	0.5	103.9	6.1	6.2	7.6

\* estimated using the quarterly data

Overall, since 2004, investments in manufacturing sectors of high and medium technologies are growing most rapidly: by 31% on average annually in high technology sectors, by 37% in medium technology sectors and by 13.5% in low technology sectors. In 9 months of 2007, investments in high technology sectors grew 1.5 times and constituted 14% of the total investments in manufacturing, while investments in low technology sectors fell by 18%. Such trends may indicate certain capital saturation in low technology sectors and drain of their development potential, which is also greatly affected by the producer price competition pressure from cheap labour countries.

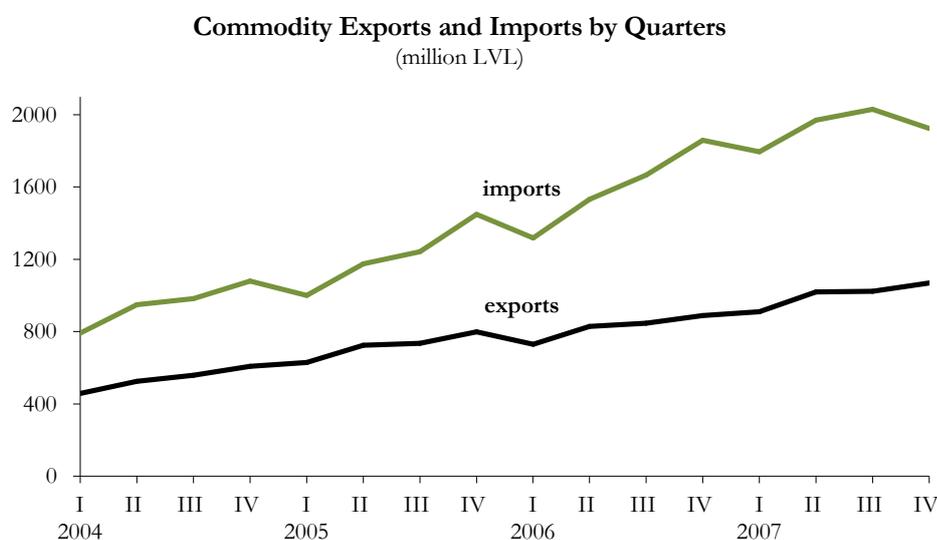
### 3.2.4. Exports and Imports

#### Exports and imports of commodities

Income from exports of Latvian commodities in 2007 was by 22.2% bigger than in the previous year, 7.7% whereof was due to increase of volumes. Imports increased bit slower – by 21%, furthermore, the import prices grew at a considerably slower pace and therefore the volumes of imports increased by 14%.

Figure 3.9 shows that increase of exports and imports was the fastest during the 2<sup>nd</sup> quarter of the year.

Figure 3.9



In 2007, the **commodity exports** were influenced favourably by changes of trade conditions, and the index of the export unit value increased by almost 15% in the first 3 quarters of the year. Rise of the export unit value was affected most substantially by product prices in the groups of wood processing and metalworking goods.

Commodity exports in 2007 went up in almost all groups of goods, especially food products that accounted for 20% of the total growth of exports; growth of wood exports took place as usual (accounting for one-fourth of the total growth of exports) but it should be noted that this growth was affected, to a great extent, by the rise of wood price in the world market. Prices of Latvian wood and wood products have increased almost 1.5 times during one year (prices in the 3<sup>rd</sup> quarter of 2007 in comparison with prices in the 3<sup>rd</sup> quarter of 2006).

Figure 3.10

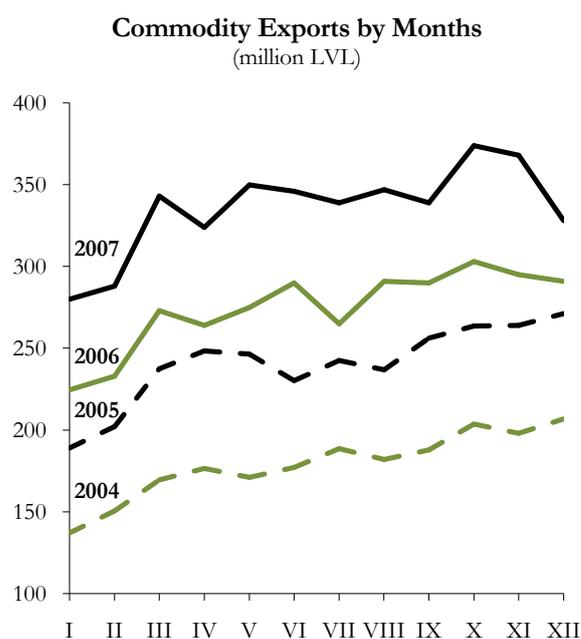
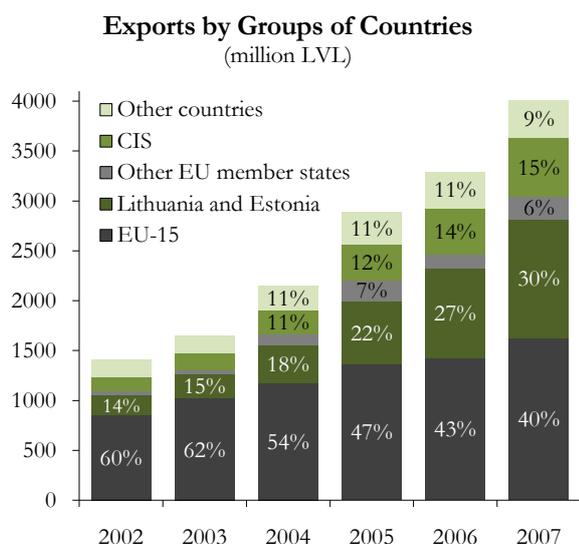


Table 3.7

**Exports by Main Groups of Commodities**  
(%, FOB prices)

	2006		2007	
	structure	increase in comparison with the preceding year	structure	increase in comparison with the preceding year
<b>Total including:</b>	<b>100</b>	<b>14.0</b>	<b>100</b>	<b>22.2</b>
wood and wood products (IX)	22.5	3.1	22.4	22.3
metals and metal articles (XV)	14.8	28.7	14.9	23.0
light industry products (VIII; XI-XII)	8.8	7.8	7.3	1.2
agricultural and food products (I-IV)	13.2	23.4	14.5	24.1
products of chemical industry and allied industries, plastics (VI-VII)	9.8	38.4	10.4	31.4
machinery (XVI)	9.8	20.2	10.5	33.2
mineral products (V)	5.5	-31.3	4.1	-9.4
transport vehicles (XVII)	6.0	78.5	7.1	45.9
other commodities (X; XIII-XIV; XVIII-XXII)	9.5	7.7	8.8	14.3

Figure 3.11



Exports to EU-27 countries in 2007 were by 23% bigger than a year before. In common with the total Latvian exports, also exports to EU-27 countries increased in almost all groups of commodities with the exception of mineral products. The abovementioned wood products (30% of the total exports to EU-27 countries) and metalworking products (17%) accounted for the greatest increase in exports to EU-27 countries. Light manufacturing products were exported to EU-27 countries in similar volumes, while the exports of mineral products slightly decreased.

Exports to the CIS countries in 2007 kept increasing at the usually rapid pace – by 27%. The biggest increases were observed for exports of machinery (27% of the total exports to the CIS countries) and for products of metalworking (14%) and food industries (17%).

Increase of **commodity imports** in 2007 was observed in all groups of commodities; the biggest increases were in the groups of machinery (25% of the total increase of imports) and transport vehicles (19%).

Figure 3.12

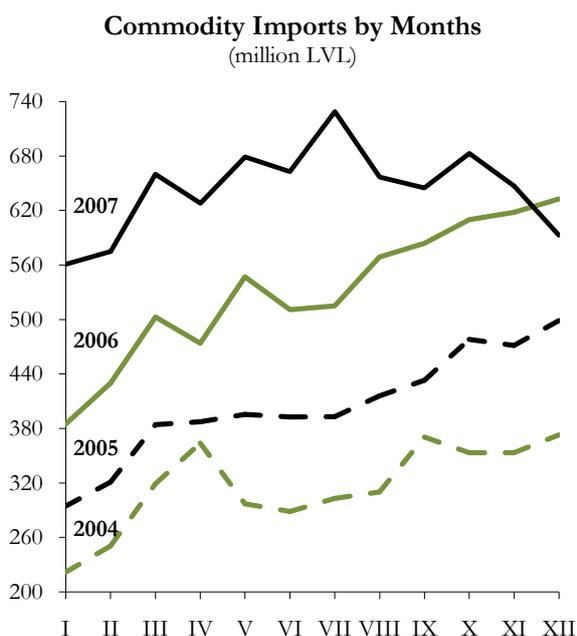


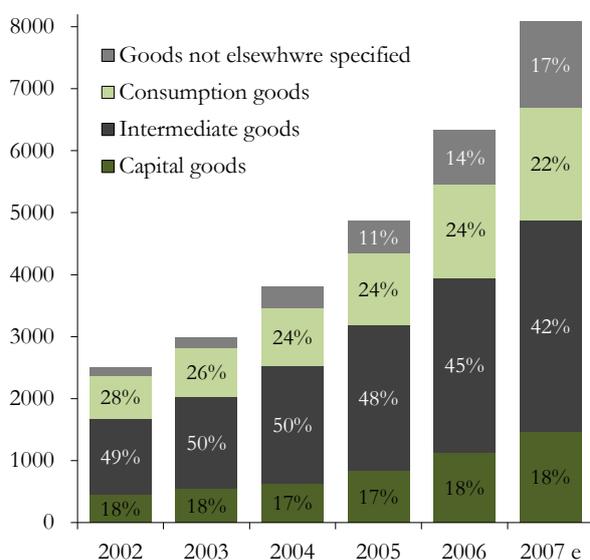
Table 3.8

### Imports by Main Groups of Commodities (%, current CIF prices)

	2006		2007	
	structure	increase in comparison with the preceding year	structure	increase in comparison with the preceding year
<b>Total including:</b>	<b>100</b>	<b>31.1</b>	<b>100</b>	<b>21.0</b>
wood and wood products (IX)	2.5	12.7	3.3	61.3
metals and metal articles (XV)	9.5	35.6	9.7	24.6
light industry products (VIII; XI-XII)	5.8	26.7	5.5	15.1
agricultural and food products (I-IV)	11.1	24.7	11.2	22.4
products of chemical industry and allied industries, plastics (VI-VII)	13.4	29.3	12.9	18.0
machinery (XVI)	19.7	29.9	20.5	29.6
mineral products (V)	13.4	13.5	12.0	6.6
transport vehicles (XVII)	13.6	66.0	14.5	31.9
other commodities (X; XIII-XIV; XVIII-XXII)	11.0	36.2	10.5	18.2

Figure 3.13

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



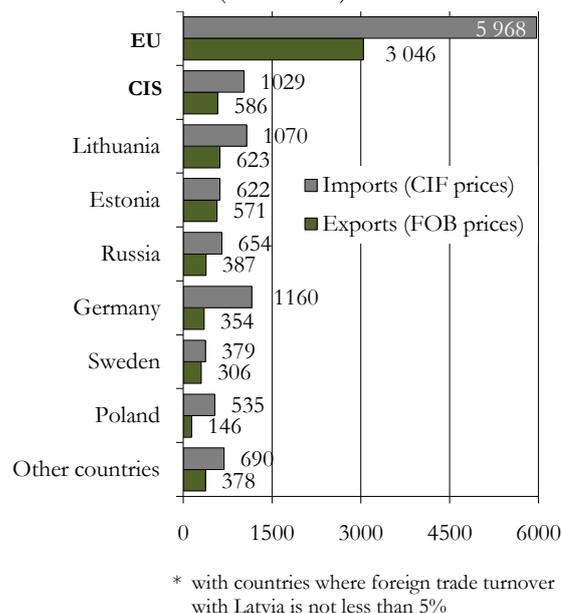
e – estimation by the Ministry of Economics

As viewed in classification of the broad economic categories, the imports have not changed much in the last five years – imports of consumption and intermediate goods have increased slightly slower than the total imports of goods (see Figure 3.13).

The main **trading partners** of Latvia in 2007 were Lithuania (14% of the total foreign trade turnover), Germany (13%), Estonia (10%), Russia (9%), Poland (6%), and Sweden (6%).

Figure 3.14

### Foreign Trade Turnover of Latvia\* in 2007 (million LVL)



\* with countries where foreign trade turnover with Latvia is not less than 5%

After accession to the EU, foreign trade of Latvia with **Lithuania** and **Estonia** keeps growing rapidly. In comparison with 2003, Latvian foreign trade with these countries has increased three times and already constitutes more than 30% of the total trade with EU member states.

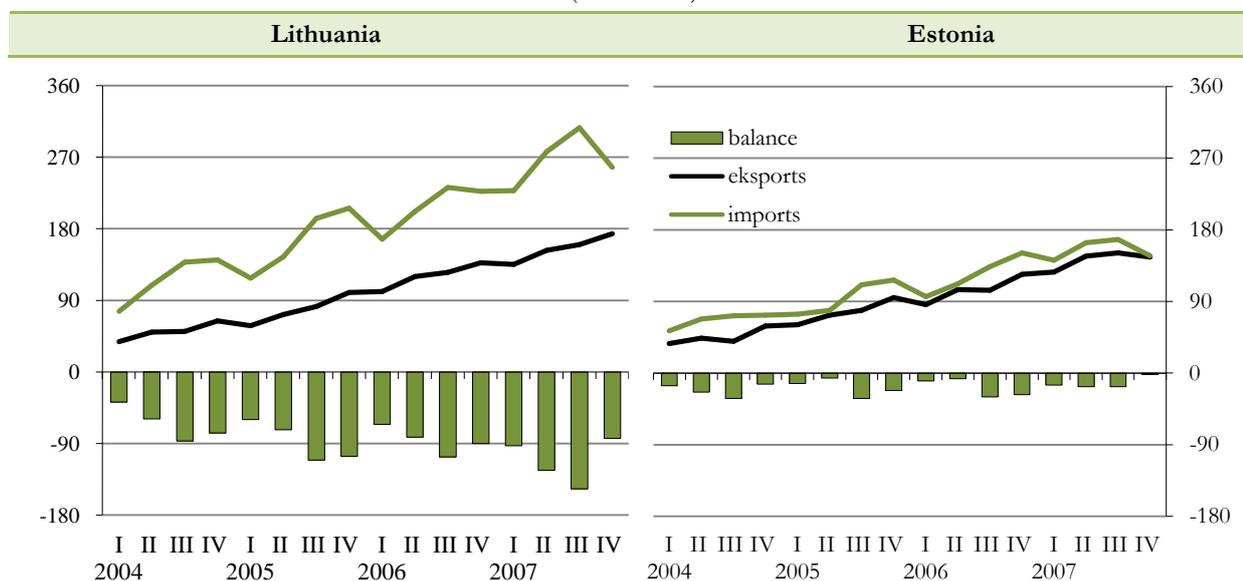
As Figure 3.15 shows, the foreign trade balance with Estonia and especially with Lithuania remains negative. In 2007, imports from Lithuania exceeded exports by 72%, while imports from Estonia exceeded exports by mere 9%. The main groups of commodities exported to Estonia are food and chemical industry products, while the main imported commodities are transport vehicles

and machinery. Main commodities exported to Lithuania are food and chemical industry products, while the main

imported are mineral products and food products.

Figure 3.15

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



**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). Data of the balance of

payments for January-September 2007 indicate that the balance of services has slightly deteriorated, as exports of services grows at a slightly more moderate pace than imports (see Table 3.9).

Table 3.9

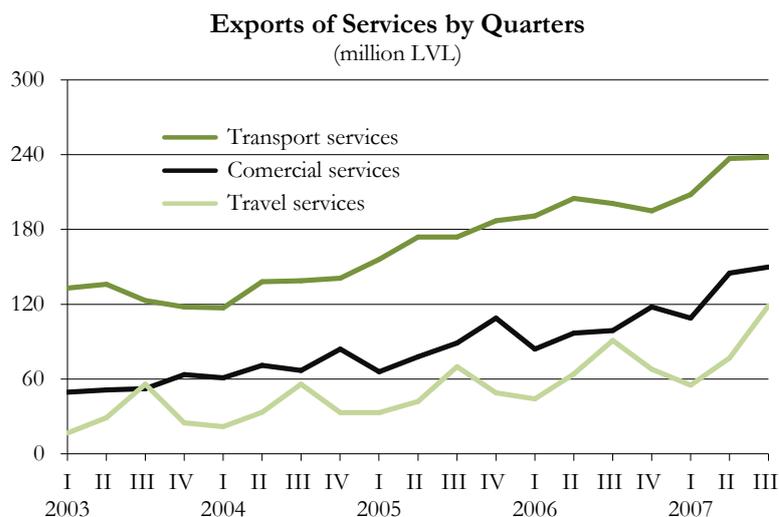
Exports and Imports of Services in January-September 2007

	Million LVL			Structure (%)		Changes in comparison with the respective period of the preceding year (%)	
	exports	imports	balance	exports	imports	exports	imports
<b>Services – total</b>	<b>1356.6</b>	<b>995.4</b>	<b>361.2</b>	<b>100</b>	<b>100</b>	<b>24.4</b>	<b>27.9</b>
including:							
Transport services	682.6	303.6	378.9	50.3	30.5	14.5	16.5
– sea transport	260.4	71.2	189.1	19.2	7.2	8.1	13.4
– air transport	100.9	104.2	-3.3	7.4	10.5	26.9	14.3
– other transport	321.3	128.2	193.1	23.7	12.9	16.4	20.3
Travel	250.7	344.9	-94.3	18.5	34.7	26.1	24.0
Commercial services	404.6	331.0	73.6	29.8	33.3	44.3	46.2
Other services	18.7	15.9	2.9	1.4	1.6	21.2	22.6

Slightly more than a 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



### 3.3. Contribution of Sectors

#### 3.3.1. Structure and Dynamics of Economy

The structure of Latvian economy in sectoral profile has changed in favour of service sectors after 2000. The share of service sectors in the value added

has increased to 74.8% in 2006 from 71.8% in 2000. 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 economy.

Table 3.10

**Structure of 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
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

The rapid economic growth over the recent years has mostly been ensured by increase of the domestic demand, which had a direct impact on fast growth of several service sectors, while the increase of industrial production volumes was mainly based on rising exports.

After accession to the EU (2004-2006), increasing trade (wholesale and retail) and other commercial services contributed to almost two-thirds of the growth. The contribution of manufacturing is considerably smaller and lags behind the contribution of the construction and transport and communications sectors.

Growth trends of the previous years were preserved in 2007 (according to statistics of the first 3 quarters) – rapid growth is based on rise of the domestic demand, which mainly affects growth of service sectors. Total production volumes in the industry did not increase essentially.

Proportion of manufacturing in Latvian economy is markedly low and distant from the EU average in this area; only such EU member states as Cyprus and Luxembourg with a big proportion of exported services in their national economy have a lower share of industry in GDP.

Table 3.11

<b>GDP Growth</b> (%)						
	<b>Growth rates</b>			<b>Contribution to growth</b>		
	Average 2004-2006	2006	2007 I-IX	Total 2004-2006	2006	2007 I-IX
Primary sectors	4.9	0.4	9.1	0.7	0.0	0.4
Manufacturing	6.2	6.2	0.7	2.8	0.9	0.1
Electricity, gas, and water supply	3.6	4.0	1.9	0.4	0.1	0.1
Construction	14.1	13.6	15.1	3.2	1.0	1.2
Trade, hotels, and restaurants	15.5	17.3	14.4	10.9	3.9	3.6
Transport and communications	11.0	9.3	9.2	5.2	1.4	1.5
Other commercial services	12.1	16.7	13.3	9.5	4.0	3.6
Public services	4.1	4.4	4.2	1.9	0.6	0.6
<b>GDP</b>	<b>10.4</b>	<b>11.9</b>	<b>11.0</b>	<b>34.5</b>	<b>11.9</b>	<b>11.0</b>

The rapid development of service sectors cannot compensate the relatively slow growth of the most export-capable sector – manufacturing; this manifests in a form of growth of commodity imports being much faster than increase of exports, which is one of the principal causes of disproportions of Latvian economy, namely, high inflation and high current account deficit of the balance of payments.

### 3.3.2. Manufacturing

Growth of manufacturing in the last years (2004-2007) has been slower than the average growth of national economy.

Table 3.12

<b>Growth of Manufacturing*</b> (per cent)			
	Average annual growth 2004-2007	Growth in 2006	January-November 2007 / January- November 2006
<b>Manufacturing – total</b>	<b>4.3</b>	<b>4.8</b>	<b>-0.5</b>
Food industry	3.9	4.8	0.1
Light industry	4.3	8.5	0.0
Wood processing	0.6	-1.4	-6.4
Paper industry and publishing	5.9	7.6	1.0
Chemical, rubber and plastic industry	15.2	21.4	4.9
Manufacture of other non-metallic mineral products	10.2	4.9	-0.2
Production of metals and metal articles	6.6	7.7	8.0
Production of machinery and equipment	0.4	-1.4	-6.0
Production of electrical and optical equipment	7.5	8.8	7.4
Production of transport vehicles	2.3	-2.9	1.2
Other industries	4.0	6.0	-4.0

\* 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.

Immediately after Latvia's accession to the EU, growth rates of manufacturing declined because companies needed some time to adjust to the new trade conditions. Considerable growth resumed in May 2005. Decreased growth of particular sectors is compensated by increased growth rates in other sectors.

However, operational data of 2007 indicate several problems in manufacturing because non-expansion or reduction of production volumes in the voluminous sectors of manufacturing, such as wood processing, food industry, light manufacturing, production of machinery and equipment, is no more compensated by growth of other sectors.

Table 3.13

**Structure of Manufacturing in 2007\***  
(%)

	By value added 2007	By number of employees 2007	Share of exports in sector's sales, 2007*
<b>Manufacturing – total</b>	<b>100</b>	<b>100</b>	<b>48.7</b>
Food industry	18.2	20.4	24.1
Light industry	6.8	12.6	76.6
Wood processing	22.7	19.3	65.1
Paper production and publishing	8.2	7.4	24.7
Chemical, rubber and plastic industry	8.5	5.7	55.8
Manufacture of other non-metallic mineral products	6.6	5.2	18.2
Production of metals and metal articles	11.2	8.4	64.6
Production of machinery and equipment	3.0	3.9	72.3
Production of electrical and optical equipment	5.4	4.5	61.1
Production of transport vehicles	3.5	4.1	75.1
Other industries	6.0	8.5	53.4

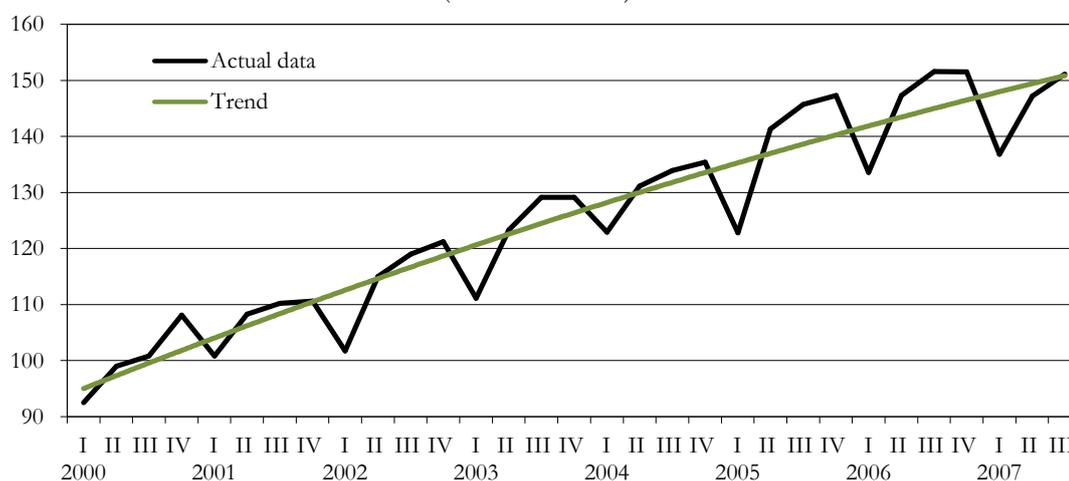
\* according to operational statistics of January-November 2007

Wood processing and production of machinery and equipment, which are among the principal Latvian export sectors, are the sectors with some of the

weakest growth indicators, even with decline of production volumes in 2006.

Figure 3.17

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

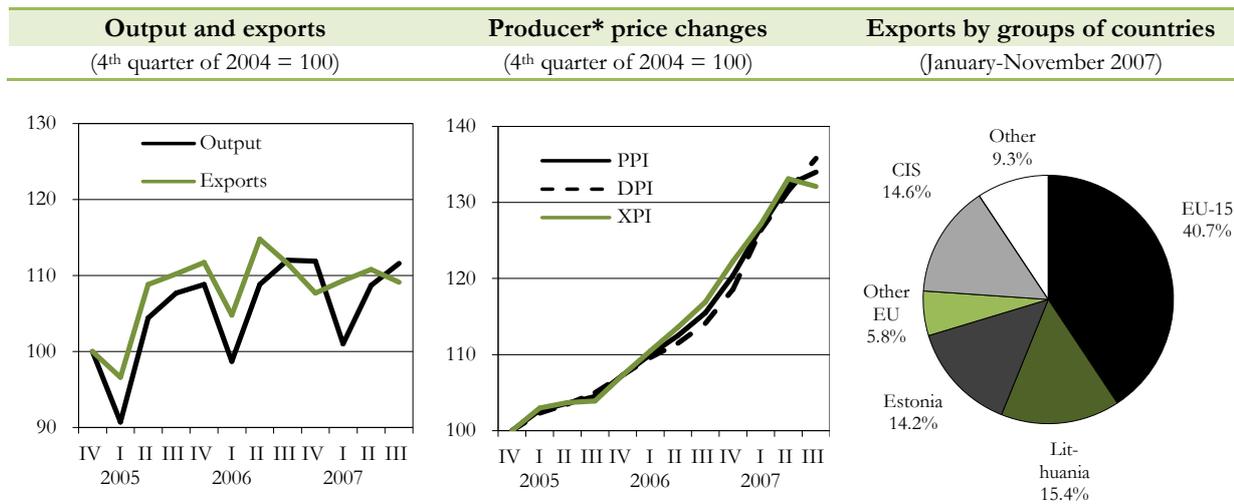


In the period after accession, exports to Estonia and Lithuania expanded most substantially and the growth of exports to these countries was greater than to the other EU member states. Exports of

manufacturing products to CIS countries also increased rapidly. Increase of exports to EU-15 countries was minimal.

Figure 3.18

**Manufacturing Indicators**



\* 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 three years, besides, the prices for exported products and for the domestically sold ones have increased almost equally. Since the 3<sup>rd</sup> quarter of 2007, producer price indices started to decline mostly due to decrease of sale prices of exported products.

Notwithstanding the rapid rise of producer prices in the last years, it does not compensate the even faster growth of wages. Producer prices in manufacturing have increased by 38.4% in the last three years (2005-2007), while the average gross wage in the sector has

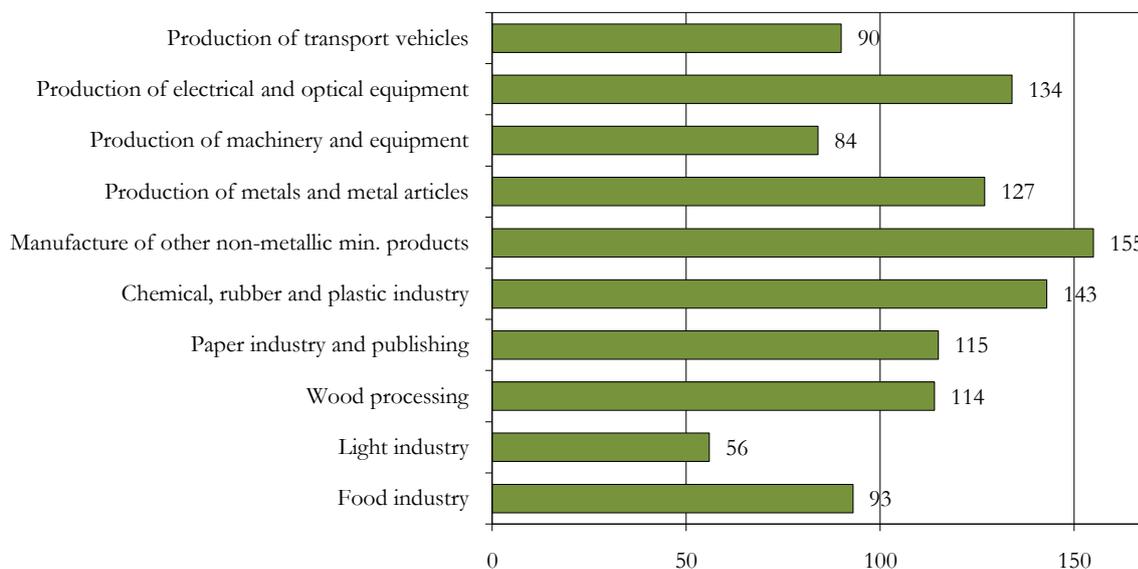
increased by 87.8% in this period. This negatively affects competitiveness of the sector in international markets and is the main problem of manufacturing in the current period.

Among the aggregated sectors, level of productivity is the highest in production of construction materials (manufacture of other non-metallic mineral products) and chemical industry 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 2005**

(average level of manufacturing = 100)

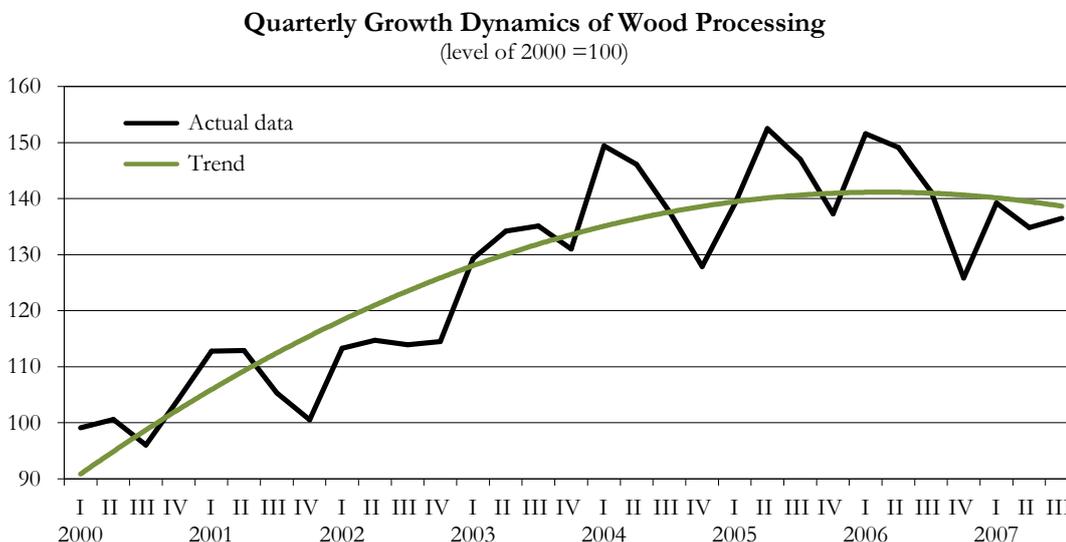


\* value added per person employed

**Wood processing** is the biggest sector of Latvian manufacturing. 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. The high share of exported products (65% of the output) is characteristic for the wood processing sector.

Figure 3.20

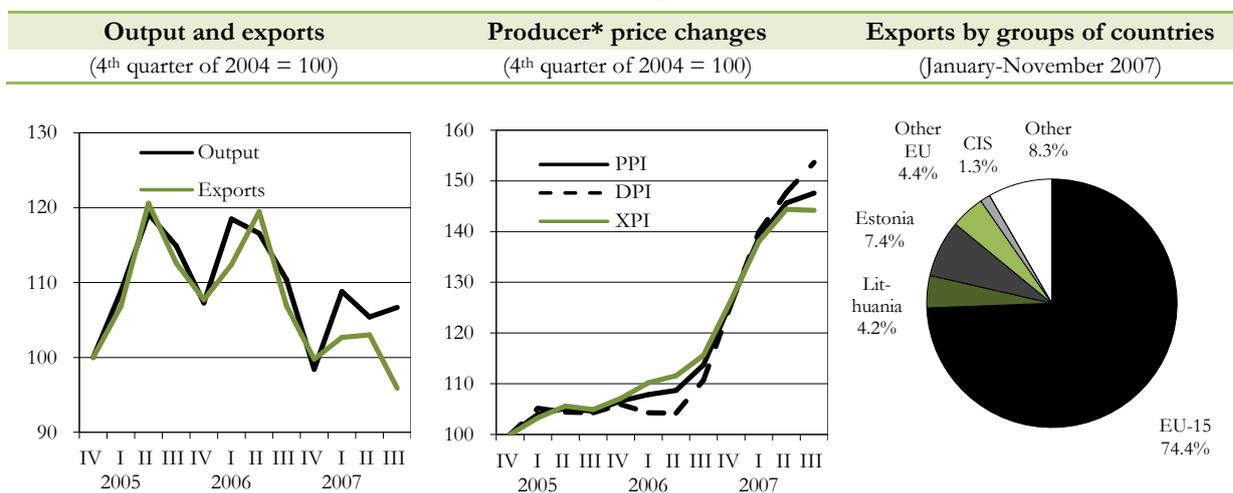


However, the growth of this sector has become more moderate and its production volumes even started diminishing slightly during the last two years. Output decreased by 1.4% in 2006 and by 4.4% in

2007 (operational data on results of January-November 2007). The main cause of decreased output is the decline in export volumes.

Figure 3.21

### Wood Processing Indicators



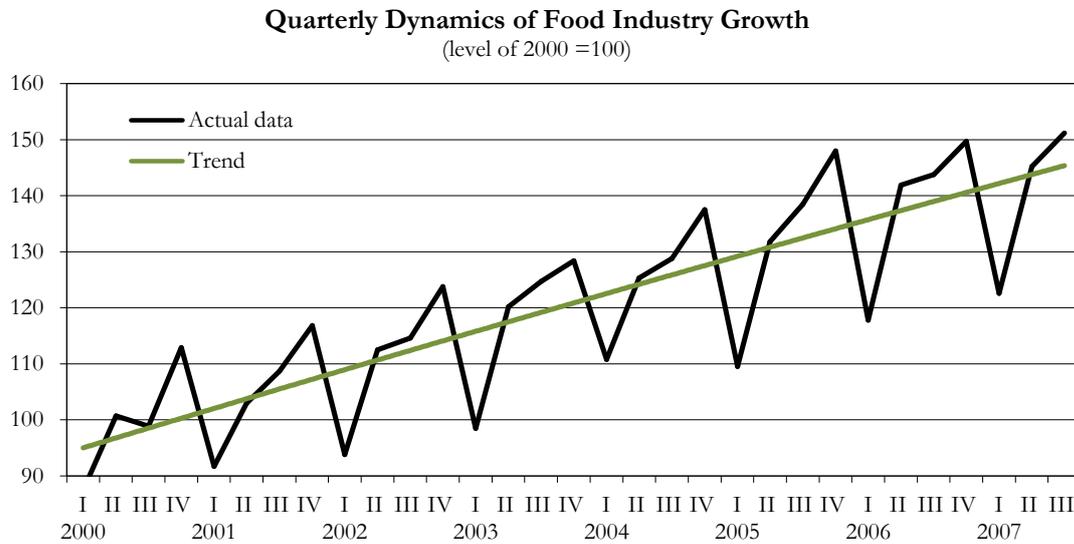
\* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Producer prices in wood processing have been steadily increasing over the period of 2005-2007. Export prices grew slightly faster at the beginning of 2006; price of products sold domestically grew during the 2<sup>nd</sup> half of 2006 due to increased domestic demand and costs. In 2007, only prices of products sold in the domestic market increased but the prices of exported products practically did not increase.

Wages in wood processing are among the lowest in comparison with other industries. They are on average lower by 10%.

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

Figure 3.22



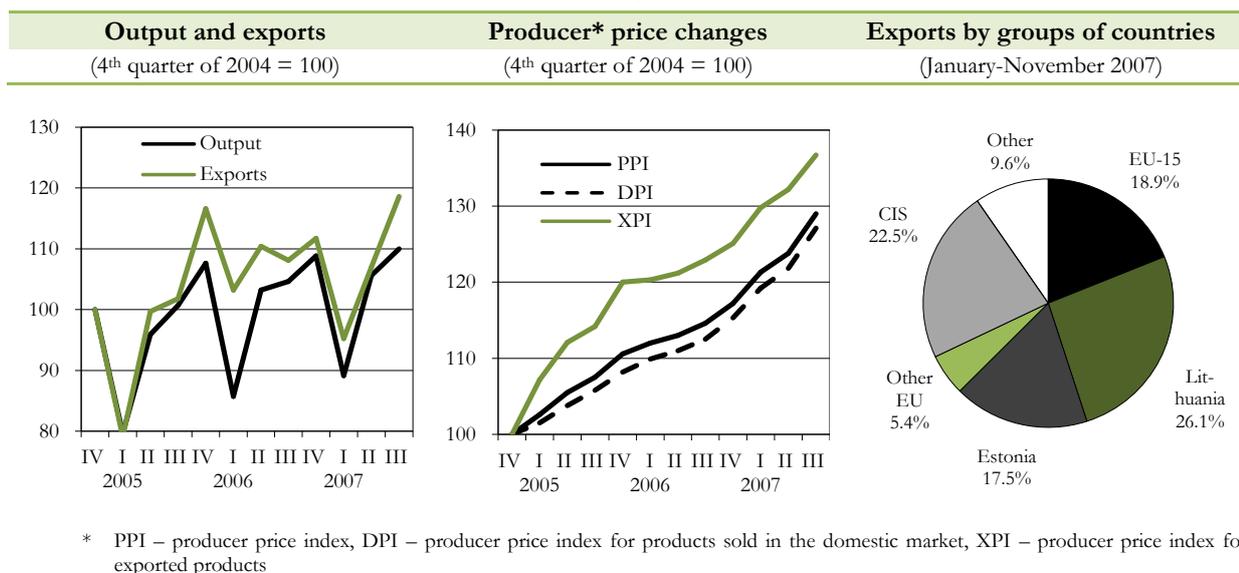
Approximately 75% of the total food industry output is consumed in the domestic market. The rest is exported mostly to Estonia, Lithuania and Russia. With accession to the EU, the demand for Latvian foodstuffs increased in all trade directions – both to Russia and other CIS countries and to the EU, and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

Following the relatively good growth in 2006 (by 4.8%), production volumes practically did not increase in 2007, as sales of the products decreased in the domestic market.

Figure 3.23

### Food Industry Indicators



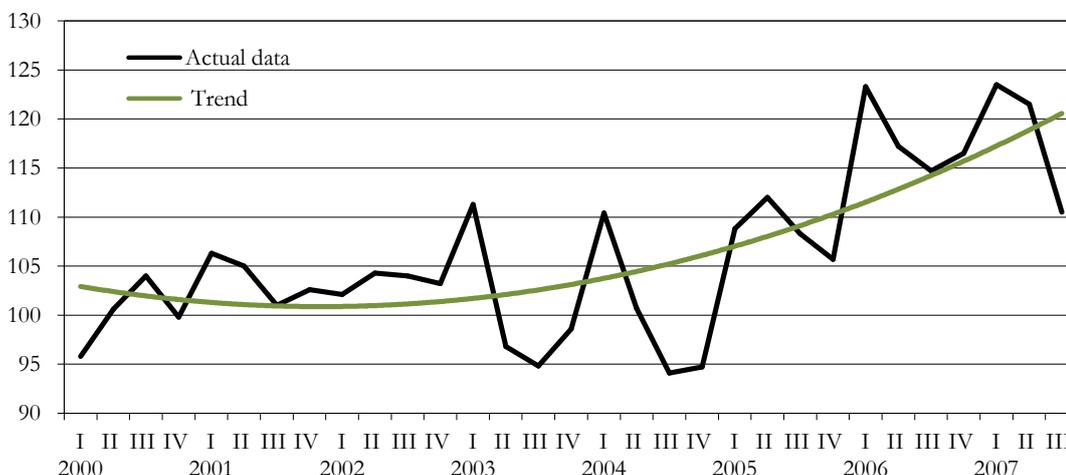
Export prices for food products have been rapidly increasing since 2005. Prices in the domestic market have been rising at a more moderate pace.

**Light manufacturing** (production of textile and leather products) accounts for less than 7% of the total value added in manufacturing. Only about one-fourth

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

Figure 3.24

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



Until 2005, production volumes and exports of *textile industry* did not increase, and they even decreased in production of clothing. Growth of production volumes only revived in 2005 and continued to grow at a faster pace during 2006. Production volumes did not increase in 2007.

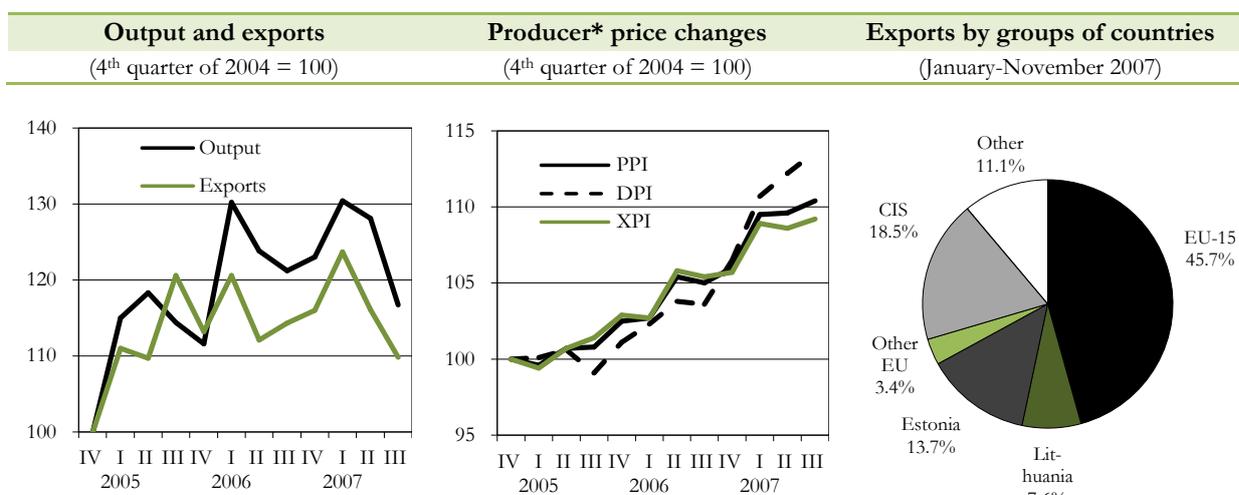
Although the main sales markets for Latvian textile industry are in the EU member states, it is hard for Latvian producers to expand production volumes due to the poor demand in EU member states and high competition in the sector despite the rapid rise of

prices in the last years. Competitiveness of the sector is considerably weakened by the substantial rise of prices although average wages of the employed in light manufacturing companies make up 70% of average wages in manufacturing.

As it has already been mentioned, growth in 2006 is observed mainly due to increased demand in the domestic market and increased exports to the CIS countries, as well as Lithuania and Estonia. Exports to the old EU member states have not increased during this period.

Figure 3.25

**Textile Industry and Production of Clothing**



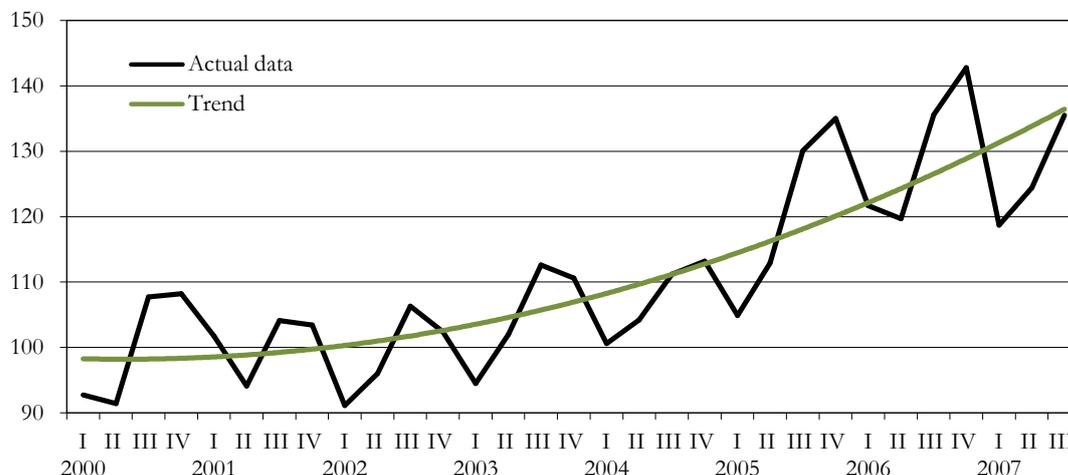
\* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

**Paper industry and publishing** is characterised by rather fast growth as from 2005 mainly due to increased exports and rapid rise of export prices. Growth was more moderate in 2007. The main sales

markets for exported products in this sector are Lithuania and Estonia, while opportunities to expand into markets of other EU member states are poor.

Figure 3.26

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

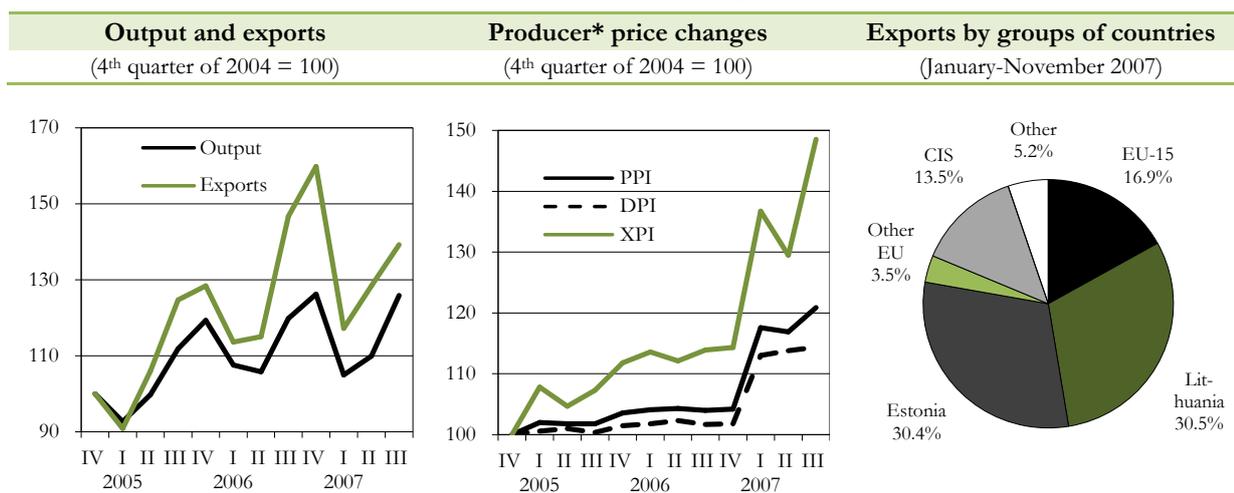


Until 2005, the growth of export prices was much slower than the average price growth because a relatively big share of exports is related to the CIS countries and other countries outside the EU and trade conditions with these countries are deteriorating due to the low exchange rate of the US dollar, which is one of the main currencies of account in these

directions of trade. However, as sales of exported products rapidly increase in Estonia and Lithuania and in other EU member states, the rise of export prices considerably exceeds the average rise of prices in the sector. Rapid growth of prices of exported products continued also in 2007.

Figure 3.27

**Paper Industry and Publishing Indicators**

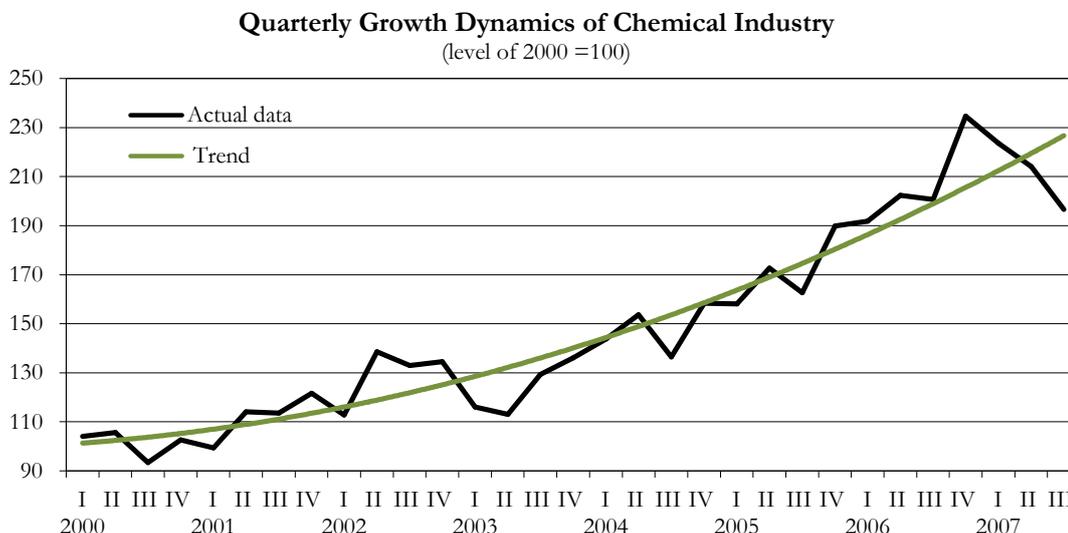


\* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

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

for research. Stable growth in the sector could be observed after 2004. Chemical industry accounts for approximately 8.5% of the total value added of manufacturing.

Figure 3.28

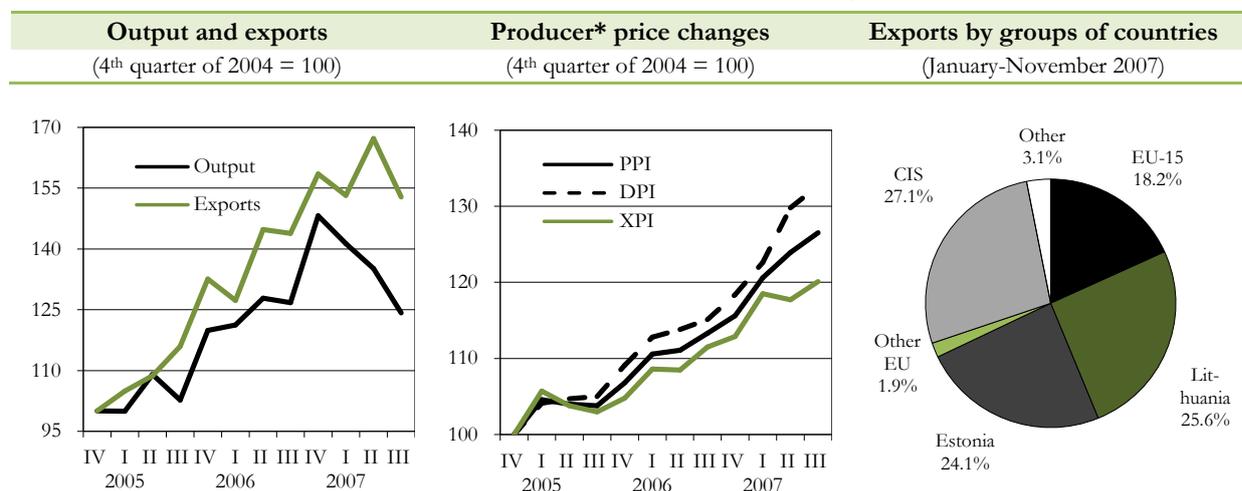


Traditional sales markets for Latvian chemical industry products are mainly in the CIS countries, Lithuania and Estonia. Markets in the old EU member states do not increase substantially. The sector shows

poor competitiveness in markets of the developed countries. Exports to Lithuania and Estonia make up about two-thirds of exports to EU member states.

Figure 3.29

**Chemical, Rubber and Plastic Industry**



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

Growth of the sector has been rapid in the last years (2004-2007). It is the fastest growing sector of manufacturing in this period. The growth was ensured largely by rise of demand in CIS countries and increased demand in domestic market. Considering the good conjuncture, the average wage level in the sector

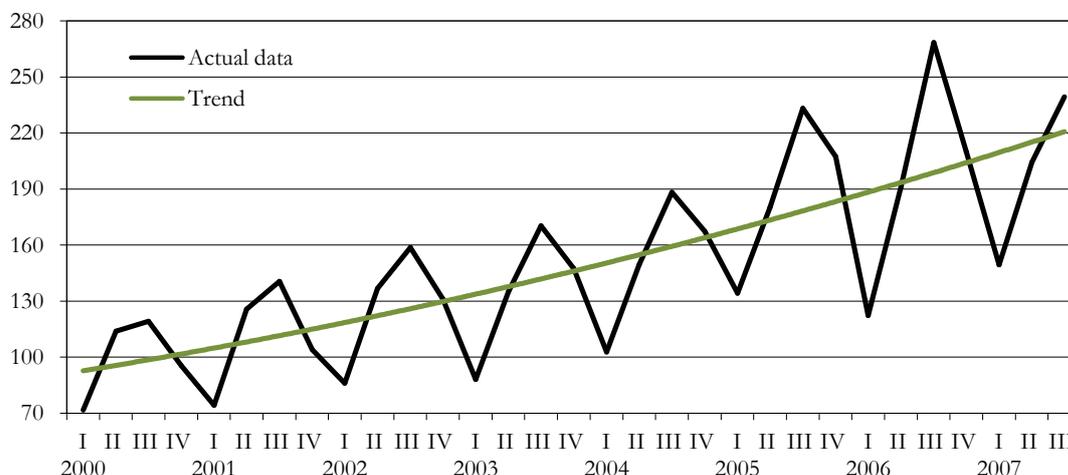
remains high and the wages increased especially fast in 2006 and 2007. However, rapid decrease of growth in 2007 must be noted, and production volumes in the 3<sup>rd</sup> quarter of 2007 were on the level of respective period of the preceding year.

**Manufacture of other non-metallic mineral products** (mostly construction materials) shows very unstable growth rates. After the steep growth in

2004 and 2005, increase was more moderate in 2006. Production volumes even slightly decreased in 2006.

Figure 3.30

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

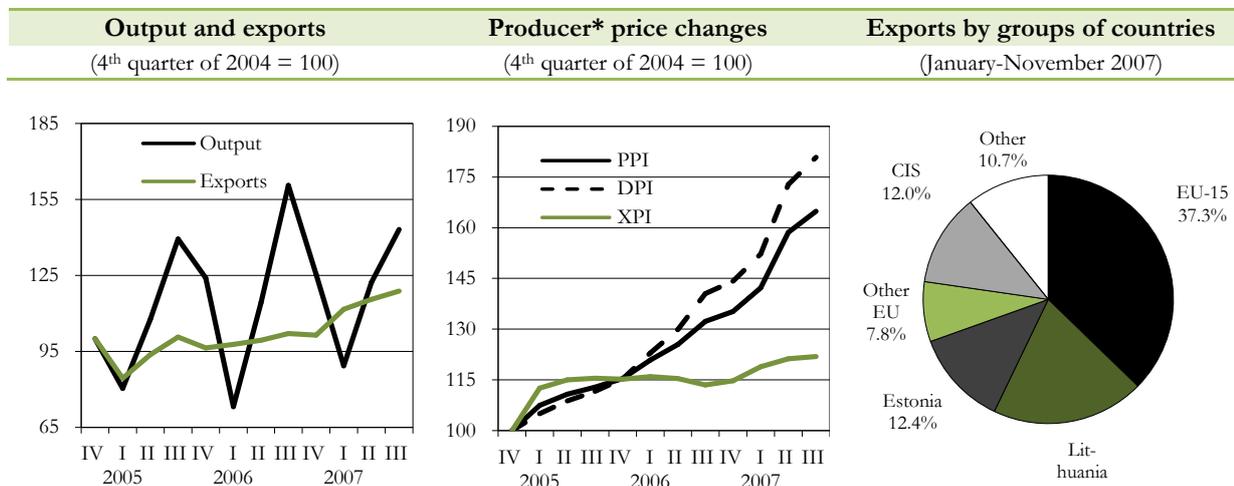


Increase of the domestic demand is the main incentive for growth in the sector. As the domestic demand grew, prices of products sold in the domestic

market increased rapidly but prices of the exported products did not rise essentially.

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

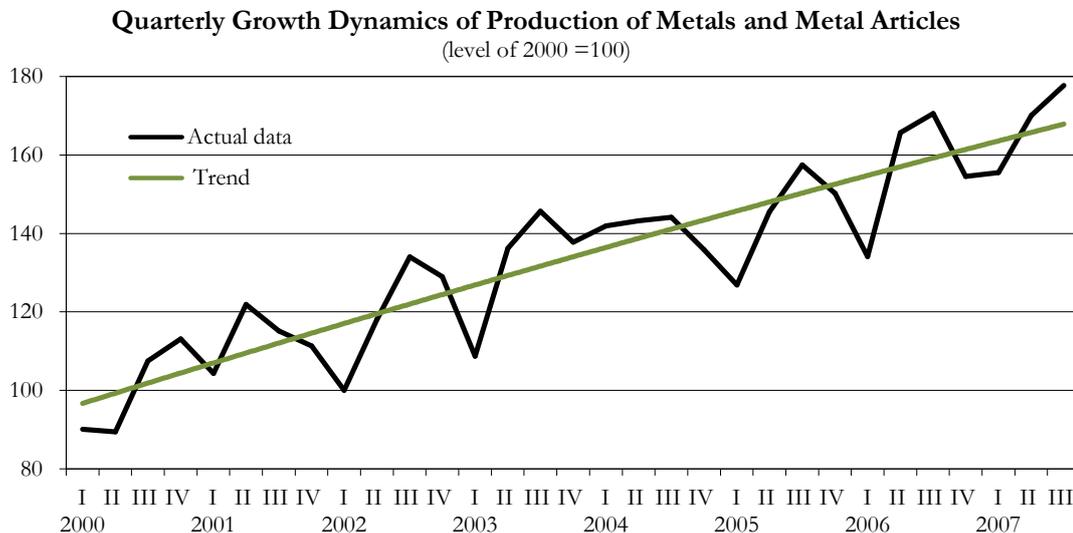
Production volumes fell during the 1<sup>st</sup> quarter of 2006 mainly due to the unfavourable climatic conditions that reduced the domestic demand, while they increased essentially in the 2<sup>nd</sup> and 3<sup>rd</sup> quarters of 2006. Due to the gradual decline of domestic demand, production volumes did not increase in 2007.

The sector has the highest level of wages in manufacturing. Wages of the employed in this sector are by one-third higher than in other sectors of manufacturing.

Sectors of *production of metals and metal articles* constitute approximately one-tenth of the total value added of manufacturing. Exports account for almost three-fourths of the total sold products of

these sectors. The domestic market share has been showing a tendency of expansion recently. Development of construction has resulted in increased demand for finished metal articles.

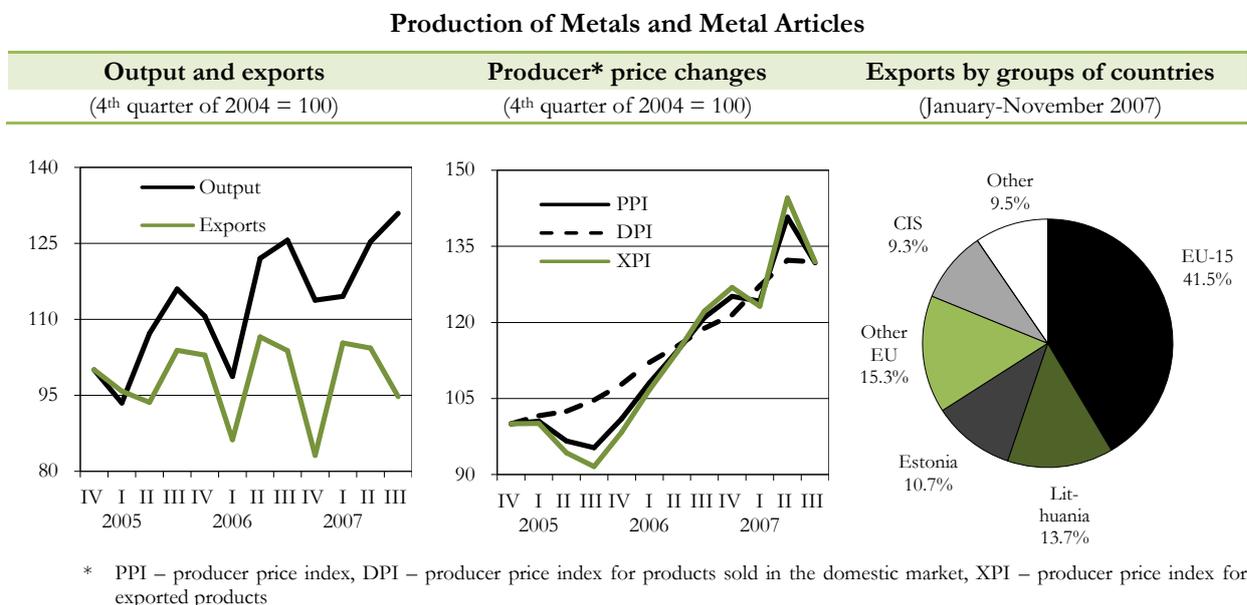
Figure 3.32



2004 was an unfavourable year for the sector, with decreased production volumes due to decline of exports, and growth picked up only in the 2<sup>nd</sup> quarter of 2005; growth rates tend to increase every year. In

2007, it was the fastest growing manufacturing sector where increase of growth was mainly ensured by the rise of demand in the domestic market.

Figure 3.33



Producer prices in the sector have substantially increased over the last years both for domestically sold products and exported products.

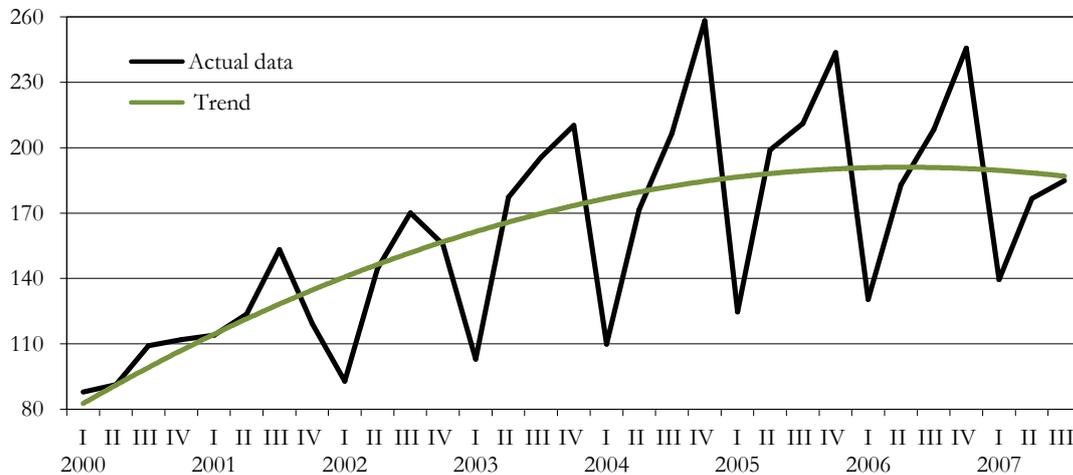
Metals and metal articles produced in Latvia are highly competitive around the world but most of them are linked with the EU member states (almost 80% of exports) and almost a half of the products are exported to the old EU member states.

*Production of machinery and equipment* was a rapidly growing sector until 2005, and its production volumes had almost doubled over the period of

2000-2005. However, its growth rates have not been increasing since 2005, and the production volumes decreased in 2006 and 2007.

Figure 3.34

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

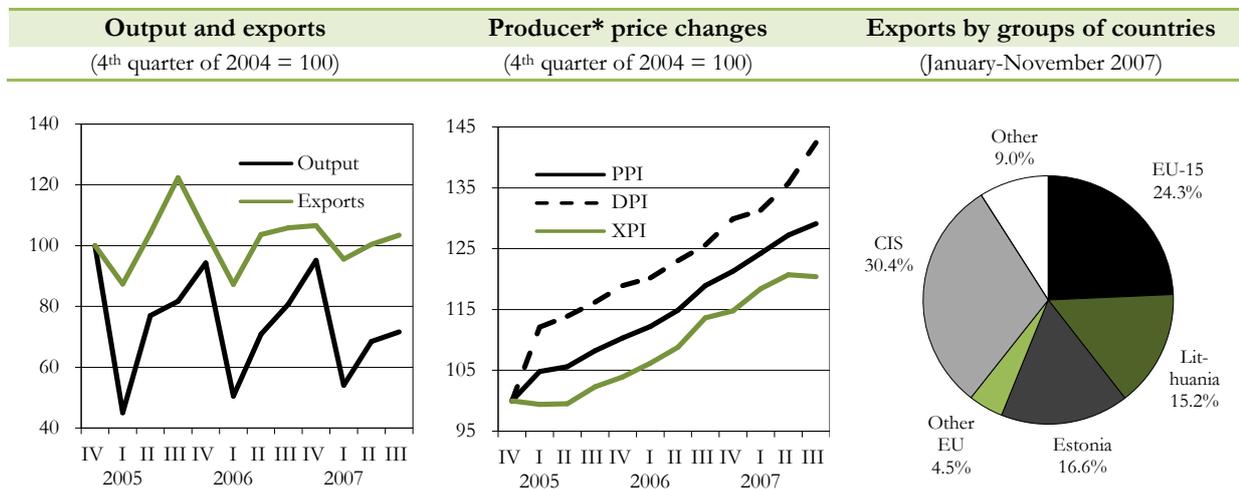


It is a typically export-oriented sector, as almost three-fourths of its products are being exported. The main sales markets of the sector are the EU member states, and almost a half of the products for exports to

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

Figure 3.35

**Production of Machinery and Equipment**



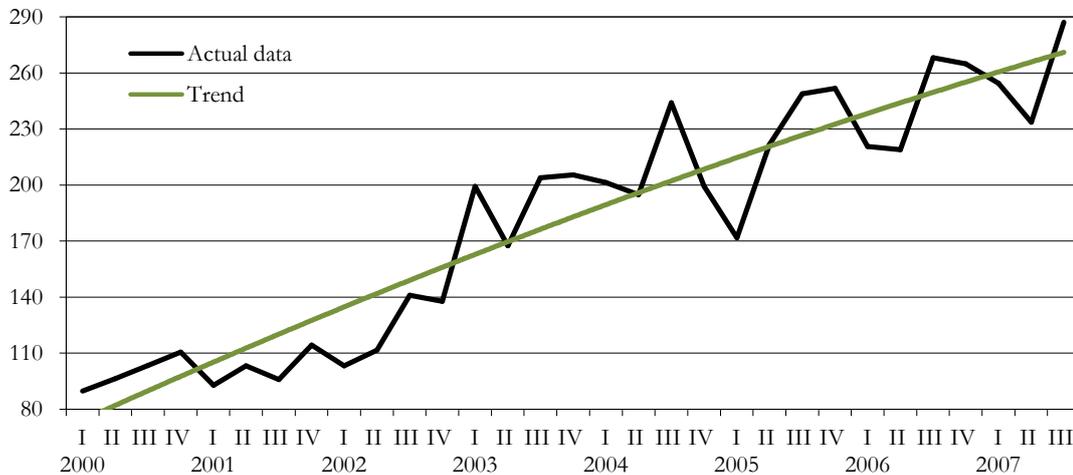
\* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

**Production of electrical and optical equipment** has been developing rapidly over the recent years. Production volumes of the sector have

almost doubled in the last five years. Fast growth in this sector is also observed in 2007.

Figure 3.36

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

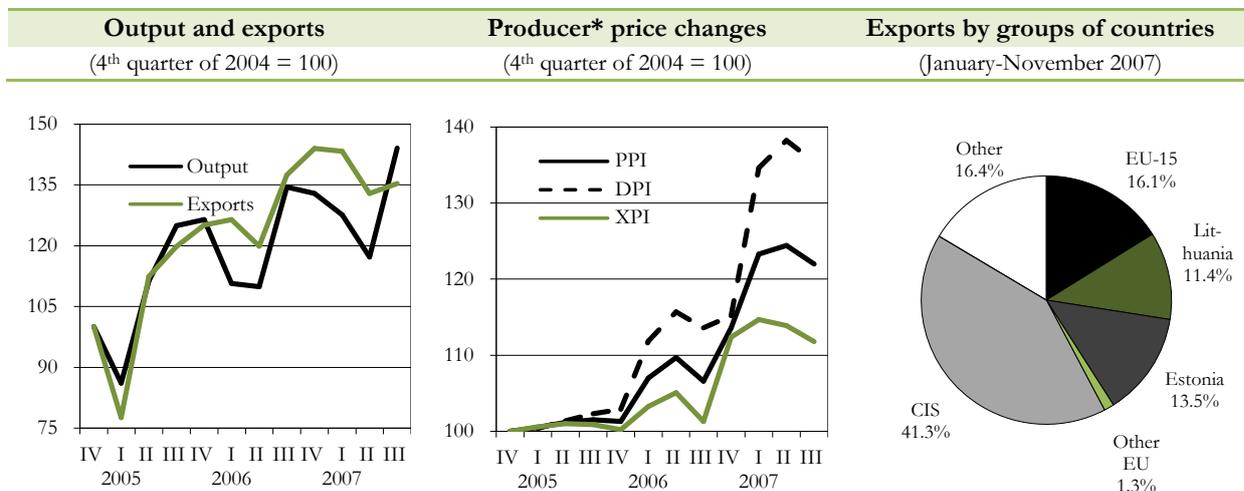


After accession to the EU, growth of the sector slightly slowed down but remained on a steady level

(6-8%). The sector has stable trading partners in the CIS countries, Estonia and Lithuania.

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

The sector exports about two-thirds of its products. The domestic market share has been

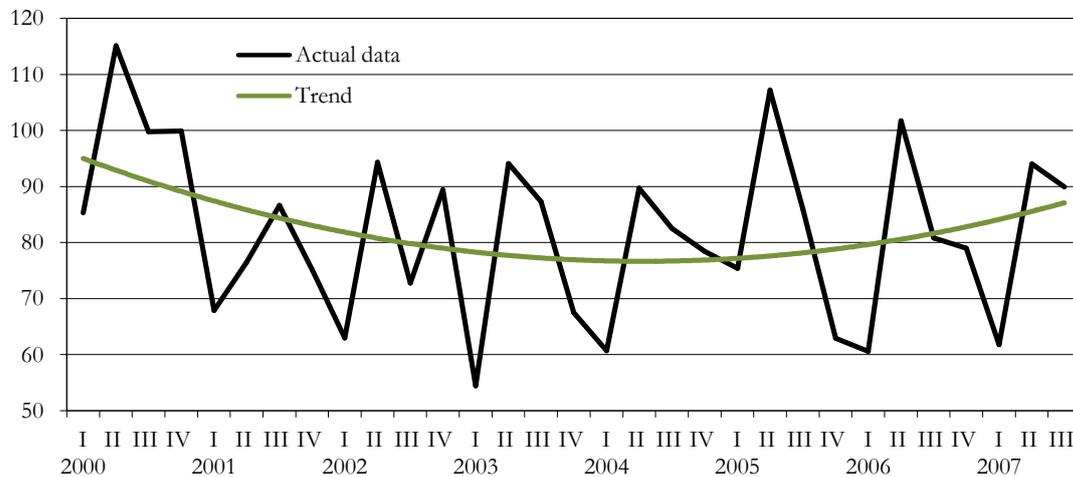
increasing in the recent years, and also producer prices for products sold in the domestic market have been growing at a faster pace.

**Production of transport vehicles** is the only manufacturing sector, which has not managed to increase production volumes, and the indices are lower by almost one-fifth in comparison with 2000,

although the volumes were slightly raised beginning with 2004 following decreased output in the previous years.

Figure 3.38

**Quarterly Growth Dynamics of Production of Transport Vehicles**  
(level of 2000 = 100)

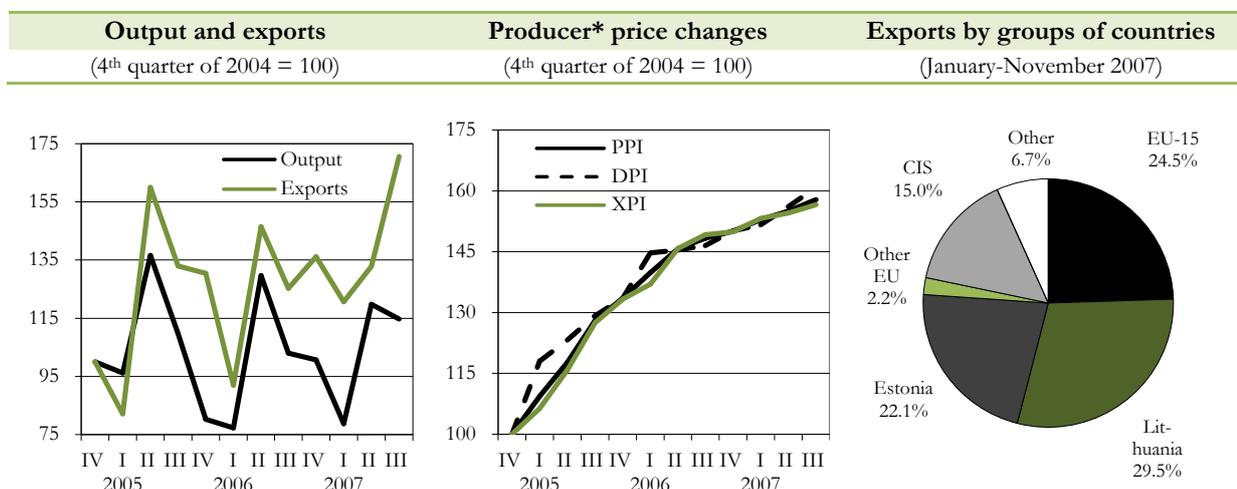


Majority of products of this sector is being exported. Export markets are distributed rather evenly in various sale directions – both to EU

member states, among them Lithuania and Estonia, and to CIS countries and other countries of the world.

Figure 3.39

**Production of Transport Vehicles**



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

The level of wages in the sector is comparatively high, and these wages have almost doubled over the last three years. However, the sector expands its production volumes due to good conjuncture (growth of export opportunities).

### 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 heating to national economy sectors, commercial consumers and population. A section of electricity is generated by Latvian HPPs and CHPs, whereas the rest is imported. Mainly the imported fuels (natural gas and oil) and local fuels (wood) are used in heat generation.

In 2006, the total energy consumption of Latvia was 205.94 PJ, and 67.9% of this consumption was ensured by imports of energy resources, mostly from

Russia (natural gas comprising 42%, heavy oil – 3%, other oil products – 46.8%, coal – 2.5%). Among local energy resources, wood was used the most (firewood, remainders of woodworking, wood chip, wood

briquettes and granules), comprising 24.1% of the total energy consumption. Share of the electricity generated by Latvian HPPs and wind power stations in the total energy consumption was 4.8 per cent.

Table 3.14

**Consumption of Energy Resources in Latvia<sup>1</sup>**  
(thousand tons of equivalent fuel – ktce<sup>2</sup>)

	2001	2002	2003	2004	2005	2006
<b>Energy resource consumption – total</b>	<b>6180</b>	<b>6226</b>	<b>6514</b>	<b>6648</b>	<b>6770</b>	<b>7026</b>
of which:						
natural gas	1999	2050	2138	2114	2155	2233
light fuel products and other oil products	1661	1717	1857	1950	1995	2231
heavy oil, oil shale	263	230	166	132	113	77
firewood, peat, coke and other types of fuel	1554	1537	1655	1719	1722	1724
coal	123	99	90	87	107	116
electricity (HPPs, wind generators and imported from abroad)	580	593	608	646	678	645

<sup>1</sup> Source: CSB and the Ministry of Economics.

<sup>2</sup> 1 ktce = 0.02931 PJ.

Volume of *electricity* generation depends directly on the flow of the Daugava River. Electricity imports from Russia, Estonia and Lithuania also play a rather substantial role in the electricity supply.

In 2006, the state JSC Latvenergo generated 59% of the required electricity, 34% was supplied by other

countries and 7% was purchased from small producers of electricity. In comparison with the preceding year, the electricity consumption has increased by approximately 4.8 per cent.

Table 3.15

**Electricity Supply in Latvia<sup>1</sup>**  
(billion kWh)

	2001	2002	2003	2004	2005	2006
<b>Total electricity supply</b>	<b>6.163</b>	<b>6.323</b>	<b>6.608</b>	<b>6.786</b>	<b>7.053</b>	<b>7.399</b>
<b>Electricity generation – total</b>	<b>4.280</b>	<b>3.975</b>	<b>3.975</b>	<b>4.689</b>	<b>4.905</b>	<b>4.891</b>
of which:						
HPPs <sup>2</sup>	2.801	2.433	2.216	3.044	3.267	2.661
CHPs <sup>3</sup>	1.246	1.238	1.363	1.225	1.278	1.740
other CHPs	0.198	0.263	0.298	0.306	0.255	0.407
small HPSs	0.032	0.030	0.050	0.065	0.058	0.037
wind generators	0.0034	0.011	0.048	0.049	0.047	0.046
<b>Imports of electricity</b>	<b>1.883</b>	<b>2.348</b>	<b>2.633</b>	<b>2.097</b>	<b>2.148</b>	<b>2.508</b>

<sup>1</sup> Source: state JSC Latvenergo, Ministry of Economics, CSB (Central Statistical Bureau)

<sup>2</sup> Daugava cascade and Aiviekste HPP (HPP of state JSC Latvenergo)

<sup>3</sup> CHP of state JSC Latvenergo

Consumption structure of the *centralised heat supply* has not changed in the recent years, with central heating comprising 65-70% and hot water supply constituting 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%). Riga region accounts for 80% of the total natural gas consumption in Latvia. Natural gas is not used 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 metalurģis”); 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 higher than 30%, including the share of heavy fuel in oil fuel balance constituting up to approximately 4%. The biggest consumers of heavy oil are heat supply (56.6%) and industry (22.6%). Complying with above-mentioned requirements of EU Directive 1999/32/EC, the Cabinet of Ministers has 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.

#### Box 3.1

Conclusions from the annual assessment report of Transmission System Operator on situation in the electricity supply of Latvia.

In August and September of this year when Ignalina Nuclear Power Plant was under annual planned repair, inter-system connections between Russia-Belarus and Belarus-Lithuania were seriously overloaded. It was due to the big volume of electricity supplies from Russia to Lithuania and Latvia as well as decreased electricity generation by 450 MW block of Kaliningrad owing to gas supply restrictions. There was a real threat that electricity supplies to Latvia might be reduced substantially and for a long time up to completion of repairs at the Ignalina NPP by order of Russian, Belarusian, or Lithuanian TSO.

Electricity supplies from Estonia (to ensure the supplies, all generation facilities are used, including the oldest ones) are unstable, as the outdated generating facilities in Narva power plants often switched off in an emergency. Sometimes, they have unpredictably decreased to 130-160 MW, which has created additional threat to service reliability in Latvia.

Taking into account that Lithuanian electricity producers will be unable to supply electricity to Latvia after 2009 and Estonian electricity producers will be unable to do this after 2012, and these energy systems themselves might be deficit ones even by use of the potential maximum imports from Finland through the ESTLINK direct current cable, the supplies from Russia limited due to carrying capacities of the network of energy systems of neighbouring countries may be insufficient to cover electricity deficit of all three countries.

Analysis of self-provision proves that, in the case of the scenario where construction of the second 400 MW block of Riga CHP-2 is planned and the forecasted electricity consumption in 2016 is covered at the level of 94%, shortage of generating capacity is essential and reaches 700 MW in 2012 and 600 MW in 2016. This shortage of generating capacity is justified by insufficiency of primary energy resources (mostly hydro resources) in particular time periods as well as by peculiarities of working conditions of cogeneration stations. In cases of load of transmission networks of neighbouring countries, deficit of the generating capacity placed in Latvia may lead to complete burnout of energy system followed by lasting energy crisis.

Latvia keeps building up oil product reserves. The total volume of oil product reserves is provided for 90 days, which is determined by EU Council Directive 98/93/EC of December 14, 1998, amending the Directive 68/414/EEC imposing an obligation on member states of the EEC to maintain minimum stocks of crude oil and/or oil products. Building up, storing, 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 state 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”, which 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 reserves 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 rather substantial and has reached 24.1%. The biggest consumers of firewood are households (62.8%), heat supply companies (14.8%), industry (mainly wood processing companies) and other consumers (22.4%). 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 Order No. 271 of April 28, 2004 of the Cabinet of Ministers “On Statistical Regions of the Republic of Latvia and Administrative Units Included therein”, Latvia was divided into six statistical regions (see Table 3.16).

There is a marked difference between Riga and other regions of Latvia in terms of economic activities (see Figure 3.40). Difference between other regions is not as pronounced. In 2005, the biggest part of Latvian GDP (57.3%) was produced in Riga. The second biggest region by contribution to GDP was Pierīga (11.1%).

Table 3.16

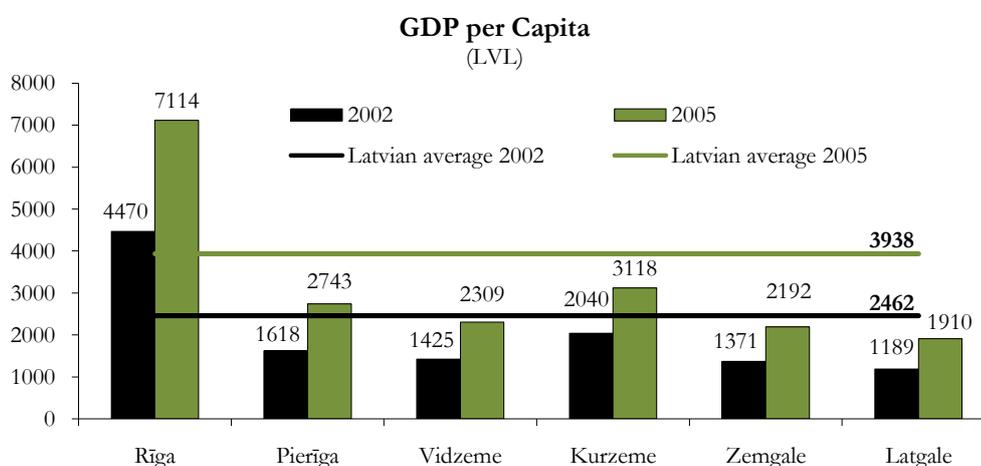
**Area, Population and Population Density  
of the Statistical Regions of Latvia  
at the Beginning of 2007**

	Area (% of the total)	Population (% of the total)	Number of inhabitants per km <sup>2</sup>
<b>Latvia</b>	<b>100</b>	<b>100</b>	<b>35.3</b>
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 2005, **GDP** per capita in Rīga was 1.8 times greater than in the country on average, while this indicator in Latgale amounted to mere 48.5% of the country average.

Over the period of 2003-2005, GDP per capita in Pierīga increased faster than in the country on average. The growth was almost equal in other regions, with the exception of Kurzeme.

Figure 3.40

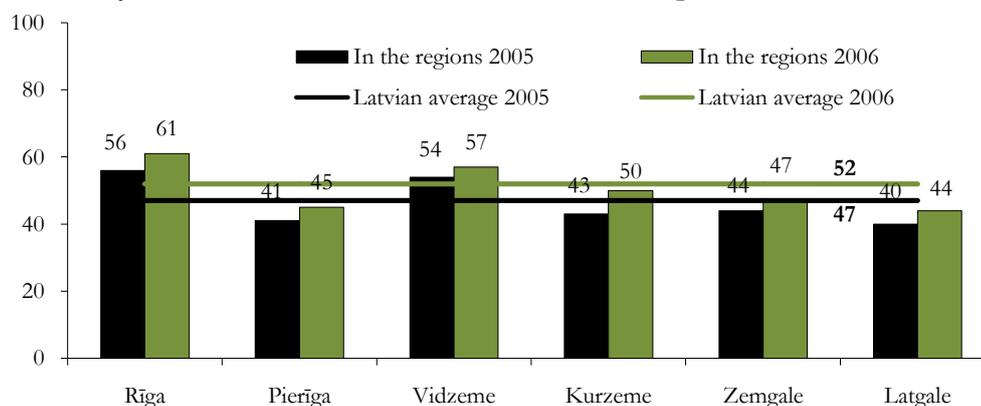


The **number of active statistical units** (self-employed persons, sole proprietors, commercial companies, agricultural and fishing farms) is growing gradually in Latvia. The number of active statistical units per 1000 inhabitants increased by about 5 units in 2006. This indicator is approximately the same in regions of Pierīga, Kurzeme, Zemgale and Latgale, amounting to 45-50 units per 1000 inhabitants. This

indicator is above the country average in Rīga and Vidzeme regions, although it should be noted that the level of active statistical units in Vidzeme region is higher mainly due to the big proportion of agricultural farms and self-employed persons. Contribution of these units to formation of GDP is markedly smaller than contribution of commercial companies.

Figure 3.41

**Economically Active Statistical Units\* of the Market Sector per 1000 Inhabitants in 2006\***

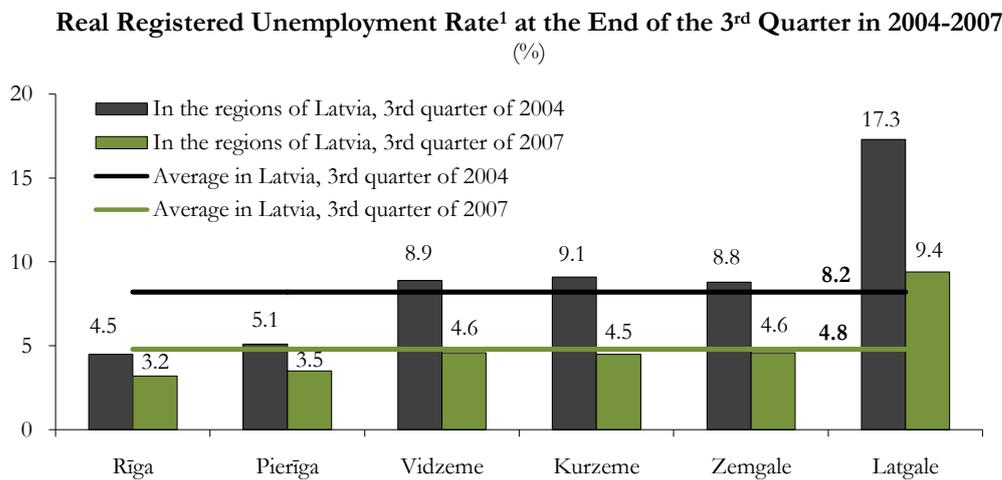


\* Statistical units of the market sector are: self-employed persons, sole proprietors, commercial companies, agricultural and fishing farms.

Decline of the **registered unemployment rate** was observed in the 3<sup>rd</sup> quarter of 2007. Demand for labour force increased substantially in the rapidly growing economy since accession to the EU thereby the unemployment rate fell to a record low level. During three years, the real registered unemployment rate decreased by 3.4 percentage points to 4.8% on

average in the country (see Figure 3.42). The registered unemployment rate in all statistical regions, with the exception of Latgale, was below 5% at the end of the 3<sup>rd</sup> quarter of 2007. However, it should be noted that also a significant number of emigrants has left an impact on the decrease of unemployment.

Figure 3.42

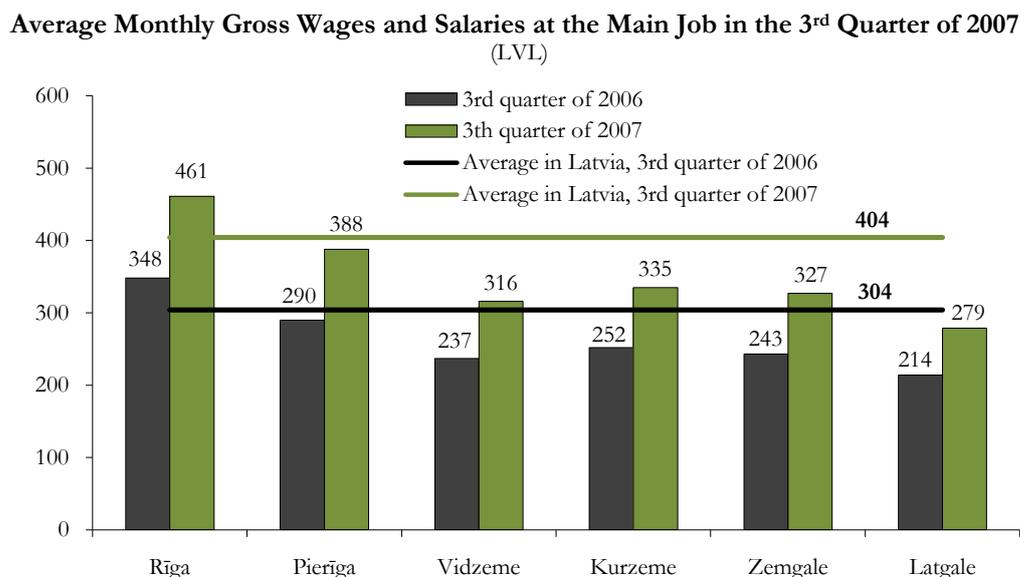


Unemployment rate in Latgale region remains high in comparison with other regions. In the 3<sup>rd</sup> quarter of 2007, it was higher than in other regions three years ago.

one-third higher than in the 3<sup>rd</sup> quarter of the previous year. Due to the breakthrough of 2007, the average gross wage has almost doubled over the last three years. The average growth in the country was 91.5%.

Wages kept growing rapidly in 2007 in all regions. Wages in the 3<sup>rd</sup> quarter of 2007 were on average by

Figure 3.43



<sup>1</sup> Share of the total available human resources in the economically active population in the age group of 15-74 years in the respective time period, with the exception of those who are not available to the labour market due to long-time involvement in active employment measures.

### 3.5. Forecasts

The Ministry of Economics has developed two scenarios of economic development forecasts for the medium-term period (until 2013): the moderate development scenario and the dynamic development scenario.

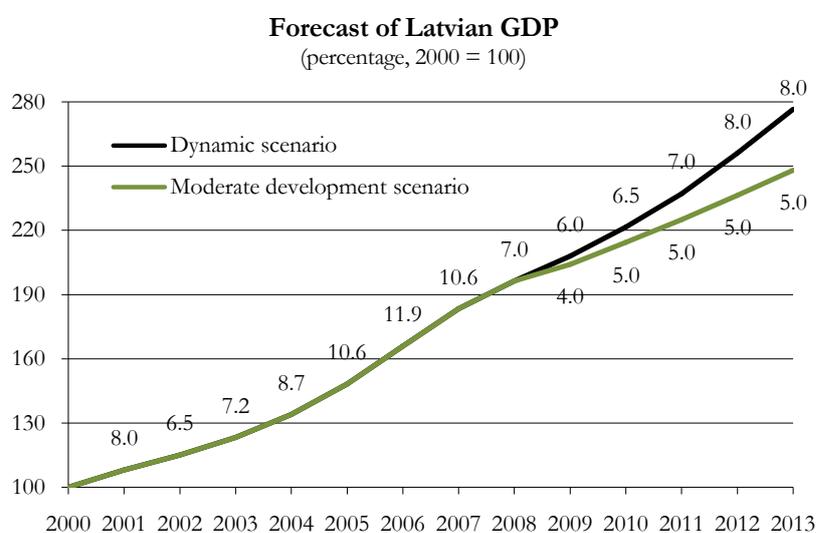
The two scenarios of economic development are formed in relation to alternatives of further economic growth. The current uncertainty of economic growth is linked with three main conditions that determine development:

- with how much success the economy will overcome those disproportions that formed

during the fast growth of previous 3 years (inflation, current account deficit of the balance of payments, much faster development of the service sectors directed to the domestic demand than growth of the export-capable sectors, especially rapid growth of home prices, etc.);

- how the processes in international financial markets will affect the capital price and the external demand of Latvia;
- impact of globalisation processes on competitiveness of Latvian industry.

Figure 3.44



The government's policy aimed at reduction of inflation (mainly reduction of the domestic demand) as well as the more moderate policy of commercial banks with regard to mortgage crediting and the processes in international financial markets will lessen the growth rate in 2008 and 2009. The question is to what extent will the domestic demand decrease and how much will it be possible to correct this process.

Both development scenarios worked out by the Ministry of Economics correspond to moderate and gradual decrease of the domestic demand. The dynamic growth scenario will come to be if Latvian manufacturing will regain the growth rates of 2004-2006, i.e., the decrease of growth of outputs in the sectors oriented to cheap labour and natural resources (light industry, wood processing, food industry) will start to be compensated with faster growth rates of other sectors, and outputs of manufacturing will increase on the whole.

There is a small probability that another scenario of development might come true, namely, the pessimistic scenario characterised by rapid decline of the domestic demand, which would be determined by inability of Latvia to overcome the existing disproportions and the negative processes in global financial markets. No

detailed forecasts are worked out for this growth scenario because there is a too big uncertainty in this case and probability of such development scenario is small, as mentioned before.

#### **Development prospects in 2008**

GDP growth rate in 2008 may be at the level of 7%, which would be assessed as optimal growth rate for level to be maintained in long term. Decline of the growth rate is mainly due to decrease of growth of the domestic demand (private consumption and investment) as outputs of construction go down and to growth of trade and commercial service sectors in comparison with the fast growth rates in the previous three years. It is forecasted that growth of manufacturing is being resumed.

Growth rates of investment and construction will fall to a smaller extent than the crediting will decline, as the growth of road construction and repair volumes will keep them at a relatively high level.

Private consumption and investment are forecasted to increase at almost the same pace as GDP; as a result, the growth of imports is not expected to be as fast as in the previous years.

Table 3.17

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

	2007	2008*	2009-2013 * (annual average)
<b>Gross domestic product</b>	<b>10.6</b>	<b>7.0</b>	<b>4.8 / 7.1</b>
Primary sectors	8.9	6.6	3.1 / 4.4
Manufacturing	0.4	2.1	4.8 / 7.8
Electricity, gas and water supply	5.3	6.1	4.0 / 5.0
Construction	13.3	8.4	4.9 / 7.7
Trade, hotels and restaurants	13.7	8.1	5.9 / 8.5
Transport and communications	10.0	9.1	5.9 / 9.3
Other commercial services	13.0	7.9	4.5 / 6.0
Public services	4.0	4.6	2.3 / 3.2

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

**Development prospects in 2009-2013**

The main risks to growth are associated with events in the international goods and financial markets and with adaptability of Latvian economy to essential changes in these markets.

Two trends that will maintain their importance in foreseeable future have clearly formed in the international financial markets at present, namely, cool-down of the real estate market and decline of access to credit resources. Accordingly, Latvia has to take into consideration that the period of cheap and easily available foreign capital (determined by lengthy cycle of low global interest rates, abundance of liquidity, high risk tolerance of investors, and search for profitability) is over, and price of the capital available to us in the future will be higher than previously. It is also necessary to reckon with the

global growth risks, as their materialisation might make Latvia to face a much poorer external demand and aggravation of price competition in the global product markets. These processes create significant challenges to further development of Latvia. On the one hand, export sectors will have to assume the role of driving force for growth in order to ensure healthy economic growth as the domestic demand declines. On the other hand, the previous competitiveness of industry was based on relatively cheap labour and low general costs but, as growth of labour costs continues domestically and the global price competition aggravates, the determinant role will be played by adequate rise of productivity and growth of complexity of export products, which would enable us to compete in the international markets much more successful.

Table 3.18

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

	2007 e		2008		2009-2013 * (annual average)	
	structure	growth rate	structure	growth rate	structure (in 2012)	growth rate
<b>Gross domestic product</b>	<b>100</b>	<b>10.6</b>	<b>100</b>	<b>7.0</b>	<b>100</b>	<b>4.8 / 7.1</b>
Private consumption	66.4	15.0	68.5	6.5	68.6 / 66.8	4.8 / 6.4
Public consumption	17.7	3.5	16.8	3.5	14.6 / 13.1	2.3 / 2.3
Gross fixed capital formation	35.3	13.5	35.1	7.5	34.0 / 32.6	5.1 / 6.4
Changes in inventories	3.4	–	2.2	–	4.6 / 4.3	–
Exports	42.8	9.4	43.6	10.0	45.8 / 47.3	5.7 / 8.6
Imports	-65.6	20.0	-66.2	12.2	-67.5 / -64.1	6.1 / 7.2
Export-import balance	-22.7	–	-22.6	–	-21.7 / -16.8	–

e – estimation by the Ministry of Economics

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

In both development scenarios, the growth rate may decrease a little more in 2009, considering the trends of decline of the external demand. The growth rate may increase as from 2010 if Latvian macroeconomic

stabilisation policy and the policy for capacity building and promotion of structural improvements of national economy (especially the sector of goods for trade) will be sufficiently effective.

## 4. MACROECONOMIC STABILITY

### 4.1. Public Finances

#### 4.1.1. Fiscal Policy and Public Debt

The fiscal policy implemented in Latvia is aimed at stable macroeconomic growth, simultaneously ensuring successful fiscal consolidation. In the previous periods, the main fiscal policy task defined by the government was progress towards formation of a balanced budget. Further improvement of the financial situation, which ensures surplus in the general government budget, is envisaged in the next planning period.

As Table 4.1 shows, the deficit of the sector of general government<sup>1</sup> in Latvia is lower than 3% of GDP allowed by the Maastricht Treaty. The balance of the general government budget tends to improve: the deficit of the general government budget was in amount of 1.6% of GDP in 2003, while it was mere

0.3% of GDP in 2006, as the financial situation improved gradually.

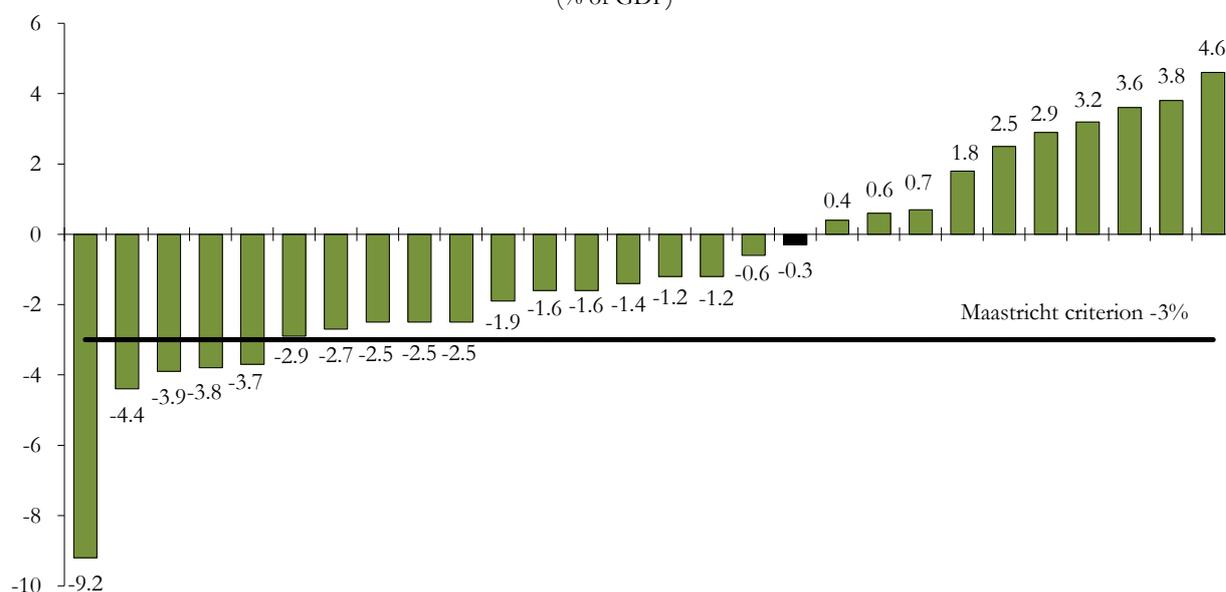
Table 4.1

General Government Budget						
	2003	2004	2005	2006	2007*	2008*
Revenues (million LVL)	2120.2	2583.2	3191.6	4165.5	5220.7	6279.2
(% of GDP)	33.2	34.7	35.2	37.0	37.3	36.1
Expenditures (million LVL)	2223.6	2659	3223.6	4196.4	5173	6168.7
(% of GDP)	34.8	35.8	35.6	37.3	36.9	35.5
Balance (million LVL)	-103.5	-75.8	-32	-30.8	47.7	110.5
(% of GDP)	-1.6	-1.0	-0.4	-0.3	0.3	0.6

\* forecast by the Ministry of Finance

Figure 4.1

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



HU IT PT PL SK CZ UK MT FR EL RO EU DE AT SI CY LT LV BE NL LU ES SE IE BG EE FI DK

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

As Figure 4.1 shows, the average level of the budget deficit in the EU was 1.6% of GDP in 2006

(2.4% of GDP in 2005, 2.8% of GDP in 2004). Fiscal balances improved in all EU member states (with the

<sup>1</sup> 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

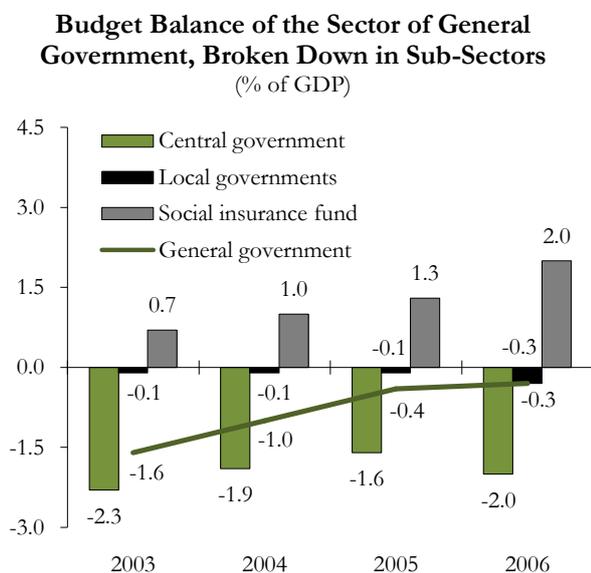
System of National Accounts are used. The indicators calculated according to this methodology are established according to the so-called principle of accrual basis, while the general government budget deficit calculated by the Ministry of Finance is established according to the cash principle, and that is why they slightly differ.

exception of Italy, Hungary, Romania, Slovakia and Lithuania) in 2006. The most extensive general government deficits as percentage of GDP were recorded in Hungary (-9.2%), Italy (-4.4%), Portugal (-3.9%), Poland (-3.8%) and Slovakia (-3.7%) in 2006. 10 EU member states had general government surplus in 2006, and the biggest surpluses as percentage of GDP were in Denmark (+4.6%), Finland (+3.8%), Estonia (3.6%) and Bulgaria (3.2%).

The general government budget deficit is mostly determined by deficit of the central government budget (see Figure 4.2). Financial situation of the social insurance budget has essentially improved in the recent years: surplus in said budget was 0.7% of GDP in 2003 but it reached 2% of GDP in 2006.

Over the recent years, the budget balance of local governments has substantially been affected by construction of the Southern Bridge in Riga; its costs in 2007 are planned in amount of 0.4% of GDP.

Figure 4.2



The Saeima approved the state budget for 2007 with a fiscal deficit in amount of 1.3% of GDP. However, in September 2007, the Saeima made amendments to the Law "On the State Budget for 2007", envisaging a surplus in amount of 0.4% of GDP. Provisional data show that 2007 is concluded with a budget surplus of LVL 94 million or 0.8% of GDP.

The Saeima has accepted the state budget for 2008 with a surplus of LVL 163 million or 1% of GDP<sup>2</sup>. Budget with a surplus is also planned in further years – a surplus in amount of 1.2% of GDP in 2009 and 1.5% of GDP in 2010.

**The state budget for 2008** is formed as an austerity budget, restricting expenses to the utmost and freezing increases of wages and staff units at institutions. In order to limit fast growth of wage for

the employed in the public sector, on September 25, 2007 the Cabinet of Ministers took a decision not to increase the wage fund in 2008 for public direct administration institutions with the exception of those where the average payment for work is lower than the average payment for work of public direct administration institutions (LVL 400 per month), as well as for teachers, medical staff, cultural workers and officials with special service ranks.

In order to ensure rational use of budget resources of local governments, the central government has agreed with the *Latvian Association of Local and Regional Governments* that local governments resolve to form an accumulation of financial resources in 2007 and use it in 2008 for fulfilment of functions set forth in normative acts.

The Cabinet of Ministers has resolved, as from 2008, to transfer 80% of personal income tax revenues to the local government budgets (instead of the current 79%) and 20% of these revenues to the state budget in order to compensate local governments for the decline of growth rate of personal income tax revenues; this decline will occur due to rise of the non-taxable minimum not subject to personal income tax (from the current LVL 50 per month to LVL 80) and increase of the tax allowance for dependent persons (from the current LVL 35 per month to LVL 56) as from 2008.

After recommendation of the National Tripartite Co-operation Council, the Cabinet of Ministers has determined that the minimum monthly wage is to be raised to LVL 160 as from January 1, 2008. Such increase of the minimum monthly wage will create a non-essential pressure on the growth of the average wage because, in the current conditions when competition in the labour market has increased considerably, growth dynamics of the average wage is ever less determined by the volume of minimum monthly wage and the determinant role is played by other factors.

The state budget for 2008 introduces a new instrument of the fiscal policy – the **long-term stabilisation reserve**, in order to:

- reduce general economic risks,
- ensure financing for long-term investment and structural reforms,
- avoid a social economic crisis or lessen it,
- ensure resources in case of emergency.

It is planned to include the central government basic budget revenues exceeding those set forth by annual budget law as well as privatisation revenues into the reserve. The Cabinet of Ministers upon a proposal by the Minister of Finance decides on utilisation of the reserve resources.

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

<sup>2</sup> General government budget deficit according to the cash accounting principle.

**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”. The concept prescribes that, as from 2008, introduction of medium-term planning of the state budget is started, envisaging preparation of a medium-term budget framework constituted by the law on budget for one year and the maximum permissible amount of expenditures distributed to ministries for two years.

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 Order No. 157 of March 21, 2007 of the Cabinet of Ministers “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 established in the *Latvian National Development Plan*:

- creation of a knowledge-based society;
- balanced and sustained 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.

In order to ensure utilisation of state budget resources in accordance with the prescribed goals and in order to ensure rational use of these resources, the Ministry of Finance in co-operation with the State Chancellery has prepared draft “Guidelines on the System of Results and Performance Indicators”. The system of results and performance indicators provides an opportunity to measure the degree of attainment of goals and to correct action in case of necessity (by increasing or decreasing investment) so as to meet society’s needs as completely as possible. It gives support information in order to inform the government on validity of policy financing volumes and provide utmost objective information on the necessary investments, as well as the achievements. The results and performance indicators give an idea of the quality of public services provided by public administration bodies and of the volume of provided services.

The guidelines prescribe introduction of two policy assessment periods – pre-assessment and post-assessment. Pre-assessment of the policy of public administration body is implemented during development of the policy-planning document, while post-assessment of the policy is performed after implementation of the policy-planning document.

The level of the **general government debt** (according to the methodology of the ESA 95 European System of National Accounts) in Latvia is the third lowest in the EU (see Figure 4.3). In 2006, the EU average level of the general government debt was 61.4% of GDP (62.7% of GDP in 2005, 62.1% of GDP in 2004). General government debts exceeded

the Maastricht criterion (i.e., 60% of GDP) in ten EU member states in 2006. In 2006, the highest general government debts in percentage of GDP were recorded in Italy (106.8%), Greece (95.3%) and Belgium (88.2%), while the lowest ones were registered in Estonia (4%), Luxembourg (6.6%) and Latvia (10.6%).

Figure 4.3

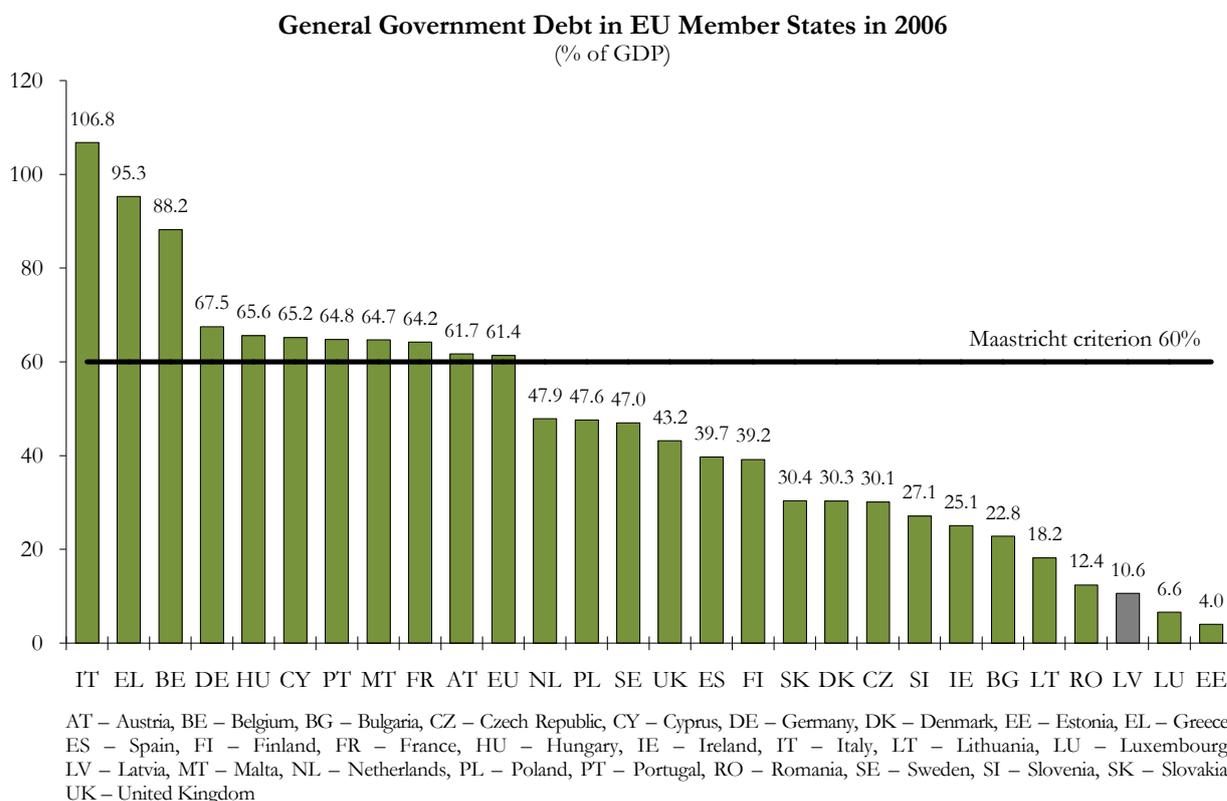
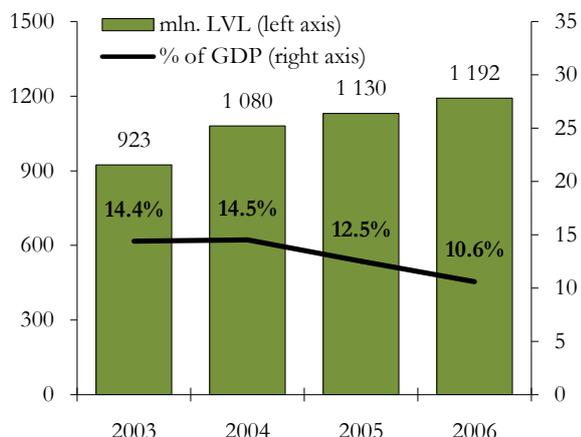


Figure 4.4

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



In the last years, the general government debt in Latvia has increased from LVL 923 million at the end of 2003 to LVL 1192 million at the end of 2006, while it has decreased in percentage of GDP from 14.4% to 10.6% of GDP respectively (see Figure 4.4).

The fiscal policy implemented in Latvia is aimed at creation of surplus in the state budget, so, the level of the general government debt in medium term is foreseen to remain considerably below the debt volume criterion (60% of GDP) set by the Maastricht Treaty.

The level of the general government debt is mainly affected by the central government debt that amounted to LVL 998.3 million and constituted 90.8% of the general government debt in 2006 (see Table 4.2).

Table 4.2

### Development of Public Debt in 2006-2010\*

	2006	2007	2008	2009	2010
	actual data		forecast		
<b>General government debt, by national methodology (accounting value/consolidated), million LVL</b>	<b>1061.1</b>	<b>1098.9</b>	<b>1290.3</b>	<b>1295.1</b>	<b>1301.7</b>
% of GDP	9.4	7.8	8.2	7.2	6.4
<b>Central government debt (accounting value/consolidated), million LVL</b>	<b>962.3</b>	<b>998.3</b>	<b>1189.8</b>	<b>1194.5</b>	<b>1201.2</b>
% of GDP	8.5	7.1	7.5	6.6	5.9
Internal debt, million LVL	421.7	418.1	426.0	448.1	468.2
External debt, million LVL	540.7	580.3	763.8	746.4	733.0
<b>Central government debt servicing costs, million LVL</b>	<b>52.8</b>	<b>57.0</b>	<b>77.3</b>	<b>79.0</b>	<b>80.0</b>
Internal debt servicing costs	25.7	30.3	32.0	44.1	45.9
External debt servicing costs	27.1	26.7	45.3	34.9	34.1

\* data of the Ministry of Finance

For financing of the state budget execution and refinancing of the central government debt, the state attracts resources both from the internal and external capital markets, using a variety of financial instruments.

Issuance of Eurobonds<sup>1</sup> is the most effective instrument for attracting extensive volume of resources, increasing volumes of the current issues or issuing new ones. Issuance of Eurobonds is planned in the 1<sup>st</sup> half of 2008. 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.

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 concerning GDP and will decrease to approximately 6% 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 medium term, it is forecasted that also the general government debt in medium term will show a similar trend, not exceeding 7% of GDP in 2010.

<sup>1</sup> 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).

### 4.1.2. Budget Revenues

As the rapid economic growth continued in 2007, also the total revenues of the sector of general government increased and amounted to LVL 5378 million or 38.2% of GDP in 2007. The revenues have increased by 33.9% in comparison with 2006.

Tax revenues constitute approximately 80% of the total budget revenues. Non-tax revenues relate to revenues from paid services, foreign financial assistance, revenues transferred to the state budget from dividends for use of the state capital (the biggest

payers were SJSC “Latvijas valsts meži”, LLC “Lattelecom” and SJSC “Latvenergo”), various state fees (the biggest revenues were from the fee for corroboration of ownership rights and collateral rights in the land register and from the fee for conduction of legal actions), collected fines and revenues from interest payments for loans. Non-tax revenues in the local government budget are mainly payments for issuance of various licences, revenues from entrepreneurship and property, payments for educational services and public utilities, etc.

Table 4.3

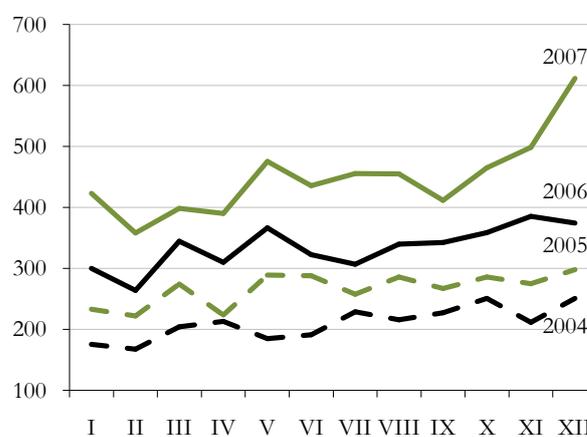
<b>Budget Revenues</b> (% of GDP)				
	2004	2005	2006	2007 e
<b>General government sector revenues</b>	<b>33.9</b>	<b>35.3</b>	<b>35.6</b>	<b>38.2</b>
<b>I Tax revenues</b>	<b>27.2</b>	<b>28.1</b>	<b>29.3</b>	<b>31.0</b>
1. Indirect taxes	9.9	11.2	11.8	11.9
– value added tax	6.5	7.5	8.3	8.5
– excise tax	3.2	3.5	3.3	3.2
– customs duties	0.2	0.2	0.2	0.2
2. Income taxes and property taxes	8.4	8.3	8.7	9.7
– corporate income tax	1.7	2.0	2.3	2.8
– personal income tax	5.9	5.6	5.8	6.3
– real estate tax	0.8	0.7	0.6	0.5
3. Social security contributions	8.6	8.3	8.5	9.0
4. Other taxes	0.3	0.3	0.3	0.4
<b>II Non-tax revenues</b>	<b>6.7</b>	<b>7.2</b>	<b>6.3</b>	<b>7.2</b>

e – estimation by the Ministry of Economics

Tax revenues keep growing faster than GDP. In 2007, tax revenues amounted to LVL 4363 million or by 30.6% more than in the previous year. Growth of tax collection was ensured most essentially by increases of the value added tax collection (contribution to the total growth of tax collection – 8.2 percentage points) and of the social security contributions (by 7.9 percentage points) as well as personal income tax revenues (by 6.9 percentage points). The main factors determining the rapid growth of tax revenues were the growing private consumption, inflation and increase of payment for work.

Tax revenues of the state basic budget on average were slightly higher than the ones planned at the beginning of the year.

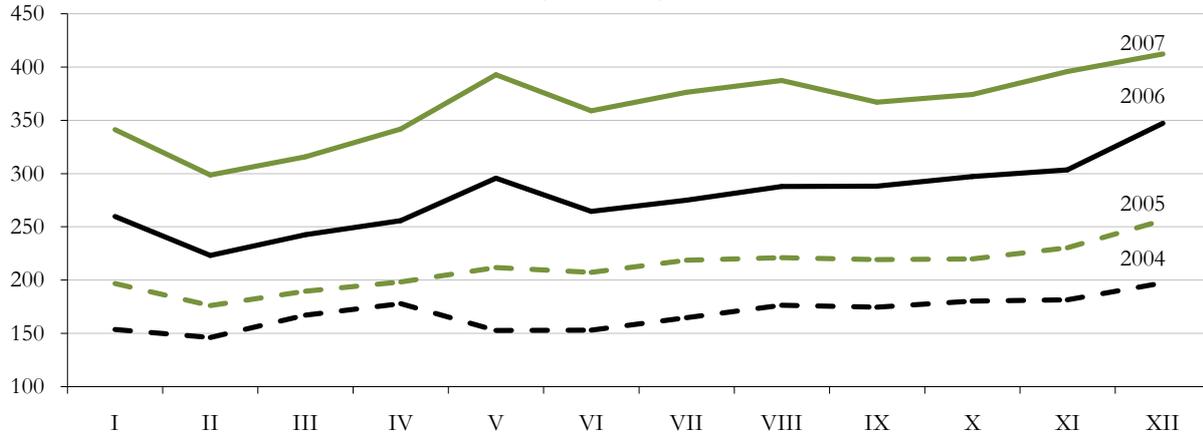
Figure 4.5  
**General Government Consolidated Budget Revenues by Months\***  
(million LVL)



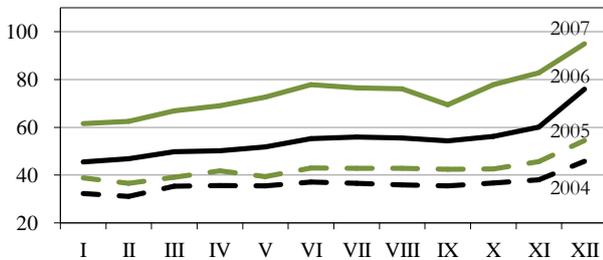
\* according to official data of monthly reports of the Treasury

Figure 4.6

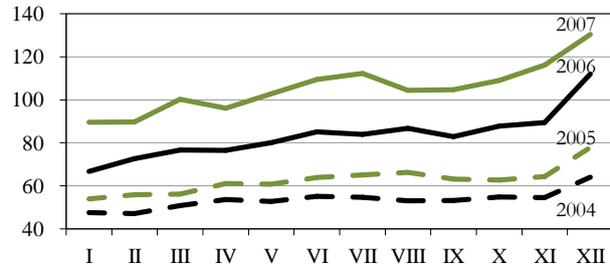
**Tax Revenues by Months\***  
(million LVL)



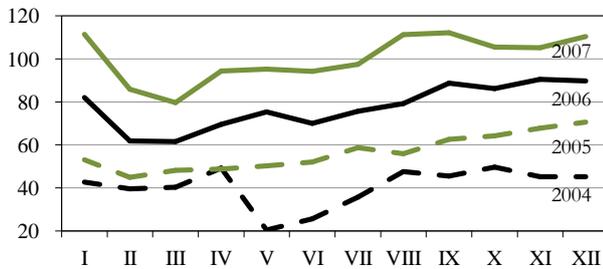
**Personal income tax**



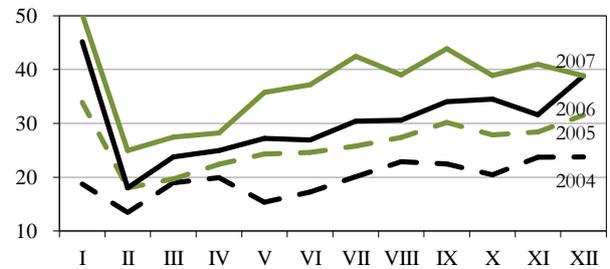
**State social security contributions**



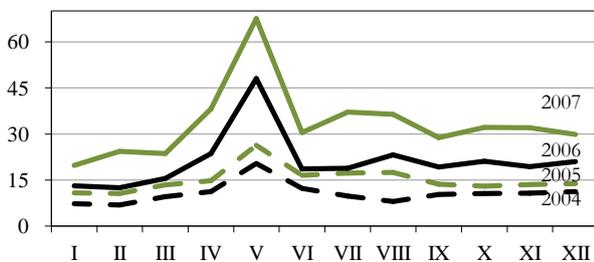
**Value added tax**



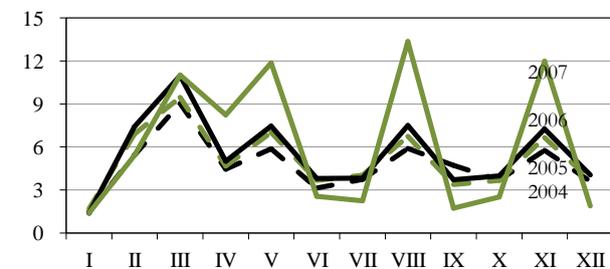
**Excise tax**



**Corporate income tax**



**Real estate tax**



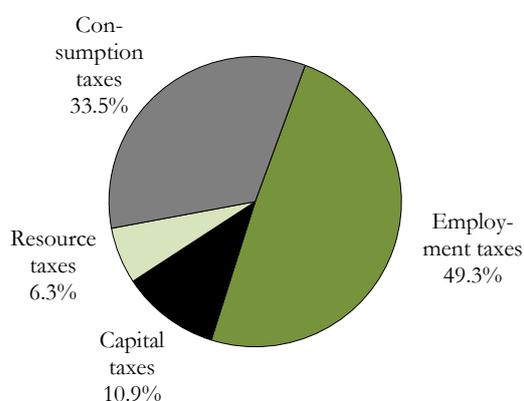
\* according to official data of monthly reports of the Treasury

Almost a half of the total tax revenues is made up by **employment taxes** (social security contributions and personal income tax). The rapid growth of collection of employment taxes in 2007 was due to the increase in

wages. Revenues from social security contributions in 2007 amounted to LVL 1264.9 million (increase by 32%), while personal income tax revenues amounted to LVL 887.9 million or by 35.1% more than in 2006.

Figure 4.7

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



The second biggest tax group is **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 80% of the total collection of consumption taxes.

The ever growing domestic demand and high inflation rate in 2007 were the main factors that fostered increase in collection of value added tax. Value added tax was collected in amount of LVL 1202.9 million in 2007, exceeding the collection of this tax in 2006 by 29.3%. Rise of revenues from the consumption component of excise tax in 2007 (by 23.4%) was affected by increased consumption of excise goods and rise of excise tax rates.

Revenues from the tax on cars and motorcycles have increased very rapidly over the last years; however, as activity in the market of new and used cars decreased, growth rates of revenues of this tax slowed down, as these revenues increased by 43.9% in 2006 and by mere 22.1% in 2007 in comparison with the preceding year.

Corporate income tax and real estate tax are included in the **group of capital taxes**. Rapid growth of corporate income tax revenues, which has been habitual in the last years, continued in 2007. Corporate income tax was collected in amount of LVL 399.8 million in the previous year, which is by 57.5% more than in 2006.

Real estate tax revenues amounted to LVL 74.2 million in 2007, which is only by 11.9% more than in 2006. This is partly 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. Procedure

for calculation of the tax on buildings is also changed. Much more pronounced seasonal fluctuations of real estate tax revenues than observed up to now were characteristic in 2007.

The group of **resource taxes** comprises the excise tax on oil products, natural resource tax and electricity tax. The share of these taxes in the total tax revenues has slightly decreased in comparison with 2006.

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 amounted to LVL 263.2 million in 2007, exceeding the volume of the preceding year by 21.6%. This was mainly due to increased consumption of oil products and growth of the excise tax rate.

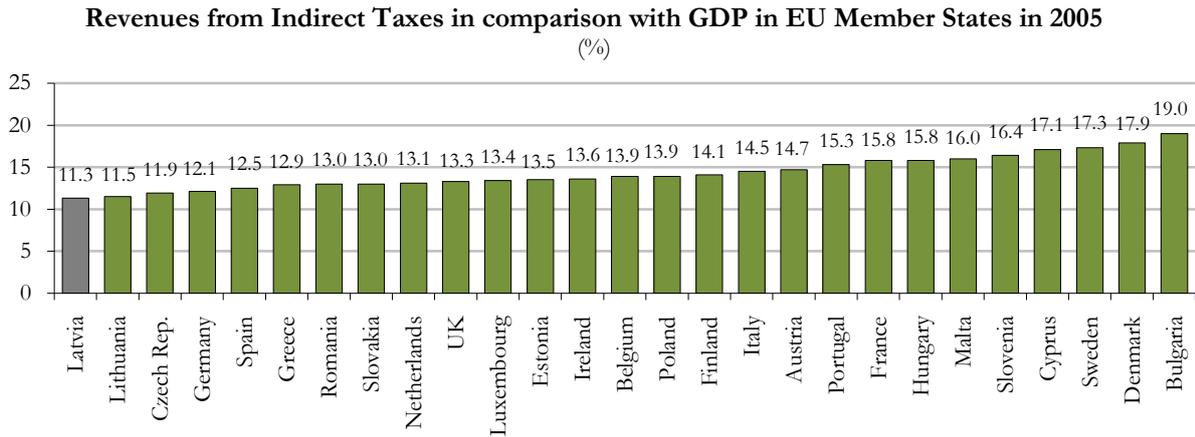
Other resource taxes have a very small proportion in the total collection of taxes. Natural resource tax was collected in amount of LVL 10.2 million in 2007, which was slightly less than in 2006, while the electricity tax introduced as from January 1, 2007 was collected in amount of LVL 95 thousand.

**Tax policy in the European Union** is still under competence of each member state but the EU supervises whether national tax systems are compatible with EU goals and do not hinder free movement of goods, capital and services. These conditions mainly pertain to indirect taxes, i.e., value added tax (VAT), excise tax and customs fees.

At present, the VAT rate in Latvia is 18%, which is among the lowest in the EU. The reduced tax rate in Latvia is 5%. EU prescribes that the minimum VAT rate is 15% as well as one or two reduced rates not less than 5% may be applied. EU directives strictly establish those goods and services to which the reduced tax rate may be applied. VAT rates are the same in all three Baltic States, i.e., the standard rate of 18% and the reduced rate of 5%.

EU directives also determine the basic principles for application of the excise tax and the goods to which the excise tax is applied. In accordance with the above-mentioned directives, the excise tax is applied on oil products, alcoholic beverages, beer, and tobacco products. A directive also determines the procedure for payment of the excise tax and general exemptions of the excise tax. EU legal acts set forth only the minimum excise tax rates, and member states are competent to set excise tax on other goods as well in their territory. During accession to the EU, the procedure on how the excise tax rates in Latvia will be approximated to the rates set by the EU was strictly determined. Therefore, it is expected that the tax rates on oil products, alcohol, and tobacco products will increase considerably in the nearest years, resulting in increased prices of these products.

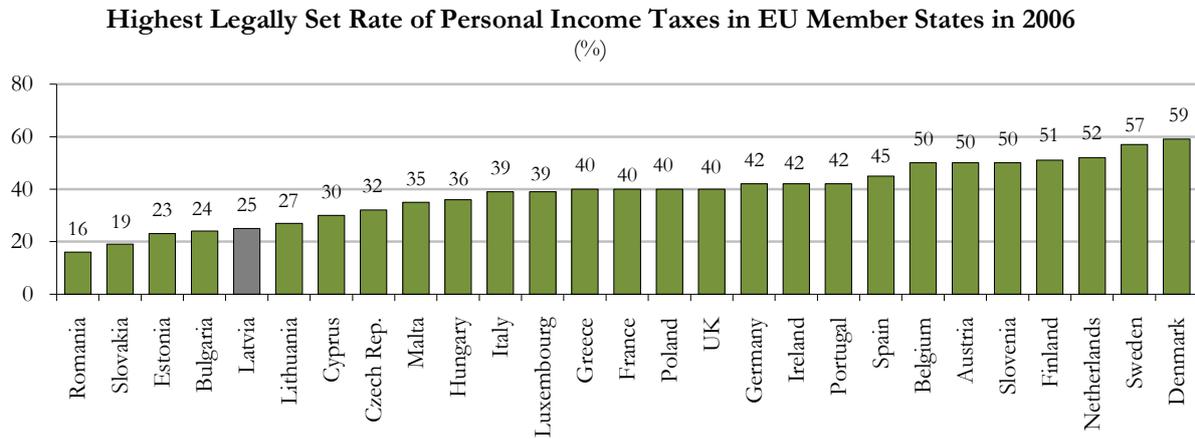
Figure 4.8



According to the legal acts that are in force in EU, member states are not subject to any restrictions regarding corporate income tax and real estate tax.

Member states are competent to apply different tax rates for different taxpayers.

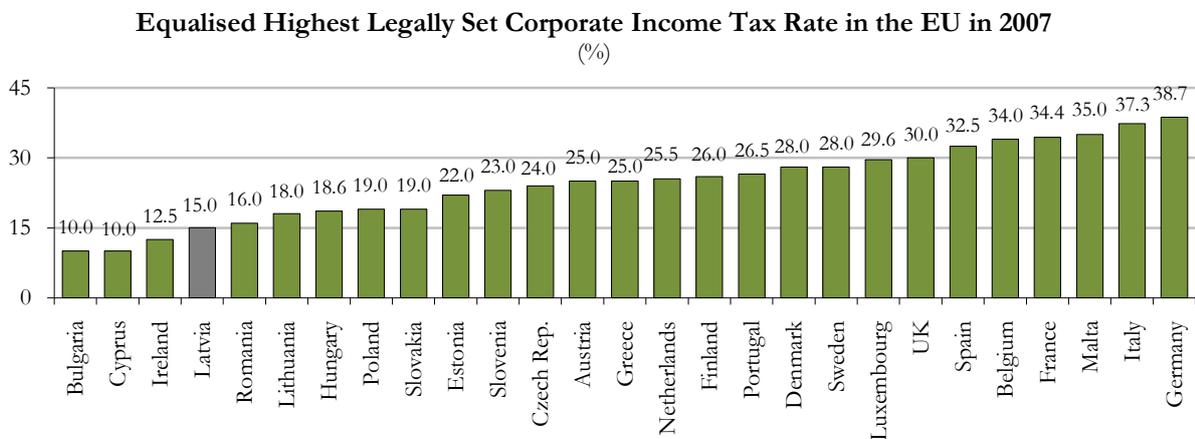
Figure 4.9



Rates of indirect taxes (personal income tax, corporate income tax, real estate tax) in Latvia are

among the lowest in the EU.

Figure 4.10



Comparison of personal income tax rate with the one applied in EU member states is complicated because majority of the states have differentiated tax

rates. Reduction of personal income tax would not solve the big problems of Latvian economy. By reduction of personal income tax rate, the budget

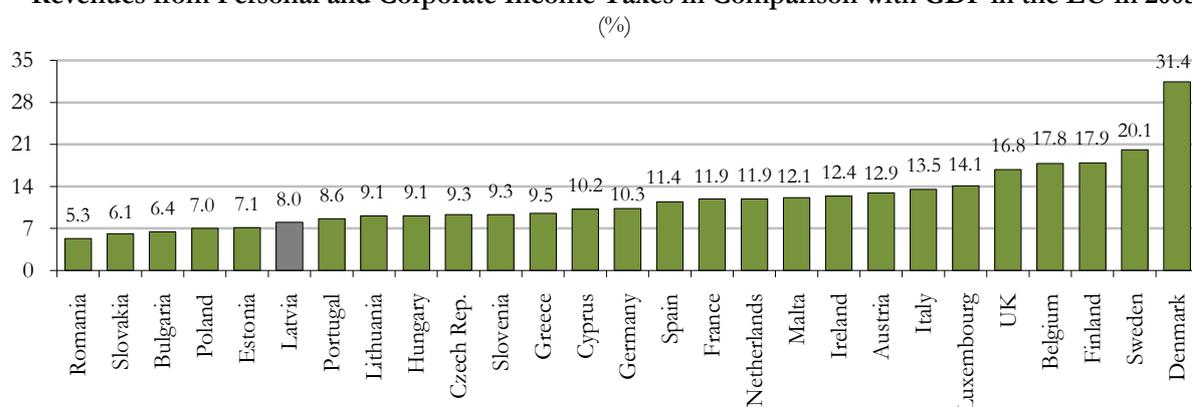
would lose considerable resources; furthermore, by compensating the tax reduction with increase of other taxes, concentration of budget resources in the state budget would take place because, at present, 75% of personal income tax goes to local government budgets. Reduction of personal income tax would foster a more significant disproportion in distribution of income of population, as inhabitants with high income would be the biggest winners from this reduction. Considerable rise of the non-taxable minimum might be a solution (non-taxable minimum amounts to mere LVL 80 at present). Rise of the non-taxable minimum would benefit inhabitants with low income the most.

It is important to review the forms of income not subject to personal income tax, such as real estate

transactions and dividends taken from a company, because the dividends are taken by natural persons who are privileged in comparison with employed persons, as they pay only 15% of the income. This would ensure additional revenues in the budget and would prevent the situation that one sector (real estate market) had a lasting advantage in comparison with other sectors because, in this sphere up to now, nothing was done in order to apply the tax on the revenues from sale of real properties. Up to now, this system had adverse effects on distribution of investment by sectors as the real estate speculations were more advantageous than investment in development of production.

Figure 4.11

#### Revenues from Personal and Corporate Income Taxes in Comparison with GDP in the EU in 2005



Particularly low share of capital taxes both in the total collection of taxes and as percentage of GDP is observed in Latvia, and the latter is the 2<sup>nd</sup> lowest in the EU.

Corporate income tax rate in the new EU member states (19.1% on average) is considerably lower than the rate in EU-15 countries (28.9% on average). Corporate income tax rate in Latvia is among the lowest in the EU but in majority of EU member states,

corporate income tax rates are differentiated, e.g., reduced rates for SME, etc. By differentiating corporate income tax rates, the state gets at its disposal a mechanism how to stimulate companies, e.g., to promote innovation, production of new products, research, etc. It is difficult to implement the mentioned tax incentives in Latvia, keeping the tax rate constant.

Figure 4.12

#### Revenues from Capital Taxes in Comparison with GDP in EU Member States in 2005

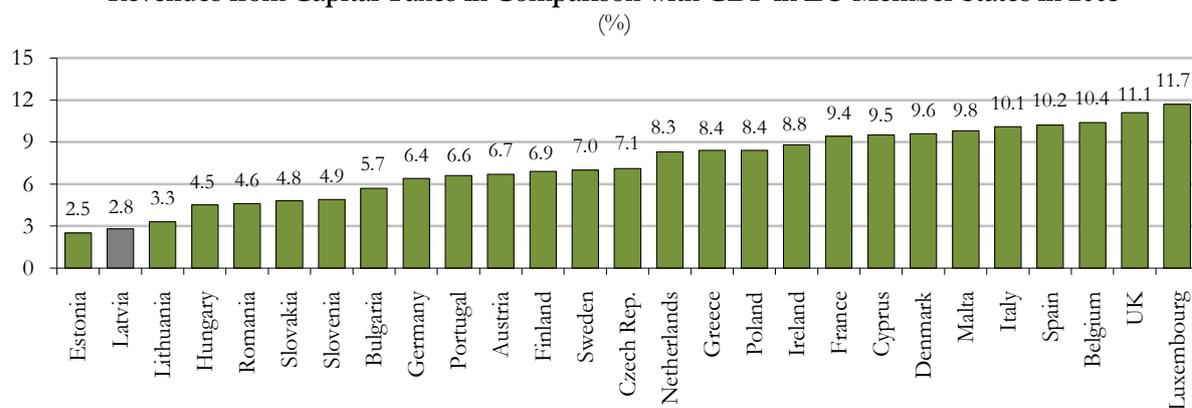


Table 4.4

**Tax Revenues by Tax Groups in the EU in 2005, According to the ESA95 Methodology**  
(%)

	Structure			Against GDP		
	Consumption taxes	Employment taxes	Capital taxes	Consumption taxes	Employment taxes	Capital taxes
Austria	28.9	55.3	15.8	12.1	23.3	6.7
Belgium	24.9	52.3	22.8	11.3	23.8	10.4
Bulgaria	51.3	33.0	15.7	18.4	11.8	5.7
Czech Republic	31.4	49.2	19.4	11.4	17.8	7.1
Denmark	31.8	49.2	19.0	16.1	24.8	9.6
France	25.7	53.0	21.3	11.4	23.3	9.4
Greece	34.9	40.8	24.3	12.0	14.1	8.4
Estonia	41.9	50.2	7.9	12.9	15.4	2.5
Ireland	37.1	34.2	28.7	11.4	10.5	8.8
Italy	24.8	50.3	24.9	10.1	20.4	10.1
Cyprus	41.4	31.8	26.8	14.7	11.3	9.5
<b>Latvia</b>	<b>42.1</b>	<b>48.3</b>	<b>9.6</b>	<b>12.4</b>	<b>14.2</b>	<b>2.8</b>
United Kingdom	30.9	39.0	30.1	11.4	14.4	11.1
Lithuania	37.8	50.6	11.6	10.9	14.6	3.3
Luxembourg	28.5	40.8	30.7	10.9	15.6	11.7
Malta	40.9	31.3	27.8	14.4	11.1	9.8
Netherlands	31.8	46.5	21.7	12.1	17.7	8.3
Poland	35.4	40.2	24.4	12.2	13.9	8.4
Portugal	37.5	43.1	19.4	12.8	14.7	6.6
Romania	44.4	39.1	16.5	12.4	11.0	4.6
Slovakia	41.7	42.2	16.1	12.5	12.6	4.8
Slovenia	34.5	53.5	12.0	13.9	21.7	4.9
Finland	31.2	53.1	15.7	13.7	23.3	6.9
Spain	27.2	44.6	28.2	9.8	16.1	10.2
Hungary	37.7	50.7	11.6	14.6	19.6	4.5
Germany	26.1	57.4	16.5	10.1	22.3	6.4
Sweden	25.5	60.8	13.7	13.1	31.2	7.0
<b>EU-27 average</b>	<b>34.3</b>	<b>46.1</b>	<b>19.8</b>	<b>12.6</b>	<b>17.5</b>	<b>7.4</b>

Essential opportunity to increase revenues from capital taxes is provided by rise of the real estate tax. At present, the amount of this tax to be paid is disproportionately low, besides the share of this tax in the total revenues from taxes decreases every year notwithstanding the high activity in the real estate market and construction in the recent years. Legislation would prescribe a wide range of the tax rate, applying the principal increase of the tax to exclusive properties, while the increase of the tax in the production sphere (agriculture, territory of industrial enterprises) would not essentially affect the costs of entrepreneurs.

The main problem of Latvian tax system is the fact that a significant part of income in the economy is not subject to taxes at all or is disproportionately low at present. This does not encourage attraction of resources in the production sectors.

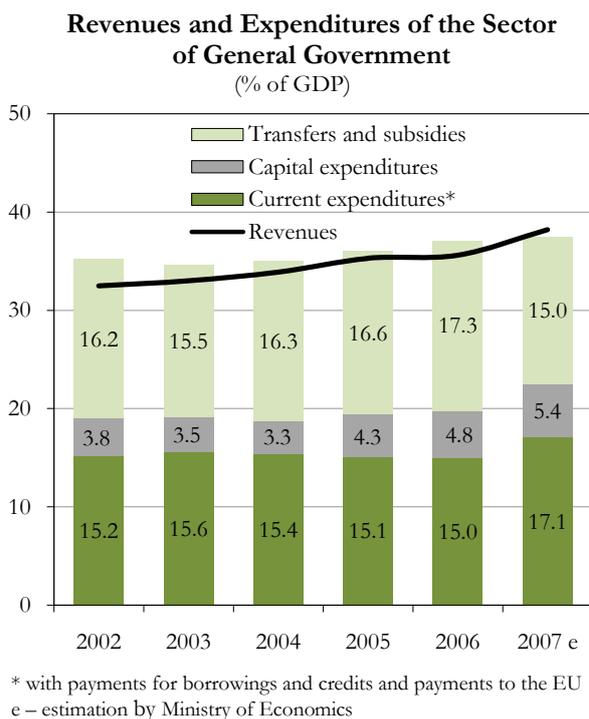
### 4.1.3. Budget Expenditures

General government expenditures amounted to LVL 5283.9 million (37.5% as percentage of GDP) in 2007, which was by 29.8% more than in the previous year.

The main shares in the government expenditures consisted of the current expenditures (46%) and transfers to the private sector (40%). Transfer expenditures contain subsidies for population (pensions, allowances, grants) and for institutions and organisations, while labour costs make up about half of the current expenditures.

In 2007, capital expenditures and current expenditures increased most rapidly (by 43.8% and 39.8% respectively), while transfer expenditures grew at a slower pace (by 8.8%). Growth of current expenditures is explained mostly by the increased pay for work of public sector employees, while the rapid growth of capital investment is related to absorption of EU structural funds resources, i.e., the state co-funding for implementation of various infrastructure projects.

Figure 4.13



The most significant shares in the total expenditures regarding government functions in 2006

were made up by social security and education, while the fastest growth was observed in expenditures for management of municipal areas and housing (by 115.6%) and for recreation, culture and religion (by 64.3%).

Figure 4.14

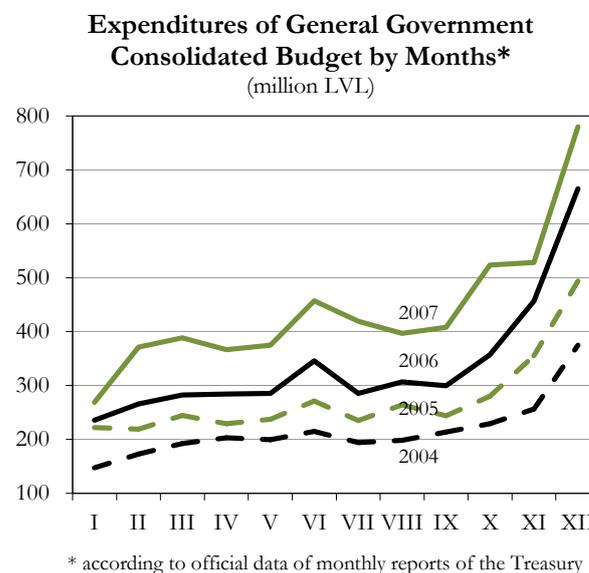


Table 4.5

**Expenditures of the Sector of General Government Regarding Government Functions**  
(percentage)

	2005		2006		2007 e	
	structure	of GDP	structure	of GDP	structure	of GDP
<b>Expenditures – total</b>	<b>100</b>	<b>35.6</b>	<b>100</b>	<b>37.3</b>	<b>100</b>	<b>38.5</b>
General government services	14.6	5.2	16.2	6.0	14.1	5.4
Defence	3.5	1.2	3.8	1.4	3.7	1.4
Public order and safety	5.8	2.0	5.9	2.2	6.2	2.4
Economic activity	13.1	4.7	16.0	6.0	16.6	6.4
Environmental protection	2.3	0.8	2.7	1.0	2.4	0.9
Management of municipal areas and housing	1.9	0.7	2.1	0.8	3.7	1.4
Health	10.8	3.8	7.6	2.8	8.8	3.4
Recreation, culture, and religion	3.4	1.2	3.3	1.2	4.2	1.6
Education	17.2	6.1	16.7	6.2	19.8	7.6
Social security	27.4	9.8	25.7	9.5	20.6	7.9

e – estimation by the Ministry of Economics

Spending of financial resources in 2007 mostly pertains to such government priorities as rise of the minimum wage, state defence and NATO membership, increase of state assistance for families with children, rise of wages of judges and court employees, increase of wages to dramatic artists, allocation of additional resources to the healthcare system, further rise of wages of employees with special service ranks of institutions in the system of the Ministry of the Interior, payment of allowances and compensations, indexation of old age pension payments, establishment of the Office of the Ombudsman, rise of competitiveness of higher

education, subsidies to various forms of passenger transportation, transportation of particular categories of passengers with preferential prices, compensation for reduction of real estate tax revenues for local governments, etc. Along with meeting the social needs, also development of national economy was ensured, envisaging a considerable share of resources for investments in national economy and absorption of resources from EU funds.

In accordance with classification of expenditures by economic categories, the principal share in financing the state basic budget expenditures in 2008 is envisaged for maintenance expenditures. It is

envisaged to channel more than a half of current expenditures to remuneration. Expenditures for remuneration will increase by 16.6% or LVL 128.3 million in 2008 in comparison with 2007. The increase is planned in order to ensure rise of the minimum monthly wage from LVL 120 to LVL 160 as from January 1, 2008, rise of wages in state direct administration institutions, where the average salary of employees is lower than the average salary of employees of state direct administration institutions (LVL 400 per month), increase of wages by 10% for officials with special service ranks, wages of teachers, cultural workers, judges, and court employees, etc. The second major expenditure item in maintenance expenditures is subsidies and social benefits, to which LVL 1535.5 million or 40.6% of maintenance expenditures is envisaged. The amount of these expenditures is increased in 2008 in comparison with 2007. The most substantial increase is constituted by expenditures for healthcare, projects co-financed from the EU structural funds and Cohesion Fund, state social benefits, etc. LVL 438.3 million or 10.4% of the total expenditures was envisaged for capital expenditures in 2008. The amount has decreased by LVL 13.7 million or 3% in comparison with 2007. The decrease mainly pertains to the fact that the financing for projects co-financed from the EU structural funds

for the new programming period has not yet been included in the budgets of ministries and other central public institutions but is reserved in a form of subsidies in the sub-programme created especially for these goals in the budget of the Ministry of Finance.

Expenditures of the state special budget for 2008 are planned in amount of LVL 1133.9 million, which makes an increase by 24% or LVL 219.6 million in comparison with the plan for 2007. In accordance with classification of expenditures in economic categories, the greatest share in expenditures of the state social insurance budget is made by subsidies and social benefits that are planned in amount of LVL 1114.5 million or 98.3% of the total expenditures in 2008, of which LVL 1108.5 million are for social benefits. It is planned to spend LVL 17 million or 1.5% of the total expenditures for current expenditures. It is planned to channel LVL 2.2 million to capital expenditures.

**Public demand** is made up by public consumption or public services (value thereof is determined by the volume of the provided public services) and public investments that are the capital investments for budget resources. Public demand constitutes approximately one-fifth of the total domestic demand.

Table 4.6

#### Public Demand

	% of GDP			Real growth against the preceding year (%)		
	2004	2005	2006	2004	2005	2006
<b>Public demand</b>	<b>22.6</b>	<b>20.8</b>	<b>21.3</b>	<b>7.6</b>	<b>5.9</b>	<b>10.2</b>
<i>Public consumption</i>	<i>19.5</i>	<i>17.4</i>	<i>17.0</i>	<i>2.1</i>	<i>2.7</i>	<i>4.4</i>
– central government*	11.2	10.6	9.4	-3.0	9.6	-5.2
– local governments	8.4	6.8	7.6	9.8	-6.6	19.4
<i>Gross fixed capital formation</i>	<i>3.1</i>	<i>3.4</i>	<i>4.3</i>	<i>43.9</i>	<i>21.2</i>	<i>33.5</i>
– central government	1.7	2.1	2.4	59.2	38.0	18.8
– local governments	1.4	1.3	1.9	28.8	0.6	58.2

\* Central government with social insurance funds

The volume of public services grows at a slightly slower pace than GDP and private consumption. Public demand increased by 10.2% in 2006, while the average growth in 2004-2006 was by 7.9%. Government

expenditures for gross capital formation grow rapidly in relation to absorption of the EU structural funds, and their average growth rate since 2004 was 32.5%.

## 4.2. Prices

### 4.2.1. Consumer Prices

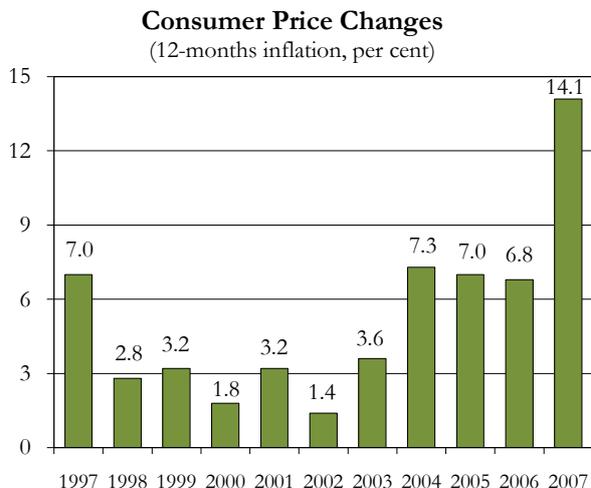
Consumer price inflation in Latvia in the period of 1998-2003 was close to the inflation rate in the developed countries and among the lowest in Central and Eastern European countries.

As from 2004, the inflation rate in Latvia increased rapidly and was one of the highest among EU member states.

Inflation in 2006 was slower than in the previous two years but still at a relatively high level. Approximately 60% of the inflation was made by core inflation and 20% of the inflation related to the increase

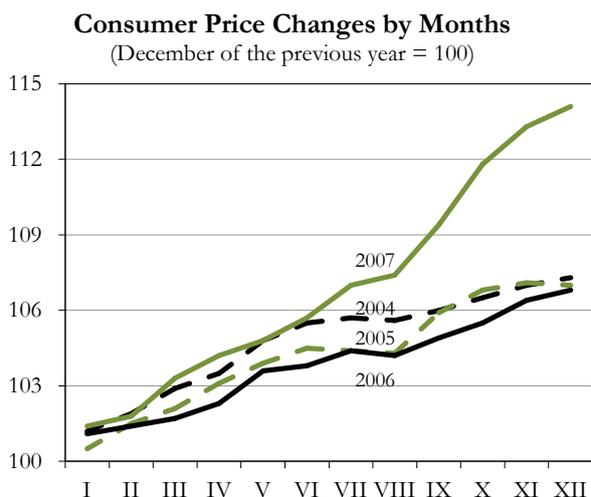
of administratively regulated prices mainly due to risen prices of heat energy and gas.

Figure 4.15



Inflation increased again in 2007 and was two times faster than in the previous year.

Figure 4.16



The high inflation in 2007 on the whole was determined by the following main factors:

- the 2<sup>nd</sup> round effect of the sufficiently high inflation rate (inflation spiral), of the previous years, which was fostered both by high volumes of mortgage crediting and by substantial increase of wages;
- the markedly fast increase of food prices, which determined a substantial increase of inflation in comparison with price changes in the previous three years. This was mainly due to general trends of price changes in the international markets and to producer price increase for domestic products, which in turn pertained to the essential increase of production costs in the previous periods;
- rise of administratively regulated prices. Prices for public utilities kept rising in 2007 – prices for water supply and sewerage, payments for electricity and waste collection, rent and prices for heat energy increased. On the whole during the year, prices increased fastest for water supply and sewerage (by 30%), heat energy (by 27.4%) and rent (by 21.5%);
- rise of world prices for oil, which substantially affected the increase of domestic fuel prices by 21.6% (December against December of the previous year).

Figure 4.17

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

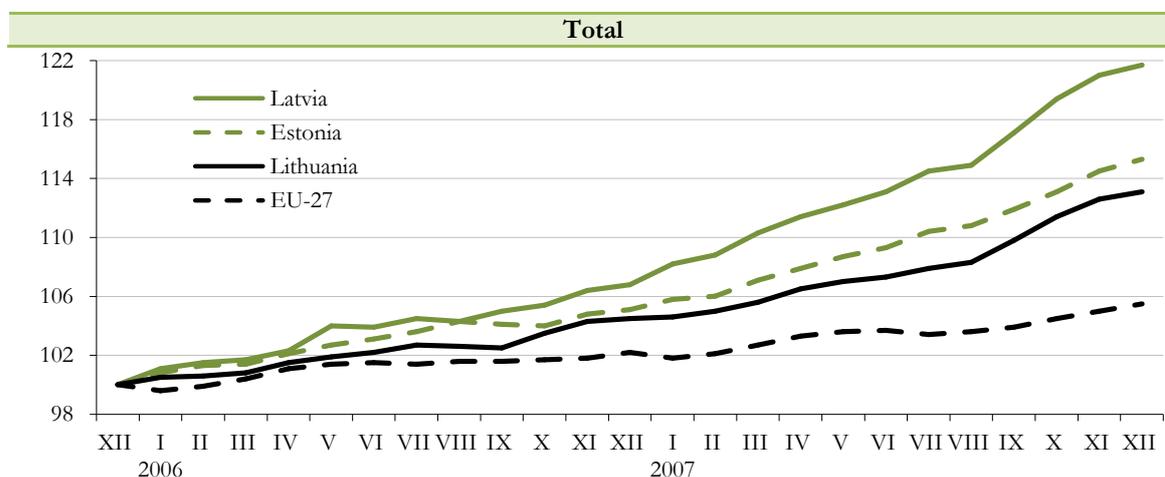
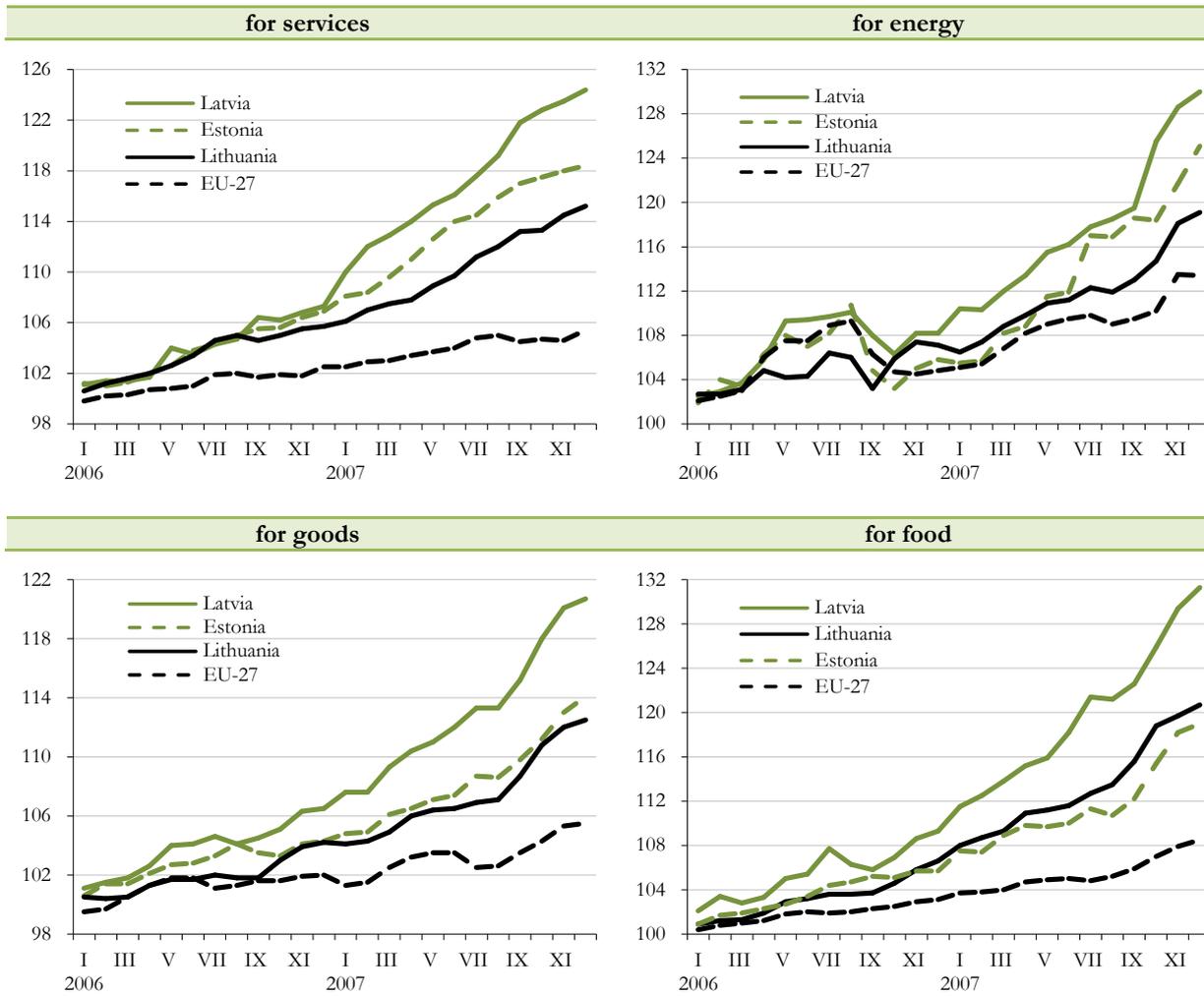


Figure 4.17. continued



Source: Eurostat

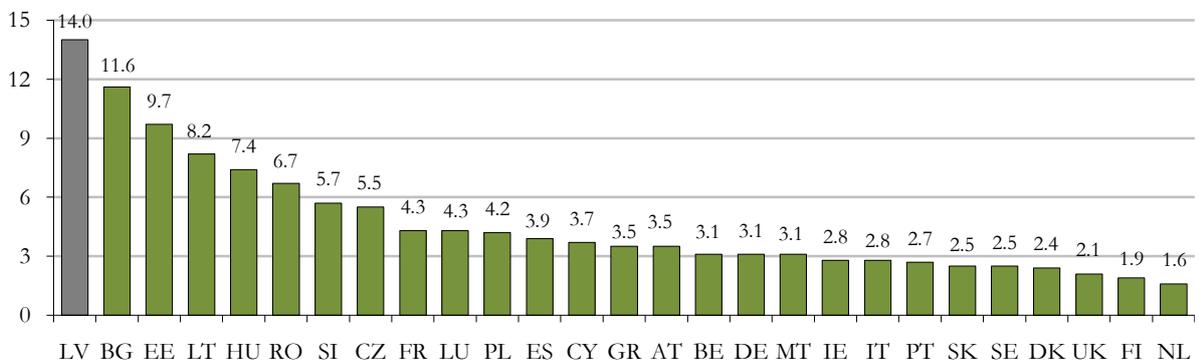
As already noted, consumer price inflation in Latvia in the last three years was one of the highest among EU member states. The second highest inflation in the EU was in Bulgaria followed by Estonia and Lithuania.

In this period, inflation was high also in the neighbouring countries Lithuania and Estonia, amounting to 8.2% and 9.7% respectively, but it was lower than in Latvia (see Figure 4.18).

Figure 4.18

**Consumer Price Changes in EU Member States in December 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

Rise of prices in Latvia was the fastest in all groups of goods and services in comparison with other Baltic States. Inflation was fastest for energy and food in Latvia, for food in Lithuania, and for energy in Estonia. It should be noted that food prices in Latvia have increased very fast in 2007 in comparison with other EU member states.

Under the current conditions, high inflation rate that remains already for three years may pose a threat to stability of Latvian economy and to 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 4.2).

#### Box 4.2

##### 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 rise of the productive capacity of 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 long term.

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 aimed at reduction of the domestic demand.

It is envisaged to achieve balanced budget in 2007 already. One should also note introduction of 3-year budget planning that 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 intended to change the taxation policy in regard to real estate, taxing the income from the sale of real estate as well as differentiating and increasing the duties related to purchase and registration of the 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 the solvency of 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 long term. These measures include promotion of economic activities, rise of productivity, improvement of energy efficiency, and promotion of competition.

One should especially note the long-term plan for 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 and development of new products jointly conducted by businessmen and scientists, and promotion of formation 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. Work is being done in order to make appropriate amendments to the Competition Law and improve market surveillance measures.

Influence of the plan's implementation on inflation will mainly affect the inflation processes in 2008 and the nearest future. However, the Ministry of Economics forecasts growth of consumer prices in 2008 slightly lower than in 2007 but still at a rather high level. Annual increase of the price level may be by 10%, which will constitute the average consumer price index in 2008 against 2007 at the level of 12-13%.

The main impulse to inflation in 2008 will be the supply-side factors:

- rise of administratively regulated prices (for electricity, natural gas and heat);
- fuel prices (big uncertainty in the world market);
- increase of food product prices;
- increase of excise on tobacco products and fuel;
- inflation expectations;
- increase of wages.

It is planned that electricity prices may increase by 37% in March 2008, meaning that the total level of

prices may rise by 0.8% for this reason. The planned increase of natural gas prices by 20-50% will raise the level of prices by 0.1-0.2%. Accordingly, heat supply tariffs may increase by 40-60% during the year, raising the total level of prices by 1.6-2.3%.

Hence the total level of prices will increase by 2.5-3.3% due to direct influence of the above-mentioned factors. Considering also a subordinate influence, the influence of these three factors on the level of prices in 2008 may amount to 4.5-5% that should be assessed as high.

One should also note the potential rise of transport costs mainly pertaining to rise of prices for public transport services and to increased prices for fuel.

In 2008, considering the trends of food price growth in international markets, food prices will keep increasing and may grow by at least 10-15%, which would raise the total level of prices by 2.7-4%.

Due to rise of the excise tax, also prices of tobacco products and fuel will increase. Considering the big share of tobacco consumption in the consumer price basket, growth of excise will raise the total increase of

consumer prices by at least 2%. Rise of the excise tax on fuel will affect the consumer price index less – by 0.2%.

### 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.

Like for consumer prices, also the growth of producer prices increased rapidly as from 2004, initially lagging behind the rate of consumer price index but exceeding it already in 2006. Producer prices went up by 13.2% in 2006 (December 2006 over December 2005), which was the highest price growth in the last ten years. Prices in wood processing and the energy sector grew most rapidly.

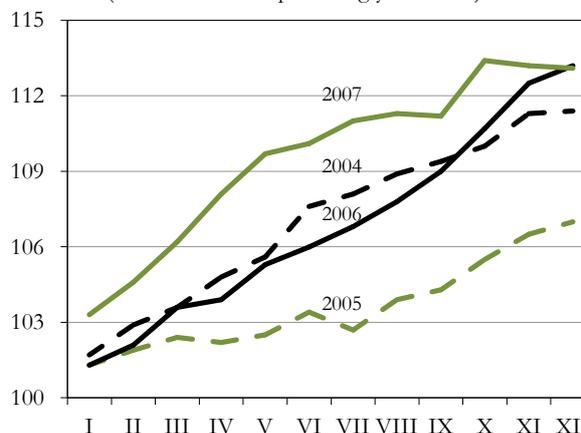
As indicated by data for 12 months of 2007, the growth of producer prices is faster than in the corresponding period of the previous year – by 13.1% (December over December of the previous year), which was mainly due to increased prices in food industry as well as (like in the previous year) to increased prices in wood processing and the energy sector.

In Latvia, as a country with a small and open economy, producer prices largely depend on changes of foreign trade prices that are determined by world

prices of the respective products and by 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 4.19

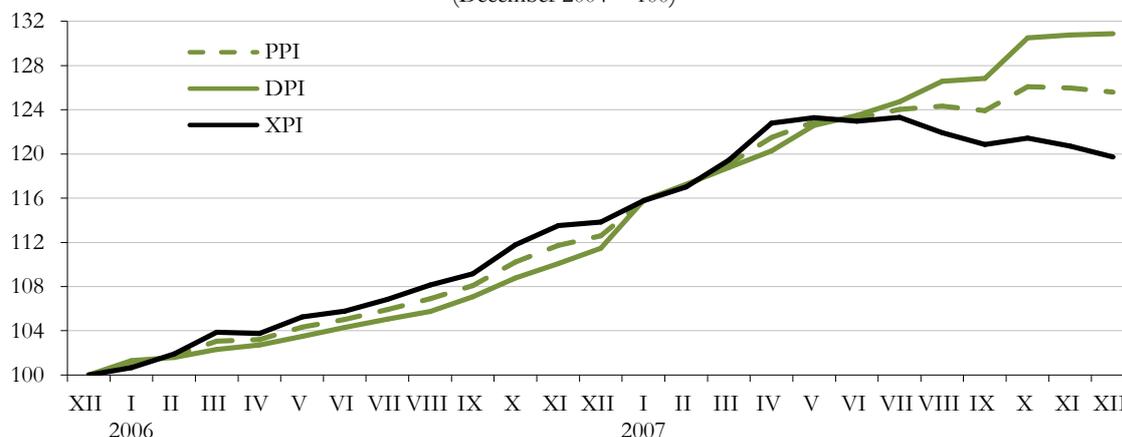
**Producer Price Changes by Months**  
(December of the preceding year = 100)



During the year (November 2007 over November 2006), prices for manufacturing products sold in the domestic market rose three times faster (by 19.7%) than prices of exported manufacturing products (by 6.3%).

Figure 4.20

**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 increase of tariffs that essentially raised production costs and by the growth of export prices in 2006 and at the beginning of 2007, 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.

Rise of producer prices, in comparison with the import price dynamics, reached the rise of import prices in the 4<sup>th</sup> quarter of 2006 but already exceeded it in 3 quarters of 2007. The more moderate increase of import prices was greatly determined by the decline of value for machinery, mechanisms and electrical appliances.

In the 2<sup>nd</sup> half of 2006 and 3 quarters of 2007, the growth of export prices more than twice exceeded the increase of the import unit value, which was mainly

determined by the rise of export unit value for wood and wood products.

Figure 4.22

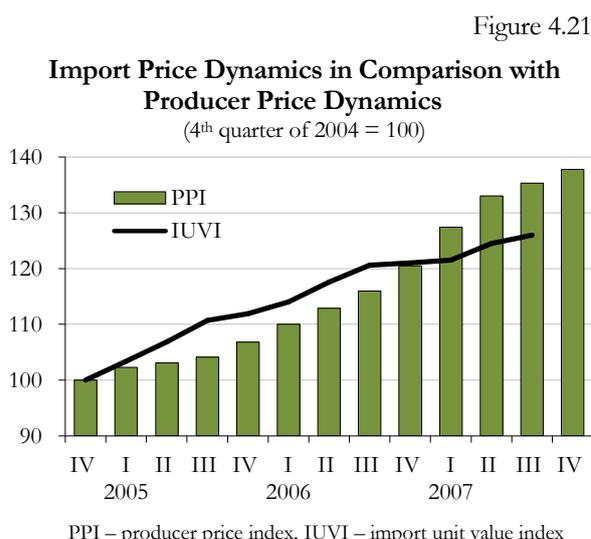
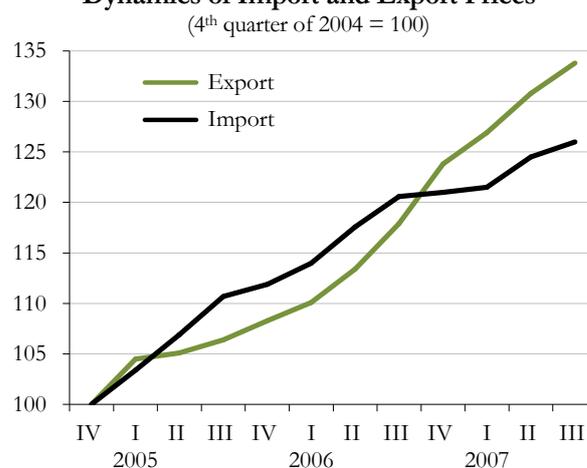


Figure 4.22



## 4.3. Balance of Payments

### 4.3.1. Current Account Deficit

Latvia typically has a relatively big current account deficit of the balance of payments. 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. The 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.

Table 4.7

**Latvian Balance of Payments**  
(percentage of GDP)

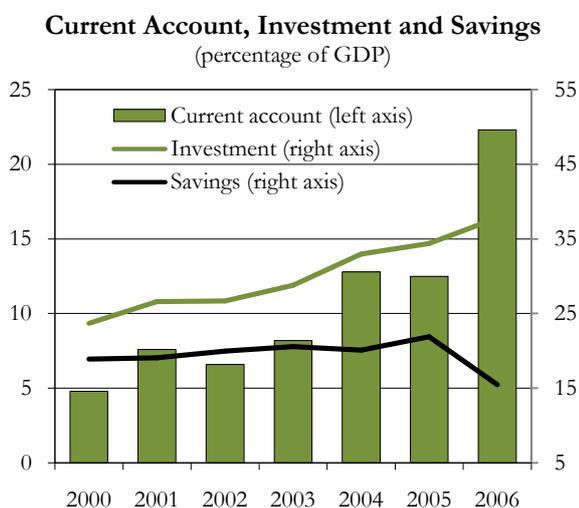
	2004	2005	2006	2006 I-IX	2007 I-IX
<b>A. Current account</b>	<b>-12.9</b>	<b>-12.5</b>	<b>-22.2</b>	<b>-20.3</b>	<b>-24.9</b>
Trade balance	-20.3	-18.9	-25.3	-24.4	-26.1
<i>exports</i>	30.6	33.5	30.5	31.5	30.6
<i>imports</i>	-50.9	-52.4	-55.8	-55.9	-56.7
Balance of services	4.4	3.8	3.3	3.9	3.6
Net income	-2.0	-1.1	-2.6	-2.7	-3.6
Current transfers, net	5.0	3.7	2.4	2.9	1.2
<b>B. Capital account</b>	<b>1.0</b>	<b>1.3</b>	<b>1.2</b>	<b>1.3</b>	<b>1.1</b>
<b>C. Financial account</b>	<b>14.7</b>	<b>16.3</b>	<b>30.2</b>	<b>29.8</b>	<b>31.0</b>
Direct investment	3.8	3.6	7.5	7.3	8.1
<i>abroad</i>	-0.8	-0.8	-0.8	-1.0	-0.7
<i>in Latvia</i>	4.6	4.4	8.3	8.3	8.8
Portfolio investment	1.3	-1.3	0.4	-0.6	-2.1
<i>assets</i>	-0.5	-1.3	-0.7	-2.1	-1.7
<i>liabilities</i>	1.8	0.0	1.1	1.5	-0.4
Other investment	9.6	14.0	22.3	23.1	25.0
<i>assets</i>	-12.9	-2.7	-9.6	-8.9	-20.5
<i>liabilities</i>	22.5	16.7	31.9	32.0	45.5
<b>D. Net errors and omissions</b>	<b>0.1</b>	<b>-1.9</b>	<b>0.6</b>	<b>0.1</b>	<b>-3.3</b>
<b>E. Reserves</b>	<b>-2.9</b>	<b>-3.2</b>	<b>-9.8</b>	<b>-10.9</b>	<b>-3.9</b>

Trade balance deteriorated considerably in 2006 (see Table 4.7), 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 22.3%. Also data for 3 quarters of 2007 indicate deterioration of the current account due to increased trade deficit.

Domestic demand in Latvia is higher than GDP, creating the current account deficit. This means that also foreign savings should be used to finance domestic investment.

As Figure 4.23 shows, the level of savings against GDP in Latvian economy has not changed essentially in the recent years and amounts to approximately 20%, while it decreased to 15.5% in 2006. In contrast, the level of investment in the economy is high, especially after accession to the EU.

Figure 4.23



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 raises the productive capacity of Latvian economy and hence improves competitiveness of the 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

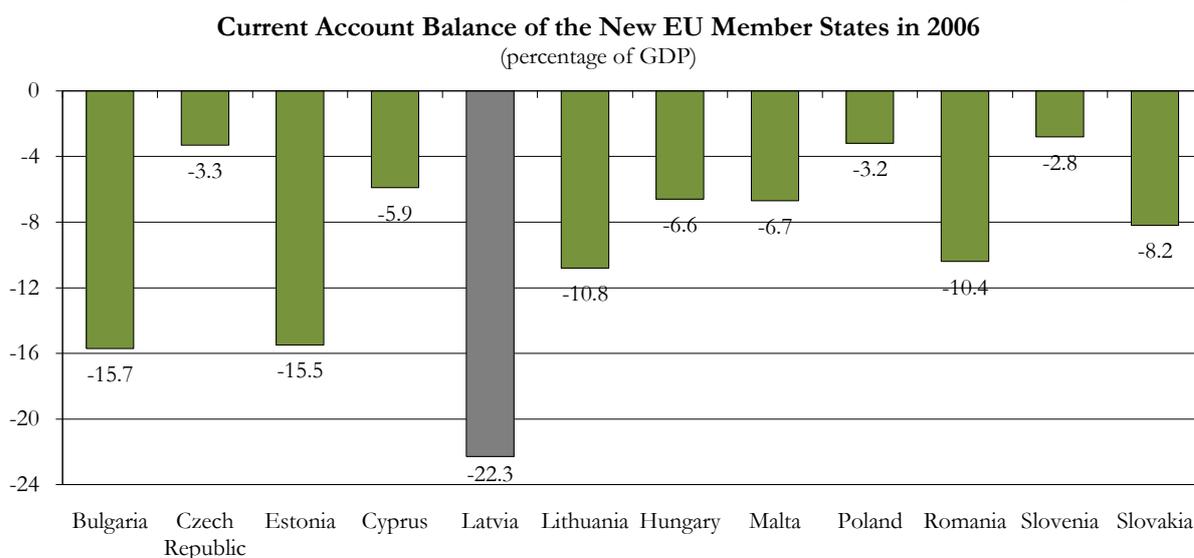
the financial sphere, would be noted especially. Unfortunately, both the attracted foreign capital and the domestic savings are predominantly channelled to investment in real estate and, to a lesser extent, for development of production sectors. This means that production of goods poorly competes with other sectors in terms of capital attraction, especially with the real estate sector.

From the macroeconomic point of view, 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 reorientation to production of goods with higher value added has occurred on 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 that is mainly linked with the high level of investment. Domestic savings are too small to implement restructuring and modernisation of national economy.

Figure 4.24



Source: Eurostat

Latvian current account deficit against GDP was the highest among the new EU member states in 2006 (see Figure 4.24). No country was with a positive current account balance, and the lowest current account deficit was in Slovenia.

### 4.3.2. Financial Flows

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

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 by the private sector. As from 2004 foreign investment increased rapidly and its volume even doubled in 2006 in comparison with the preceding year. Foreign investment in 3 quarters of 2007 is 1.5 times higher than in the corresponding period of the previous year.

Figure 4.26

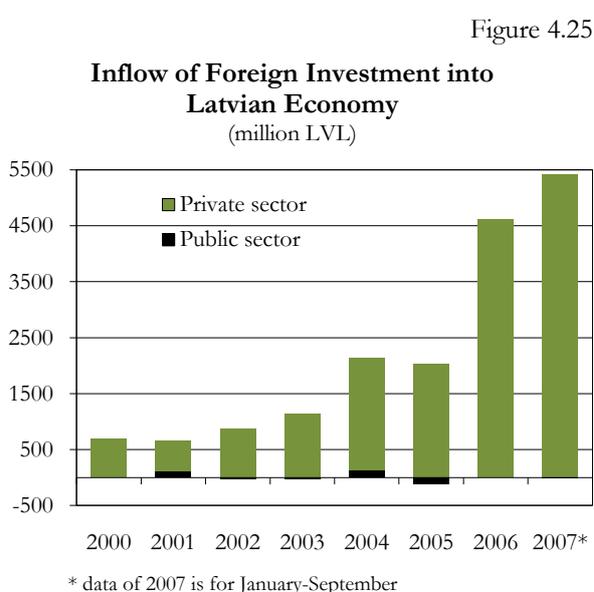
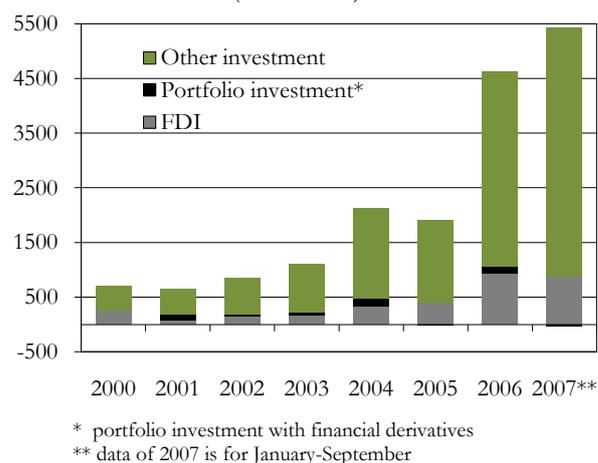


Figure 4.25

### Inflow of Foreign Investment into Latvian Economy by Types of Investment

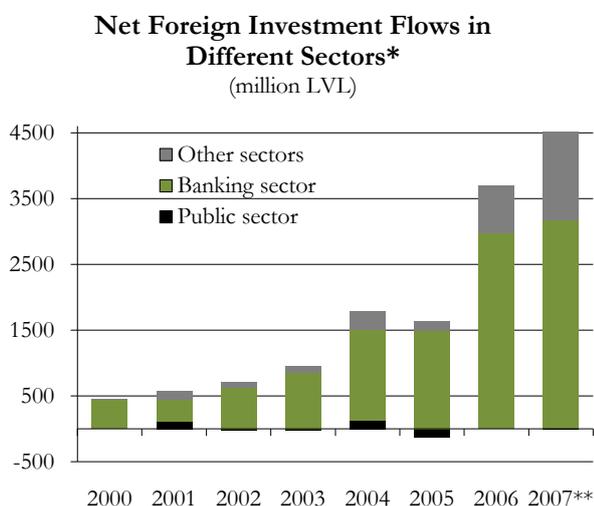
  
(million LVL)


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

Inflow of foreign direct investment in 2004 and 2005 was with a volume twice bigger than in the preceding years and covered 39% and 32% respectively of the negative current account balance. Inflow of foreign direct investment covered 37% of the current account deficit in 2006, while it slightly decreased and covered 35.6% of the current account deficit in 3 quarters of 2007.

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 was negative in 3 quarters of 2007, as Latvian banks increased investment in debt securities abroad to a bigger extent.

Figure 4.27



\* excluding foreign direct investment  
 \*\* data of 2007 is for January-September

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.

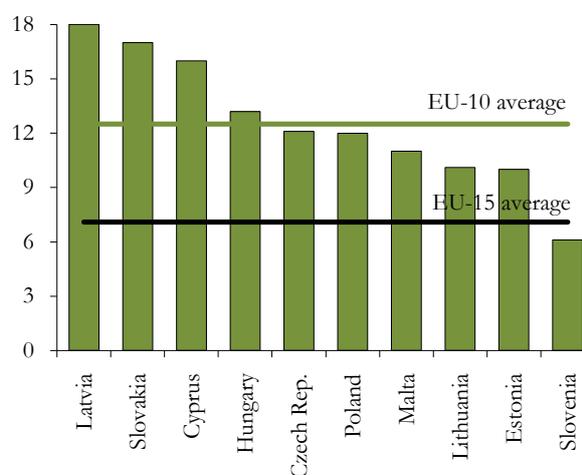
Therefore, Latvia is a capital-attracting country. In 3 quarters of 2007, the attracted capital exceeded GDP by 60%, while the debt of Latvia to the rest of the world was 130% of GDP, including the central government debt (5%). The amount owed to Latvia by the rest of the world was equal to 80% of GDP.

### 4.3.3. Foreign Direct Investment

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 of 2001-2003. Foreign direct investment per capita in Latvia amounted to LVL 1760 in 2006, and Latvia took the 6<sup>th</sup> place among the new EU member states by this indicator.

Figure 4.28

Profitability of FDI in the new EU member states in 2006 (percentage)

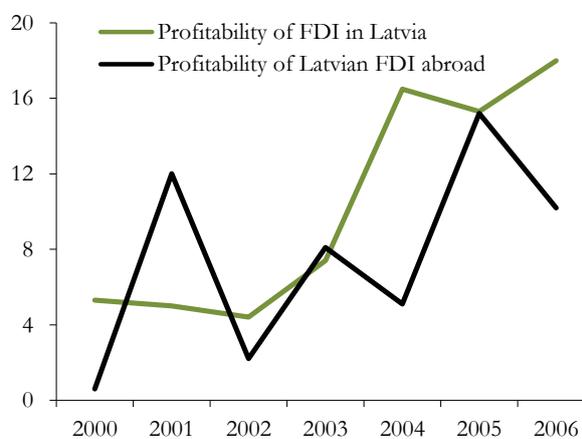


Source: Eurostat database, Latvian balance of payments.

Rapid increase of FDI flows is also observed in other new EU member states in the last three years. Inflow of foreign capital in the form of direct investment into the new EU member states increased 1.5 times on average since their accession to the EU, among them 2 times in Lithuania and 2.5 times in Estonia. It should 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 the geopolitical situation of the country. Also profitability of FDI<sup>1</sup> 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 4.29

Profitability of FDI in Latvia in 2000-2006 (percentage)

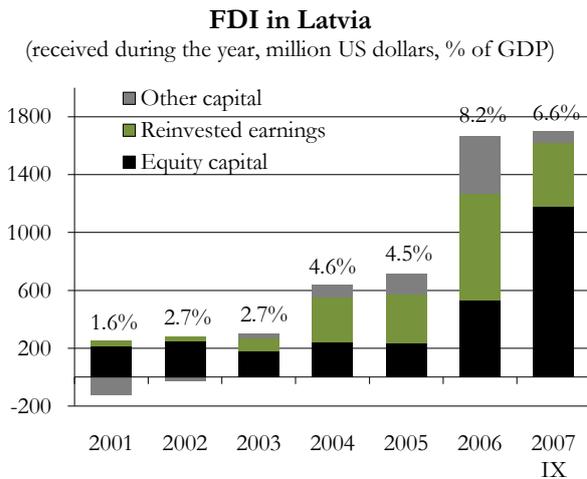


Source: Eurostat database, Latvian balance of payments.

<sup>1</sup> 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.

Investment abroad by Latvian entrepreneurs grows every year. FDI stock of Latvia abroad increased by 28.4% at the end of 3<sup>rd</sup> quarter of 2007 in comparison with 2006 and reached LVL 327.2 million. Almost half of Latvian investment was made in Switzerland (mostly in the trade sector) and Lithuania (in trade and financial mediation). Latvian entrepreneurs have recently become more active also in Russian markets. Latvian investment in Russian economy has increased 1.5 times in 9 months of 2007, constituting 11.2% of Latvian FDI. Profitability of Latvian direct investment abroad was 10.2% in 2006.

Figure 4.30

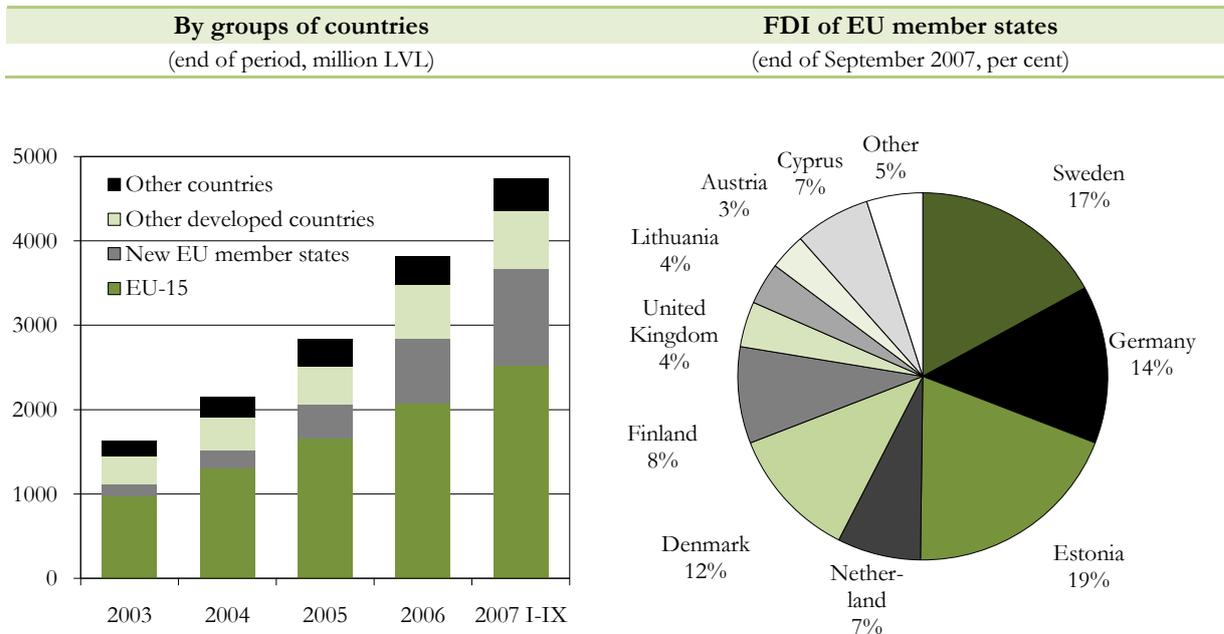


Volume of the FDI inflow reached LVL 932.1 million (USD 1664.1 million) in 2006, while FDI flows (mostly in the form of equity capital and reinvested earnings) in 9 months of 2007 exceeded the flows in the corresponding period of preceding year by 34.1%.

In accordance with the balance of Latvian international investment, the FDI stock in Latvian economy amounted to LVL 4992.3 million or almost 36% of GDP at the end of the 3<sup>rd</sup> quarter of 2007. It should be noted that the share of FDI in the structure of the accumulated foreign capital decreases every year, which pertains to faster inflow of foreign capital in the form of other investment (mainly bank loans). The share of FDI in assets of non-residents in Latvian economy made up 27.7% at the end of 2003 and 23.4% at the end of September 2007. Considering that the attracted foreign capital is an important source for financing of domestic investment, it may be concluded that debt commitments in the structure of their financing are more and more increasing.

Figure 4.31

**FDI Stock**



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 91.1% of the total FDI stock at the end of

2006 and 92% of the total FDI stock at the end of September 2007. The majority of it is made up by investment of EU member states. Investment of EU member states constituted 77.4% of the total FDI stock in Latvia at the end of the 3<sup>rd</sup> quarter of 2007.

The biggest amounts of investment are received from Sweden, Estonia, Germany and Denmark. FDI stock of these four countries made up 50% of the total FDI stock in Latvian economy at the end of September 2007. Markedly dominant sectors exist in all mentioned countries (except Denmark). Swedish FDI is focussed in the sectors of financial services (46.9%) and commercial services (25.6%). Almost 70% of Estonian FDI is in financial services. German entrepreneurs have mainly invested in the energy sector (38.4% of German FDI stock in Latvian economy). Danish entrepreneurs have made important investment in the sector of financial services during the last year hence the share of this sector in the structure of Danish FDI stock has increased to 41.4%.

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 national economy at the end of 2006. High growth rate (by 46.4%) also remained in 9 months of 2007. Among the new EU member states, Estonia has marked leader positions. Estonian FDI stock in Latvian economy has increased almost 1.5 times in 9 months of 2007, constituting 19% of the FDI stock. Lithuanian investment has increased by 39.4% and 34.7% respectively in 2006 and 3 quarters of 2007 and constituted almost 4% of the FDI stock (11.9% of the FDI stock of the new EU member states) at the end of September 2007.

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 29% at the end of September 2007. LVL 1076.5 million in the form of direct investment was invested in the sphere of financial services since the end of 2003, constituting 42% of the FDI attracted in Latvian economy during more than three years.

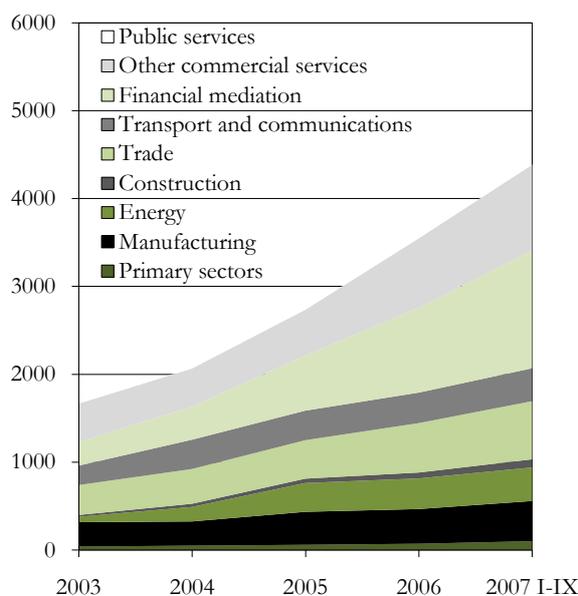
Since Latvia's accession to the EU, the FDI stock both in goods and services more than doubled. In the sphere of production of goods, FDI growth was especially fast in the energy sector (almost 6 times) and in construction (more than 4 times). FDI growth was less rapid in manufacturing (1.5 times).

In 9 months of 2007, the FDI stock increased by 24.6%, of which by 17% in the sphere of production of goods and by 25.7% in the sphere of services. The biggest volumes of foreign investment are still attracted by two sectors – financial mediation and real estate transactions. In 9 months of 2007, FDI in these sectors increased by 38.9% and 23.5% respectively. The share of these sectors in the

structure of the FDI stock constituted 51.4% at the end of the 3<sup>rd</sup> quarter. Big investments were made in trade where the FDI stock increased by 17.7% in 9 months of 2007 and made up 11% of the FDI inflow. Steadily high FDI growth rate (by 37%) remained in the construction sector.

Figure 4.32

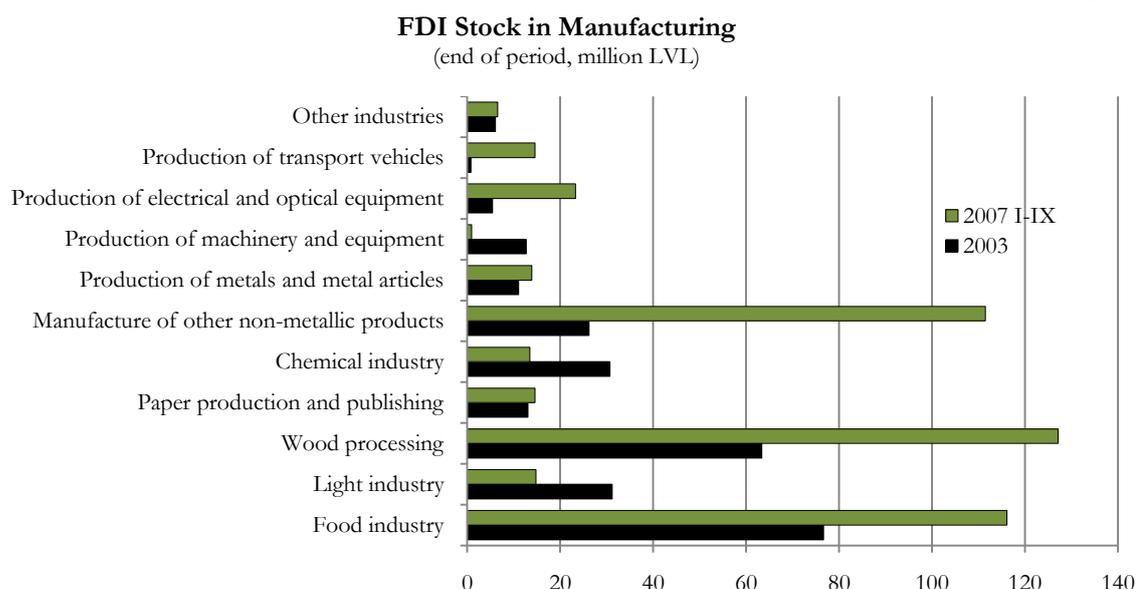
**FDI Stock by Sectors**  
(end of period, million LVL)



As noted, FDI growth rate in manufacturing is rather moderate. On the whole, there is no marked difference between FDI dynamics before and after Latvia's accession to the EU. FDI stock in industries increased by 31.2% in the period from 2000 until the end of 2003, while it increased by 42.5% during the three years after Latvia's accession to the EU. At the same time, important changes in attraction of FDI are observed in sub-sectoral profile of manufacturing. In comparison with the end of 2003, the FDI stock in light industry and chemical industry decreased by almost one-half, while the FDI stock in production of machinery and equipment decreased more than five times. FDI has increased substantially in such industries as production of electrical and optical equipment (4 times), manufacture of other non-metallic products (4 times), and production of transport vehicles (18 times).

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 77.6% of the total FDI stock in manufacturing at the end of September 2007. It should be noted that these are low and medium-low technology sectors, which indicates that the relatively low accessibility of labour force and natural resources is still important in attraction of foreign capital in Latvia.

Figure 4.33



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. LIDA strategy for attraction of investment is oriented to high-quality servicing of incoming investment projects and pro-active operation in attraction of investment projects, addressing potential investors in accordance with priorities set in the national economy development strategy of Latvia.

On the whole, foreign investors evaluate Latvian business environment as favourable and hence attractive for making investment and starting operation. However, there are problems, solution of which will allow increasing foreign investment flows.

One of the most essential problems faced by potential foreign investors in Latvia is shortage of labour force, especially hard science specialists. Latvia has become less attractive for those investors whose operation requires big human resources. At the same time, shortage of highly skilled labour force hinders establishment of high technology production facilities. The high inflation rate in Latvia substantially affects interest of foreign investors. Considering the possible rise of costs for doing business in Latvia, this creates additional risk for potential investors and makes them reserved.

Advantage of Latvia with regard to its geographic location has become especially important in the couple of last years: European border with the Russian Federation, access to the Baltic Sea, and integrated and developed transport infrastructure are only a few factors frequently considered as essential by foreign firms. Since Latvia's accession to the European Union,

a sales market with approximately 480 million people is open to foreign investors. By placing a new production facility in Latvia, free access to markets of EU member states is automatically ensured for the company. It is essential that Latvia and 8 other new EU member states joined the Schengen zone on December 21, 2007; which prescribes to lift border control hence facilitating not only free movement of persons but also free movement of land cargo transportation, saving time and costs of entrepreneurs.

Low-quality transport infrastructure in Latvia, which is a drawback identified by foreign investors earlier, is being eliminated gradually. The direct Liepāja–Moscow rail line that will be used as alternative to land transportation was opened in October 2007. Considering the currently complicated situation on the Latvian-Russian border, this rail line will allow saving up to 48 hours in cargo transportation. As regards development of air transport, the runway of Riga airport is being extended by 650 metres (the total length will be 3200 metres) and the lights system of the airport is being modernised. Construction and reconstruction of Via Baltica road which will link the Baltic States with Western Europe hence strengthening the role of Latvia as a transit country is also essential. The activities done and investment made in development of transport infrastructure and in improvement of its quality gradually diminish the idea of difficulties in access to Latvia and moving on Latvian roads and hence promote attraction of foreign investment.

On the whole, one would conclude that competition between countries in attraction of foreign investment increases ever more. Therefore, it is necessary to continue orientation towards rise of overall competitiveness of Latvia and expand activities for improvement of business environment in order to attract significant foreign investors also in the future.

## 4.4. Financial and Capital Markets

### 4.4.1. Monetary Policy and the Exchange Rate<sup>1</sup>

Law "On the Bank of Latvia"<sup>2</sup> 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 orders of the government or government 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 SDR<sup>3</sup> 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 Unions (EMU)<sup>4</sup> (see Box 4.1).

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.

#### Box 4.3

##### Latvia's National Euro Changeover Plan

In order to ensure the technical and legal base for introduction of the euro at national level, an appropriate organisational structure of the euro introduction project was formed in summer of 2005 and the Cabinet of Ministers approved the *Latvia's National Euro Changeover Plan* in 2006, which prescribes carrying out several measures in regard to adjusting laws and regulations for adjusting the normative base and ensuring technical operation of the money and payment system, financial system, public debt management, budgetary accounting and statistics, business environment and consumer protection, taxes and social security, as well for informing the 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 changeover to the euro, the responsible institutions and terms for implementation of the defined activities.

The timetable for introduction of the euro, approved by the Cabinet of Ministers, envisaged that Latvia will join the EMU on January 1, 2008. Taking into account that the set target has become unachievable due to high inflation, Latvian government reviewed the previous plans in September 2007 and decided to announce the target date for introduction of the euro not later than 24 months before the expected introduction of the euro – when the 3-year forecasts included in the *Convergence Programme of Latvia* will approach fulfilment of the Maastricht criteria. In accordance with information of the Ministry of Finance, introduction of the euro in Latvia is possible in the period of 2011-2013.

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 the European Central Bank.

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 of the Bank of Latvia constantly cover the reserve

money (see Figure 4.34), and their amount equals to the value of goods and non-factorial services imported by the country in 3-4 months.

The coverage of reserve money (currency in circulation and deposits in the Bank of Latvia) with net foreign assets was 123% at the end of 2007. Net foreign assets of the Bank of Latvia had gone up by 15% in comparison with the end of 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 5758 million at the end of 2007 (USD 4509 million at the end of 2006, USD 1535 million at the end of 2003).

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

<sup>2</sup> The Bank of Latvia is the central bank of the state.

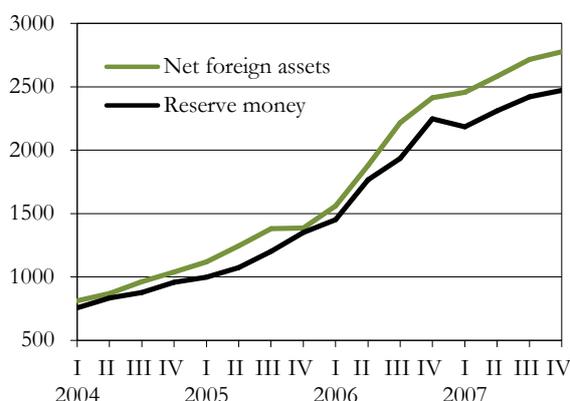
<sup>3</sup> Special Drawing Rights – SDR; currency code according to the classification of currencies international standard ISO 4217 – XDR.

<sup>4</sup> 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.

Figure 4.34

### Net Foreign Assets of the Bank of Latvia and Reserve Money, Quarterly Profile

(million lats, end of period)



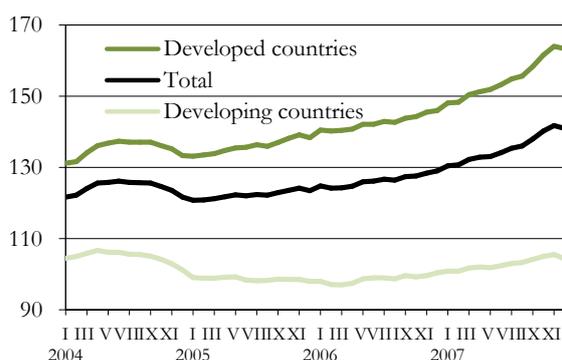
The Bank of Latvia calculates the real effective rate of the lat<sup>1</sup> against the currencies of 13 countries that are the main trading partners of Latvia<sup>2</sup>. It shows the relative export competitiveness of Latvia in global markets (see Figure 4.35).

Due to relatively high inflation, the real exchange rate of the lat tends to appreciate with regard to currencies of the developed countries since 2005 and also with regard to currencies of the developing countries since the middle of 2006. Growth of the real effective exchange rate of the lat is favourable for Latvian importers.

Figure 4.35

### 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).

<sup>1</sup> 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.

<sup>2</sup> 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.

## 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 two branches of foreign banks operated in Latvia at the end of September 2007. 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 (hereinafter FCMC)<sup>3</sup>, 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. Only the *Mortgage and Land Bank of Latvia* is fully owned by the state. Foreign shareholders own almost 70% of the total paid-up equity capital of banks.

Total amount of bank assets reached LVL 20.4 billion at the end of September 2007 (LVL 15.9 billion at the end of 2006). Loans issued to companies make up about half of the credit portfolio of banks. However, a substantial growth is observed in loans issued to households.

Commercial banks operate with profit. According to operational information, the total profit of the banking sector amounted to LVL 375 million in 2007, which was by 40.4% or LVL 108 million more than in 2006. Return on assets (ROA)<sup>4</sup> reached 2% at the end of September 2007, while return on equity (ROE)<sup>5</sup> reached 24.2% (2.1% and 26.3% respectively at the end of 2006).

16 **insurance companies**, of which five were life insurers and 11 provided non-life insurance, as well as 7 branches of foreign insurance companies operated in Latvia at the end of September 2007. 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 amounted to LVL 228.6 million in 3 quarters of 2007, which was by 55% more than in 3 quarters of 2006, while the volume of paid gross indemnities was LVL 93.9 million or by 33% more than in 3 quarters of 2006.

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. 309 applications from insurance supervision bodies of 27 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 September 30, 2007.

<sup>3</sup> 165 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 September 30, 2007.

<sup>4</sup> ROA – ratio of profit/losses to assets.

<sup>5</sup> ROE – ratio of profit/losses to capital and reserves.

**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 June 2007, market capitalisation of Latvian companies at Riga Stock Exchange (RSE)<sup>1</sup> was LVL 1999 million (LVL 1430 million or 12.7% of GDP at the end of 2006, 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). 47 companies were listed on the stock exchange in the 1<sup>st</sup> half of 2007 (40 companies at the end of 2006).

The RSE capitalisation index OMXR (January 1, 2000 = 100) reached 748 points at the end of September 2007 (656 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 previously performed by the Credit Institutions Supervision Board of the Bank of Latvia, Securities Market Commission and State Insurance Supervisory 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 *Deposit Guarantee Law*, 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 61.7 million was accumulated in the *Deposit Guarantee Fund* at the end of August 2007 (LVL 48.6 million at the end of 2006). 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 3.3 million was accumulated in this fund at the end of August 2007 (LVL 2.5 million 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 as well as inflow of foreign capital predetermine stable growth of the basic monetary indicators of the banking system of Latvia (see Table 4.8 and Figures 4.36 and 4.37).

It should be noted that a decrease of the growth of monetary indicators was observed in the 2<sup>nd</sup> half of 2007 due to influence of the *Anti-Inflation Plan* approved by the government in March 2007.

The **volume of deposits** of companies and individuals drawn by residents increased by 23.7% at the end of September 2007 in comparison with the end of September 2006. As Table 4.8 shows, the volume of deposits increased by 30-40% on average annually in 2004-2006.

Approximately 60% of all deposits drawn by residents are deposits in LVL, whereas the rest is deposited in foreign currencies. Dominant role in deposits is played by demand deposits, and their share in the total deposit structure was 54% at the end of 2007 (66% at the end of 2006).

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)<sup>2</sup>.

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*.

<sup>1</sup> 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.

<sup>2</sup> To compare: the share of non-residents in the total deposits makes up 16% in Estonia and 8% in Lithuania.

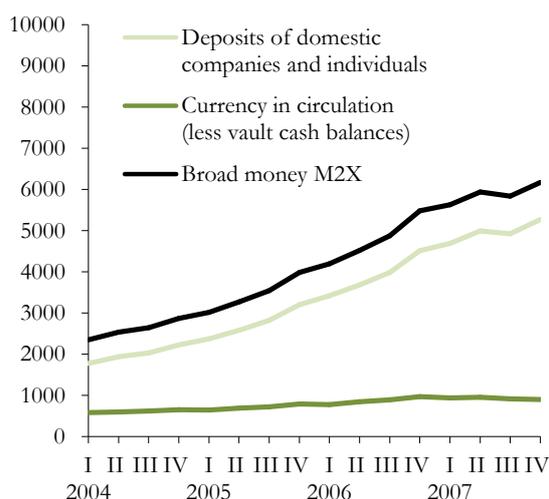
Table 4.8

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

	2004	2005	2006	2007
	(million LVL)			
Net foreign assets	-231.0	-1326.6	-2634.7	-4482.8
Net domestic assets	3098.9	5311.2	8114.6	10015.7
Domestic loans	3948.1	6441.3	9877.4	13018.2
to government (net)	173.4	266.3	100.5	-87.4
to companies and individuals	3774.7	6175.0	9776.9	13105.6
Other assets (net)	-849.2	-1130.1	-1762.8	-2364.2
Broad money M2X	2867.9	3984.7	5479.9	6171.3
Currency in circulation (less vault cash balance)	645.4	786.4	969.3	900.0
Deposits of individuals and companies	2222.4	3198.3	4510.6	5271.3
of which:				
demand deposits	1295.6	2020.2	2974.5	2864.9
time deposits	926.8	1178.1	1536.1	2406.4
	(changes against the preceding period, per cent)			
Domestic loans	39.9	63.1	53.3	31.8
of which:				
to companies and individuals	46.8	63.6	58.3	34.0
Broad money M2X	27.0	38.9	37.5	12.6
Currency in circulation (less vault cash balance)	7.4	21.8	23.3	-7.1
Deposits of individuals and companies	34.1	43.9	41.0	16.9
<b>GDP (in current prices)</b>	<b>16.3</b>	<b>21.8</b>	<b>24.3</b>	...

Figure 4.36

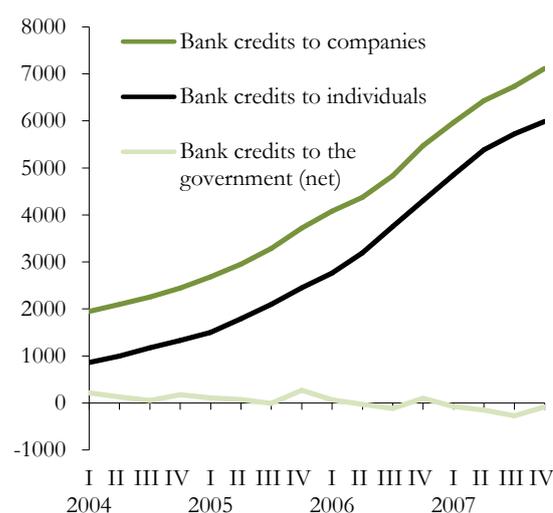
**Dynamics of Broad Money (M2X)  
and its Components, Quarterly Profile**  
(end of period, million LVL)



The volume of **loans** issued to companies and individuals increased by 50-60% annually in 2004-2006, which was encouraged both by enlivened economic activity and by inflow of foreign capital.

Figure 4.37

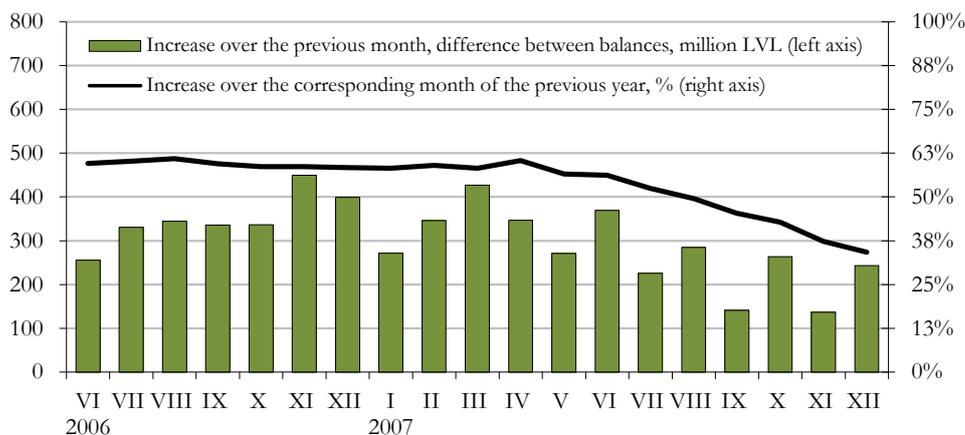
**Bank Credits to Domestic Companies, Individuals  
and the Government, Quarterly Profile**  
(end of period, million LVL)



Decline of the growth rate of crediting is observed as from the 2<sup>nd</sup> half of 2007 (see Figure 4.37).

Figure 4.38

**Loans to Resident Financial Institutions, Non-financial Corporations and Households (Total)**



Decline of the growth rate of crediting is related to the *Anti-Inflation Plan* approved by the government in March 2007, which envisaged the following requirements with regard to crediting: for commercial banks and providers of leasing services to determine solvency of customers and grant loans only on the basis of their legal incomes; create a common register of borrowers; determine a compulsory initial payment for loans to be granted in the amount of at least 10-15% of the loan; set the maximum amount of loan against the value of collateral; introduce a compulsory declaration of legal income in particular transactions and purchases for a sum above 100 minimum monthly wages; and stimulate savings.

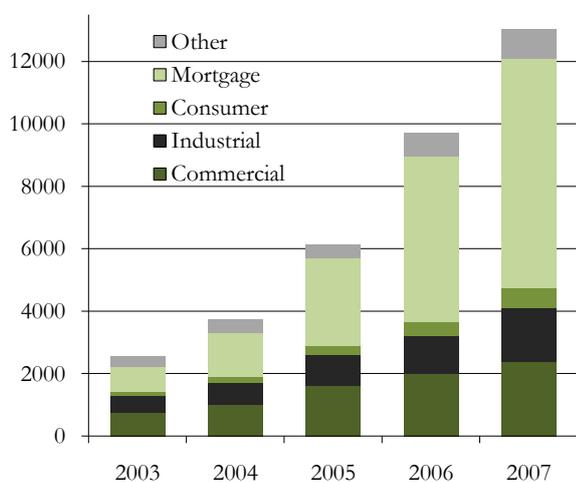
Along with these government policy measures, the crediting policies of the biggest Latvian commercial banks have become more cautious.

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.

Considering that the rapid economic growth gradually becomes stable and the role of the banking sector in overheating the domestic demand has diminished due to a slower growth of crediting, besides also the change of situation in the global financial markets along with the measures previously carried out by the Bank of Latvia has furthered additional appreciation of crediting in Latvia, the Bank of Latvia decided to reduce the reserve norm for bank commitments above 2 years from 8% to 7% on January 17, 2008.

Figure 4.39

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

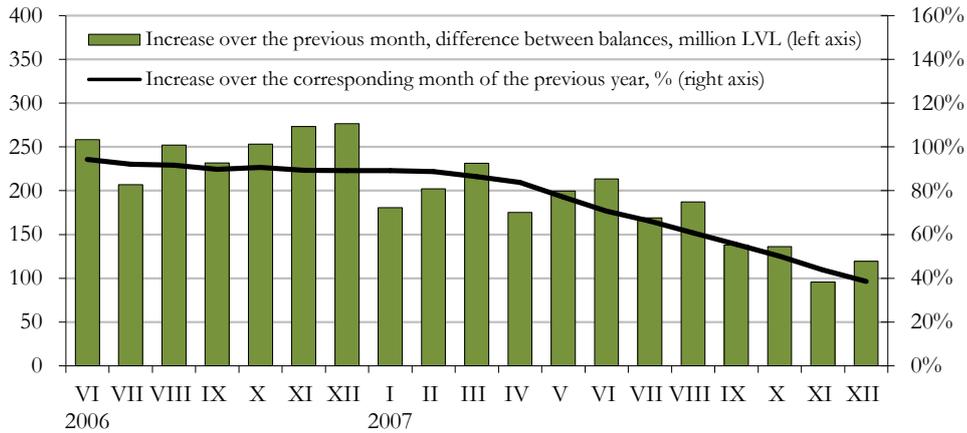


Mortgage loans constitute the biggest share in the structure of loans issued to domestic companies and individuals. Their share in credit portfolios of banks has grown from 22% at the end of 2002 to 46% at the end of 2005 and 55% at the end of 2006. The share of commercial loans (to increase current 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 4.40).

The volume of issued mortgage loans increased by 89% in 2006. Mortgage lending has gone up by 55% at the end of September in comparison with the end of September 2006. As Figure 4.40 shows, decrease of the growth rate of mortgage lending is observed as from the 2<sup>nd</sup> half of 2007.

Figure 4.40

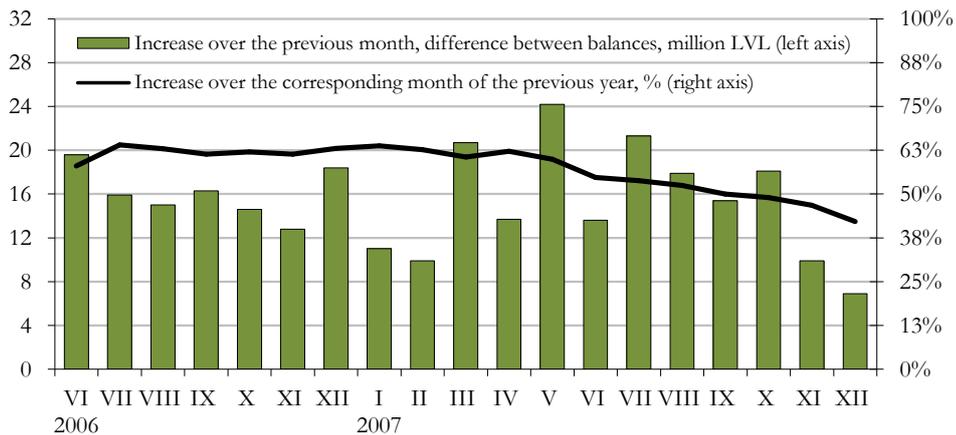
**Mortgage Loans Issued to Resident Financial Institutions, Non-financial Corporations and Households**



Growth rate of consumer lending also decreases (see Figure 4.41).

Figure 4.41

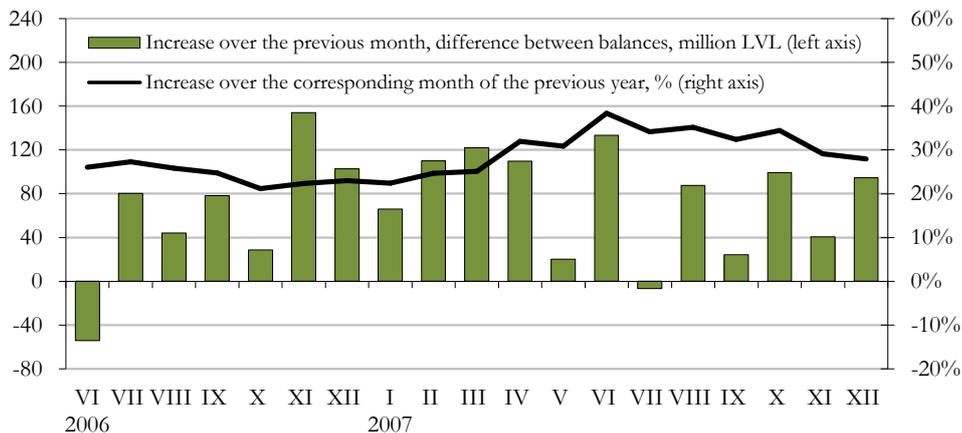
**Consumer Loans Issued to Resident Financial Institutions, Non-financial Corporations and Households**



Dynamics of industrial and commercial loans issued to resident financial institutions, non-financial corporations and households is displayed in Figure 4.42.

Figure 4.42

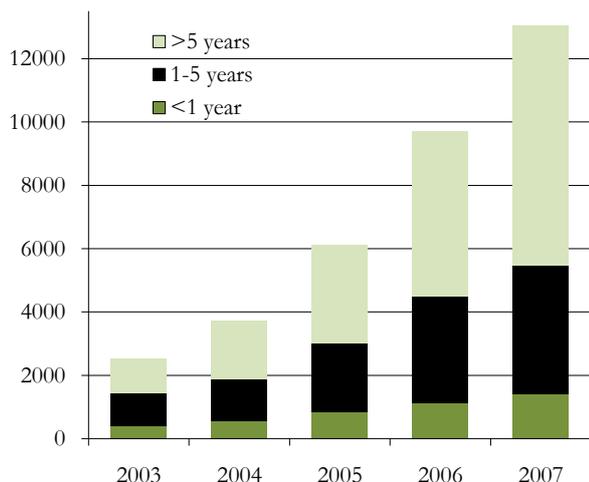
**Industrial and Commercial Loans Issued to Resident Financial Institutions, Non-financial Corporations and Households**



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 decreases, while the share of long-term loans increases (see Figure 4.43). The share of long-term loans in the total credit portfolio was 57% at the end of September 2007.

Figure 4.43

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



While the volumes of crediting increase, the quality of loans does not decrease. At the end of

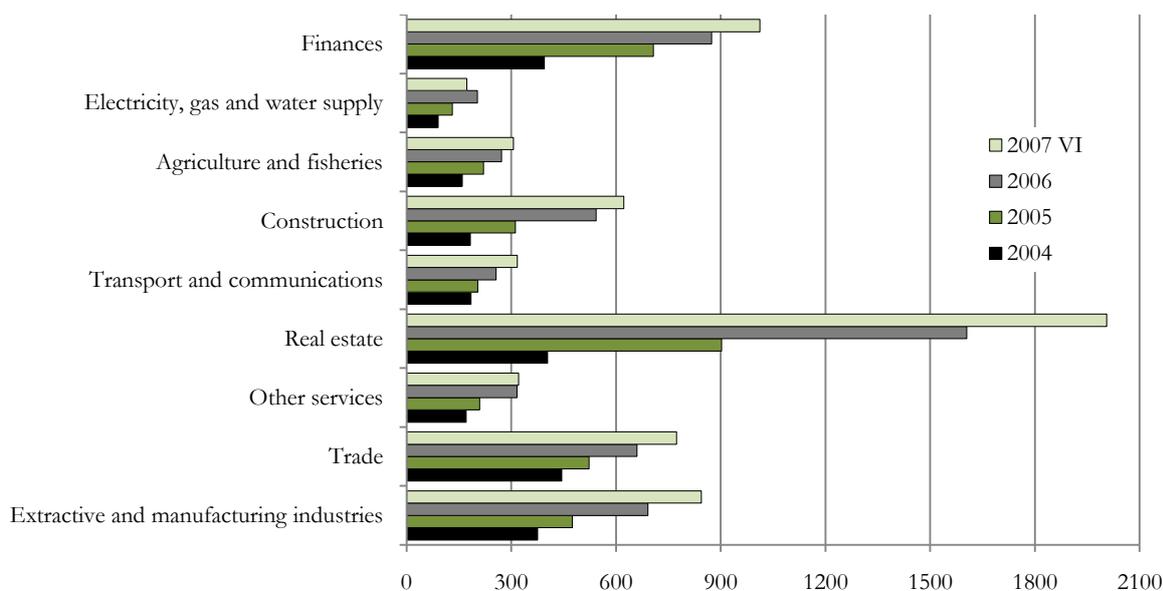
September 2007, the quality of loans issued by banks was as follows: 99.3% of all issued loans were evaluated by banks as standard loans, 0.3% were evaluated as loans under supervision, and only 0.4% were evaluated as loans generating no income (sub-standard, doubtful, or lost)<sup>1</sup>. In compliance 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 72 million at the end of September 2007, exceeding the volume of loans generating no income by 26%.

At the end of 2006, the biggest volumes of loans had been issued by commercial banks to the following national economy sectors: real estate transactions, manufacturing, financial mediation and trade, which received 30%, 13%, 16% and 12% respectively of the total volume of loans to national economy sectors.

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” (13.1 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 4.44).

Figure 4.44

**Balance of Long-Term Loans Issued to Companies in National Economy**  
(end of period, million LVL)



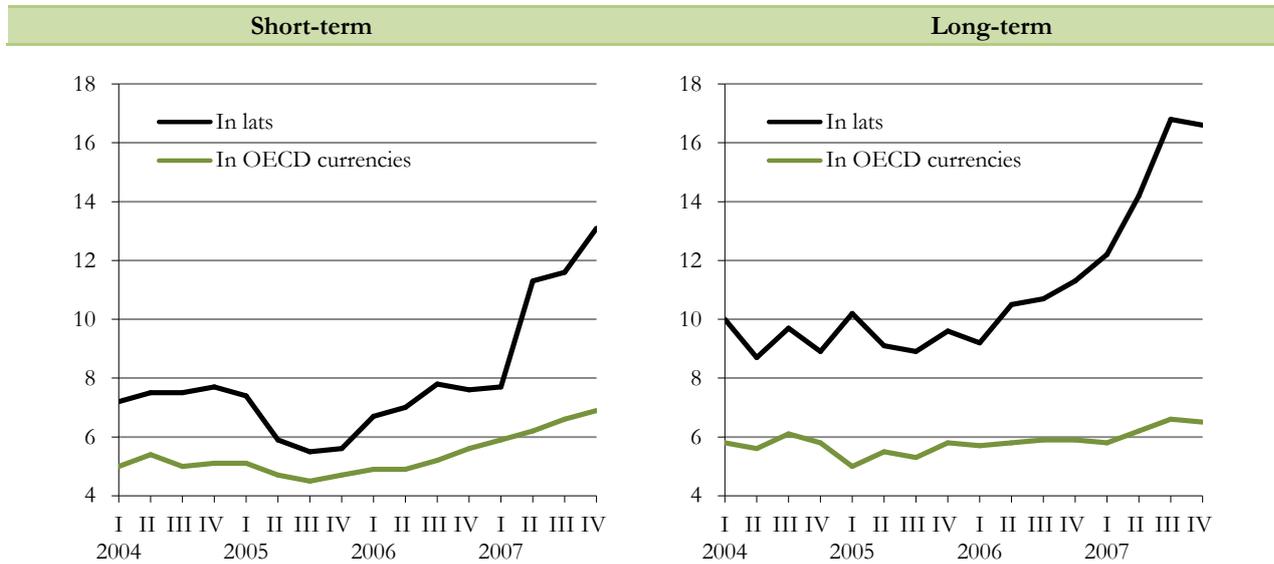
<sup>1</sup> To compare: 0.4% of all issued loans were evaluated as generating no income at the end of 2006 (0.7% at the end of 2005, 1.1% at the end of 2004, 1.4% at the end of 2003).

Dynamics of loan interest rates in quarterly profile is shown in Figure 4.45. The interest rates for loans issued

in lats have increased substantially in 2007.

Figure 4.45

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

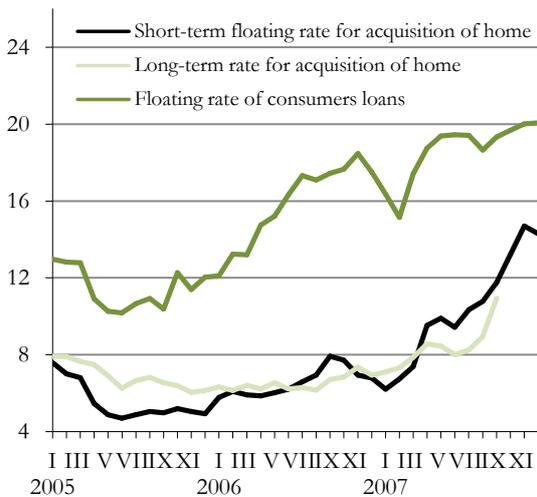


In the 3<sup>rd</sup> quarter of 2007, the average weighted annual interest rate for short-term loans in lats to companies and individuals was 11.6%, the rate for long-term loans in lats was 16.8%, while the respective rates for loans in OECD currencies were 6.5% and 6.6%<sup>1</sup>.

In the 3<sup>rd</sup> quarter of 2007, the average weighted annual interest rate for short-term deposits in lats was 5.9%, the rate for long-term deposits in lats was 7%, while the respective rates for deposits in OECD currencies were 3.9% and 4.5%.

Figure 4.46

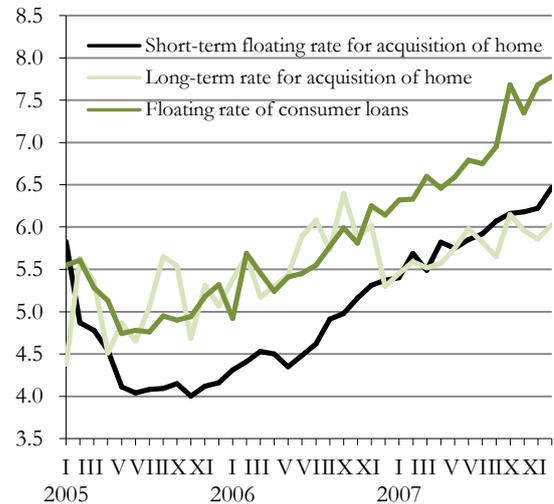
**Interest Rates for Loans in Lats to Households**



Interest rates for loans issued in lats to households rapidly increased in 2007, while the growth of interest rates for loans in OECD currencies was much more moderate.

Figure 4.47

**Interest Rates for Loans in OECD Currencies to Households**



<sup>1</sup> Short-term with floating interest rate.

## 5. LABOUR MARKET

### 5.1. Employment and Unemployment

Rapid economic development of Latvia has positive influence on 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 over the last three years (2004-2006), while the unemployment rate has declined from 10.6% in 2003 to 6.8% in 2006.

In 3 quarters of 2007, the employment rate kept increasing and reached 67.7% but the unemployment rate decreased to 6.2 per cent.

In the last three years (2004-2006), the **employment rate** in Latvia has increased by 4.5 percentage points. Employment rate in Latvia in 2003 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 achieved in 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 lagged behind the set target by mere 0.8 percentage points, while the data of 3 quarters of 2007 indicate that Latvia has exceeded the target set for 2010 by 0.7 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 average by 2.9 percentage points in 2003 and by 5 percentage points in 2006. Male employment in Latvia tends to increase every year but still lags behind the EU average (by 4.7 percentage points in 2003 and by 1.6 percentage points in 2006).

Table 5.1

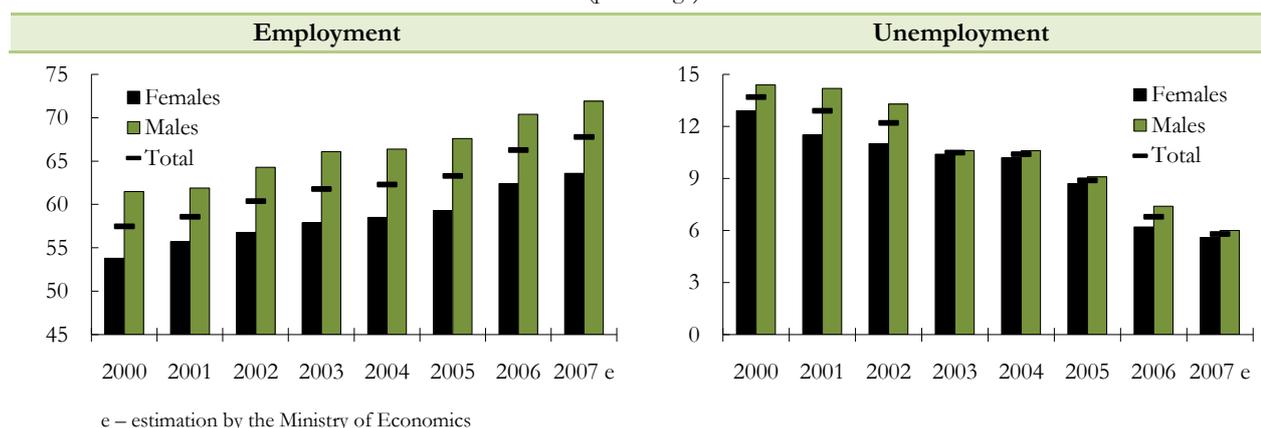
Key Indicators of Employment and Unemployment\*

Indicators	2000	2005	2006	3 quarters of 2007
Population in the age group of 15-64 years (thousand)	1600.3	1583.8	1580.4	1573.4
Economically active persons in the age of 15-64 years (thousand)	1074.7	1100.8	1126.1	1137.3
Employed persons (thousand)	917.6	1003.6	1047.3	1064.6
Participation rate (%)	67.2	69.5	71.3	72.3
Employment rate (%)	57.3	63.4	66.3	67.7
Unemployed (job seekers) (thousand)	158.3	99.1	79.9	73.7
Unemployment rate (%)	14.4	8.7	6.8	6.2
Registered unemployed persons (end of period, thousand)	93.3	78.5	68.9	54.7
Registered unemployment rate (end of period, %)**	7.8	7.4	6.5	5.1

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

\*\* percentage of registered unemployed persons in the economically active population from 2002, according to the new methodology

Figure 5.1

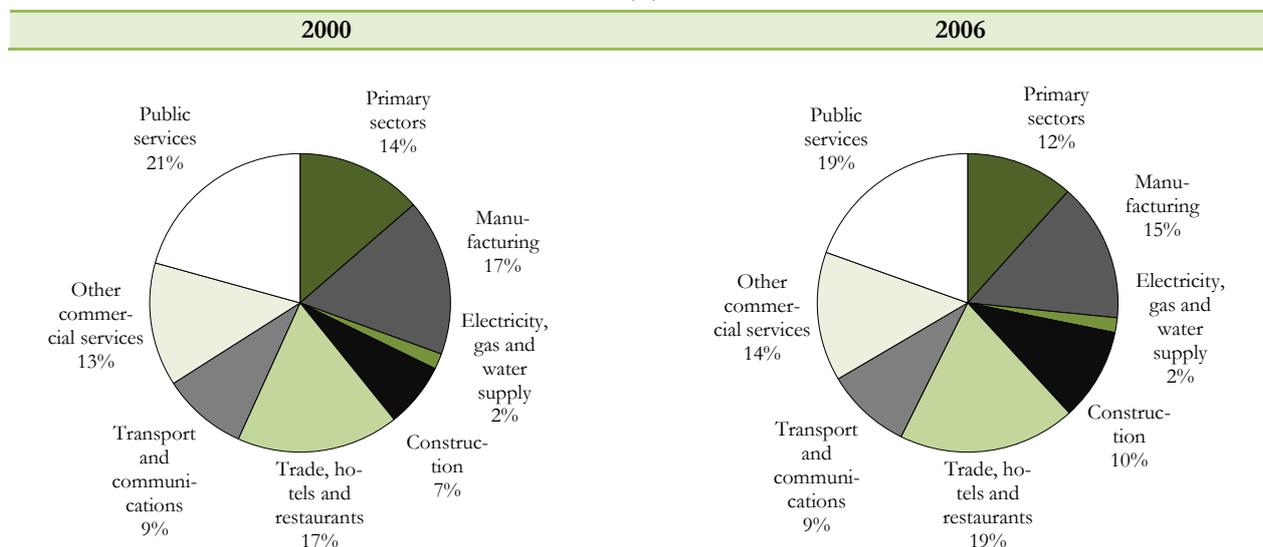
Employment and Unemployment in Latvia  
(percentage)

Of all employed persons in 2006, 71% were employed in cities and 29% were employed in the rural areas. It has to be noted that the share of employed persons in cities grows every year but the share of employed persons in the rural areas 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 the employed in trade and communications, while the number of persons employed in agriculture and industry has decreased.

Figure 5.2

Structure of Employed Persons Broken Down by National Economy Sectors (%)



Source: Eurostat

In 2006, Latvia filled the 13<sup>th</sup> position among the EU-25 countries in terms of the employment rate, while the position of Latvia in terms of the unemployment rate (the 12<sup>th</sup> position among the EU-25 countries) has improved considerably 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 0.9 percentage points lower than in the preceding year and amounted to 6.5%.

The lowest rates of registered unemployment are in cities of Riga and Jelgava and in Riga, Ogre, Saldus and Tukums districts (3.8%, 4.9%, 4.8%, 5%, 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 highest registered unemployment still remains in Latgale region. At the end of 2006, it was 14.4% and

exceeded 20% in two districts of Latgale: 23.4% in Ludza district and 22.6% in Rēzekne district. The unemployment rate is high due to poorly developed business activity, poor self-employment, and insufficient traffic infrastructure.

The majority of all unemployed persons are representatives of simple, low-skilled professions. 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 group of 35-54 years. The share of the pre-retirement age unemployed in the total number of unemployed persons keeps increasing every year, which is greatly due to the increase of retirement age according to the law on retirement.

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

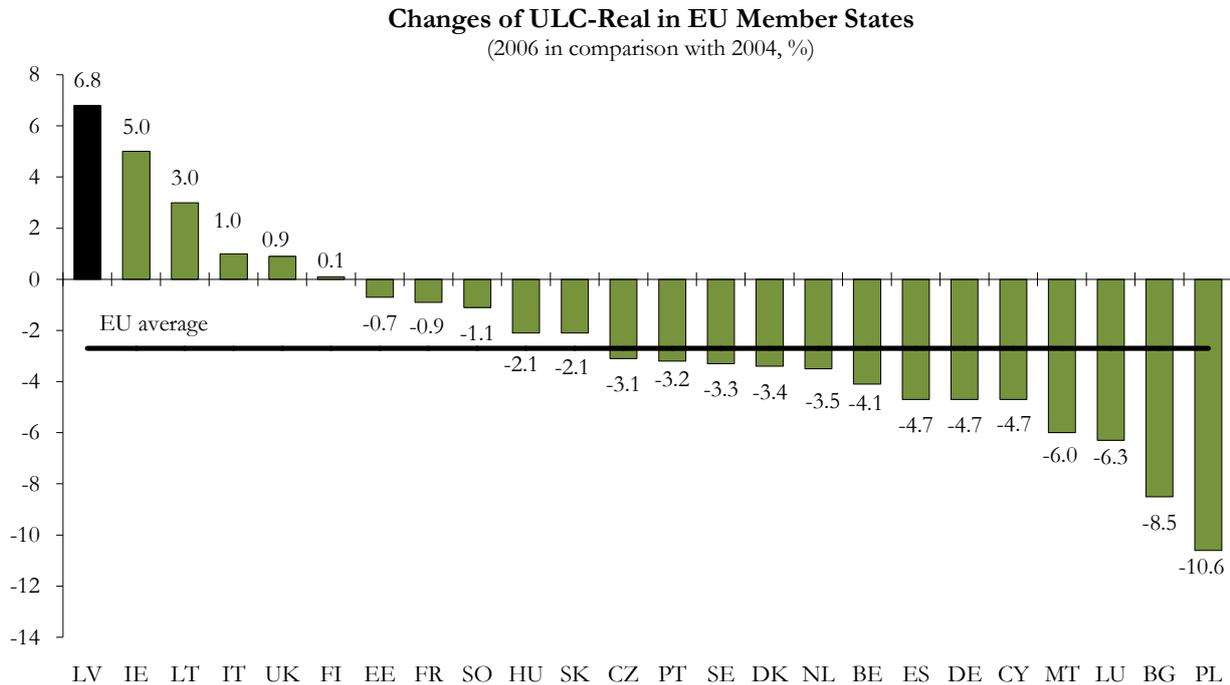
Labour costs per production unit (ULC) constitute one of the indicators characterising

competitiveness (both for the country on the whole and for separate sectors). Dynamics of this indicator

shows that the position of competitiveness of Latvia in EU member states deteriorates. In the period of 2004-2006, ULC-real increased by 6.8% in Latvia,

while it decreased by 2.7% on average in EU member states.

Figure 5.3

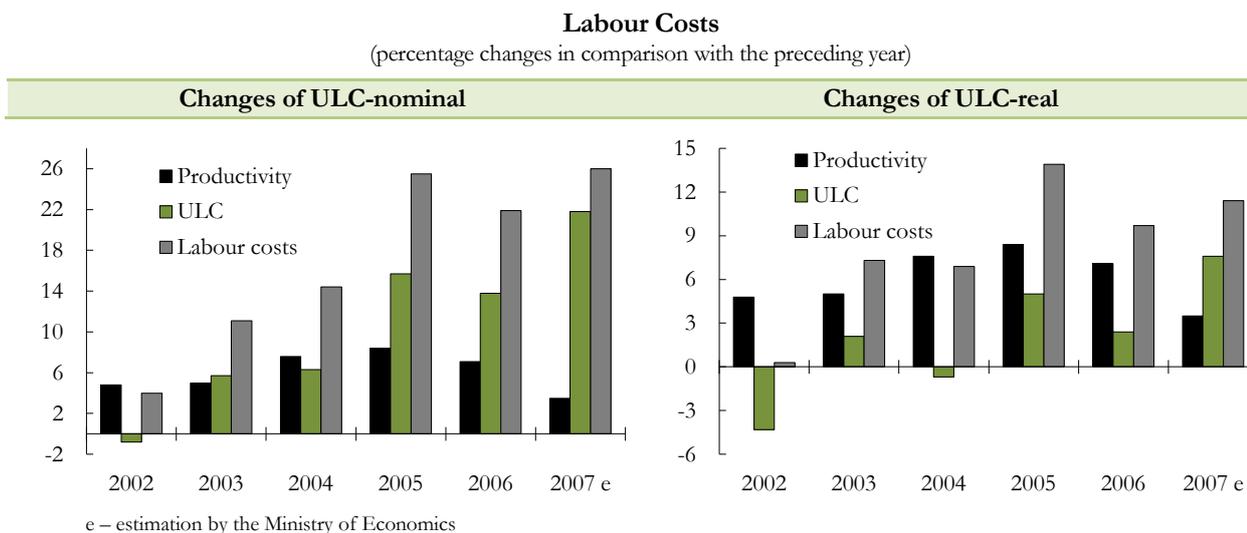


AT – Austria, BE – Belgium, BG – Bulgaria, CZ – Czech Republic, CY – Cyprus, DE – Germany, DK – Denmark, EE – Estonia, EL – Greece, ES – Spain, FI – Finland, FR – France, HU – Hungary, IE – Ireland, IT – Italy, LT – Lithuania, LU – Luxembourg, LV – Latvia, MT – Malta, NL – Netherlands, PL – Poland, PT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

Although productivity growth rates in Latvia in the recent years are among the highest in the EU member states, labour costs (both the real<sup>1</sup> and the nominal<sup>2</sup>

ones) grow faster than productivity and labour costs per production unit increase.

Figure 5.4



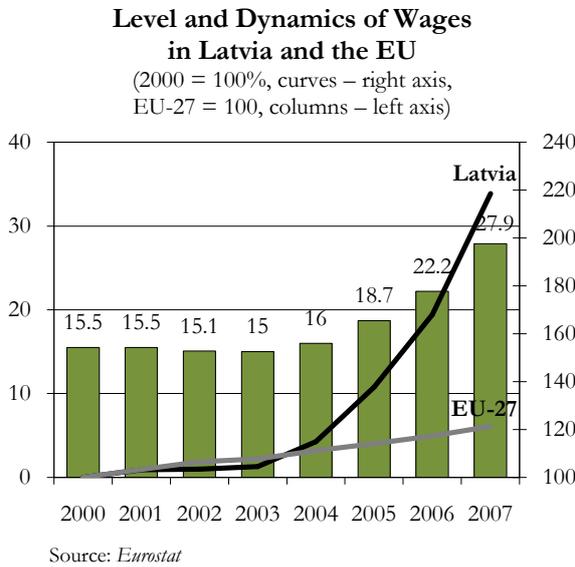
The substantial growth of labour costs per production unit in the recent years was mainly due to rapid increase of wages. The increase of wages since 2004 was affected by three main conditions: high inflation, rapidly growing demand for labour force, and opening

of labour market in such highly developed countries as Ireland and the United Kingdom, which increased competition in Latvian labour market (labour supply decreases due to growing emigration). On the whole, this created a big pressure on wages. It should be noted that the dynamics of wages is, to a big extent, also a result of the convergence process where gradual

<sup>1</sup> corrected by producer price index or deflator  
<sup>2</sup> not corrected by producer price index or deflator

equalisation of labour costs takes place within the EU single market. This process in Latvia is among the fastest in the EU member states, which is partly explained by the very low level of wages in comparison with the EU average.

Figure 5.5



The level of wages of the employed in Latvia is very low in comparison with the EU average. In 2003, it made 15% on average of the EU level. As a result of the fast dynamics of wages, the level of wages grew to 22.2% of the EU average in 2006 and, according to provisional data, reached 28% in 2007.

Lagging behind the EU average in terms of productivity level was not so pronounced. Therefore, increase of wages objectively may occur faster than the dynamics of productivity and price equalisation (convergence) processes.

Dynamics of labour costs per production unit differs by sectors. Labour costs per production unit in 2007 exceed the level of 2002 in all sectors. Increase of ULC was especially high in construction – almost by one and a half times.

Figure 5.6

**Level and Dynamics of Productivity in Latvia and the EU**

(2000 = 100, curves – right axis, EU-27 = 100, columns – left axis)

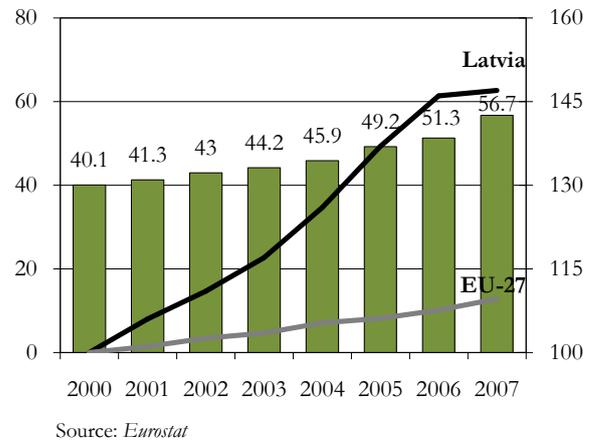


Figure 5.7

**Changes of ULC-Real by Sectors**  
(percentage against 2002)

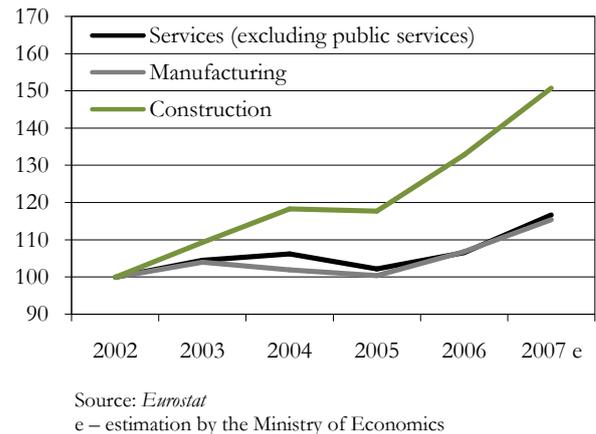
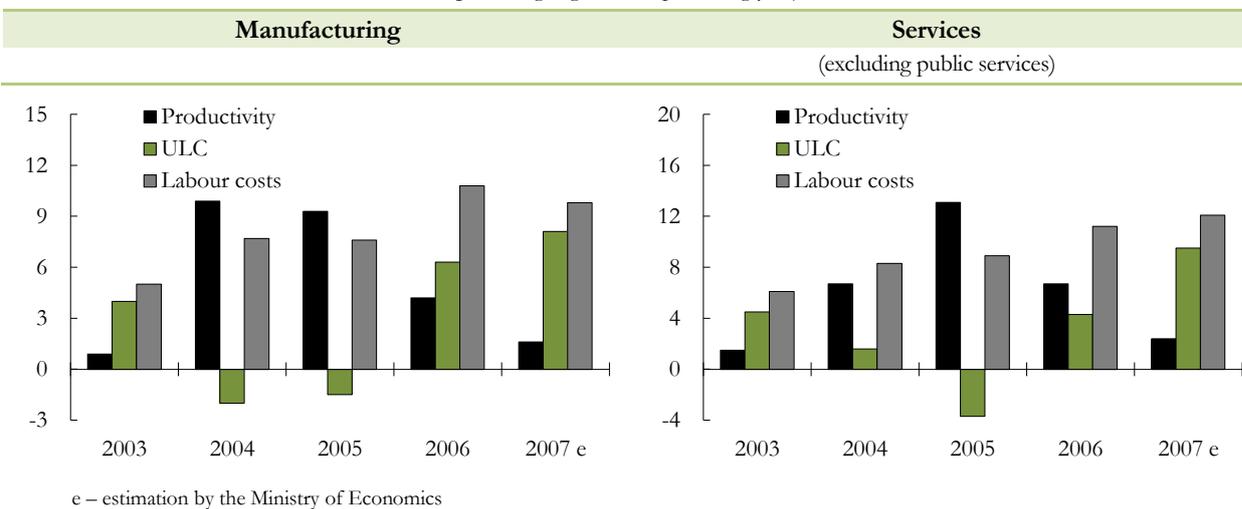


Figure 5.7

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



Labour costs have been increasing every year since 2003 both in services and in manufacturing. Increase of wages in manufacturing in 2004 and 2005 was compensated by growth of productivity, and labour costs per production unit decreased. Such compensation is not so typical in service sectors and labour costs per production unit increased, with the exception of 2005. ULC-real increased both in manufacturing and in service sectors in 2006 and 2007, which was mainly due to decreased rates of productivity growth. Over the last three years, labour costs per production unit have increased by 13% in

manufacturing and by 10% in service sectors. The most rapid increases of ULC-real in 2005-2007 were in construction (by 27.5%), transport and communications (by 19%) and real estate (by 17%)

Overall, it can be concluded that the growth of labour costs per production unit in the last two years was more affected by slowdown of productivity growth rates than by the growth of wages. 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, especially in export sectors.

### 5.3. Employment Policy

Latvian employment policy is closely related to the employment policy of the EU. A goal to promote economic and social development and high employment is set at the EU level. In order to achieve this goal, the member states and the Community elaborate a co-ordinated strategy in the field of employment.

In March 2000 in Lisbon, the European Council accepted a strategy with the aim to achieve sustainable economic growth with more and better jobs and bigger social cohesion, setting long-term employment targets: to reach an overall employment rate of 70% in the EU by 2010 (including 60% for women and 50% for pre-retirement age population of 55-64 years).

In order to achieve fulfilment of the main targets of the European employment strategy, the European Council accepted the Integrated Guidelines package in July 2005, 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 the relevant situation, these lines of action are specified in the National Lisbon Programmes of the member states.

Considering the situation of Latvian labour market, priorities in the field of employment of the *National Lisbon Programme of Latvia for 2005-2008* (see Chapter 6.1) were set. The Programme establishes the following priority directions of Latvian 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 raising the employment rate overall to 67% (62% for women and 50% for persons in the age of 55-64 years) by 2010.

The rapid economic growth in the recent years is reflected also in the dynamics of labour market indicators. The employment rate has increased in all target groups. The most important employment policy targets for 2008 set in the Programme were already achieved in 2006, while the employment rate for women and persons in the age group of 55-64 years reached the target set for 2010 in 2006. Stable trend of the rise of employment rate and the decline of unemployment rate can be observed in Latvian labour market. With emigration of labour force to those old EU member states, which have opened their labour market, new changes appear in the labour market. As the current conditions remain, shortage of labour force develops in several national economy sectors.

The State Employment Agency (SEA) implements the state policy in the areas of reduction of unemployment and support to unemployed persons and job seekers. In order to employ a higher number of people, SEA organises **active employment measures**.

SEA implements such measures for reduction of unemployment as:

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

Co-financing from the European Social Fund has allowed rapid increase in the number of unemployed persons involved in active employment

measures. 54.6 thousand unemployed persons were involved in these measures in 2003, and 166.4 thousand were involved in 2006 (one unemployed person may be involved in several activities). As the unemployment rate decreased, the number of involved unemployed persons in 2006 was by 13.2 thousand lower than in 2005.

The majority of participants are involved in measures to raise competitiveness (145.7 thousand job seekers in 2006). Other measures are implemented to the following extent: 8.6 thousand unemployed persons are involved in professional training, retraining and raising skills of the unemployed, 9.6 thousand are involved in paid temporary works, and 2.4 thousand are involved in measures for certain groups of persons.

Creation of workplaces is being subsidised in the framework of measures for certain groups of persons. 797 subsidised workplaces were created by the measure "Subsidised employment of unemployed persons from target groups". 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 being implemented 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.

Amendments to the *Unemployed and Job Seekers Support Law* were adopted in June 2007, expanding the range of active employment measures. In order to promote inclusion of people in the labour market, measures to foster regional mobility will be carried out. New target groups of measures have been determined, such as economically inactive population, persons taking care of family members, and persons with alcohol/drug addiction problems.

As from 2008, SEA plans to offer training not only to the unemployed but also to the employed and self-employed persons in addition to the organised active employment measures. It will be possible for entrepreneurs and branch associations to improve skills of their employees by attracting co-financing from the European Social Fund. Also persons willing to start their small business will have an opportunity to apply for the support. The necessary training as well as subsidies and loans for their first steps in business will be available for them.

For **inclusion of young people in the labour market**, the Professional Career Counselling State Agency (PCCSA) gave 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 being involved in a priority manner into the active employment measures organised by SEA. Resulting from institutional changes, PCCSA is included in SEA as from September 1, 2007 in order to concentrate professional career counselling services in the context of job seeking into one institution.

Promotion of youth employment is carried out in the framework of several projects. Several projects to raise competitiveness of young people are in process of implementation with support of the European Social Fund. E.g., opportunities of practice are ensured for young people in the framework of measure "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" is under implementation for several years. The aim of this measure is to promote summer employment of schoolchildren and create an opportunity for them to gain 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 of the manager for 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.

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. 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. The proportion of women employed in low-paid work is essentially higher than said proportion for men.

Trends of society's ageing draw greater attention to prolongation of working life. Significant thought is given to keeping or involving **aged people** in employment.

In 2006, SEA started implementation of special employment measure "Prolongation of active life for seniors" for job seekers in the pre-retirement and retirement ages. 9 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.

Although the employment rate has increased in all regions, considerable **regional differences** still exist. In 2006, the difference between regions with the

highest and the lowest employment rates (Riga and Latgale regions respectively) was more than 15 percentage points.

In the planning period of 2007-2013, extensive attention is devoted to reduction of regional differences. E.g., preference to local governments with high unemployment will be given in implementation of the activity "Support to implementation of local employment promotion plans".

Due to the growing globalisation of economy, rapid development of technologies and negative demographic processes, an increasingly greater attention to issues of **flexicurity** (labour market flexibility and employment security) is paid in the European employment strategy. Already in March 2006, the European Council asked member states to pay more attention to implementation of reforms in labour market and social security policies.

Flexicurity contains 4 spheres of action that, through interaction, have to promote labour market flexibility and employment security. It is necessary to achieve that labour legislation and agreements are sufficiently flexible and correspond to the interests of both the employer and the employee. In case of necessity, active labour market policies have to promote efficient transition from one workplace to another or from the status of unemployed person to employment. It is necessary to improve the lifelong learning systems that would enable employees to be employed throughout the period of capacity for work. At the same time, a modern social security system has to be created, which would render adequate assistance to population in case of unemployment as well as would promote mobility and faster return to the labour market.

It is important to ensure modernisation of work organisation and safety at work. It should be noted that Latvia lags behind other EU member states in this regard. It is necessary to improve safety at work, the number of people injured in accidents at work is still rather high, and the number of persons suffering from occupational diseases tends to grow.

Latvia has a relatively high **rate of undeclared employment**, especially in construction, manufacturing, agriculture and transport services, which reduces the social security benefits and does not allow diminishing 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 increased, raising the minimum wage and increasing the amount of non-taxable minimum, state control institutions are strengthened and co-operation with social partners (trade unions and employer associations) is activated.

For reduction of illegal employment, administrative capacity of the State Labour Inspectorate is raised. Formation of the register of employed persons has been started.

An essential role in the aspect of employment is played by **the educational system, accentuating the necessity of lifelong learning**. 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 demands 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 system of lifelong learning.

Lisbon Strategy envisages that at least 85% of young people in the age group of 20-24 years will complete secondary education by 2010. Situation in Latvia in this regard is better than in the EU on average. It is expected that this target set for 2010 will be achieved.

Considerable work for improvement of the educational system has been done over the last years, and also resources of the EU structural funds are used for this purpose. Material and technical provisions of professional education establishments are modernised and a set of measures to ensure practice of students is established. In order to raise prestige of engineering sciences, natural sciences, medicine and other disciplines necessary for development of Latvia, more attention is paid to development and implementation of information campaign and to increase of the number of study places financed from the state budget in these disciplines.

A topical task is to reduce the number of students who do not graduate or do not achieve professional education.

It is necessary to activate development of the lifelong learning system. According to the EU target, at least 12.5% of people in the age group of 25-64 years will be involved in activities of lifelong learning by 2010. Mere 6.9% of the employed in the age group of 25-64 years participated in professional training activities or attended some educational establishment in 2006.

In February 2007, the Cabinet of Ministers accepted the *Lifelong Learning Policy Guidelines for 2007-2013*. This document formulates the basic principles, objectives, directions and plans of action of lifelong learning policy. Attention is paid to recognition of informal education and to development of lifelong learning in regions. Lifelong learning programme for implementation of the guidelines in the nearest years is in the process of elaboration.

Changes in the labour market to timely balance the demand and supply of the labour market cause a necessity to develop the system of **labour market forecasting**. 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.

The Ministry of Economics has started work and has created the institutional framework to develop labour market forecasts. Labour Market Forecasting Co-ordination Division is established at the ministry with the task to co-ordinate development and application of medium-term and long-term forecasts of the labour market.

To carry out the direct work, i.e., elaborate labour market development scenarios and medium-term and long-term forecasts, the Cabinet of Ministers accepted expansion of functions of the state agency "Latvian Institute of Statistics" (as from July 1, 2007, the name of this agency was "Latvian Institute of Statistics and Labour Market Forecasting").

In order to ensure more economical spending of state budget expenditures and optimise conduction of public administration functions, the Ministry of Economics initiated reorganisation of the state agency "Latvian Institute of Statistics and Labour Market Forecasting". The Cabinet of Ministers accepted incorporation of the agency into the Central Statistical Bureau as from November 1, 2007 and takeover of the agency's functions by the bureau.

It is planned to establish the Advisory Council of Labour Market Forecasting that will include representatives of the interested institutions and social partners. Its aim will be to ensure inter-institutional co-operation. The prepared forecasts will be discussed and solutions for further action will be sought at this council.

In order to work out scenarios and forecasts of labour market development, it is necessary to create an appropriate set of instruments for modelling. With the support of the European Social Fund, the Ministry of Welfare commissioned the study "Research of long-term forecasting system of labour market demand and analysis of its improvement opportunities". Results of the study include the set of modelling instruments necessary for development of medium-term and long-term forecasts of the labour market. The Cabinet of Ministers instructed the Ministry of Economics to begin implementation of the function of medium-term and long-term forecasting of the labour market, taking over the results of the mentioned study. After receiving the set of instruments at the end of June, the ministry has assessed its applicability and has conducted its approbation. Preliminary medium-term forecasts of the labour market by 2013 are being prepared after making the necessary improvements in the set of instruments.

## 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 2005<sup>1</sup>.

The Programme is based on the policy-planning documents approved in Latvia and reflects the most essential problems of Latvia for achievement of the Lisbon Strategy goals, indicates main lines of action and activities to solve the problems as well as performance indicators for achievement of 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 Programme<sup>2</sup> indicates that the principal goals set in it are achievable. Very fast growth is observed in Latvia in the recent years. GDP has increased by 10.4% on average annually since 2004. Rapid economic growth continues in 2007 as well. In the first 3 quarters of 2007, GDP increased by 11% in comparison with the respective period of 2006. Such rapid growth of GDP certainly decreases Latvia's backwardness from the old EU member states.

Indicators of employment also improve rapidly in Latvia. Employment rate reached 66.3% in 2006, i.e., it increased by 3 percentage points in comparison with 2005. It means that Latvia approaches the

Programme's target to ensure employment rate of 67% in 2010.

Despite these achievements, Latvia is clearly aware of the existing problems and develops appropriate policies to solve them. Latvia supports decisions taken at the Spring meetings of the European Council in 2006 and 2007 and recommendations to the country. Measures to fulfil these decisions are being implemented.

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, 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 the 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 avert additional economic instability, at the same time taking into account the consequences of inflation;
- to ensure successful accession of Latvia to the euro zone.

<sup>1</sup> In March 2000 in Lisbon, the European Council approved the EU strategic development document (Lisbon Strategy) that sets as its 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 that combine the Broad Economic Policy Guidelines and the Employment Guidelines and constitute a base for development of national reform programmes.

<sup>2</sup> On October 9, 2007 the Cabinet of Ministers supported the *Report on Progress in Implementation of the National Lisbon Programme of Latvia for 2005-2008* that is developed by the Ministry of Economics and evaluates the progress in achieving the Lisbon Strategy goals.

One of the main economic development risks in Latvia is the high inflation rate and the high current account deficit caused by high domestic demand.

Government has worked out and started implementing the *Inflation Reduction Plan* that is directed at restriction of the domestic demand.

Fiscal consolidation successfully carried out already in the previous years continued in 2006, which ensured that the general government budget deficit was 0.3% of GDP in 2006. *Inflation Reduction Plan* prescribes that a balanced budget must be achieved in 2007 and 2008, while it is planned to form a budget with surplus in 2009 and 2010. However, by the Law “Amendments to the Law “On the State Budget for 2007””, the Saeima has approved the state budget for 2007 with a surplus of 0.4%, and the government plans to reach even bigger budget surpluses in 2008, 2009 and 2010 than in 2007 (see Chapter 4.1.1).

The Cabinet of Ministers has taken decision on the maximum permissible amount of the total expenditures of the state budget for 2008-2010. It is also envisaged to raise efficiency of the public sector without increasing the number of its employees. In order to ensure purposeful development and efficient spending of the state budget resources, ministries introduce the strategic planning and, as a result, budget formation is based on financing the action policy goals and results.

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

Assessment of sustainability of public finances of Latvia is positive and, in accordance with assessment by ECOFIN, Latvia is among countries at low risk with regard to sustainability of public finances.

*Latvia's National Euro Changeover Plan* is being implemented, which prescribes to carry out several measures with respect to alignment of laws and regulations for adjustment of the normative base of money and payment systems, financial system, management of state debt, budget accounting and statistics, business environment and consumer protection, tax and social provision and ensuring its technical operation as well as for informing the society. The Cabinet of Ministers approved the Latvia's National Euro Changeover Plan updated according the current situation in the country and its Appendix No. 1 “Action Plan for Introduction of the Single European Currency in Latvia” on September 25, 2007.

Economy based on **knowledge and innovation** is a precondition for development and competitiveness of the Latvian 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 29.8 million in 2006 and LVL 32.4 million in 2007.

National programme “*Support for Implementation of Doctoral Programmes and Post-Doctoral Research*” is being implemented for renewal of intellectual potential of scientific activity. In order to foster renewal and development of intellectual potential of scientific activity, it is envisaged to achieve increase of the number of new doctors to 500 doctors of science trained annually by 2013 (106 doctoral theses were defended in 2006).

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).

Commercial companies have the opportunity to submit projects to the Ministry of Education and Science to receive assistance for implementation of the projects in the framework of *EUREKA programme*. *Market-Oriented Research Programme* is being implemented and research projects aimed at fostering integration of science and production are being supported in its framework.

To promote transfer of technologies and knowledge, operation of technology transfer contact points at Latvian higher education institutions is supported and work of the *Innovation Relay Centre* is ensured.

Implementation of the *Innovation Centres and Business Incubators Development Programme* was started in 2007. Its goal is to promote improvement of innovation infrastructure as well as support innovation centres and formation and operation of business incubators. 11 projects of innovation centres and business incubators have been supported in the framework of the programme.

In the next financial perspective period (2007-2013), it is planned to implement new programmes directed to promotion of co-operation between industries and research institutions, such as support to competence centres, promotion of technology transfer, support to business incubators and 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 (see Chapter 6.6). The first, which has 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: 31% of households had Internet access in 2005, while 42% had it in 2006. 14% of households had broadband access to Internet in 2005 (23% in 2006). Internet was available for 80% of enterprises in 2006. Progress is smaller in terms of access to public services and use of these services by enterprises.

In order to develop and improve the infrastructure of electronic government and the range and quality of its services:

- integrated state information systems are being formed, which include electronisation of services and integration of information systems of institutions. State and local government registers are planned to be connected into united system in the future;
- unified state portal is being established, which will be the main channel of access to electronic services of the public sector;
- assessment of normative acts related to electronic signature and development of appropriate normative acts are continued. Since October 4, 2006 every inhabitant of Latvia is provided with opportunity to acquire means for creation of safe electronic signature, which are ensured by the state JSC “Latvijas Pasts” as accredited provider of certification services;
- electronic procurement system maintained by the *Electronic Procurement State Agency* is established;
- new public Internet access points are being developed and provision of information society services is being promoted, e.g., the project of digital library, expanding the opportunities of access to digital content for population.

Conditions for ensuring a **conductive environment for investment and work** improve every year. Reforms for improvement of business environment are evaluated positively in various surveys. In the survey “*Doing Business in 2008: How to reform*” conducted by the World Bank Group, business environment of Latvia takes the 22<sup>nd</sup> place among 178 countries, which is by 2 positions higher in comparison with the previous year, due to

achievements in the spheres of taxation, licensing and liquidation of enterprises.

The study *Global Entrepreneurship Monitor* conducted annually by the *Stockholm School of Economics in Riga* reveals that the proportion of young entrepreneurs (in the age of 18 to 34 years) grows rapidly in Latvian business: from 8% in 2005 to 11% in 2006. Young people in the age of 18 to 24 years represent 27% of all early-stage companies in Latvia.

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 SMEs;
- 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.

Latvia supports introduction of instruments for implementation of the EU *better regulation* initiative both at the European Community level and at the national level of EU member states.

For evaluation of the impact of administrative burden in Latvia, a system of annotations of normative acts is established under supervision of the *State Chancellery*. In the framework of the *better regulation* initiative, pilot projects for determination of administrative burden in such spheres as tax legislation, labour legislation, construction, real estate transactions, fuel market, etc. are being implemented in 2007.

*Action Plan for Improvement of Business Environment* is worked out annually since 1999. Problems included in the Action Plan and their solutions are identified through close co-operation with organisations representing entrepreneurs (see Chapter 6.4).

The Action Plan for 2007 includes 27 measures. The most important issues that are being solved in the framework of this plan are assessment of the rate of state social security payments, improvement of medium-term and long-term forecasting of the labour market, simplification of the procedure for assessment of requirements of labour environment, more efficient settlement of labour disputes, bringing into effect the real estate registration system and simplification of registration procedures, development of infrastructure of the State Land Service, creation of information system of planning and construction, development of

the process of cadastral survey of buildings, improvement of exchange of information, etc.

Coming into force of the new *Insolvency Law* is planned on January 1, 2008. It will provide legal conditions for balancing the interests of debtors and creditors by changing the applicable procedures, principles and goals in insolvency situations and prescribing more favourable legal conditions for restoration of insolvency of debtors and continuation of economic activity.

In the sphere of protection of competition (see Chapter 6.8), the priority up to now has been to fight the gravest violations of the *Competition Law* – conclusion of prohibited agreements and abuse of dominant position. This priority still remains in terms of importance of the violation, however, assessment of the impact of company merger on competition becomes increasingly topical because, in conditions of fast economic growth, intensive merger of companies to ensure competitiveness both in the domestic market and outside it, is observed. Amendments to the *Competition Law* have been developed, which introduce prohibition of abuse of essential influence.

In order to improve access to financing for SMEs (see Chapter 6.7), more attention is paid to allocation of financing for development of business activity in early stage and availability of finances in the form of risk capital as well as to co-financing for development projects of businessmen in territories requiring special assistance. Financial support to entrepreneurship and innovation from the structural funds is planned in the amount of EUR 480 million in the financial perspective period of 2007-2013.

Latvia supports the decision of the 2006 Spring European Council meeting regarding the **energy policy**. It is important to improve the security of energy supply and diversify energy sources thereby reducing the 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 between the neighbouring countries are being developed or implemented in order to lessen the energetic isolation from other EU member states.

The government has accepted the *Energy Development Guidelines for 2007-2016* that envisage several strategic measures to reduce the energy dependence of the country, among them construction of a new power station in Latvia and increased use of renewable energy resources, especially biomass, in energy production (see Chapter 6.3.2).

Discussion of safe supply of natural gas in perspective is allowed by the fact that Latvia has a potential for underground storage of gas in the

amount of up to 70 billion m<sup>3</sup>, which may be explored and used for storage of gas in the future.

Latvian electricity market is open for all consumers as from July 1, 2007. It is planned to open the domestic gas market by 2010. Opportunities for competition in the energy market will be created in this way.

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 rise of energy efficiency and use of cogeneration and renewable energy resources as well as promotes development of environmental technologies. Latvia supports the decision of the 2007 European Council meeting in regard to setting the common EU target of renewable energy resources in the amount of 20% of the total EU consumption of energy resources by 2020 on condition that EU member states are fully involved in division of this target by member states. However, Latvia sees many risks from the economic, technical and environmental aspects and the aspect of sustainable development of resources.

It must be noted that, considering the Decision No. K(2007)3409 adopted by the European Commission on July 13, 2007 regarding amendments to the quota distribution plan of Latvian greenhouse gas emissions, the total decrease from the emission quota volume necessary and planned for Latvia reaches 55%. Latvian state has well-founded concern about development of the Latvian economy and growth of prices in regard to purchase of the necessary volume of quotas, and Latvia currently plans to bring an action in the Court of First Instance of the European Communities against the European Commission for repeal of the mentioned decision.

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.

As already mentioned, labour market indicators in Latvia have considerably improved in the last years due to rapid economic development, improvement and diversification of active labour market measures and other factors. All most important employment policy targets planned in the Programme for 2008 and partly for 2010 (employment rate of women and people in the age group of 55-64 years) were reached already in 2006. However, the employment rate, level of participation of population and other labour market indicators still lag behind the level reached in several EU member states. At the same time, individual sectors of national economy start to face shortage of labour due to emigration of the labour force.

In order to employ the existing labour resources more completely, active labour market policy measures are being expanded. The total number of unemployed persons involved in active labour market policy measures financed by the state increases constantly (54.6 thousand in 2003 and 166.4 thousand in 2006), mainly at the expense of raising competitiveness of the measures.

Several new measures related to inclusion of young people, pre-pension age people and women after childcare leave as well as the disabled and people from other social exclusion risk groups in the labour market were expanded or started in 2006.

In order to improve competitiveness of population in the labour market, the SEA, in addition to the organised active labour market policy measures, plans to offer training not only to unemployed persons, but also to employed and self-employed persons as from 2008. Entrepreneurs and industry associations will be able to apply for co-financing from the European Social Fund for training of their employees. Also persons willing to start small business will have access to the necessary training and to subsidies and loans for the first business activities.

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, 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.

Latvia has a relatively high rate of undeclared employment. The Cabinet of Ministers has approved the *Action Plan for 2005-2009* in order to reduce illegal

employment. The work is being done in three main directions – to raise the administrative capacity and improve the control of the *State Labour Inspectorate*, improve the co-operation of control institutions, and carry out measures to inform the society and promote the legal culture.

One of the most efficient means to stimulate population to work in formal economy is raising the net wages of persons with low income. Thereby the government increased the minimum monthly wage, the monthly minimum not subjected to personal income tax and the monthly tax allowance for dependent persons both in 2006 and 2007. The minimum monthly wage has been raised to LVL 160 as from January 1, 2008.

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 institutions, education institutions 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.

Co-operation between public institutions, education institutions and employers for adjustment of the supply of educational system in accordance with labour market needs is strengthened, cost efficiency is raised at all stages and forms of education, availability of education at all levels is improved, the overall level of technological skills and natural science knowledge is raised, and the system of life-long learning is improved in order to ensure improvement of education and skills.

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. Latvia already exceeds the respective EU average indicator of the share of young people (20-24 years) with at least a secondary

education. This share reached 81% in 2006 in comparison with 77.7% in EU-25 member states.

Several measures are being carried out so that all children of the compulsory education age would be included in the education system (currently 95% on average). Special equalising education programmes providing opportunity for schoolchildren, who finished the 9<sup>th</sup> grade with school-report to acquire certificate of basic education during one year were implemented in 2006/2007 academic year. The number of schoolchildren, who finish the 9<sup>th</sup> grade with school-report i.e. do not acquire basic education, is decreasing.

Both in 2005/2006 academic year and in 2006/2007 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.

Lifelong learning system that would provide opportunity for population to adapt to the conditions of the changing labour market is being created. The Cabinet of Ministers approved the *Lifelong Learning Policy Guidelines for 2007-2013* on February 13, 2007. Introduction of lifelong learning strategy is being carried out by offering to all Latvian inhabitants, who want to acquire education or have to acquire it compulsorily an education that ensures inclusion in the labour market, active participation in civic society and growth of personality. *Draft Action Programme for Implementation of Lifelong Learning Policy Guidelines 2007-2013 for 2007-2010* is worked out, which reflects the set of measures, planning of time for their fulfilment, and the current and necessary costs for their implementation.

**Utilisation of structural funds** of the European Union facilitates achieving the targets set in the Lisbon Strategy in Latvia. Approximately 60% of financial resources from structural funds in 2004-2006 planning period were channelled for implementation of priorities of the Lisbon Strategy. Likewise, in the 2007-2013 planning period of structural funds and the Cohesion Fund, it is planned to channel approximately 61% of the total granted financing 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 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*).

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 institutions, 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. It should be noted that the *Supervisory Board of the Lisbon Strategy* was expanded in 2007, including the Minister for Special Assignments in Managing EU Resources and a representative of the Commission of European Affairs of the Saeima;
- 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.

The issues related to the Lisbon Strategy are discussed at commissions of the Saeima, at the National Economy Council, Latvian Council of the Small and Medium-Sized Enterprises and Crafts, Free Trade Union Confederation of Latvia, seminars, conferences, etc. The EU Information Agency organises discussions on Lisbon Strategy issues on a regular basis.

It should be noted that the assessment by the European Commission of implementation of the national Lisbon programme in Latvia as well as recommendations to Latvia were reviewed both at the meetings of the Advisory Working Group and at the meetings of the Supervisory Board of the Lisbon Strategy. Proposals for implementation of recommendations of the European Commission were discussed during these meetings.

In summer 2007, the Ministry of Economics commissioned the study "Assessment of Progress in Implementation of the *National Lisbon Programme of Latvia*" in order to assess progress in implementation of this programme for 2005-2008 and influence of its measures on reaching the Lisbon Strategy targets in Latvia, and to work out recommendations for new measures and further policy. Round table discussions

were organised in the framework of this study, inviting experts, etc.

Social dialogue is important to achieve 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 level and the regional level. 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.

On December 12, 2007 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. This annual progress report contains also the European Commission's recommendations for every EU member state. Summary of the assessment of implementation of the Programme and recommendations to Latvia by the European Commission are reflected in Box 6.1.

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

#### Box 6.1

##### **Assessment of implementation of the Programme and recommendations to Latvia by the European Commission**

**European Commission considers that the main challenges for Latvian economic policy are as follows:**

- bigger attention should be paid to the development of more concrete measures to secure macroeconomic stability in the face of overheating pressures;
- priorities of the R&D strategy should be set, as well as private sector involvement should be increased;
- labour supply should be increased and the labour skills should be improved.

**Recommendations of the European Commission to Latvia are as follows:**

- to pursue a more restrictive fiscal policy, with a careful prioritisation of expenditures and wage developments that are in line with productivity, in order to contribute to correcting overheating pressures and reducing the risk of macroeconomic instability;
- make faster progress in the implementation of the research and innovation policy reforms, in order to meet the ambitious targets set. This concerns especially policies to stimulate partnerships between research and education institutions and businesses;
- within an integrated flexicurity approach, intensify efforts to increase labour supply and productivity by improving regional mobility and enhance the responsiveness of education and training systems to labour market needs by putting in place a lifelong learning system and pursuing active labour market policies.

**In addition, Latvia should focus on:** improving further the regulatory environment, notably by means of an explicit better regulation policy and improving access to childcare.

## 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

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 of the support from the Structural Funds by Latvia 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 the European Commission decision C(2004) 2121 of June 17, 2004.

Total funds accessible in the framework of the Structural Funds, which the beneficiaries could apply for, consisted 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% are financed from the state budget and budgets of the local governments. In order to apply for support from the Structural Funds, the beneficiary has to provide own 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).

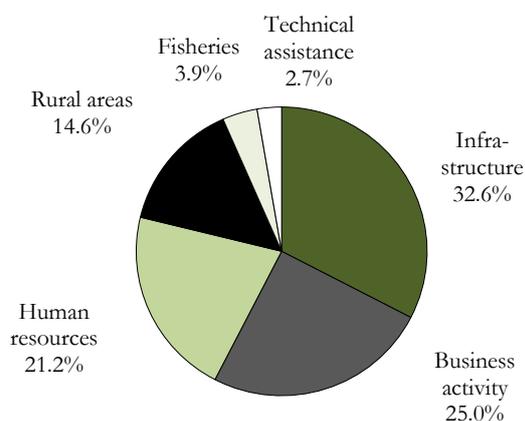
Financing of EUR 625 million from the EU Structural Funds consists of resources from the following funds:

- 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 6.1).

Figure 6.1

#### 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 Resources<sup>1</sup> on implementation of activities of the Single Programming Document and use of financing, absorption of EU financial resources is successfully proceeding in Latvia.

In most 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 allocation of financing by the end of 2008. Projects for total available financing (100%) from SF have been co-ordinated in Structural Funds Steering committees already 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, in respect to the implementation of the activities within its sphere of competence in accordance with orders 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.

LVL 226.8 million or 51.6% of the total available Structural Funds financing have been paid to beneficiaries of SF financing or project implementers by the end of the 3<sup>rd</sup> quarter of 2007, hence this indicator has increased by 9 percentage points in comparison with the results of the previous report. Resources were most successfully paid in the projects co-financed by EAGGF and FIFG, where 81.7% and 85.7% respectively of the available Structural Funds financing were paid. Progress by 4.58 percentage points in the EAGGF framework and by 14.68 percentage points in the FIFG framework was observed in comparison with the indicators of the previous report.

Payments in the ERDF and ESF projects have increased substantially. In both funds, payments have increased by 10 percentage points in comparison with the preceding quarter and, by the end of the 3<sup>rd</sup> quarter of 2007, LVL 109.5 million had been paid to implementers of ERDF projects and LVL 49.9 million were paid to implementers of ESF projects (these amounts constituted 40.8% and 55.7% respectively of the total resources granted from the respective fund).

By September 30, 2007 refunds of Structural Funds financing were requested from the European Commission for 42.2% of the total financing granted to the country, which is by 13.74 percentage points more than as of March 31, 2007. By the moment, when the report was prepared, 28.39% of the total granted financing had been received. Difference between the ESF resources declared in the European Commission and the refunds paid by the Commission is LVL 60.49 million (see Table 6.1).

Implementation of ERDF activities on the whole is assessed as satisfactory. A part of the projects has been completed and all open tenders of project applications and most support programmes have been completed as well, which means that a major part of the projects will be completed by the end of 2007.

<sup>1</sup> 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, November 13, 2007.

Table 6.1

## Progress in Absorption of the Structural Funds as of September 30, 2007

	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	109.52	40.79	59.53	22.17	
ESF	89.50	88.06	98.39	49.85	55.70	4.89	5.46	
EAGGF	64.55	64.84	100.45	52.72	81.68	48.65	75.37	
FIFG	17.10	17.03	99.55	14.66	85.70	11.74	68.64	
<b>Total</b>	<b>439.65</b>	<b>441.58</b>	<b>100.44</b>	<b>226.75</b>	<b>51.58</b>	<b>124.81</b>	<b>28.39</b>	

Measures and priorities of the Development Plan, Economics, are characterised in Box 6.2 and Tables 6.2 which are under management of the Ministry of and 6.3.

**Box 6.2****Measures and priorities set forth by the Development Plan, which are under supervision 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 supervision 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 systems 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 activities;
- 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.

Implementation of almost all open tenders and support programmes under competence of the Ministry of Economics was completed in 2006.

Administrative assessment of the open tender "Efficient use of cultural and historical heritage in tourism" was completed on February 28, 2006. 85 out of 112 of the received projects were submitted to the Ministry of Economics for further assessment according to the 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. Implementation of projects, as well as granting additional financing in the form of surplus obligations from the state budget to implement project activities and cover the rise of prices continued in 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 out of 87 of the received project applications were submitted to the project assessment commission established by the Ministry of Economics for assessment according to the qualitative and specific criteria of assessment. 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. Implementation of projects, as well as granting additional financing in the form of surplus obligations from the state budget to implement project activities and cover the rise of prices continued in 2007.

6 projects with the 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 Activities.

Regarding the progress in implementation of ESF activities under responsibility of the Ministry of Economics, in the 1<sup>st</sup> quarter of 2006, a decision was taken to implement also the ESF national programme along with 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.

**Box 6.2 continued**

In addition, the ESF national programme for the second activity of the Ministry of Economics “Training and consultations for beginners of commercial activity and self-employment”, which was previously considered as problematic, was co-ordinated in the 1<sup>st</sup> 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 the SJSC “Mortgage and Land Bank of Latvia” (hereinafter – MLBL). In the framework of the programme, support is provided 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. Upon completion of the training, the participants have to prepare a business plan for launching a commercial activity, which is assessed by experts of the MLBL. 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 has received 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 December 2007).

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 a simplified procedure for submission of the project.

1272 projects have been submitted to LIDA by December 31, 2006, of which the majority is made by 520 projects for receiving 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 administered by the Ministry of Economics for the private sector, agreements have been concluded with the total support in the amount of LVL 137.1 million. Support was provided for implementation of 1074 projects. Activity of applicants and breakdown of financing by regions would be assessed as equal. 22% of all resources are channelled to projects that are being implemented in Riga, 19% – in Riga region, 16% – in Kurzeme and Zemgale regions, 15% – in Vidzeme region 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 higher activity of entrepreneurs from regions. Assessment of the activity of applicants leads to a conclusion that the objective is fulfilled successfully, because breakdown of the required support volume by regions was not considerably different: Lielrīga – 38%, Kurzeme – 17%, Zemgale – 17%, Vidzeme – 16% and Latgale – 12% of the total required support volume.

In order to level out the 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. Assistance from the Cohesion Fund is available for 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.

Similar to the situation as it is 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 was set at 80-85%. Furthermore, the contribution from the EU may even reach up to 90% of the total project costs if financing is also received from the Structural Funds. 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, which only sets out the 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 in comparison with ISPA:

- transport sector – roads, railways, ports, airports, public transport;
- environmental sector – management of household waste (regional waste landfill sites), sewage treatment, drinking water supply.

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 in National Economy Sectors**

	Total provided support		Number of project applications	
	million LVL	%	number	%
Agriculture	0.3	0.2	2	0.2
Textile processing	5.4	3.9	27	2.5
Logging/woodworking	25.0	18.2	159	14.8
Chemical industry	13.7	10.0	60	5.6
Metal working	17.7	12.9	83	7.7
Production of electronic equipment	4.3	3.2	34	3.2
Mining industry, production of building materials, construction services	26.6	19.4	137	12.8
Services	11.2	8.2	232	21.6
Food industry	6.7	4.9	34	3.2
Printing and publishing industry	8.0	5.9	38	3.5
Transport	3.5	2.6	27	2.5
Energy	1.2	0.9	4	0.4
Trade	2.6	1.9	112	10.4
Processing of raw materials	2.8	2.0	7	0.7
Healthcare	1.9	1.4	9	0.8
Recreation/Tourism and hotel services	5.0	3.7	79	7.4
Other sectors	1.1	0.8	30	2.8
<b>Total:</b>	<b>137.1</b>	<b>100</b>	<b>1 074</b>	<b>100</b>

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 currently under implementation (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.

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**

	Total provided support		Number of project applications	
	million LVL	%	million LVL	%
SSP 2.0 "Support to development of new products and technologies"	3.7	2.7	40	3.7
SSP 1.2 "Improvement of commercial activity according to the requirements of international standards"	99.8	72.8	251	23.4
SSP 1.3 "Support to shared infrastructure development"	6.4	4.6	15	1.4
SSP 1.1 "Support to infrastructure development: connection and reconstruction"	4.6	3.4	25	2.3
SSP 3.2 "Participation in international exhibitions and trade missions"	1.2	0.9	95	8.9
SSP 3.1 "Consultation services"	2.7	2.0	286	26.6
SSP 4.0 "Support for training, retraining and further education of the employed"	2.7	2.0	177	16.5
"Loans (incl. microcredits) for launching commercial activity"	6.7	4.9	84	7.8
"Development of loan guarantee system"	9.3	6.8	101	9.4
<b>Total</b>	<b>137.1</b>	<b>100</b>	<b>1 074</b>	<b>100</b>

EUR 343 million (48.32% of the approved CF financing for Latvia in 2000-2006) were received from the European Commission and EUR 290.4

million (40.86% of the financing) were paid to executors in the framework of the concluded agreements by September 30, 2007 (see Table 6.4).

Table 6.4

### Progress in Absorption of the Cohesion Fund as of September 30, 2007

	CF financing	Projects approved by the European Commission		Paid to beneficiaries of CF financing		Payments received from the European Commission	
	million LVL	million LVL	% of available financing	million LVL	million LVL	million LVL	% of available financing
Ministry of Environment		353.2	49.7	120.0	34.0	136.8	38.7
Ministry of Transport and Communications		353.9	49.8	169.5	47.9	205.2	58.0
Ministry of Finance		3.7	0.5	1.0	27.2	1.4	38.1
<b>Total</b>	<b>710.8</b>	<b>710.8</b>	<b>100</b>	<b>290.4</b>	<b>40.9</b>	<b>343.4</b>	<b>48.3</b>

20 Cohesion Fund projects have been approved in the environmental sector, including 17 infrastructure projects and 3 technical assistance projects with the total CF financing in the amount of EUR 217.6 million (total financing of the projects is EUR 366.2 million).

14 Cohesion Fund projects have been approved in the transport sector, including 11 infrastructure projects and 3 technical assistance projects with the total CF financing in the amount of EUR 312.2 million (total financing of the projects is EUR 563.6 million).

Implementation of Cohesion Fund projects takes place steadily. A part of the projects has been completed but implementation of several projects has been delayed for two years. Implementation of some CF projects by 2008-2009 is planned in accordance with decisions or financial memoranda of the European Commission. 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 the projects that were planned and started in the previous years. This substantial rise of prices is explained by the rapid growth of prices both of fuel and of construction materials, as well as by increased labour costs due to the total increase of demand in the construction sector. The substantial rise of prices is also promoted by lack of competition in the construction sector.

#### Planning period of 2007-2013<sup>1</sup>

Financing from all of the abovementioned financial sources was available in the period of 2004-2006. This multi-annual budget-planning period (also called financial perspective), lasting from 2000 to 2006 for the old EU member states, expired in 2006 and therefore 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 5 to 7 years. Preparation of documents is currently in progress, in order to ensure utilisation of co-financing from EU funds for the next period – from 2007 to 2013.

In order to ensure high-quality absorption of the Structural Funds and the Cohesion Fund, all necessary planning documents and normative acts, which would ensure starting of absorption of SF and CF, must be prepared. Latvia has had access to the resources starting with January 1, 2007, but development, co-ordination and approval of the planning documents took a long time and this did not allow launching timely absorption of finances.

In order to start efficient absorption of SF and CF resources, it is offered to carry out programming on 3 levels in accordance with draft general regulation of SF and CF (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 member states).

The *National Strategic Reference Framework Document* for the period of 2007-2013 (hereinafter – NSRFD) is the main SF and CF planning document on 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 framework 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), as well as considering provisions of the long-term conceptual document “The Growth Model for Latvia: People First” approved by the Saeima.

The general management framework and planning documents of SF and CF are being worked out, mutually co-ordinating them with the bodies involved

<sup>1</sup> Source: Ministry of Finance.

in management of EU funds and consulting with partners (social partners, representatives of regions, NGOs) about a wording acceptable for all parties. Ministry of Finance has been appointed the institution responsible for implementation of NSRFD. The ministry has to submit quarterly informative reports on implementation of NSRFD to the Cabinet of Ministers as from 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, it is most essential to channel SF and CF investments in the period of 2007-2013 in Latvia to 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 a precondition to balanced development of the country and its territory.

On June 19, 2007, the Cabinet of Ministers approved NSRFD, on which the distribution of the EUR 4.53 billion worth financing from the SF and CF available for Latvian state in the period of 2007-2013 is based. The European Commission also approved it on September 20, 2007 – thus the absorption of the programme and resources could be started.

Balanced development of the territory, macro-economic stability, equal opportunities, sustainable development and information society are determined as the horizontal priorities.

In order to achieve the goals, it is planned to manage SF and CF investments by using three operational programmes that determine the beneficiaries of financing, as well as the activities and sectors to be supported in greater detail:

- Operational Programme “Human Resources and Employment” of the European Social Fund;
- Operational Programme “Enterprise and Innovation” of the European Regional Development Fund;
- Operational Programme “Infrastructure and Services” of the European Regional Development Fund and the Cohesion Fund.

All three operational programmes are approved both by the Cabinet of Ministers and by the European Commission, thereby allowing start of absorption of the available resources and promulgation of the support programmes.

Sources of financing of the OPs are the European Regional Development Fund (53.86% 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) (see Table 6.5). Along this, the financing from the state budget and the private co-financing has to be ensured.

Table 6.5

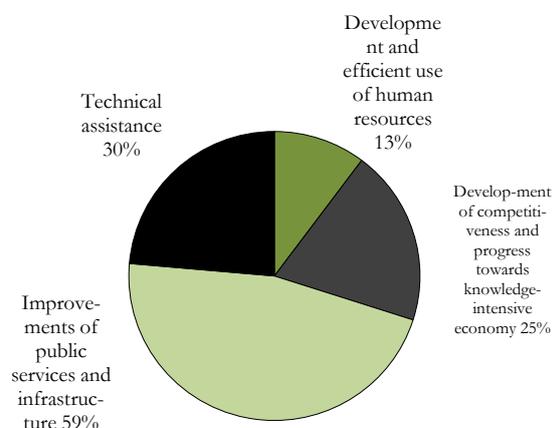
**Financing Available for Latvia in the Financial Perspective Period of 2007-2013**  
(million EUR)

	Assignment	% of the total assignment
ERDF	2 440	53.86
ESF	551	12.15
CF	1 540	33.99
<b>Total</b>	<b>4 531</b>	<b>100</b>

EUR 4.53 billion from the Structural Funds and Cohesion Fund financing is available to the Latvian state. Breakdown of the support by sectors shows that the biggest share of the financing (59%) is provided for infrastructure projects and business development promotion projects (25%) (see Figure 6.2).

Figure 6.2

**Breakdown of Assignment from the EU Structural Funds and the Cohesion Fund by Thematic Axes and Measures of Draft National Strategic Reference Framework Document for the Period of 2007-2013**



Activities under competence of the Ministry of Economics are summarised in Box 6.3.

**Box 6.3****Activities under competence of the Ministry of Economics**

Being one of the branch ministries, the Ministry of Economics is responsible for management of the measures and activities that are under its competence. The following measures and activities are under responsibility of the Ministry of Economics:

**1<sup>st</sup> Operational Programme “Human Resources and Employment”:**

- Support to training of the employed for promotion of competitiveness of entrepreneurs – support to training organised in partnerships;
- Micro-loans for business beginners in the framework of an investment fund;
- Support to training of the employed for promotion of competitiveness of entrepreneurs – support to individually organised training of entrepreneurs;
- Recruitment of highly skilled employees.

**2<sup>nd</sup> Operational Programme “Enterprise and Innovation”:**

- Competence centres;
- Technology transfer contact points and centres;
- Development of new products and technologies;
- Availability of financing;
- Attraction of strategic investors;
- Support to entrepreneurship and improvements of equipment.

**3<sup>rd</sup> Operational Programme “Infrastructure and Services”:**

- Tourism;
- Energy efficiency and availability of apartment houses;
- Energy.

Activities of the 2<sup>nd</sup> Operational Programme under competence 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.

Implementation of the support programmes under competence of the Ministry of Economics is ensured by the Latvian Investment and Development Agency.

**6.2.2. Foreign Trade Policy**

Common trade policy is implemented within the EU, where the European Commission negotiates bilaterally and multilaterally with third countries on behalf of 27 EU member states. In these negotiations, the European Commission voices a common EU position that is co-ordinated with member states in the

committee on foreign trade policy issues or the so-called Article 133 Committee of the EU Council.

A new turn in the EU foreign trade policy was made at the end of 2006, when the EC came forward with a new external competitiveness strategy “Global Europe: Competing in the World”, setting as a goal the contribution of trade policy to ensuring growth and creating new jobs in Europe (see Box 6.4).

**Box 6.4****EC in implementation of external competitiveness strategy**

In the framework of the mentioned strategy in the 2<sup>nd</sup> half of 2007, active work took place in all three dimensions of the EU common trade policy – multilateral relations, bilateral relations, and local measures, in order to achieve the principal goals directed at general liberalisation of trade, rise of EU competitiveness, and strengthening traditionally democratic values, especially in the context of regional co-operation and development of developing countries:

- In multilateral relations, the EU maintains its priority of liberalisation of trade on multilateral level and still is the main driving force in multilateral negotiations of the WTO and in the process of entry of new member states;
- In bilateral relations, several rounds of talks with South Korea, India, and ASEAN countries were held on new-generation Free Trade Agreements aimed at increased access to market and enhanced co-operation in the context of trade. Progress is also observed in the negotiations started earlier on conclusion of FTA and Association Agreements.
- A dialogue has been started with China on co-operation in strengthening trade relations, aimed at balanced openness of EU market for Chinese exports with cancellation of high tariffs and tariff peaks concerning EU goods.
- At the same time, plenty is done to implement the Market Access Strategy prescribing several measures for identification, prioritisation, and prevention of obstacles to trade, hence helping EU exporters in the markets of third party countries. Work is also continued in implementation of initiatives of public procurement and intellectual property rights in order to promote duly access for EU companies to public procurement orders of third party countries and protect IPR interests of the EU in the markets of third party countries.

Work is also being completed on the new reform of market protection instruments, having an objective to duly review the current EU protection measures in order to adjust to changes of globalisation of economy.

At the same time, implementation of EU trade policy is also taking place in the context of development policy, which is characterised not only by unilaterally determined preferential trading regime for individual developing countries, but also by willingness to promote regional co-operation of these developing countries for ensuring further growth and regional stability.

**Multilateral relations**

Strengthening the multilateral trade system remains a priority of the EU trade policy. Furthermore, the

most efficient way to promote economic development and welfare, ensuring predictable trade flow in the

global space, is having unified international trade rules and implementation of legal norms set therein.

In the framework of the **round of multilateral trade liberalisation talks (DDA)** started in the capital of Qatar – Doha – in 2001, work is continued to prepare modality texts of trade conditions for agricultural and industrial goods, which will be already the second set of documents of the kind after the initial drafts developed in July 2007, which were subjected to essential differences of opinions between developing and developed countries.

Successful DDA talks constitute one of priorities of Latvian foreign trade. Latvia hopes to benefit from liberalisation of multilateral trade by getting freer access to markets of industrial goods and services of third party 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 also expected that freer access to markets of other countries will encourage expansion of export markets of other EU member states and of Latvia both directly and indirectly and further growth of economy of the country.

Increased access to the global market of industrial goods (see Box 6.5) would promote export development opportunities of perspective Latvian industries (among them machine building and metal-working, chemical industry, wood industry and light manufacturing) in the markets of developed countries (including USA and Japan) and fast-growing developing countries (e.g., China, India, and Brazil). For implementation thereof, reduction and suspension not only of import tariffs but also of various non-tariff barriers (export restrictions, unjustifiably high standards, etc.) is important; these non-tariff barriers frequently have much greater distorting influence on international trade than tariffs.

Considering the big share of services in Latvian GDP, it is important to achieve abolition of global service trade barriers, e.g., regarding restrictions on equity shares, restrictions on the number of foreign employees, inspections of economic necessity, etc. Thus, new opportunities would be created for development of cross-border trade in services, movement of individual persons – service providers, and new investment for provision of professional, business, transport, financial, and information technology services.

By simplifying and harmonising international trade rules, as well as by reducing amounts of various payments (e.g., customs fees), decrease of the length of international trade operations and of the costs of companies involved in trade would be fostered, which has an important role in development of global trade. The most essential for Latvia in trade promotion talks is to achieve conditions promoting development of transit, among them recognition of pipeline transport as a type of transport, as well as ensuring free and non-

discriminatory access to ways of transit and types of transport.

Increase of market access within the multilateral trade system is ensured also by **admitting new member states to the WTO** with corresponding commitments. 29 countries are in the process of admission to the WTO at present, among them such trade partners important for Latvia as the Russian Federation and Ukraine. Admission of the mentioned countries to the WTO is essential for Latvia hence the further mutual trade relations would be based on the contractual base of the WTO. Despite this, admission talks of every candidate state greatly depend both on ability to align legislation and trade regime in accordance with the WTO norms and with priorities of the candidate state itself.

Although the **Russian Federation** constantly asserts willingness to join the WTO in the nearest future, there are several issues on which it has to reach agreement both bilaterally with individual WTO member states (Georgia and Saudi Arabia) and multilaterally with all WTO member states on such issues as state trade companies, technical barriers to trade, sanitary and phytosanitary measures, protection of intellectual property rights, agriculture, export duties, and customs formalities. Issues unsolved in the multilateral process of accession and several bilateral trading disputes with the EU and Georgia have substantially slowed down the process of accession of the Russian Federation to the WTO and accession talks at present seem difficult to be completed also during the next year.

EU completed bilateral talks with the Russian Federation in 2004 but, in the framework of multilateral accession talks, the European Commission maintains issues of export duties on wood materials and railway cargo transportation tariffs of the Russian Federation, of which the last issue is set among EU priorities in WTO accession talks of the Russian Federation due to close co-operation between Latvia and other EU member states (Estonia, Lithuania, Poland, Finland, Hungary, Sweden).

**Ukraine** is close to completion of WTO accession talks and, despite the domestic policy problems, has been able to align the trade regime in accordance with WTO requirements and hopes to complete the accession started in 1993 by the end of 2008. In the middle of November, Ukraine overcame the last obstacle to its accession to the WTO by concluding bilateral talks with Kyrgyzstan. Latvia completed bilateral market access talks with Ukraine in 2002 and with the EU in spring of 2003. Despite this, in the framework of multilateral accession talks, the EU maintains open the issues on commitments of Ukraine in regard to export duties and transit of energy resources.

Cape Verde is the closest to accession to the WTO, being ready to become a WTO member state after accession talks that lasted eight years. EU completed the bilateral market access talks with Cape Verde at the

end of October. Cape Verde hopes to become a WTO member state by the end of the year.

#### Box 6.5

##### **Market access for industrial goods – one of the main areas of DDA negotiations of the WTO**

Despite the fact that considerable reduction of import tariffs for industrial goods has been implemented up to now in the framework of Kennedy (1964-1967), Tokyo (1973-1979), and Uruguay (1986-1994) rounds of negotiations of the General Agreement on Trade and Tariffs (GATT), high import tariffs for industrial goods – so-called tariff peaks (higher than 15-20% of the import value) and tariff escalation (the higher the value-added of the commodity, the higher the import tax rate applied to it) – have remained in many WTO member states, as well as new and frequently non-transparent non-tariff barriers (standards, quantitative restrictions, import and export prohibitions, etc.) are being introduced, which essentially and often unjustifiably restrict the international trade flows. Considering that the international trade of industrial goods constitutes about 90% of the global trade of goods, reduction of trade restrictions for these goods in the DDA framework is especially important for attainment of long-term global development goals.

In order to ensure multilaterally efficient and predictable reduction of import tariffs, WTO member states in the DDA have agreed on the use of a comprehensive non-linear formula – so-called Swiss Formula, which is applied according to the principle: the higher the initial tariff rate, the bigger the cut. It is expected that such cuts together with restriction of non-tariff barriers, considering the development interests of developing countries, especially the least developed WTO member states, will facilitate access of Latvian industrial products, among them chemical products, textiles, wood products, machinery, and metal-work, etc., not only to the markets of the developed WTO member states (USA, Canada, etc.) but also to the dynamically fast-growing markets of developing countries (Brazil, Argentina, India, etc.) in long term. Hence, in order to promote diversity of export markets outside the EU, it is important for Latvia to achieve as big reduction of import tariffs for industrial goods of third countries as possible, and it is especially important to achieve transparency regarding introduction of non-tariff barriers of WTO member states and ensure effective abolition of unsubstantiated non-tariff barriers. Comprehensive reduction of trade restrictions for industrial goods in the WTO framework is substantial for Latvia also because such important trade partners as Russia, Ukraine, and Belarus are among WTO candidate countries and have to assume certain obligations within the accession process, among them reduction in trade restrictions for industrial goods.

In the negotiations on market access for industrial goods currently taking place in the DDA framework, WTO member states work at a draft text of the agreement. As the main open issues considered are: the tariff cut rate of the so-called Swiss Formula for developing countries and developed countries, as well as tariff cut preferences for developing countries, especially the least developed countries. Further progress of market access talks for industrial goods greatly depends on the ability of developed and developing countries to agree on other essential issues in the service market access talks held at the same time, as well as in the agricultural talks that are set as the main precondition for successful result of the DDA by agrarian developing countries.

##### **Bilateral relations in the framework of the EU common trade policy**

Trade relations of Latvia with third party countries are regulated by agreements concluded by the European Union. Bulgaria and Romania joined the EU on May 1, 2007, increasing the EU internal market 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 party 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<sup>1</sup>, and several overseas countries and territories;
- Customs unions with Turkey and Andorra;
- Stabilisation and Association Agreements with Macedonia, Croatia, Serbia, Montenegro, and Albania;
- Trade, Development and Co-operation Agreement with South Africa.

EU member states, in addition to the previously started free trade agreement (FTA) talks with Mediterranean region countries and with countries of

the Gulf Co-operation Council<sup>2</sup> (hereinafter *GCC*), Association Agreement talks with countries of the Southern Common Market<sup>3</sup> (hereinafter *Mercosur*), and Economic Partnership Agreement (hereinafter *EPA*), talks with countries of the African, Caribbean and Pacific Group of States (hereinafter *ACP*), have agreed to start new-generation enhanced FTA negotiations with the Republic of Korea, Republic of India, and countries of the Association of Southeast Asian Nations<sup>4</sup> (hereinafter *ASEAN*), as well as start talks on association agreements including FTA with Central American States<sup>5</sup> and countries of the Andean Community<sup>6</sup>.

Member states of the European Community (hereinafter Community) have also agreed to begin talks on conclusion of enhanced FTA with Ukraine and the Russian Federation (hereinafter Russia) after their accession to the World Trade Organisation (hereinafter WTO).

<sup>2</sup> Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates

<sup>3</sup> Argentina, Brazil, Paraguay, Uruguay

<sup>4</sup> Burma, Brunei, Philippines, Indonesia, Cambodia, Laos, Malaysia, Singapore, Thailand, and Vietnam

<sup>5</sup> Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua, as well as Panama, after its engagement in the Central American economic integration process

<sup>6</sup> Bolivia, Ecuador, Columbia, and Peru

<sup>1</sup> Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestinian Autonomy, Syria, Tunisia

**Box 6.6**

**EU–Russia economic co-operation** is regulated by a Partnership and Co-operation Agreement (PCA), which will expire on November 30, 2007. Development of a new EU–Russia framework agreement is taking place. A meeting of EU and Russian leaders was held in Mafra, Portugal on October 26, 2007, during which the parties agreed on extension of the term of the PCA, considering the fact that the new agreement had not been enforced.

FTA talks with Russia priority for Latvia fully depend on the progress of the process of Russia's entry in the WTO. EU member states, including Latvia, support joining of Russia in the WTO as soon as possible, but the results of the talks are more important than the speed of the entry. Considering the position of the Community envisaging to start the process of FTA talks with Russia only after admission of Russia to the WTO, the talks on conclusion of FTA with Russia still have not taken place.

**EU–Ukraine relations** are currently determined by a PCA that will expire in 2008 and will be replaced by an Enhanced Agreement. Talks on conclusion thereof were initiated on March 5, 2007. Up to now, the EC has held several informal rounds of talks with Ukraine, where the negotiators discussed mutual interests and agreed on the shape of the planned enhanced FTA in the framework of the Enhanced Agreement. Formal talks of the Community on conclusion of FTA with Ukraine will be launched immediately after Ukraine's entry in the WTO – most probably, at the end of 2008.

Latvia has special economic interests regarding conclusion of FTA between the Community and Ukraine, considering that such agreement with Ukraine existed before Latvia's accession to the EU and fostered development of transit and trade. Latvia is especially interested in substantial reduction of bureaucratic requirements and elimination of other non-tariff barriers for entry into Ukrainian market.

**Economic co-operation between the EU and US** takes place in the framework of the Transatlantic Economic Initiative. In order to strengthen the transatlantic economic relations, the EU–US initiative to enhance economic integration and growth was accepted at the EU–USA summit on June 20, 2005. The initiative envisages promoting co-operation between high-level regulators, building more open and more competitive financial markets, encouraging investment for long-term development, co-operating in protection of intellectual property (including third countries), supporting and stimulating innovation and technological development, enhancing security of trade not limiting the trade flow and applying visa-free regime to all EU member states, conducting negotiations in the aviation sphere on conclusion of a new agreement, strengthening co-operation in the sector of services, and ensuring 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 document envisages promotion of co-operation in such spheres as intellectual property, security of trade, financial markets, innovation and technologies, and investment. Transatlantic Economic Council supervising and promoting implementation of economic co-operation between the EU and the US was established during the summit. The aim of the Council is to achieve harmonisation of EU and US regulations and to promote development of mutual trade and dialogue of entrepreneurs.

Latvia will continue supporting implementation of the initiative, while paying attention to promotion of foreign trade, investment, and co-operation of entrepreneurs.

**The 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 the kind in China was initiated in 2004. The programme consists of 6 elements: 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.

The first round of negotiations on conclusion of new PCA took place in Beijing on October 18, 2007; during the negotiations, the parties discussed issues related to trade. At these talks, China indicated its willingness to complete the talks by the EU–China summit in 2008. The next round of talks is planned in Brussels at the end of 2007.

In 2007 the EU started negotiations on conclusion of FTAs with **the South Korea, ASEAN** countries, and **India**. At the moment, FTA talks with **South Korea**, which were initiated in May 2007, have progressed the most and this country has confirmed its willingness to complete the dialogue by the end of 2007. Process of FTA negotiations with **India** was launched in Brussels on June 28–29, 2007, where both parties agreed on conclusion of a comprehensive FTA. It is planned that conclusion of the FTA may occur in 2008.

A dialogue with **Mediterranean countries** on conclusion of Free Trade Agreements was started in 1995 with a goal to create a Community–Mediterranean free trade area by 2010. It is envisaged that the FTAs will be asymmetrical – the Mediterranean countries will have to assume a lower level of commitments.

Talks with **GCC countries** on conclusion of FTA were resumed in 2002, comprising also conditions of service trade and investment. The aim of this FTA is asymmetrical and development-oriented opening of goods and services trade in compliance with WTO norms, considering the development level of GCC countries.

Out of the **Western Balkan countries**, Albania, Montenegro, Croatia, Macedonia, and Serbia have signed the Stabilisation and Association Agreements with the EU. Talks on conclusion of the agreement with Bosnia and Herzegovina are completed but it is not signed due to the political situation. These agreements are aimed at creation of a free trade area between the EU and Western Balkan countries.

In the framework of talks on conclusion of the Association Agreement between the EU and the **Andean Community countries**, the first round of trade talks took place in Bogota (Columbia) on September 17–21, 2007, where the parties agreed that, considering the development level of involved countries, this agreement will be asymmetrical one, i.e., the least developed countries will initially have to assume less commitment in creation of the free trade area.

The first round of negotiations on conclusion of the Association Agreement between the EU and the **Central American States** took place in Costa Rica on October 22–26, 2007, where aspects of FTA were discussed along with other traditional spheres of negotiations on association agreements. It is planned that this agreement will be asymmetrical, focussing on development needs of countries of the region.

**Box 6.6 continued**

Talks on conclusion of *EPA* between the Community and **ACP countries** must be completed by January 1, 2008. The main goal of *EPA* talks is to promote gradual integration of *ACP* countries in the global economy, which is planned to be implemented by agreeing on asymmetrical trade conditions, thus increasing the trade capacity of countries of these regions and fostering reciprocal integration of regions.

**Economic relations with third party countries: economic co-operation agreements of Latvia**

In order to activate bilateral economic co-operation after accession to the EU, Latvia has concluded bilateral economic co-operation agreements with the Russian Federation, People's Republic of China, Republic of Belarus, Ukraine, Republic of Kazakhstan, Republic of Azerbaijan, Georgia, Republic of Moldova, and Republic of Uzbekistan. Agreement on economic, industrial, scientific, and technical co-operation between the governments of the Republic of Latvia and Kyrgyz Republic was concluded on September 13, 2007.

These agreements are the most important umbrella agreements regulating bilateral economic co-operation and comprising 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.

Work is in progress at conclusion of Agreements on Economic Co-operation with government of **Vologda Region** and administration of **Yaroslavl Region** of the **Russian Federation**.

Economic co-operation agreements concluded between Latvia and third party countries prescribe establishment of Intergovernmental Commission and/or Joint Committee, which ensure supervision of validity of these agreements and opportunities of analysis on how to improve further co-operation.

**A meeting of the work group of the Latvia-Russia Intergovernmental Commission took place in Riga on June 20, 2007**, where issues of the condition of Latvian–Russian commercial and economic relations, development of the legal base for conclusion of bilateral co-operation agreements, condition of road border control points on the Latvia–Russia border, co-operation in the energy sector and finances, etc. were reviewed. At the meeting, a working group on co-operation in transport was established. In order to prepare for this meeting, a meeting of the working group On Economic Co-operation of the Latvia-Russia Intergovernmental Commission took place in Moscow on June 6, 2007, where the issues of economic co-operation and co-operation in the transport sphere were reviewed.

**The 3<sup>rd</sup> meeting of the Intergovernmental Commission established in the framework of the Economic, Scientific, and Technical Co-operation Agreement between the Government of the Republic of Latvia and the Government of the Republic of Belarus took place in Riga on October 8-10, 2007**, where co-operation in such

spheres as transport, entrepreneurship, pharmaceuticals, certification in the construction sector, agriculture, tourism, and scientific and technical co-operation was discussed. At conclusion of the meeting, a protocol of intent was signed between JSC *Grindeks*, the leading Belarusian pharmaceutical company “Borisov Factory of Medications”, and the Belarusian pharmaceutical and microbiological concern “Belbiofarm” on co-operation in implementation of the investment project “Establishment of production unit for final dosage forms”, and a co-operation agreement between the Employers Confederation of Latvia and the Association of Non-commercial Organisations “Confederation of Entrepreneurs and Industrialists” was signed.

**The 6<sup>th</sup> meeting of the Latvia–China Joint Committee took place in Beijing on November 13-14, 2007**; in framework thereof, representatives of Latvian and Chinese institutions discussed topical issues of economic co-operation between both countries, including topics relating to transport, transit and logistics, industry, innovation, and within the economic dialogue between the EU and China. At the meeting, the parties stressed the necessity to activate co-operation in manufacturing sectors, consider opportunities of further co-operation between information technology clusters of Latvia and China, and expand co-operation between industry associations of both countries, including in the fields of wood processing, biotechnologies, information technologies, and telecommunications. Issues of transport, transit, and logistics constituted a significant part of the meeting's agenda. The parties discussed directions for development of further co-operation in the spheres of road transport, air transportation, railway, and maritime transport. They came to an agreement to establish a group of experts for co-operation in railway transport with a task to study opportunities to create a container transportation corridor China-Latvia-Western Europe.

Meetings of Intergovernmental Commission of several concluded economic co-operation agreements with **Ukraine, Moldova, Georgia, and Kazakhstan** are planned in the spring of 2008.

In order to create bilaterally equal business conditions both for domestic and foreign entrepreneurs, it is important to provide the **legal regime for protection of investment (financial resources or property)**. It is essential, e.g., for international companies operating in all Baltic States and willing to start business, for example, in the Russian Federation. At present, Latvia has concluded investment protection agreements with more than

40 countries, but such countries as the Russian Federation, Argentina, and Venezuela are not among them. Considering the positive changes in mutual

relations of Latvia and the Russian Federation, agreement on protection of mutual investments might be the next step to inter-state co-operation.

#### Box 6.7

##### Work Group on Economic Co-operation of the Council of the Baltic Sea States

Council of the Baltic Sea States (hereinafter CBSS) is one of co-operation forums of Baltic Sea region countries, which implements regional co-operation in various spheres. One of goals of CBSS is improvement of competitiveness and sustainable development of the region.

Member states of CBSS are Denmark, Estonia, Finland, Germany, Iceland, Latvia, Lithuania, Norway, Poland, Russia, and Sweden.

Several work groups are established in the framework of CBSS: Working Group on Economic Co-operation, Baltic Sea Region Energy Co-operation (BASREC), Working Group on Customs Co-operation and Border-Crossing Aspects, Business Advisory Council, etc.

Latvia is the presiding state of CBSS from July 1, 2007 to June 30, 2008.

Work of the Working Group on Economic Co-operation (WGEC) of CBSS during the presidency of Latvia is organised by the Ministry of Economics.

The following priorities for WGEC of CBSS are set during the presidency of Latvia:

- innovation,
- competitiveness and cluster formation in the Baltic Sea region,
- obstacles to trade and investment.

The 1<sup>st</sup> meeting of the CBSS WGEC took place in Riga on September 13-14, 2007, where the following issues were considered in its agenda:

- priorities of CBSS WGEC during the presidency of Latvia;
- innovation in development of economy;
- competitiveness and cluster formation in the Baltic Sea region, using experience of the Nordic Council of Ministers;
- exploration of obstacles to trade and investment in the region.

Mandate for reform of CBSS, on the basis of priorities set by member states, was given to Latvian presidency of CBSS at the Meeting of Foreign Ministers of CBSS in Malmo on June 13, 2007. The issue of reorganisation of the council is currently being discussed at CBSS in order to ensure its correspondence with the current goals, so that it would make a real contribution to co-operation of the Baltic Sea states. Hence Latvia has to prepare specific proposals for reform of CBSS both in content and structurally and financially during its presidency. At the meetings of CBSS WGEC, also the issue on how WGEC can participate in the reform regarding issues of its competence will be discussed.

### EU sectoral agreements

#### Steel

Steel is a special strategic commodity due to its diverse applications in various sectors and the processing capacity thereof. The steel sector has an important role in international trade.

In the 1<sup>st</sup> half of 2007, steel production in the world reached 761.8 million tons and increased by 7.9% in comparison with the 1<sup>st</sup> half of 2006. Growth of production volumes was ensured by Asian countries with the production increase of 12.6%, especially China where steel production increased by 18.5% (or 279 million tons). Steel production in the EU increased by 2.1% and reached 124.9 million tons in the mentioned period. The high level of prices for steel in Europe continues raising import volumes, which grew by 48% in the 1<sup>st</sup> half of 2007 in comparison with respective period in 2006, while unfavourable exchange rate of the euro and US dollar influenced the decline of EU steel exports by 6% in the 1<sup>st</sup> half of 2007.

EU and Latvia being an EU member state apply provisions of the double control system with quantitative restrictions to import of several steel products from those countries, which are not WTO members (Russia, Ukraine, and Kazakhstan), and adequate agreements on steel trade are concluded with these countries. In July 2007, the EU signed a new

steel agreement with Ukraine, which determines quantitative restrictions to import of several steel products and will be in force by December 31, 2007 and will be extended automatically afterwards. In October 2007, the EU and Russia concluded an agreement on steel trade for 2007 and 2008, which prescribes to increase quota volumes for several steel products in 2007 and 2008, considering also volumes of Russian exports to Bulgaria and Romania, which joined the EU in January 2007. In regard to Kazakhstan, autonomous measures are currently being applied for 2007 and talks on new agreement for 2008 are under way. However, while the new agreement on increased quota volumes for 2008 have not been enforced, the autonomous measures will be set similar to the previous year. After entry of Russia, Ukraine, and Kazakhstan in the WTO, the EU steel agreements with these countries will lapse automatically.

Extension of the agreements provides the entrepreneurs with the guarantees of predictable development, as well as ensures continuity and growth of the traditional trade flows.

Prior surveillance system is applied to imports of several steel products from all third party countries.

#### Textiles

The textile sector is a socially sensitive economic sector characterised by intensive use of labour force, it

is of big importance both in regional development and in international trade. During the last years, the role of several third countries (e.g., China, India, and Pakistan) in textile trade has grown considerably. In the European Union, trade policy issues related to development of this sector are considered by work groups of the Article 133 Committee/Textile of the EU Council of Ministers.

Since January 1, 2005, no quantitative restrictions have been applied between WTO member states. EU and Latvia being an EU member state apply the double control system with quantitative restrictions to imports of textiles from those countries that are not WTO members (Belarus, Montenegro, 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 concluded between the EU and China on June 10, 2005, import restrictions for 10 categories of goods of Chinese origin are prescribed until 2008. In order to ensure gradual transition to quota-free regime after the end of 2008, the double-checking system without quantitative restrictions will be applied for 8 categories of textiles in regard to imports of Chinese origin from January 1, 2008 to December 31, 2008. In the 1<sup>st</sup> half of 2007, the imports of textiles and clothing of Chinese origin amounted to EUR 15311 million or 33.2% of the total EU imports and increased by 22% in comparison with a similar period in the previous year.

### **Trade defence instruments**

#### **Trade defence instruments of the European Community**

The system of trade defence instruments (hereinafter TDI) operates in the European Union, (hereinafter EU) as well as in majority of economies of other countries importing 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 more stringent criteria in application of TDI, hence establishing a system that is more open and more balanced than TDI system of other WTO member states, avoiding unfounded and excessive defence of companies as much as possible.

126 anti-dumping and 11 anti-subsidy measures against various goods in the European Community were in force as of September 30, 2007. Inspection procedures are performed in 82 cases.

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 in the 2<sup>nd</sup> half of 2007:

- anti-dumping proceeding concerning imports of ammonium nitrate originating in Russia and Ukraine;
- anti-dumping proceeding concerning imports of, inter alia, silicon manganese originating in Ukraine;
- anti-dumping proceeding concerning imports of integrated electronic compact daylight bulbs originating in the People's Republic of China;
- anti-dumping proceeding concerning imports of, inter alia, Russian steel tows and cables.

#### **Trade defence instruments applied by third party countries**

As EU applies trade defence measures, also other third party 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 a certain third party country affects the interests of Latvian companies in the markets of the respective countries, Latvia solves the emerged problem both on the level of bilateral relations and on the EU level. EU consults member states on how to represent their interests more efficiently in trade defence instrument proceedings performed by third party 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 party country is the anti-dumping measures against imports of steel bars from Latvia, which are in force in the US. Upon request of the EU, a Panel of the WTO Dispute Settlement Body was formed on June 4, 2007, which reviews the compliance with WTO norms of the practice used by the US in conduct of anti-dumping proceedings; this, inter alia, also affects a Latvian company. US used the so-called “zeroing” method in its decisions adopted for determination of the dumping difference. If the US had not used this method against the Latvian company, then the established dumping difference would be small or non-existent. Intermediate report of the WTO Panel in this process of settlement of disputes is expected in May 2008.

### 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 currently comprises 30 countries (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 market, where the 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 citizens.

In Latvia, the process of implementation of the principles of the free movement of goods and services and the right of establishment, which arise from 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 legal norms that may potentially or actually hinder implementation of the freedoms in the EU internal market, *inter alia*, by assessing the legislative acts currently in a draft stage.

Within the framework of the procedure established for notifying draft technical regulations (Directives 98/34/EC and 98/48/EC), which prescribes a legal obligation of EU member states to submit draft technical regulations to the European Commission and other EU member states and European Economic Area countries for further assessment with a view to preventively assess and avert the introduction 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 7 draft technical regulations by November 16, 2007. As of May 1, 2004 until May 1, 2007, Latvia informed the European Commission about 49 draft technical regulations and received the European Commission's detailed opinions in 10 cases. In most cases, the detailed opinions of the EC related to the fact that draft normative acts did not comprise the principle of mutual recognition, which prescribes that products legally manufactured or placed in circulation in one of the EU member states or Turkey, or legally manufactured in one of the European Free Trade Association countries, which is a contracting party to the European Economic Area Treaty, should be granted free access to the Latvian market by the national authorities concerned.

The principle of mutual recognition is nearly the only legal instrument in the non-harmonised sphere of application of national technical regulations and standards to ensure the free movement of goods in the EU internal market.

The European Commission, by acknowledging the problems currently existing in practical application of the principle of mutual recognition, in February 2007 launched a new initiative for a *Proposal for a Regulation of the European Parliament and of the Council*, aimed at

setting the procedures for application of national technical regulations to products legally sold in other member states. The aim of the regulation is to improve the way of how the principle of mutual recognition works in practice, as well as to provide the public institutions with the necessary instruments for correct introduction of the principle into a daily practice and enable business representatives to use the advantages provided for by the principle of mutual recognition to the full. The Regulation will not be applied to goods with Iceland, Norway, Liechtenstein and Turkey as the country of origin.

Starting with the second half of 2005, Latvia has considerably improved the statistics of implementation of **internal market directives**. 99.2% of internal market directives were transposed into national legislation by July 2007, which is the second best indicator among all EU directives and 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%.

In order to encourage business activity and innovation, promotion of **free movement of services** is one of priorities of Latvia in the European Union. 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 within 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 burden. The directive envisages such measures for prevention of administrative burden 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, which 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 in the European Economic Area, was actively implemented in 2007. The idea of SOLVIT operation is to find a fast and real solution to the internal market problems that have appeared resulting from incorrect application of EU legal norms by public entities. The SOLVIT centres solve problems both of residents and of entrepreneurs, and SOLVIT services are free of charge.

Since the beginning of 2007, Latvian SOLVIT centre has received 18 cases to be reviewed, of which 2 cases were received from SOLVIT centres of other

member states; has sent 10 cases for solution and has reviewed 8 complaints, where violations of EU legal norms were not established.

Due to the fact that a solution found by SOLVIT network (unlike a court decision) is not binding for the public entity, which violates EU normative acts, the proportion of successfully solved cases is an essential indicator and the proportion of such cases was 80 per cent in 2007.

Up to now, residents have complained most frequently about raising different requirements in recognition of professional qualification, necessity of visas, social security (e.g., resident of Latvia applies for unemployment benefit in Belgium, resident of Germany wants to receive disability pension from Latvia also in the future), as well as rights of family members of EU citizens to reside and work abroad. Only one complaint (regarding the border control) was received from companies.

## 6.3. Sector-Specific Development Policies

### 6.3.1. Industrial Policy

One of the main goals of the economic development of Latvia is to create an efficient and competitive industry that would ensure high and stable growth. Industry has a vitally important role in improvement of the foreign trade balance. 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.

On June 28, 2007 the Cabinet of Ministers approved the *Entrepreneurship Competitiveness and Innovation Promotion Programme for 2007-2013* developed by the Ministry of Economics. 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 Latvian economic policy in this strategically important policy direction, which up to now was included in the framework of the National Innovation Programme for 2003-2006, Programme of 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.

**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.

#### Box 6.8

##### Potential of cluster development

Analysis shows that sectors have different potentials of cluster development, because their previous experience of co-operation as well as market situation and development problems are different.

Co-operation in the framework of clusters of information technologies and clusters of forestry and related sectors is organised already for several years, and main focus of the strategy is on development of medium-term action plans for development of co-operation and implementation of joint projects. Several perspective spheres for cluster development are identified in other sectors, however, it is necessary to do additional work for creation of co-operation mechanism and formation of confidence between potential participants of a cluster. Final report of the chemistry and pharmaceuticals sector sets development of research co-operation of pharmaceutical and biotechnology enterprises as a perspective sphere for cluster development. Final report of the textile industry and related sectors recognises development of production of flax and flax products and of the intelligent clothing as perspective directions for cluster development, thereby promoting orientation to production of high value added. Final report of biofuels and related sectors stresses the necessity to initially create a stable co-operation network between enterprises and institutions involved in the biofuels sector, researchers in Latvia and abroad, distributors, consumers and growers of raw materials. Joint research projects in the spheres of plant oil fuel, biodiesel and bioethanol might be carried out initially in the framework of the cluster, turning to transitional biofuels (from the 1<sup>st</sup> generation biofuel to the 2<sup>nd</sup> generation biofuel) and several 2<sup>nd</sup> generation biofuels (such as refined biogas) in further perspective. Final report of the machine building and metal working sector identifies opportunities to develop several specialised clusters in such fields as shipbuilding, production of rail transport, automotive industry, etc. in the course of time.

In 2007, the Ministry of Economics in co-operation with industry associations conducted research on prospects of cluster development in nine

industries. Nine co-operation agreements on development of cluster strategies were concluded. In accordance with agreement conditions, the

associations recruited experts, whose task was to conduct analysis of the situation, identify spheres where preconditions to development of competitive clusters exist, carry out exploration of enterprises and research and educational institutions in the respective and related sectors and do explanatory and motivating work with enterprises and organisations potentially involved in a cluster. As a result of the work, initial strategies of the potential or existing clusters were developed, which contain a jointly defined vision and the set goals, main tasks to achieve these goals and principal spheres of co-operation of cluster participants.

The reports on cluster development prospects and on cluster strategies developed in December 2007 were presented and discussed in seminars with participation of representatives of the respective sectors. Research on the potential of cluster development and development of cluster strategies were carried out in such sectors as:

- information technologies;
- electronics and electrotechnics;
- machine building and metal working;
- biofuels sector;
- textile industry;
- forestry and wood industry;
- chemistry and pharmaceuticals;
- furniture production;
- food industry.

In 2008, it is planned to start the *State Support Programme for Cluster Development* co-financed from the EU Structural Funds, which will offer co-financing for ensuring cluster co-ordination and implementation of cluster strategies through a tender.

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 6<sup>th</sup> 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 experience 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.

One task of the project is to work out and launch one or more inter-state innovation and cluster promotion programmes. Two working groups are created in the framework of the project, and their task is to work out and present descriptions of such potential programmes in the 1<sup>st</sup> half of 2008 in

accordance with the identified operation spheres of potential inter-state programmes. One of the expected inter-state programmes is oriented to development of co-operation between clusters of the region's countries. This co-operation may be both horizontal co-operation (which includes formation of co-operation and contacts between similar clusters) and inter-sector co-operation that involves clusters at different value-added chain levels or clusters from different spheres, which may potentially supplement each other and promote formation of synergy. In 2008, it is planned to launch a pilot programme where 3-4 models of inter-state co-operation of clusters would be involved. Assessing results of the pilot programme, it is envisaged to start implementation of a full programme in 2009, which has a goal to create co-operation between clusters of the Baltic Sea region. Other important sphere where inter-state programme is being implemented relates to the issues of capacity building. It is planned to create an inter-state programme, in the framework of which a mutual exchange of experience and training of the persons and institutions involved in cluster development would be ensured. Target audience for such programme is co-ordinators and personnel of clusters as well as the state agencies and institutions that carry out the cluster promotion policy.

Cluster development is set as a priority at the EU level. The European 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, urging EU member states at the national and regional levels as well as EU institutions at the EU level to promote cluster development and giving recommendations for implementation of cluster support initiatives.

**Legislative requirements** in the sphere of technical supervision of the equipment to be used in **industrial production** as well as in the spheres of design, production, installation, conformity assessment and market surveillance of the equipment are also important for successful development of industrial policy. Provisions of normative acts in the sectors involving usage of equipment, e.g., such sectors as design, production, conformity assessment and market surveillance of individual means of protection, electromagnetic compatibility of equipment and low-voltage equipment are also essential. Application of the mentioned normative acts is an essential factor both in improvement of business environment and in order to ensure labour safety of industrial workers hence, to a certain extent, also promoting competitiveness of local industrial enterprises in the European Union.

The aim of the Law "On Technical Supervision of Dangerous Equipment" is to achieve safe usage and maintenance of dangerous equipment without harm to human life, health, property and environment, set the

legal and organisational base for assembly, repair, maintenance, modernisation and tests of dangerous equipment, as well as determine the functions of state supervision and control institutions in the sphere of technical supervision of dangerous equipment. Provisions of the Law apply to the dangerous equipment, its holders, service staff and persons that use the dangerous equipment in production processes or carry out assembly, repair, maintenance, modernisation and tests of this equipment, and to the public institutions that perform supervision and control in this area. In accordance with the aim of the Law, the provisions that must be observed in organisation and doing work with any type of the dangerous equipment are currently determined in 19 Cabinet of Ministers regulations derived from the Law “On Technical Supervision of Dangerous Equipment”.

Taking into account the proposals made by entrepreneurs, substantial improvements of normative acts with regard to procedure of registration of dangerous equipment have been made during the last year, envisaging a facilitated procedure of registration and reducing the time required for registration of dangerous equipment, as well as facilitating reception of permit for usage of dangerous equipment. Cabinet of Ministers regulations on technical supervision of pressure equipment and its complexes specify requirements for the holder of pressure equipment complex during usage of the complex as well as duties of service staff. Requirements for facilities of pressure equipment complexes are specified. Duplication of norms is prevented as well as the state supervision and control functions are specified, preventing possibilities of interpretation of norms. Cabinet of Ministers regulations on technical supervision of cargo cranes expedite reception of permit for registration and usage of cargo cranes as well as specify and simplify provisions of regulations.

With increased awareness of entrepreneurs and development of production, the number of units of dangerous equipment used in industrial production processes also increases. Such dangerous equipment as pressure equipment, cargo cranes and service elevators is registered most often during the last years.

At present, **requirements** of all EU “**new approach**” **directives** in the sphere of equipment and appliances run and produced in industry are transposed into national legislation – Cabinet of Ministers regulations.

Improvement of provisions of normative acts in accordance with requirements of EU legislation, considering national needs of industrial producers, is a constant process where public institutions closely co-operate with entrepreneur and expert associations of the sector, taking into account recommendations of non-governmental organisations and their proposals that first of all result from practical needs of industrial producers. The EU legislative requirements transposed in national legislation is a support to local industrial

entrepreneurs, promoting further development of production processes in conditions of equal competition with industrial producers of other EU member states and hence finding new and new opportunities for export of products to other EU member states, EEA countries and other countries.

The Ministry of Economics, involving the experts working in the sector and representatives of entrepreneur associations, has developed draft Cabinet of Ministers regulations “Safety Rules of Machines” and “Amendments to Cabinet of Ministers Regulation No. 157 of April 25, 2000 “Regulations Regarding Conformity Assessment of Design, Manufacture and Installation of Lifts and Safety Components Thereof””, where requirements of the Directive 2006/42/EC of the European Parliament and of the Council *on machinery and amending Directive 95/16/EC (elevators)* are introduced. In accordance with terms of the directive, the requirements have to be transposed in national legislation by June 29, 2008 and the new requirements will be in force as from December 29, 2009.

The essential requirements of safety and harmlessness for machines and safety components as well as the mechanism for supervision of observance of these requirements is currently determined by the Regulation No. 186 of the Cabinet of Ministers of May 30, 2000 “Regulations regarding the Safety of Machinery”. The new draft regulation of the Cabinet of Ministers “Regulations regarding the Safety of Machinery” mainly specifies the product type that provisions of the regulation will be applied to, expands and hence specifies terminology, sets in detail the risk assessment principle also in regard to arrangement of working place and improves the constructive requirements for machines, their protective equipment and additional equipment, increasing the safety requirements for machines during their operation. The draft regulation details requirements for documentation and the kind of information to be indicated by producer in accompanying documents of the machine. In accordance with provisions of the directive, the draft regulation is expanded with requirements for such machines of a certain group as machines used in cosmetics and pharmaceuticals as well as includes additions for manually portable and manually controllable machines and mobile machines.

### 6.3.2. Energy Policy

Main directions of the energy policy are aimed at improving security of energy supply of the country by encouraging diversification of supplies of primary energy resources and creating conditions for increased self-provision of electricity generation, as well as preventing isolation of the regional electricity market. Creation of competition conditions, promotion of use of renewable and local energy resources, and environmental protection also play a substantial role.

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.

In **electricity supply**, more than 90% of all electricity generated in Latvia is generated by JSC Latvenergo, which also ensures import of electricity and its supply to consumers. Starting with September 1, 2005, functions of electricity transmission system operator are performed by JSC “Augstsprieguma tīkls”. Starting with July 1, 2007, functions of electricity distribution system operator are implemented by JSC “Latvenergo Sadales tīkls”. JSC Latvenergo is the sole owner of both companies. In

addition, more than 100 small power plants and 15 licensed electricity distribution and sale companies operate in Latvia.

Latvia, as an EU member state, has to ensure compliance with the unified requirements set forth in EU legal acts concerning the energy sector (see Box 6.9). In electricity supply, it means that the electricity market in Latvia operates in accordance with provisions of Directive 2003/54/EC of the European Parliament and of the Council of June 26, 2003 concerning common rules for the internal market in electricity. In accordance with this directive, starting with July 1, 2007, every electricity user is entitled to choose their supplier of electricity.

#### Box 6.9

##### **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” that regulates the procedure for oil product reserves to be established by merchants;
- **electricity sector.** The Electricity Market Law and regulations of the Cabinet of Ministers issued in accordance with this law constitute the legal regulation for efficiently functioning electricity market where electricity is supplied safely, qualitatively, and at justified rates, and rights to choose electricity merchant freely are ensured for all users of electricity, as well as electricity generation by use of renewable energy resources is promoted. On June 26, 2007, the Cabinet of Ministers adopted Regulation No. 452 “Regulations on Trade and Use of Electricity”, which determines the procedure for electricity supply to related users and the users, who are participants of the market, rights and duties of electricity merchant, system operator and user, the procedure for change of the merchant, and the procedure of covering costs of compulsory purchase of electricity. On November 6, 2007, the Cabinet of Ministers adopted Regulation “Amendments to Cabinet of Ministers Regulation No. 322 of April 25, 2006 “Regulations on Annual Assessment Report of Transmission Operator””. These amendments expand and specify the requirements regarding the content of the assessment report, prescribing that the assessment report must include a clear and unambiguous conclusion of electricity transmission system operator, which objectively characterises condition of the system. Regulation No. 503 of the Cabinet of Ministers “Regulations on Electricity Generation by Use of Renewable Energy Resources” was adopted on July 24, 2007, establishing the requirements to be fulfilled for receiving the rights to sell electricity produced from renewable energy resources within compulsory purchase.
- **gas sector.** On May 26, 2005, the Saeima passed the Law “Amendments to the Energy Law” establishing the 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 to 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 regulating principles for operation of the natural gas market are set forth by a special law. The law on procedure for enforcement of particular paragraphs of the Energy Law prescribes that these norms of the Energy Law will be enforced on January 1, 2010.

On July 23, 2004, the Cabinet of Ministers accepted the draft policy-planning document “Guidelines for Creation of Prerequisites 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 prerequisites for the market opening, market participants, and basic functions, duties and rights thereof, and principles of the perspective structure and regulation of the sector. It also formulates the problems that currently hinder opening the Latvian electricity market and implementation of the rights of choice granted to the users of electricity. The draft guidelines were prepared, considering 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 a legal environment for efficiently functioning and

competitive market in electricity based on the guidelines, the Saeima passed the Electricity Market Law on May 5, 2005.

JSC “Latvijas Gāze” is the only merchant operating in the **natural gas market** in Latvia at present. In compliance with licences issued by the Public Utilities Commission, “Latvijas Gāze” performs 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 the main conditions for opening the natural gas market and were developed, considering 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 become effective on January 1, 2010.

By choosing a regulated procedure of access, member states carry out the necessary measures to confer rights of accessing the system to natural gas companies and qualified users inside or outside the area containing an interconnected system on the basis of published rates 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” establishing the procedure, according to which an energy supply merchant supplies thermal energy and a thermal energy user uses it, and the procedure, according to 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 met other commitments to the supplier.

#### **Investment in the energy sector**

State assistance in the energy sector is only granted to those projects, which are linked to adjustment of heat supply systems. In the budget for 2007, in the framework of the energy policy appropriation planned for the Ministry of Economics, earmarked subsidies to local government budgets in the amount of LVL 5 million were included with the aim to support improving efficiency of thermal energy production, transmission, and distribution, as well as to foster energy efficiency of public buildings. The above-mentioned financing was granted to 42 local government projects through a tender of projects of the *Energy Efficiency Programme of Local Governments*.

In the framework of utilisation of the EU Structural Funds (see Chapter 6.2.1), support to the public and non-governmental sectors is envisaged. The priorities for use of the Structural Funds are listed in the Single Programming Document (hereinafter 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 for 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, a total of LVL 11.6 million has 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

increasing efficiency of centralised 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 to 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 centralised heating systems, construction of heat sub-distribution units and other heat regulation equipment and reduction of heat losses in buildings, the Decree No. 192 of April 23, 2007 of the Minister of Economics “On Energy Efficiency Programme of Local Governments” was issued in 2007, wherewith, utilisation of appropriation in 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 build environmentally friendly, healthy and modern buildings for national economy needs, saving energy and resources.

Planning the development of construction in Latvia, the Cabinet of Ministers has accepted the following policy documents:

- *Concept for State Strategy in Construction* on November 5, 1996,
- *Concept for Strategy on Terms for Converting the Former USSR Technical Norms of Construction and on Financing* on September 28, 1999,
- *National Programme on Construction* on August 30, 2002.

It must be noted that these policy documents have partly lost their topicality at present, as membership of Latvia in the European Union has considerably changed both the economic situation and the normative environment.

*National Programme on Construction* is an integrated target programme for 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 situation in the sector.

Updating the *Action Plan for Implementation of the National Programme on Construction for 2007-2012*, 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, drafts of the *Programme for Promotion of Renovation of Apartment Houses* and of the *Concept for Development of Social Dwellings*, and other measures important for construction and renovation of housing were included in the Action Plan.

The construction sector develops rapidly in recent years, attracting investment, providing other national economy sectors with buildings and structures necessary for their operation, and making up a big share of gross domestic product.

Availability of financing (investment and credit policy) has fostered rise of demand, and the volume of construction increases.

As situation in the sector changes, it became necessary to increase administrative capacity of institutions involved in development and implementation of construction policy and improve the construction control system. Re-division of functions between ministries has taken place at the beginning of 2007, as the Housing Policy Department and the Housing Agency were included in the structure of the Ministry of Economics.

After assessment of performed functions, competence and sphere of activity of the institutions involved in construction, optimising the institutional structure in order to prevent overlapping of functions and at the same time release the ministry from performance of functions uncharacteristic to it, reorganisation of several agencies and inspectorates has been carried out. From the 1 of January of 2008 will commence its activities, the Construction, Energy and Housing Agency, which is established on the basis of the state agency "Housing Agency" besides all the functions of the reorganised State Energy Inspection and several functions of the State Labour Inspectorate

will fall under competence of the State Construction Inspection.

On the basis of the order of Minister of Economics of August 13, 2007, has been established working group for preparation of amendments to normative acts regulating construction. The working group includes representatives both of public bodies and of non-governmental professional organisations. At the moment it seeks solutions to such topical issues as reduction of illegal employment, improvement of quality and operation of structures, professional indemnity insurance, etc.

By the way of legislation, the state regulates only those requirements in construction, non-observance of which may affect human life, health, environment or interests of all society. Continuing improvement of the normative base, 4 new normative acts have been issued and amendments prepared to 7 normative acts in force during 2007. Special attention is paid to fire security issues, safety of building structures, prevention of administrative obstacles and reduction of possibility of corruption in the construction process. Introduction of requirements of *EU Directives on energy efficiency of buildings* as well as introduction of *Eurocode standards* in building design is important for environmental sustainability.

Amendments to the *Construction Law* obligate (delegate the responsibility of) local governments to publish the information on received construction applications (accounting cards and decisions taken by construction board in regard to them) at least once a month on their website or in the local newspaper if such website is not created. Hence (Accordingly), transparency of the performance of construction process is ensured at the level of law.

In order to harmonise interests of society and initiator of the building intention, ensuring transparency of local government decisions in regard to territorial development as well as opportunity for society to participate in adoption of decisions, on 22 of May of 2007 was issued Regulations of Cabinet of Ministers No. 331 "Procedure for Public Discussion of the Intended Building" was issued on May 22, 2007.

In order to optimise the performance of construction process by shortening the timing of building and reducing administrative obstacles, Regulations of Cabinet of Ministers No. 420 of June 26, 2007 "Amendments to Regulations of Cabinet of Ministers No. 112 of April 1, 1997 "General Construction Provisions"" determines new forms of performance of construction process (combined design and execution of construction works), simplifies the procedure for connections of existing buildings to existing networks, and specifies the limit of responsibility of everyone involved in the performance of construction process.

In order to ensure transparency of the performance of construction process, reduce administrative obstacles and improve construction management and

control functions, amendments to Article 4 of the *Construction Law* and Regulations of Cabinet of Ministers No. 983 of December 5, 2006 “Regulations of Construction Information System” (CIS) was constituted grounds for establishment of a single system that would include 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 at this moment preparatory work for a tender for introduction of CIS is under way. It is planned to put into effect (enforce) the system in its entirety by 2010, ensuring accumulation of construction information as well as electronic exchange of information between 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 verify legality efficiently of operations both of companies and of specialists.

In accordance with Article 10 of the *Construction Law* and Regulations of Cabinet of Ministers No. 453 of June 28, 2005 “Regulations for the Registration of Construction Merchants”, merchants are being registered in the *Construction Merchant Register*. 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 merchant’s convenience, certificates are being issued throughout the workday.

As of November 1, 2007 the *Construction Merchant Register* contains information on 5711 construction merchants, staff employed by companies, persons with rights of permanent practice in accordance with Article 8 of the *Construction Law*, data characterising company activities, information on violations in construction and violations of rules of the Register. 490 construction merchants have struck off the Register.

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 the *Latvian Architects Society*.

The joint register of certified specialists, which is maintained by the Ministry of Economics, contains information on 10080 practice certificates, of which 9158 are construction practice certificates in various fields of construction, and 922 are architectural practice certificates.

The issue of how to reduce costs without deterioration of quality of execution of construction

works and by observing principles of sustainable development is topical<sup>1</sup>.

On March 6, 2007 the Cabinet of Ministers approved the report “On Development of Consumer Price Inflation and Proposals for its Reduction”; in the measures to limit increase of consumer prices, it was provided that the Ministry of Economics has to summarise information about the current and perspective big (over LVL 3.5 million) construction procurements of state and local governments. Data received from institutions indicated that the construction demand (LVL 1541.1 million) planned by state and local governments in 2008 might exceed market opportunities, taking into account that the total volume of construction in Latvia was LVL 1131.6 million in 2006 (by data of the Central Statistical Bureau). Through analysis of the current situation in construction and economy on the whole, the Ministry of Economics concluded that the state must follow the planned construction procurements and conduct monitoring of the process on a regular basis. Henceforth, this task will be under competence of the newly established state agency “Construction, Energy and Housing Agency”. Analysis of demand and supply will allow easier forecasting of possible price changes in the construction market and will help to plan public procurements in a balanced way.

General supervision and co-ordination of construction in the country is carried out by the Ministry of Economics, while supervision of particular spheres is under competence of other ministries. The competence of the Ministry of Transport and Communications includes road construction (JSC “Latvijas Autoceļu direkcija”), 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 the 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 areas is being 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, provinces, rural municipalities or united boards) and 99 building inspectors operate in Latvia.

Number of construction violations is still comparatively high. Data summarised by the State Construction Inspection indicate that 63 builders were

<sup>1</sup> Due to rapid increase of prices for resources and building products, costs of construction in 2007 rose by 20.9% on average in comparison with 2006.

brought to administrative responsibility for violations of requirements of normative acts, the claimed amount of fines was LVL 8690, construction was suspended in 37 cases, and 3 building permits were revoked.

During examinations, indications of insecurity were established in several objects of construction, 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 enforce application of the *Code of Administrative Violations* in construction, the informative work with construction boards of local governments must 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 the policy and normative documents of the construction sector, procedure of the performance of construction process, responsibilities of producer and the set 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 merchants, as well as the required application forms.

In order to carry out purposeful development of construction, the main priorities are:

- development of a new policy planning document – *Construction Guidelines* – and of the *Programme on Construction for 2009-2014*;
- enforcement of the construction information system;
- improvement of the construction control system.

Urgent tasks also are as follows:

- improvement of the conformity assessment system of construction products and market supervision of construction products;
- promotion of development of the scientific spheres related to construction;

- development of production of domestic construction materials;
- improvement of the educational system for training of highly skilled construction specialists.

Non-governmental professional organisations of the sector make considerable contribution to implementation of the tasks, giving proposals and actively engaging themselves in preparation of important decisions and processes of drafting of policy-planning documents and legal acts. The following active social partners involved in formation and implementation of the construction policy are: Latvian Architects Society, Latvian Association of Civil Engineers, Latvian Construction Contractors Association, Strategic Partnership of Construction Development, 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, Latvia's Electricians' Brotherhood, Latvian Association of Electricians and Energy Construction Specialists, Latvian Consulting Engineers' Association, as well as Society of People with Disabilities and their Friends "Apeiron".

### 6.3.4. Tourism Policy

The main goals of Latvian state tourism policy are to improve competitiveness of the tourism sector and, through promotion of sustainable growth of tourism, create new workplaces, encourage balanced development of regions, preserve cultural and natural heritage, and foster social integration of the society.

#### Box 6.10

##### **Guidelines of Tourism Development Policy of Latvia**

The Guidelines are a medium-term policy planning document defining the basic principles of tourism development policy and the goal of tourism development policy of Latvia for 2004-2008: increased share of tourism in GDP of Latvia.

The following lines of action are identified for achievement of this goal:

- Positioning of Latvia as a distinctive, safe, and recognised tourist destination;
- Development of incoming and domestic tourism;
- Promotion of co-operation.

##### **Tourism Development Programme of Latvia for 2006-2008**

The Programme is a medium-term policy-planning document with the goal to ensure annual increase of the added value of the tourism sector by 10-15% and growth of the share of the tourism sector in GDP by 20% annually (at current prices).

**An Action Plan of Latvian Tourism Development for 2007** has been elaborated on the basis of the Guidelines and Programme and it includes specific activities for promotion of tourism development and determines the responsible institutions, expected financing, terms of execution, and indicators of assessment.

In order to determine and implement the state tourism development policy, a system of policy planning documents (see Box 6.10) and normative acts of tourism (see Box 6.11) has been created and is being improved on a regular basis in Latvia.

Guidelines of Tourism Development Policy of Latvia (hereinafter Guidelines) approved by Decree No. 559 of August 11, 2004 of the Cabinet of Ministers define basic principles of tourism development policy, set goals of tourism development, and identify main lines of action to achieve these goals.

In order to ensure achievement of goals set forth in the Guidelines, the Tourism Development Programme of Latvia for 2006–2008 (hereinafter Programme) has

been elaborated, which was approved by Decree No. 505 of July 5, 2006 of the Cabinet of Ministers.

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 Decree No. 552 of August 31, 2007 of the Cabinet of Ministers.

The Programme and the Plan include horizontal activities for tourism development, which are being implemented by the Ministry of Economics, Latvian Tourism Development Agency (hereinafter Agency), other ministries, and public institutions in co-operation with local governments, the private sector, and non-governmental organisations.

#### Box 6.11

##### Changes in normative acts

On grounds of the delegation stipulated by the Law “*Amendments to the Tourism Law*” adopted by the Saeima on February 16, 2006, the Cabinet of Ministers has approved two Regulations of the Cabinet of Ministers elaborated by the Ministry of Economics:

- Regulation No. 67 of January 23, 2007 of the Cabinet of Ministers “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”;
- Regulation No. 226 of April 3, 2007 of the Cabinet of Ministers “Regulations regarding the Procedures for Filling in, Keeping, and Submitting a Foreigner’s Declaration” pertaining to Latvia’s joining the Convention Implementing the Schengen Agreement. Regulation of the Cabinet of Ministers “Amendments to Regulation No. 1017 of December 19, 2006 of the Cabinet of Ministers “Regulations regarding a Database of Tourism Services Providers”” has been drafted. In the framework of implementation of this regulation, a connection of the database of tourism service providers with the Integrated State Information System was established in 2007, thereby providing a base for a single information system about tourism services providers in Latvia.

In December 2007, the Saeima will review the amendments to the Law “Code of Administrative Violations” in the 3<sup>rd</sup> reading, which were elaborated by the Ministry of Economics and supported by the Cabinet of Ministers; these amendments determine the administrative responsibility of merchant, performer of economic activity, and tourist group leader for violation of regulations in regard to filling in, checking, keeping, and submitting a foreigner’s declaration form. At the same time, the mentioned draft law prescribes to include review of cases of this administrative violation in the competence of the State Police.

LVL 1.3 million were allocated to the state budget programme “*Implementation of the Tourism Policy*” in 2007, and these finances were used in accordance with priorities set forth in the Guidelines: for 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 continued in 2007 on the whole (see Box 6.12).

#### Box 6.12

##### Indicators of Latvian tourism development

In 2006, the share of the tourism sector in Latvian GDP was 2% (preliminary results), compared with 1.8% in 2005. Over the period from 2000 to 2003, a stable increase in the incoming tourism has 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 annual increase was 23.4%.

In 9 months of 2007, the number of foreign travellers in Latvia reached 4.1 million, which is by 13% more than in the respective period of 2006. Expenses of foreign travellers in Latvia reached LVL 259.3 million in 9 months of 2007, which is by 25% more than in the respective period of 2006.

Growth of the tourism sector in 2007 was mostly promoted by the following factors:

- strengthening of Latvia as a new tourist destination after accession to the European Union;
- measures of Latvian tourism marketing implemented in high-priority, priority, and perspective countries;
- increased number of direct flights;
- increased number and expanded volume of low-cost airline services;
- increased number of tourist class hotels.

In spite of these positive trends, the indicators of tourism balance of payments are still negative – expenses of Latvian residents abroad in 9 months of 2007 exceed the expenses of foreign travellers in Latvia by LVL 99.9 million.

Despite activities of the public and private sectors for promotion of development of the sector, the supply of tourism services lags behind the evergrowing

demand, hence a decrease of the quality of provided services has been observed. The high inflation in the country has affected rise of prices for tourism services,

thereby deteriorating correspondence of the value of provided services with the price, which up to now was one of the biggest factors of attractiveness of Latvia from the viewpoint of foreign tourists.

In order to improve quality of Latvian tourism services, development of a quality system of Latvian tourism services has been started and will be continued in the following year.

In caring for safe tourism in Latvia, the “*Tourist Hotline 22033000*” was introduced. It enables those tourists, who have got into various problem situations and need help, to receive informative support 24 hours a day.

In order to improve awareness of employees of the tourism sector about topicalities in the sector, in addition to the previously held tourism information days, the Agency has started publication of a new free periodical “*Tūrisms*” (“Tourism”). Three issues have been published this year, and one more edition is planned by the end of the year.

Considering the crucial role of tourism in the EU economy, the European Commission adopted the **Renewed EU Tourism Policy** in March 2006 with the main objective to improve competitiveness of the European tourism industry and create more and better jobs, promoting sustainable growth of tourism in Europe and globally. On October 19, 2007, the European Commission adopted the Communication “*Agenda for a Sustainable and Competitive European Tourism*” (hereinafter Communication) (see Box 6.13). The Communication was elaborated on the basis of the Report “*Action for more Sustainable European Tourism*” published in February 2007 by the Tourism Sustainability Group established by the Commission and on the basis of results of further public discussion of the report. The agenda is another contribution to the implementation of the renewed EU Lisbon Strategy for Growth and Jobs and of the renewed Sustainable Development Strategy.

#### Box 6.13

##### **Communication of the European Commission “Agenda for a Sustainable and Competitive European Tourism”**

The communication defines the following objectives of the European tourism policy:

- economic prosperity;
- social equity and cohesion;
- environmental and cultural protection.

This communication is the official launching and endorsement of a medium-long term agenda, in which all stakeholders should undertake the necessary steps to strengthen sustainability of Europe as the most attractive tourist destination and facilitate its competitiveness. European Commission invites all EU member states to respect the following rules:

- take a holistic and integrated approach;
- plan for the long term;
- achieve an appropriate pace and rhythm of development;
- involve all stakeholders;
- use best available knowledge;
- minimise and manage risks;
- reflect impacts in costs;
- set and respect limits, where appropriate;
- undertake continuous monitoring.

In order to ensure further international intergration of Latvian tourism sector, representation of state interests, and adoption of better practice, **international co-operation** is being developed, e.g., taking part in the UN World Tourism Organisation and the European Travel Commission and in the work of the Tourism Advisory Committee and the Tourism Sustainability Group of the European Commission. At present, Latvia is the presiding country of the Council of the Baltic Sea States (from July 2007 to June 2008), and promotion of development of a sustainable tourism network in the Baltic Sea region is among its priorities. In 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*”, held the seminar “*Sustainable Development – Opportunity for Growth of a Competitive Tourism Sector*” in June 2007, organised the training seminar “*Development of Supplies of Nature Tourism*

*Products and Successful Marketing of these Products*” in October, and is drafting the national Agenda for the 21<sup>st</sup> century (*Agenda 21*) of the tourism sector. On September 23-30 of this year, an annual convention of the European Union of Tourist Officers and international scientific conference on tourist destination management “*Sustainable Development of Tourist Destinations*” took place in Latvia and it was attended by 160 participants from 26 countries.

Three more **studies** – “*Development of Latvian Sections of the EuroVelo Network*”, “*Assessment of International Practice of Crisis Management in the Tourism Sector and Proposals for Implementation thereof in Latvia*” – commissioned by the Ministry of Economics are being conducted at present. For successful planning of tourism development and activities of the Agency in the future, a study on behaviour of foreign travellers has been commenced and will be completed by the end of this year. Such study is necessary because the current statistical data do not give a complete insight into wishes and needs of foreign tourists, motivation

of their travel, use of tourism products, quality assessment, and obtainment of tourism information. Specification of the Explanatory Dictionary of Terms

of Tourism and Hospitality continues, and it is planned to be published at the end of the year.

#### Box 6.14

##### Activities of the Latvian Tourism Development Agency in 2007

Continuing development of high-quality tourism infrastructure and a single tourism information system, the Agency has engaged in implementation of the INTERREG project “*Creation of a New Tourist Destination by Combining Supplies of Latgale and Rytų Aukštaitija Border Regions*”, thereby encouraging tourism development and growth of the tourist flow in the region and promoting recognition of this region as a joint tourist destination – Baltic Land of Lakes.

For promotion of recognition of Latvia’s tourism image and popularisation of Latvia as a tourist destination in the international tourism market, the Agency has:

- performed annual marketing activities, taking part in international tourism fairs, publishing several types of informative materials of tourism in various languages, organising working seminars and visits of foreign media representatives and tour operators to Latvia, especially focussing on Latvia’s high-priority target markets of tourism (Estonia, Russia, United Kingdom, Lithuania, Finland, Germany, Sweden), as well as implementing particular marketing activities in the prospective distant tourism markets – USA and Japan;
- organised an international working seminar for tourism professionals “*Buy Latvia, Buy the Baltics*” in February of this year; during the seminar, foreign participants could meet and establish co-operation with representatives of Latvian tourism sector, 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. Considering the big interest (more than 200 foreign and 100 Latvian representatives of the tourism sector), such measure will be held in the next year as well;
- launched an extensive advertising campaign “*You Won’t Believe It Until You See It*” with the goal to awake interest of potential European travellers in Latvia before the start of the tourism season. In the framework of this campaign, advertising trailers about Latvia were broadcasted on several international TV networks, advertisement banners were placed on the biggest Internet portals of Latvia’s priority target market countries, and posters were set up in the underground train stations of London.

By developing the “*Latvian Travel Marathon*”, which was successfully implemented in the previous year, and by promoting co-operation between the Baltic States in creation and popularisation of joint tourism products, the Agency has initiated and organised the “*Baltic Travel Marathon*” in co-operation with national tourism organisations of Lithuania and Estonia. This project was implemented with the goal both to encourage development of domestic tourism and enable residents of the Baltic States to acquaint themselves with tourism opportunities in all regions. Each participant of the marathon had an opportunity to visit 36 tourism sites in all three Baltic States in summer, getting a stamp note in the certificate of marathon participant and thereby qualifying for prizes.

The Ministry of Economics and the Agency have taken part in the pilot project of the European Commission “*European Destinations of Excellence*”, and a wide publicity for the best Latvian tourist destination, Kuldīga, was ensured in the framework of this project. The project has the aim to draw attention to diversity and different and shared values of European tourist destinations and to promote destinations, where the economic growth is ensured by sustainable tourism development. The theme of the competition in 2007 is emerging destinations of rural tourism – rural areas, development whereof takes place in accordance with basic principles of sustainable development and which may be an example in planning and implementation of tourism development. Project application for the next year is prepared and approved by the European Commission, hence a competition for the best Latvian tourist destination will be organised in 2008 as well. The theme of the competition is tourism and local intangible heritage.

From the standpoint of Latvian tourism development perspective, the most important work for the Ministry of Economics and the Agency 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 3<sup>rd</sup> 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 within this measure: 4.2.1 “*Development of Tourism Product of National Importance*” and 4.2.2 “*Development of Tourism Information System*” (see Box 6.15).

#### Box 6.15

##### Utilisation of resources from the European Regional Development Fund Measure “Tourism”

##### Activity 4.2.1 “Development of Tourism Product of National Importance”:

##### Sub-activity 4.2.1.1 “Conservation and Renovation of Urban Planning Monuments of State Importance and Adjustment of Infrastructure to Development of Tourism Product”:

- objective – to promote development of cultural tourism products of national importance, ensuring improvement of tourism infrastructure for internationally recognised Latvian cultural and historical values;
- volume of ERDF financing – EUR 15 million;
- type of implementation – limited selection of project applications;
- potential places of investment – urban planning monuments of state importance in accordance with a list of the State Inspection for Heritage Protection;
- beneficiaries of financing – state and local government institutions.

**Box 6.15 continued****Sub-activity 4.2.1.2 “Development of Bicycle Tourism Product of National Importance”:**

- objective – establishment of infrastructure of Latvian sections EV10 and EV11 of the international network of EuroVelo routes and of the national bicycle route NV1;
- volume of ERDF financing – EUR 7 million;
- type of implementation – limited selection of project applications;
- beneficiary of financing – Latvian Tourism Development Agency.

**Sub-activity 4.2.1.3 “Development of Cultural, Active, Health and Recreation Tourism Product of National Importance”:**

- objective – support in development of new products of cultural, active, health and recreation tourism or essential improvement of the current ones;
- volume of ERDF financing – EUR 17.6 million;
- type of implementation – open selection of project applications;
- beneficiaries of financing – legal entities that manage or own a real estate where investments of the project will be made.

**Activity 4.2.2 “Development of Tourism Information System”:**

- objective – to establish a complex system of tourism information carriers, which would ensure the travellers with a convenient way of finding tourism sites and obtaining information;
- volume of ERDF financing – EUR 2.7 million;
- type of implementation – limited selection of project applications;
- beneficiaries of financing – Latvian Tourism Development Agency.

## 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 activities. Considerable reforms and improvements have been achieved in registration of enterprises, taxation policy, customs legislation and procedures, 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 2008: How to reform”* ([www.doingbusiness.org](http://www.doingbusiness.org)) conducted by the World Bank Group, business environment of Latvia takes the 22<sup>nd</sup> place among 178 countries, which is by 2 positions higher in comparison with the previous year (in “Doing Business in 2007”, Latvia took the 24<sup>th</sup> place among 175 countries<sup>1</sup>). Latvia managed to get a higher rating due to its achievements on the issues of taxation, trading across borders and execution of contracts. Latvia also has a high standing (3<sup>rd</sup>) in the section of “Enforcing contracts”, and starting a business has also been simplified.

Business environment is evaluated in 10 aspects, and Latvia is estimated as follows:

- 3<sup>rd</sup> place – in enforcing contracts (11<sup>th</sup> place in 2007);
- 13<sup>th</sup> place – in loan availability (13<sup>th</sup> place in 2007);
- 19<sup>th</sup> place – in trading across borders (28<sup>th</sup> place in 2007);
- 20<sup>th</sup> place – in paying taxes (52<sup>nd</sup> place in 2007);

- 30<sup>th</sup> place – in starting a business (25<sup>th</sup> place in 2007);
- 51<sup>st</sup> place – in protecting investors (46<sup>th</sup> place in 2007);
- 64<sup>th</sup> place – in closing a business (62<sup>nd</sup> place in 2007);
- 82<sup>nd</sup> place – in dealing with licenses (65<sup>th</sup> place in 2007);
- 85<sup>th</sup> place – in registering a property (82<sup>nd</sup> place in 2007);
- 96<sup>th</sup> place – in employing workers (123<sup>rd</sup> place in 2007).

*Action Plan for Improvement of Business Environment* is elaborated annually since 1999. This inter-ministerial policy planning document sets 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 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

<sup>1</sup> This year, Lithuania takes the 26<sup>th</sup> place which is by 10 positions lower than in the previous year, while Estonia is in the 17<sup>th</sup> place, keeping unchanged position since the preceding year.

activity, reduction of the number of procedures and required time, and improvement of information accessibility.

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 obstacles 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;
- improving efficiency of 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.

Informative report on progress of implementation of the *Action Plan* was prepared in August 2007.

In the framework of the *Action Plan*, Regulation No. 660 of October 2, 2007 of the Cabinet of Ministers “Procedure for Conduction of Internal Supervision of Labour Environment” was adopted, amendments to the Law “On the Register of Enterprises of the Republic of Latvia” were adopted, envisaging that an insolvency register will be established at the Register of Enterprises, draft “Law on Information System of Encumbered Territories” was prepared, draft concept on simplification of procedures for registration of real estate ownership rights was prepared, practical training measures “Start Your Business! Fulfil the Dream!” – regional seminars in Jelgava, Ventspils, Valmiera, Liepāja and Rēzekne and final conference in Riga – were carried out, and a set of informative material “Guide for Entrepreneurs. Services and Inspections in Latvia” was prepared and distributed.

Meetings of the **Foreign Investors Council in Latvia (FICIL)** with higher government officials are held annually. The Prime Minister, Minister of Economics, Minister of Foreign Affairs, Minister of Finance and other government officials who meet with leaders of biggest international investor companies and other senior officials representing various sectors and countries take part in the high-level meetings. Since the 2<sup>nd</sup> High-Level Meeting, recommendations of FICIL have been included in the *Action Plan*. The 11<sup>th</sup> 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.

Ministry of Economics conducted the regular (already the 4<sup>th</sup>) **survey to assess measures for improvement of business environment** in 2007. The survey consists of three main elements: business survey, self-evaluation of the influence exerted by national and local government institutions on business environment, and a report of policy recommendations. LLC AKSEDO interviewed 720 company managers in Latvian cities and regions. About 50% respondents were interviewed in Riga, 10% – in Pierīga (vicinity of Riga), 10% – in Vidzeme, 8% – in Kurzeme, 13% – in Zemgale, 10% – in Latgale; approximately 18% of respondents were interviewed in Daugavpils, Liepāja, Jelgava, Ventspils, Jūrmala and Rēzekne, about 9% of respondents – in other district centre towns, approximately 16% of respondents – in other towns, and about 9% of respondents – in the countryside. The companies were selected in such manner that they would correspond to the criteria of sphere of action, legal form, age, proprietary rights and size of companies.

The survey covered 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 contained questions about administrative costs and time spent fulfilling requirements of supervision institutions during daily business activities of entrepreneurs in the start-up phases, choice of location, and operation.

Results of the survey conducted in 2007 will be available on website of the Ministry of Economics at the end of December.

The survey allows comparing development trends of business environment and identifying spheres where new reform programmes are required as well as measuring effectiveness of various activities for improvement of business environment. The survey helps both developing measures of assistance to small and medium-sized enterprises and finding out the opinion of entrepreneurs about operation of national 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 Small and Medium-Sized Enterprises and Crafts, Foreign Investors Council in Latvia, Latvian Employers' Confederation, 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, 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. Discussions with experts and representatives of entrepreneurs were organised in October in order to discuss technical data of the survey regarding issues of construction, labour relations, electronic government, taxes, customs and other issues as well as discuss measures to be conducted for prevention of the established problems and for improvement of business environment.

A conference was held on December 14, 2007, where results of the survey and recommendations for improvement of business environment were discussed with officials of the responsible institutions and involved entrepreneurs.

## 6.5. Innovations and New Technologies

One of the objectives of *Programme for Promotion of Entrepreneurship Competitiveness and Innovation for 2007-2013* (approved by the Cabinet of Ministers Decree No. 406 of June 28, 2007) is promotion of increase in capacity and efficiency of the national innovation system by creation of a regulating, financial, and informative environment favourable to innovative activities. In order to ensure attainment of this objective, various measures, which can be divided into 3 blocks, are implemented:

- measures to inform and encourage;
- measures to promote start-up of innovative business activity;
- measures of assistance to current entrepreneurs.

As a result of these measures, favourable environment for innovative activity is created, co-operation of science, education and the private sector is improved, transfer of knowledge and technologies, as well as development of new products and technologies is supported, and efficient use of human resources is promoted.

**Measures to inform and encourage.** The event of Regional Innovation Days is one of the instruments for promotion of public awareness of innovation, as well as creation of favourable environment for innovative activities. In 2007, the Latvian Investment and Development Agency (LIDA) held informative seminars for popularisation of innovation in Latvian regions. The aim of the seminars was to explain the idea of innovation and importance thereof in development of entrepreneurship, motivate businessmen and local governments to seek ways of co-operation for promotion and development of business activity, as well as explain necessity of and

In 2007 the Ministry of Economics and the Latvian Investment and Development Agency have started pilot projects to measure **administrative burden on entrepreneurs**. This year, pilot projects are implemented in areas of taxes, construction, real estate, fuel circulation and labour legislation and in obtaining licences and permits, as well as for determination of administrative burden on self-employed persons. The Standard Cost Model methodology used in several EU member states will be applied for the pilot projects. Results of the pilot projects will allow assessing conformity of the used methodology with Latvian situation so that measurements in other areas as well as repeated measurements for assessment of efficiency of the implemented changes may be conducted in further years as well. Results of the pilot projects are expected at the end of this year.

opportunities for creation of innovative business activities. The seminars provided information about State Support Programmes for 2007-2013 administered by LIDA. “The Regional Innovation Days” took place in Jēkabpils, Madona, Valka, Ludza, Tukums, Krāslava, Saldus, and Sigulda. Such informative measures are planned for year 2008 as well.

The regularly held international forum “Baltic Dynamics 2007” devoted to innovation and innovative activity was organised with support of the Ministry of Economics. It was the most widely visited event organised up to now, and its main goals were:

- 1) to promote public awareness of the role of innovations as economic driving force in national economy, to facilitate efficient formation and implementation of innovation policy on national and regional level, explore the driving forces that could participate in it, closer co-operation of science and the private sector, “awakening” of innovative business spirit in entrepreneurs and their subordinates in order to promote development of knowledge-based business activity;
- 2) to promote reciprocal co-operation of the Baltic States in the spheres of innovation and technological development on different levels, to endorse integration of the three Baltic States into the EU in sectors of science, technologies, and business.

In giving information on importance of knowledge-based economy in national economy and in strengthening awareness of society about issues related to innovation, special attention is paid to motivation of young people to implement their ideas in

entrepreneurship. “Cup of Ideas” is a competition of innovative business ideas, the participants whereof have an opportunity to get advice and contacts from experts to start their business, as well as to attract equity capital to start their business activities. It is a measure to promote creation of new innovative companies in Latvia, which is supported reciprocally by the state and the private sector. Participants of the measure have an opportunity to expand their business ideas to a business plan with the help of specialists, and the best ones of them get prizes. For the final of the competition “Cup of Ideas 2007 – Beyond Limits of Theory”, 56 business plans were submitted, of which the best 10 applicants got awards. The top three winners and several other authors of the competition have started a practical work to implement their ideas, which also indicates that the received consultations and training have facilitated establishment of new sustainable companies in Latvia.

Students of Latvian higher education establishments have an opportunity to hear lectures of specialists and participate in practical sessions at the free entrepreneurship and innovation course of instruction “Businessman in 5 Days” held by LIDA in order to get from the phase of an idea to a business plan. In 2007, the intensive courses were designed in co-operation with the University of Latvia, Business

College of Latvia, Latvia University of Agriculture, Rēzekne Higher Education Institution, and Ventspils University College. Courses of instruction were carried out at every mentioned higher education establishment, and all students of Latvian higher education establishments, who plan or have intended to make a career in their company, were eligible to participate. The goal of the course of instruction is to provide with the necessary knowledge and skills to authors of innovative business ideas, as well as to motivate them to improve ideas up to successful marketing and business plans, which would be implemented in sustainable companies in Latvia.

**Measures to promote start-up of innovative business activity.** In order to promote development of knowledge-based business activities, it is also important to enhance commercialisation of knowledge and to strengthen co-operation of entrepreneurs with scientists during this process. LIDA has supported operations of the Innovation Relay Centre (IRC) aimed at providing assistance to Latvian entrepreneurs, promoting transfer of innovative technologies from Latvia to Europe or from European countries to Latvia. IRC Latvia is one of 71 European IRC network centres that operate according to a uniform programme.

#### Box 6.16

##### Uniform EU entrepreneurship support network

In December 2006, the European Commission, in the framework of the Competitiveness and Innovation Framework Programme (CIP), announced an open competition for rights to establish a unified EU entrepreneurship support network in every EU member state.

In April 2007, LIDA, establishing a uniform consortium on the basis of an already existing EIC and IRC, in co-operation with LTC, prepared and submitted a uniform application to the EC for the announced competition for creation of such uniform network as from 2008.

The aim of the uniform entrepreneurship support network is to include as wide a range of business and innovation services as possible, which would comprise:

- increase of competitiveness of Latvian companies in external markets;
- promotion of international co-operation;
- informative support and consultations to Latvian entrepreneurs about EU programmes, EU legislation, and explanation of EU policies;
- implementation of measures for promotion of technology transfer and absorption;
- promotion of participation of Latvian SME (small and medium-size enterprises) in projects of the 7<sup>th</sup> European Community Framework Programme, and other services.

LIDA is the leading partner of the project, organiser of network co-ordination measures and provider of services related to promotion of business activities, while LTC (Latvian Centre of Technologies) operates as the second partner of the consortium, which ensures the range of services related to innovation.

An important instrument of commercialisation of science and transfer of technologies is made up by technology transfer contact points, the main goal whereof is to encourage co-operation between scientists and entrepreneurs and to ensure efficient introduction of research results of state research institutions into production, hence establishment and support of such contact points is a very important prerequisite to commercialisation of science. Ministry of Economics continued supporting operation of 6 technology contact points at 5 higher education

establishments in 2007. LVL 202 000 were granted in 2007 in order to ensure operation of contact points.

Knowledge and Innovation System Department ZINIS of LIDA has engaged in a project of the 6<sup>th</sup> Framework Programme of the European Commission for establishment of new training system for Technology transfer managers “CERTIFIED TRANS-NATIONAL TT-MANAGER” – Building up a framework to qualify TT-Managers on a trans-national level and with mutual recognition (CERT-TTT-M). This project is aimed at development of a uniform, internationally recognised training

programme for technology transfer managers in order to strengthen their capacities, awareness, and international co-operation between them, hence promoting development of the European science sphere and commercialisation of science.

For the planning period of 2007-2013 of the EU Structural Funds, the *Technology Transfer Programme* has been elaborated with a goal to promote commercialisation of research results both in Latvia and abroad, as well as systematically explore the current research competence at higher education establishments and scientific institutes and purposefully promote development of the necessary research competence this way. It is planned to create 8 new technology transfer contact points within framework of this programme.

In 2007, the Ministry of Economics started implementing the *Programme for Development of Innovation Centres and Business Incubators* that has an objective 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 within framework of the programme. LVL 1 628 212 have been granted for operations of the centres and incubators in 2007, and LVL 1 641 594 have been granted for operations in 2008.

For the planning period of 2007-2013 of the EU Structural Funds, the *Business Incubators Programme* has been elaborated with a goal to promote establishment and development of new sustainable and competitive companies in Latvian regions, providing them with the necessary environment for business activities, including infrastructure and consultative services. Establishment and management of business incubators and provision of services will be supported within framework of the programme.

In order to increase activity and quality of potential projects in the framework of this programme, LIDA held training seminars for incubator managers. 80 representatives of local governments, regional agencies, and entrepreneurs, as well as 24 current managers of business incubators were trained within the seminars.

**Measures of assistance to current entrepreneurs.** In 2008, it is planned to start implementation of the *Competence Centres Programme*, co-financed from EU Structural Funds, which is aimed at increase of competitiveness of companies by promoting co-operation of the research and industrial sectors in implementation of projects of industrial research and development of new products and technologies.

In order to support establishment of co-operation of Latvian entrepreneurs with the leading research institutions, a competition for assistance to development of the strategy of competence centres was announced. After assessment by the competition commission, 12 projects in various sectors were approved, e.g., in sectors of bio-fuels and bio-energy, electronics and electrical engineering, pharmacy and biotechnology. For increase of competence and initiation of partnership, measures of training and partnership stimulation for participants of competence centres were implemented as well: presentations for branch associations and groups of entrepreneurs and scientists related to competence centres were given, and about 200 participants in total took part in these presentations.

In order to promote not only establishment of new companies, but also modernisation of the existing companies and increase of their competitiveness, LIDA has implemented the pilot programme “Increase in production efficiency in SME” in 2007. The objective of the programme is provision of individualised and partly paid expert engineering and innovation management services to slowly growing stable small and medium-sized innovative enterprises with a goal to diagnose competitiveness of the particular company, as well as to develop and implement a rapid growth strategy, based on increased export capacity of the company. Implementation of said programme is also planned in 2008.

In 2008, it is planned to start implementation of the *Programme for Development of New Products and Technologies*, which will provide assistance for development of new or essentially improved products and services and, within framework thereof, new technological processes, also ensuring support to introduction of the successfully developed new products and services into production. Innovative entrepreneurship will also be promoted with assistance of the State Support Programme *For Recruitment of Highly Skilled Employees*; its goal is to increase competitiveness of companies and promote research activities in companies by recruiting highly skilled employees – engineers, scientists, or other skilled specialists for solution of particular technological problems or development of new products in companies. It is also planned to start implementation of this programme in 2008. Furthermore, in order to stimulate domestic companies to invest in knowledge-intensive and technology-intensive projects, as well as to attract foreign investment in spheres with high added value, hence promoting transfer of latest technologies from abroad, the State Support Programme *Support to Entrepreneurship with High Value Added* has been developed.

## 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 society, and the level of individual skills and knowledge. As a result of development of information and telecommunication technologies, information and knowledge are more and more widely used in work and labour relations, education and everyday life.

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, SMEs and households (see Box 6.17);
- 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.

According to estimation by the Ministry of Economics, the share of the ICT<sup>1</sup> sector in GDP reached 6.5% in 2006. According to CSB data, 2910 companies operated in the ICT sector in Latvia in 2006, 23 750 persons were employed in them, the total turnover of the companies amounted to LVL 2.2 billion, the personnel costs were LVL 129 million. Value added of ICT production was LVL 29 million, while provision of ICT services amounted to LVL 603 million. Foreign trade balance of ICT was negative and amounted to LVL -246.9 million, because imports remarkably exceeded exports, which were LVL 337.6 million and LVL 90.6 million respectively.

According to data of the “European Information Technology Observatory 2007”, Latvian expenditures for ICT amounted to 9.89% of GDP in 2006, of which expenditures for information and telecommunication technologies were 2.34% of GDP and expenditures for telecommunications were 7.55% of GDP. To compare, expenditures for ICT amounted to 9.66% of GDP in Estonia and 6.72% of GDP in Lithuania.

### Box 6.17

#### **Computer and Internet usage in Latvia**

According to the data of the CSB survey “Computer and Internet Usage in Households”, 49% of all households (households where at least one person in the age of 16-74 years lives) had computers and 51% of households had Internet connection in 2007. 58% of inhabitants (inhabitants in the age of 16-74 years) used computer on a regular basis (in the last 3 months) and 56% of inhabitants used Internet on a regular basis. 32% of all households had broadband Internet connection. In order to access Internet, desktops and mobile phones with Internet service were most used in households (38% and 30% respectively).

93% of companies with at least 10 employees had computers, 84% of such companies had Internet connection and 38% of such companies had their own Internet website in January 2007. 44% of companies with at least 10 employees used Internet for communication with public institutions. 28% of all employees of companies used computer on a regular basis, while Internet was used regularly by 24% of employees.

At the beginning of 2006/2007 academic year, the number of computers per 100 full-time students at higher education institutions and colleges was 11.6 (8.8 at professional education institutions and 7.3 at comprehensive schools). 100% of higher education establishments and colleges, 86% of professional education institutions and 97% of comprehensive schools had Internet connection.

With Latvia's accession to the EU, the European Union initiatives with regard to building the information society (see Box 6.18) became binding for Latvia.

<sup>1</sup> The ICT sector was determined according to the definition of OECD that provides the inclusion of the following economical activities (NACE) in the ICT sector: ICT manufacturing (manufacture of office machinery; manufacture of computers and other information processing equipment; manufacture of insulated wire and cable; manufacture of electronic valves and tubes and other electronic components; manufacture of television and radio transmitters and apparatus for line telephony and line telegraphy; manufacture of television and radio receivers, sound or video recording or reproducing apparatus and associated goods; manufacture of instruments and appliances for measuring, checking, testing, navigating and other purposes, except industrial process control equipment; manufacture of industrial process control equipment) and ICT services, including wholesale (wholesale of

electrical household appliances and radio and television goods; wholesale of computers, computer peripheral equipment and software, wholesale of other office machinery and equipment; wholesale of other electronic parts and equipment, wholesale of other machinery for the use in industry, trade and navigation), telecommunications (telecommunications) and services (renting of office machinery and equipment, including computers; hardware consultancy; publishing of software, other software consultancy and supply; data processing; database activities; maintenance and repair of office, accounting and computing machinery; other computer-related activities).

**Box 6.18****European Union initiatives in building the information society**

To boost development of digital economy, the European Commission launched a new initiative “*i2010: European Information Society 2010*” on June 1, 2005, 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 e-government 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.

On June 6, 2007 the European Commission adopted the Communication “Towards a general policy on the fight against cyber crime”, envisaging specific actions to improve co-ordination between law enforcement authorities and between law enforcement and private sector operators, which plays an important role in the fight against cyber crime in Internet. The Communication also envisages several measures at the national, European and international levels.

On November 8, 2007 the European Commission adopted the Communication on the *European i2010 initiative “To be part of the Information Society”* to the European Parliament and to the Council, European Economic and Social Committee and Committee of the Regions.

**Declaration of the Intended Activities of the Cabinet of Ministers headed by the Prime Minister Ivars Godmanis** emphasises the following tasks:

- in public administration policy: implementation of better regulation policy by providing electronic services and electronic processing of documents and taking measures aimed at mutual compatibility and exchange of information of all national information systems;
- in regional policy: development of a spatial planning information system, providing availability of all spatial plans and construction regulations on the Internet;
- in public involvement: ensuring involvement of the civic society in the early stages of drafting of policy planning documents and legal acts by providing information on the Internet;
- in education: enhancement of the education information system; provision of natural science cabinets in secondary education establishments with modern equipment; promotion of linkage of higher education and research, etc.
- in communications: adoption of rules for privatisation of LLC “Latt telecom”; covering the losses of the state-owned JSC “Latvijas pasts” and introduction of the universal postal service; creation of the Post Bank; implementation of the project “Development of broadband communication infrastructure in rural regions”, providing electronic communications throughout the territory of the country; ensuring repeated use of information accumulated in public administration; support to the national information systems and their integrating services; protection of data and computer networks by presenting uniform principles and approaches for computer network protection; alignment and improvement of the Resident Register;
- in general availability of information services: implementation of the State Library Information System project; ensuring structural development of the Latvian National Library by implementing also the project of the National Digital Library; development of a digital stock of the heritage of the Latvian culture and memory institutions; development of an interconnected electronic information portal of archives, museums and libraries by 2010; development of a cultural education information system; development of the Latvian Culture Map; enhancement of the system of national orders to public broadcasting organisations;
- in improvement of the business environment: ensuring actual operation of e-government;
- in innovations and science: provision of support to medical sciences, and ensuring and introducing of innovative technologies (e-health) and solutions in health care; elaboration of the Latvian National Digital Encyclopaedia project;
- in security: development of electronic security and protection systems for safeguarding information systems against cyber crimes;
- in culture: establishment of the Latvian Register of Intangible Cultural Heritage; creation of a Single State Archive Information System; implementation of a linked electronic catalogue of archives, cinema, museums and libraries by 2010;
- in environment: development of single environmental monitoring and information system which would be compatible with similar EU and international systems.

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 governments 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 actions for development of the information society are as follows:

- 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 innovations;
- to develop ICT science and research;
- to promote creation of export-capable ICT products and services.

Financing from the EU structural funds and resources from the state and local government budgets will be used for implementation of the development programme.

### eCommerce<sup>1</sup>

13% of all companies with at least 10 employees had made purchases over the Internet, while mere 3% of companies had sold goods or services over the Internet in 2006. The turnover of goods and services purchased over the Internet made up 2.2% of the total purchases in Latvia, while the turnover of goods sold over the Internet constituted 1.4% of the total net turnover in 2006. As indicated by *Eurostat*, the total turnover of e-commerce of EU companies made up 11% in 2006.

In the 1<sup>st</sup> quarter of 2007, 15% of all inhabitants or 25% of Internet users had at least once made purchases and ordered goods or services for their needs over the Internet. Purchases over the Internet are mostly made by its users in the age group of 25-34 years (32%).

On June 28, 2007 the Cabinet of Ministers approved the *Entrepreneurship Competitiveness and Innovation Promotion Programme for 2007-2013* worked out by the Ministry of Economics. Main goals of the programme are:

- to provide favourable conditions for development of business;
- to promote increase of capacity and efficiency of the National Innovation System;
- to achieve substantial growth of competitiveness and productivity in industry, fostering increased volumes of manufacturing products with a high value added.

In the framework of the programme, measures for promotion of e-commerce relations will also be worked out: e-commerce information days and seminars will be held and the competition “Best Entrepreneur of eCommerce” and other activities will be organised, which will foster improvement of healthy competition and trade quality among entrepreneurs of e-commerce with every year.

## 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 6.19).

Assistance to SME in Latvia is regulated by the *Law on Control of Aid to Commercial Activity*, which was enforced on January 1, 2003.

<sup>1</sup> Source for Latvian data: CSB; source for EU data: *Eurostat*

**Box 6.19****The number of small and medium-sized enterprises in Latvia**

There were 61 294 economically active businesses and commercial companies in Latvia in 2006 (excluding agricultural and fishing farms and self-employed persons who perform economic activity), of which more than 99.4% belong to the category of SME. The distribution of economically active enterprises in Latvia according to their size is similar to the one in EU member states: micro enterprises – 77.7%, small enterprises – 17.9%, medium-sized enterprises – 3.8%, large enterprises – 0.6%. 69.9% of the private sector employees in the country are employed in SME that create 63.2% of GDP.

An 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 6 years from 17 in 2001 to 27 in 2006.

It is of the same importance to accentuate the number of self-employed persons, which amounted to 43 832 in 2006 (19 per 1000 inhabitants), and the number of agricultural and fishing farms, which equalled to 14 404 in 2006 (6 per 1000 inhabitants). Considering the fact that there is no single methodological practice among EU member states for calculation of an 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 businesses and commercial companies but also self-employed, agricultural and fishing farms, etc. Accordingly applying an analogous practice, Latvia had 52 performers of economic activity per 1000 inhabitants in 2006, 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 businesses 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 23% more than in 2005 (10 927). Growth of the number of newly founded enterprises continued in the first 4 months of 2007 as well. 5146 new commercial companies and businesses were registered in this period, which is the highest indicator in the last 13 years and by 18% more than in the respective period of the previous year (4370). This 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 gradual growth of the number of newly established enterprises are already ensured with accession to the European Union and substantially increased opportunities of local enterprises. Nevertheless, promoting establishment of newly established enterprises is not sufficient to ensure sustainable development. In order to ensure increase of competitiveness, these newly established enterprises must be sustainable. Statistical data show that the total number of enterprises increases by approximately half of the growth of the number of newly established enterprises hence indirectly indicating problems in regard to their sustainability.

Although an active and successful policy for improvement of business environment has been implemented and activities to support the small and medium-sized business have been implemented in the previous years, the study “Impact of Administrative Procedures on Business Environment in Latvia” conducted by the Ministry of Economics in 2007 shows that development of the SME sector in Latvia is still hindered by several essential problems:

- Inflation – the most prevalent hindrance to business, mentioned as an obstacle to performance of business activities by 81.3% of entrepreneurs. Spread of inflation as a factor hindering business activities still tends to grow: inflation created problems for 39.4% of entrepreneurs in 2001, for 48.1% in 2003 and for 72.3% in 2005;
- Tax rates – the second prevalent hindrance to business, which hinders business activities for 71.1% of entrepreneurs;
- Frequent changes of laws and regulations – the third prevalent hindrance to performance of business activities. This factor creates problems for 58.9% of entrepreneurs.
- Tax laws and regulations/tax administration – the fourth prevalent hindrance to business in Latvia, which hinders performance of business activities for 50.3% of entrepreneurs.

On January 27, 2004, the Cabinet of Ministers approved the “**Basic Guidelines for Development Policy of the Small and Medium-Sized Enterprises in 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, spur initiative of entrepreneurs and lessen the total risk, prevent obstacles to entrepreneurship, and foster stability and efficiency of the financial system and of the capital market in order to improve competitiveness of enterprises in the market.

*Basic Guidelines* prescribe 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 considering the specifics of SME development problems in Latvia.

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 practice of the European Commission to review the development policy planning of entrepreneurship, innovation, and industrial manufacturing together, on June 28, 2007,

the Cabinet of Ministers approved the **Programme for Promotion of Business Competitiveness and**

**Innovation in 2007-2013** worked out by the Ministry of Economics.

#### Box 6.20

##### Definition of SME

**Law on Control of Aid to Commercial Activity** establishes the definition of SME (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 annual 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 annual 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 annual balance sheet value is under EUR 2 million.

The programme comprises set-ups and action policy of business competitiveness promotion, innovative activity and industrial development, describing the vision of competitiveness promotion and of the development of innovation and industry for the next 7 years. Main goals of the programme are:

- to provide favourable conditions for development of business;
- to promote increase of capacity and efficiency of the National Innovation System;
- to 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 implemented 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, and for promotion of development of industries and improving 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 those 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 implemented by the Ministry of Economics.

Mortgage and Land Bank of Latvia (hereinafter Mortgage Bank) plays an important role in the **SME support system**. With mediation of the Mortgage Bank, the “*Programme of Crediting Latvian SME Development*” is being implemented since 2000. Implementation of the programme insofar has substantially promoted accessibility of capital to SME and has encouraged more active engagement of commercial banks in SME crediting. In the framework of the first phase of the programme, the Mortgage Bank has granted approximately 1000 loans for the total amount of LVL 33.9 million, while 1000 loans for the total amount of LVL 53.9 million were granted in the framework of the second phase of the programme.

In October 2006, the Cabinet of Ministers accepted the concept “On Development of the State Joint Stock Company “Mortgage and Land Bank of Latvia” for 2007-2013”, envisaging a gradual transformation of the Mortgage Bank to a full-spectrum development bank. The concept determines that establishment and development of SME remains one of priorities of operation of the Mortgage Bank.

Essential role in implementation of the support instruments is played by a structural unit of the Mortgage Bank – Administration of Support Programmes ALTUM. This administration implements support programmes financed by the state and the EU, granting high-risk loans to sustainable and perspective projects of SME and business beginners, which are not financed by commercial banks due to insufficient collaterals and other risks of the project.

Within framework of the *Crediting Programme for Business Beginners*, loans for implementation of investment projects are granted to business beginners, i.e. companies that have been established less than 5 years before getting the loan. The total budget of the programme is LVL 20.56 million, and it is financed by

the ERDF, the state and the Mortgage Bank. In accordance with conditions of the programme, SME may apply for a loan up to LVL 700 thousand with a term of 3 to 10 years. Requirements regarding the loan security are preferential – the loan may exceed the security up to two times. Approximately LVL 20 million to finance almost 200 investment projects of beginners have already been granted within framework of the programme. Issuance of loans will continue until the end of operation of the programme in August 2008.

*SME Crediting Programme* grants loans for implementation of investment projects to rapidly

growing enterprises. Unlike loans to beginners, it is possible to get a loan of up to LVL 2 million in the framework of this programme. The programme is financed from a state-guaranteed loan, and so far 106 loans with the total amount of approximately LVL 11 million have been granted within framework.

*Programme of for Training and Consultations and Financial Support for Business Beginners* is provided for people willing to start their business, but lacking the necessary knowledge and initial financing. The total budget of the programme amounts to LVL 8.38 million and consists of financing from the ESF, the state and the Mortgage Bank (see Box 6.21).

#### Box 6.21

##### Programme of Training and Consultations and Financial Support for Business Beginners

The programme was launched at the end of 2006 when the Mortgage Bank selected one training provider in each of five planning regions of Latvia through a tender procedure. The training process started in January 2007 and will continue until January 2008. It is planned to train up to 1000 interested people during this period of time. Training is organised in groups of up to 20 people, 5 groups in every planning region. Participants of the programme take the training course in about 2 months and, on its completion, they have to prepare a business plan for starting a business activity. The business plan then is examined by experts of the Mortgage Bank. If they take a positive decision, the participant of the programme gets funding for implementation of the project (microloan, grants for starting operation of enterprise and ensuring subsistence in the initial period of operation, payment for mentor services).

Although the training opportunities of the programme are being used very actively in all regions of Latvia, a relatively lower activity so far was observed in utilisation of financial instruments of the programme (less than 70 applications to get financial support were received by December 2007, while it is planned to finance up to 300 beginner projects in the framework of the programme).

In order to ensure absorption of resources of the programme in the planned amount, the range of applicants to get support of the programme was expanded for 3 months as from January 2008. Along with the current graduates of training of the programme, also other emerging businesses with adequate higher or professional education or adequate skills (completed other similar training courses) or with adequate employment experience in the chosen business sphere will be allowed to apply for financial support. In addition, the amount of financial support is increased both for the current and the new clients of the programme: the amount of loans is increased to LVL 50 thousand, and the amount of grant for ensuring subsistence is raised to LVL 3.7 thousand.

Along with programmes implemented by ALTUM, through performance of functions of a development bank, the Mortgage Bank additionally continues work at development and introduction of new support instruments in the framework of its resources. So, *Mezzanine loans* are offered to businesses as from October 2007. Mezzanine loan is not classifiable as a standardised simple type of loan: legally speaking, *Mezzanine* is a loan, but it is regarded as an investment in capital of a company from the economic standpoint. The new product of financing is suitable for enterprises, owners of which do not want to attract new investors (risk capital funds, etc.) but their equity capital is too small to implement plans for development of the enterprise with help of financing from commercial banks. Mezzanine loan is applicable for clients in situations when entrepreneur plans to expand operation or introduce a new product/technology, to start operations in a new sector or expand production by acquiring another enterprise, but lacks collateral and/or has insufficient equity capital to be able to attract additional resources in the necessary amount from a commercial bank.

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.

During 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, the 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. As of November 2007, the LGA has issued 138 guarantees to enterprises for the total amount of LVL 11 253 818. Since December 2006, the 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 elaborated by the Ministry of Economics. In 2005, the 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. The funds started active investments in 2007 and have already made 15 investments for the total amount of LVL 2 201 319 as of November 2007.

EU member states approved the **European Charter for Small Enterprises** at the European Council meeting in Feira on June 19-20, 2000. It is one of the most important political documents of the EU for achievement of the Lisbon goal. 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 6.22).

#### Box 6.22

##### **European Charter for Small Enterprises**

Ten directions of operations 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. employing 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)** (CIP) would be established. 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). The total budget of the CIP amounts to EUR 3 620 million.

#### Box 6.23

##### **Competitiveness and Innovation Framework Programme (2007-2013)**

The programme has 3 separate subprogrammes or pillars:

- the Entrepreneurship and Innovation Programme;
- the Information and Communications Technology 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 investments in this sector. It is planned to ensure the support in the following way:

- by developing a single European information space and strengthening information products and services of the Internal Market;
- by stimulating innovations and its implementation and investment in information and communication technologies;
- by developing an inclusive information society and effective services in the interest of the society, as well as by improving the quality of life.

**Box 6.3 continued**

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 increase 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 improvement of energy efficiency in transport and to promotion of use of renewable energy resources (among them biofuel) in transport were implemented;
- COOPENER programme envisaged development of energy policy and market conditions.

## 6.8. Competition Policy

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 such situation where the market works in the interests of the consumer and strong competition between fairly operating companies exists.

The CC acts in accordance with the Competition Law and other normative acts, as well as the Operational Strategy of the CC for 2007-2009. 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 against the following violations of the Competition Law: prohibited agreements, abuse of dominant position and unfair competition. The Competition Law also prescribes control over merger of enterprises.

**Prohibited agreements and abuse of dominant position** are the most grievous violations of competition law because, by performing these prohibited actions, economic operators may cause the most essential damage to the business environment, economic situation, and society on the whole. In the 2<sup>nd</sup> half of 2007, the CC has established violations of prohibited agreements within the framework of two examined cases. In both cases, the economic operators in elaboration of proposals in procurement tenders have engaged in mutually agreed-upon practices that constitute a violation of competition law. Thus, for instance, a violation was established and fine imposed on LLC “Machinery Latvia” and LLC “Komponents L” for prohibited agreement in the competition organised by LLC “Preco” for supply of metal-working equipment (*see Box 6.24*).

**Regarding the regulation on 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 25 million lats or the combined market share of the market participants in the merger in this relevant market is more than 40 per cent. As merger of enterprises can be considered joining of one market participant to another market participant, merging of two or more market participants in order to become one market participant, 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 if market participants do not meet the binding merger regulations set forth by the competition supervision authority, the CC may take a decision regarding imposition of a fine of up to LVL per day, counting from the day when the notification should have been submitted.

The number of company merger cases to be examined by the CC has increased lately. It is related to growth of economic activity in several sectors of national economy. Under conditions of fast economic growth, not all companies are able to keep their positions in the market. As a result of merger of market participants, competitiveness of companies has increased and strengthened, which ensures lower prices, better quality of goods or services, as well as a wider choice in the range of goods and services. Taking into account that assessment of the influence of merger of market participants on competition in the relevant market must not hinder further activity of merger participants and the fact that company merger cases make increasingly bigger proportion in the list of cases to be examined by the CC, control over merger of market participants becomes a priority in operations of the CC. Intensity of the merger of companies is indicated by the number of decisions taken by the CC in these cases: in 2004 – 9 decisions; in 2005 – 18 decisions; in 2006 – 28 decisions; in 10 months of 2007 – 62 decisions.

**Box 6.24****CC establishes violation of prohibited agreement**

On October 3, 2007, the CC adopted a decision on establishment of violation of prohibited agreement and imposition of fine on LLC “Machinery Latvia” and LLC “Komponents L”.

The Competition Law stipulates that agreement regarding participation or non-participation in competitions or auctions, or regarding the provisions for such activity constitutes a horizontal cartel agreement. This legal provision was violated when two companies coordinate their actions in the competition organised by LLC “Preco” for supply of metal-working equipment. The procurement tender was organised in the framework of the project for creation of a metalwork production facility for LLC “Preco” in accordance with labour safety requirements, which was submitted to the Latvian Investment and Development Agency with a goal to attract financing of EU structural funds for implementation of the project.

Proposals made by four applicants (LLC “Machinery Latvia”, LLC “Komponents L”, LLC “A.I.K.komunikācijas”, and LLC “IRT”) were submitted for the tender. Documentation regarding the process of the competition indicates that the offer made by LLC “Machinery Latvia” was acknowledged the most favourable offer with rights to execute the agreement, as the company submitted an acceptable offer for the lowest price of LVL 699 289.98 (EUR 995 000).

In the process of examination of the case, the Competition Council established that LLC “Machinery Latvia” had at its disposal complete or partial information on financial offers made by competitors LLC “Komponents L” and LLC “A.I.K. komunikācijas”. Three of offers for the competition were fully or partially prepared by LLC “Machinery Latvia”. Therefore, information on competitors enabled LLC “Machinery Latvia” to prepare its offer so that it was economically the most beneficial.

Facts acquired in the case indicate that LLC “Machinery Latvia” and LLC “Komponents L” coordinated their participation in the competition, mutually agreeing that LLC “Machinery Latvia” will win. Evidence for existence of direct contacts between LLC “Machinery Latvia” and LLC “Komponents L” in the form of e-correspondence was acquired, which indicated existence of prohibited agreement between both applicants in the framework of this procurement tender. Evidence that would indicate the coordination of content and prices of the offer between LLC “A.I.K. komunikācijas” and LLC “Machinery Latvia” was not acquired.

It must be concluded that LLC “Machinery Latvia” played an active role in the particular violation, which is also proved by the fact that LLC “Machinery Latvia” has benefited by winning in the competition. With the agreement, competition in the tender was excluded and replaced with mutually concerted action. Thereby one would admit that this agreement was aimed at distortion of competition, in such a way inflicting damage to the state, because the competition was organised with a goal to attract financing of the structural funds of the EU with considerable volume.

As the tender is concluded and the negative consequences have been set in, it was impossible to determine the legal duty to restore the situation to its previous condition it was before the violation. In accordance with the Competition Law, fines were imposed on the parties involved in the violation – LVL 28 049.49 to LLC “Machinery Latvia” and LVL 775.79 to LLC “Komponents L”, corresponding to 1.5% of the net turnover of each in the last financial year before establishment of the violation.

In 2007, mergers have taken place mainly in the sectors of fuel retail trade, medicine retail trade and construction materials. Assessing the influence of merger of market participants on competition in the relevant market, the CC is competent to allow merging, prohibit merging as well as to allow de-merging by setting the incumbent provisions. In 2007, the CC has allowed conducting merger of market participants in most cases; however, there was one decision on prohibition to merge and 3 decisions on permission to merge by setting the binding provisions. One decision on establishment of violation was also taken because market participants had not, prior to merger, submitted a notification to the CC, as stipulated by the Competition Law.

As an example where the CC has allowed merger of market participants by setting the binding regulations, one may mention the merger case of LLC “Latvijas Mobilais Telefons” and LLC “ZetCOM” can be given (see Box 6.25).

The role of legislature in the field of Competition Law becomes more and more topical and important.

Its importance is also indicated by the fact that the publication “Verdicts and Decisions of the Department of Administrative Affairs of the Senate of the Supreme Court of the Republic of Latvia 2006” includes Chapter “Judgements in Cases on Decisions of the Competition Council” for the first time. Market participants use the right to appeal against decisions taken by the CC. In 10 months of 2007, there were 63 outstanding legal cases, and proceedings are completed in 9 of them. In 8 completed legal cases, the CC decision remained valid by court verdict. 54 legal cases regarding decisions taken by the CC in the period from 2002 till 2007 are still pending this year. 45 of them are brought to the first instance, 8 – to the appeal instance, and 1 – to the cassation instance. The right to judicial review of verdicts of the Administrative District Court and of appellate court is used both by market participants and the CC in accordance with the Administrative Proceedings Law. Of all outstanding appeal and cassation cases, 4 are brought on the basis of appeal by the CC.

**Box 6.25****CC allows merger where LLC “Latvijas Mobilais Telefons” acquires determinant influence over LLC “ZetCOM”**

The merger notification submitted to the CC points out that both participants of the merger operate in the market of mobile communication services. Mobile communication services may be divided into services provided in wholesale trade and services provided in retail trade. Wholesale mobile communication services are the services provided by mobile electronic communication merchants to market participants who themselves provide services to the end consumers. Retail mobile communication services are the services provided by mobile electronic communication merchants to the end consumers.

Of the merger participants, only LLC “LMT” provides wholesale mobile communication services. Retail services are provided both by LLC “LMT” and LLC “ZetCOM”. According to information at disposal of the CC, LLC “LMT” provides wholesale mobile communication services to LLC “ZetCOM”. LLC “ZetCOM” is the so-called value-added mobile operator that uses its SIM cards, assigning mobile phone numbers to users, does not have its infrastructure of mobile communications and uses the electronic communication network owned by LLC “LMT”.

Despite the fact that LLC “ZetCOM” operates, using the mobile communication infrastructure of LLC “LMT”, LLC “ZetCOM” and LLC “LMT” are to be considered competitors at the retail trade level. LLC “LMT” and LLC “ZetCOM” offer substitutable services in the market. LLC “ZetCOM” offers services with “Amigo” and “Hallo!” prepayment cards, LLC “LMT” offers services both with postpayment and prepayment – “OKarte”. The relevant market where this merger takes place and which is affected by this merger is the market of retail mobile communication services in Latvia.

In the process of examination of the case, it was concluded that the merger will not result in dominant position of LLC “LMT” but its market power will increase because conditions of the relevant market in Latvia are such that also a small market participant with a little market share can affect competition conditions and create pressure of competition. Hence, takeover of LLC “ZetCOM” will essentially increase the market power of LLC “LMT”. The merger enables LLC “LMT” to acquire competitive advantage in the form of a base of customers not through a natural way of competition, which would require campaigns of active reduction of prices etc., but only due to takeover of a competitor.

At the same time, one would take into account that the merger creates certain advantages for consumers: due to bigger number of prepayment cards, LLC “LMT” will be able to achieve better conditions for distribution of prepayment cards in retail trade, reduce purchase costs of SIM cards and costs for functions performed simultaneously by LLC “LMT” and LLC “ZetCOM”, e.g., customer service by phone. As a result of the merger, customers of LLC “ZetCOM” would get the opportunity to become users of postpayment services of LLC “LMT” without change of number.

Through assessment of all circumstances, the CC decided to allow the merger of LLC “Latvijas Mobilais Telefons” and LLC “ZetCOM”, setting the binding conditions for its participants. Only if the set legal duties and conditions are fulfilled, the merger is to be considered as such, in the result of which LLC “Latvijas Mobilais Telefons” will not be able to considerably hinder, restrict or distort competition in the market of retail mobile communication services in Latvia. Participants of the merger must ensure that:

- information about the deal is distributed by sending to all users of “Amigo” and “Hallo!” prepayment cards of LLC “ZetCOM” short messages with the following content: “We inform that the operator ZetCOM of Amigo (or Hallo respectively) prepayment cards is merged with LMT”; as well as placing information that the mentioned deal has taken place, on Internet websites [www.lmt.lv](http://www.lmt.lv), [www.okarte.lv](http://www.okarte.lv), [www.amigo.lv](http://www.amigo.lv), [www.hallo.lv](http://www.hallo.lv);
- LLC “ZetCOM” will exist as a separate legal entity at least until January 1, 2009;
- “Amigo” brand will exist at least until January 1, 2009;
- at least until January 1, 2009, most favourable terms (incl. terms regarding keeping the number) than the ones set in cases when customers of other operator become customers of LLC “Latvijas Mobilais Telefons” will not be applied for users of prepayment cards of LLC “ZetCOM” if they express wish to become customers of LLC “Latvijas Mobilais Telefons”;
- at least until January 1, 2009, the merger participants will not carry out marketing measures especially aimed at attraction of customers of LLC “ZetCOM” to services of LLC “Latvijas Mobilais Telefons” neither by themselves nor by any third party involved.

**Competition promotion and advocacy**

This direction of activity includes supervision of market sectors and formation of competition culture in society. 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.

In the 2<sup>nd</sup> half of 2007, the CC has completed market surveillance over taxi services and parking market near objects of strategic importance (airport, hotels, etc.) in Riga and has sent its conclusion both to the Ministry of Transport and to Riga International Airport, as well as has completed supervision in chipboard market and fixed and mobile voice telephony markets (see Box 6.26).

One of the tasks of the CC in competition promotion and advocacy 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 solve conflict situations more successfully in their initial stage as well as prevent them in a timely manner.

Discussions regarding the draft law “Amendments to the Competition Law” are of essential importance. CC actively engages in giving explanations of the essence and necessity of the amendments both to members of the Saeima and to law offices and non-governmental organisations, providing information in mass media. The draft law “Amendments to the Competition Law” was adopted by the Saeima in the 1<sup>st</sup> reading on September 20, 2007, and the dialogue on these issues continues.

In order to promote awareness of entrepreneurs on competition policy issues, in September 2007 the CC

organised a seminar for representatives of construction and building materials trade about the Competition Law, development and enforcement thereof, basic

principles of fair competition, giving examples and explanations for particular situations.

#### Box 6.26

##### **Competition situation in fixed and mobile voice telephony markets**

Competition situation is different in markets of fixed and mobile voice telephony services, but a positive trend – development of competition, oriented towards benefit for consumers – has been observed in recent years.

Through assessment of mutual substitutability in the fixed electronic communications network and the mobile electronic communications network by price, functionality and other factors, the CC has come to the conclusion that the services are not mutually substitutable.

40 merchants provide voice telephony services in the fixed electronic communications network in Latvia. Market share of the market participant LLC “Lattelecom” indicates dominant position in the market of voice telephony services in the public fixed electronic communications network. Another equivalent operator would be necessary to change this situation, but there are many obstacles that must be overcome for successful competition of the new market participants in this relevant market.

Competition in the market of voice telephony services provided in the fixed electronic communications network is assessed as low, and regulatory measures are essential to ensure balance between market participants. Main market risks involve potential abuse of dominant position.

During recent years, rapid development of the market of voice telephony services in the mobile electronic communications network has been observed and the selection of services offered to end users has increased; as a result, call tariffs have decreased continuously. Currently, there are several big mobile network providers on the market – LLC “Tele2” and LLC “Latvijas Mobilais Telefons”, which own substantial market shares, but each of them separately does not hold a dominant position in the relevant market.

Assessment of the sector of voice telephony in the mobile electronic communications network on the whole leads to the conclusion that competition in the market is efficient and, as the result, new services are being offered to consumers and tariffs are being reduced.

CC has conducted assessment of draft normative acts and policy documents in the scope of competition protection and development. Assessing several draft CM regulations and law amendments, among them “Amendments to the Energy Law”, it was concluded that several provisions included in it are insufficiently precise or contain conditions that may cause such behaviour of market participants, which might be treated as abuse of a dominant position. In this regard, the Competition Council prepared respective proposals for more specific definitions of the mentioned draft law.

Through examination of draft CM regulation “Amendments to Regulation No. 297 of July 3, 2001 of the Cabinet of Ministers “Regulations on Types of Regulated Public Utilities”, the CC proposed to regulate also the liquid gas industry in the energy sector, concerning sale of liquid oil gas from underground or above-ground group facilities to population for household needs. The proposal was made on the basis of assessment of the current situation, namely, CC initiated several cases regarding violation of abuse of dominant position in this market, as stipulated by the Competition Law.

In examination of the draft law “Amendments to the Waste Management Law”, the CC analysed rights of service recipients to choose a provider of services as well as the opportunity not to limit the number of merchants authorised to provide service of waste management, so that competition would not decrease and free circulation of the provided service would not be restricted. Thereby the CC proposed to elaborate amendments to the “Waste Management Law” and other normative acts regulating waste management, so that the waste management market would be at least

partly opened to free competition regarding merchants and recipients of the respective services, and meanwhile the CC noted the necessity to assess the opportunity of utmost reduction of barriers to free competition in that particular segment of waste management market, where recipients of services are households.

##### **Strengthening the role of the Competition Council in development and implementation of EU legal acts and in international organisations and networks**

CC, through participation in various working groups, co-operates with the European Commission and competition authorities of other European countries in development of various legal acts and mutual exchange of information.

CC continues participating in work groups of the European Competition Network, e.g., Work Group on Pharmacy and Sub-Group on Banking and Payments, main tasks of which are mutual exchange of information and discussions on application of normative acts regulating competition to each of the mentioned sectors, work group on co-operation with consumers, and in joint meeting of experts of competition bodies and national regulators in relation to recommendation about specific markets in the sphere of electronic communications. CC participates in further discussions on issues included in the Green Paper *On Requirements of Actions for Damages for Breach of the EC Antitrust Rules*, supporting the necessity to facilitate claims for damages for breaches of the antitrust rules as an important factor in prevention of unfavourable consequences of the breaches for other market participants and a preventive measure against potential breaches in the future.

CC representatives participate in Work Group on Penalty Imposition Issues of the European Competition Authorities, the objective whereof is to summarise penalty imposition rules of competition authorities and practice of their enforcement, explore their common and different traits as well as problems that may be created by differences of penal systems.

Exchange of experience with representatives of institutions from neighbouring countries supervising competition is always important because their market situation is similar and, in some cases, even market participants are the same. In 2007, representatives of competition bodies of Finland, Estonia, Latvia,

Lithuania and Poland met at the annual Baltic regional conference and discussed issues about competition situation in the energy, gas, central heating and water supply markets, and the role of national and local regulating bodies in these spheres, about violations of the Competition Law in activities of professional associations, about liberal professions and competition. During the conference, several practical examples were considered in work groups, discussions were held and situation was analysed in such spheres as retail trade of foodstuffs and daily consumption goods, media and copyright.

#### Box 6.27

##### Working visit of the European Commissioner for Competition in Latvia

In October 2007 Ms. Neelie Kroes, the European Competition Commissioner, visited Latvia for a one-day working visit in order to acquaint herself with competition issues and topicalities in Latvia and to discuss the current European competition policy. Within framework of the visit, Ms. Kroes paid a visit to Mr. Valdis Zatlers, the President of Latvia, and had meetings with representatives of the CC, governmental, and business sector. The Commissioner repeatedly emphasised the necessity to liberalise the energy market and proposed to open this market for free competition, which would make a positive impact on welfare of consumers.

Discussing issues related to the current system of duties in the Riga International Airport, the Commissioner noted that the CC decision fully complies with decisions adopted up to now by the EC and the European Court of Justice. The CC decision noted that price discounts applied by the airport are unfair, are not justified by the achieved effect of volume and have a negative impact on competition between airlines. CC established that the system of discounts of the airport constitutes violation of prohibition of abuse of dominant position set out in Paragraph (c) of Article 82 of the EC Treaty and imposed legal duty to cease application of the set discounts.

At the meeting with representatives of Latvian business sector, issues of market concentration and mergers were discussed. The Commissioner advised the leading representatives of Latvian companies to set their goals higher and use the opportunities offered by the EU single market of 500 million inhabitants instead of increasing market focus on national markets.

## 6.9. Regulation of Public Utilities

According to the Law “On Regulators of Public Utilities”, a two-level regulation system of public utilities is established in Latvia and the sectors regulated on the state level are separated from the sectors regulated on the local government level.

The Public Utilities Commission (hereinafter Commission) regulates public utilities on 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 recovery), water supply, sewage, and heat supply (except combined heat and power). It must be noted that the Commission does not supervise the local government regulators and is not authorised to influence their operations.

The Public Utilities Commission is a multi-sector regulator performing regulatory functions in the sectors of energy, electronic communications, postal services, and railway transport. The task of the Commission is to ensure the opportunity to receive uninterrupted and safe services to all users for economically reasonable prices and to ensure the possibility to develop to businesses providing public services 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 by 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 therein, protecting interests of users and promoting development of public service providers, setting rate calculation methodologies and approving rates 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 services with license conditions and specified requirements of quality.

In accordance with decision taken by the Cabinet of Ministers of May 2, 2007, initiation of implementation of the Concept on establishment of an efficient public utilities regulation model that is best suitable for the situation in Latvia and prescribes establishment of a uniform system for public utilities regulation, is postponed until June 1, 2009. The Commission currently negotiates with several local government regulators in regard to conclusion of

contracts on regulation of public utilities in administrative territory of the respective local government.

According to the decision taken by the Cabinet of Ministers on July 10, 2007, a working group for development of a uniform model to finance the universal service in the regulated sectors is established. The working group is administered by a representative of the Commission. The working group, through assessment of importance and general availability of sectoral services and requirements of the European Union and normative acts, has chosen the first three sectors to be included in the model of the universal service – electronic communications, postal, and electricity supply sectors. The model of the universal service will prescribe for directing the support to users of poor protection for receipt of electronic communications and electricity supply services towards low-income households, as well as directing the support to the disabled for receipt of electronic communication services – disabled persons of the 1<sup>st</sup> group and persons with hearing disabilities, as well as disabled persons with movement disorders. In the postal sector, in relation to development of the new Postal Law, the issue of postal services to be included in the universal service basket is topical.

#### **Situation 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 electricity supply is played by JSC “Latvenergo”, which generates more than 90% of the electricity generated in Latvia and ensures import of electricity, as well as delivery to those users, who have not chosen another supplier. As from September 1, 2005, all functions of electricity transmission system operator are carried out by JSC “Augstsprieguma tīkls” fully owned by JSC “Latvenergo”. On July 1, 2007, the distribution system operator JSC “Sadales tīkls” started its operations, completely taking over functions of a distribution system operator from JSC “Latvenergo”.

Electricity is also generated in 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. 12 other licensed businesses implement distribution or sale of electricity.

Latvian electricity market is completely open to competition as from July 1, 2007, and several electricity users have already used the opportunity to change their power supplier.

Supply of natural gas in Latvia is ensured by the vertically integrated business JSC “Latvijas Gāze”. According to amendments of October 23, 2007 to the Regulation No. 297 of the Cabinet of Ministers “Regulations on Types of Regulated Public Utilities”, only distribution of liquefied oil gas from above-ground and underground reservoirs by pipelines to the

input into apartment houses is regulated in the liquefied gas supply as of November 1, 2007. Thereby, refill and sale of liquefied gas in cylinders is not regulated anymore as a public service. 11 businesses are licensed for distribution of liquefied gas in Latvia.

##### ***Electronic communication and post***

The biggest market participants in the sector of electronic communications are the land-line network operator LLC “Lattelcom” and mobile communication operators LLC “LMT” and LLC “Tele2”. A total of 496 companies were registered in the sector of electronic communications as of November 8, 2007.

Latvian mobile communication operators have timely fulfilled requirements determined by the EU Regulation on international mobile roaming services, which were enforced in June 2007.

Opinion of the European Commission (hereinafter EC) on the Commission’s notification regarding analysis of Market 18 of electronic communications (Broadcasting services for the delivery of content transmitted to final users) was received in November 2007. The EC opinion did not include notes about the submitted notification. Hence, the Commission has fully completed market analysis in all markets of electronic communications.

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.

##### ***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”.

Reorganisation of the state JSC “Latvijas dzelzceļš” has been concluded; during the reorganisation process, three new subsidiaries (LLC “LD<sub>z</sub> Cargo”, LLC “LD<sub>z</sub> Infrastruktūra” and LLC “LD<sub>z</sub> ritošā sastāva serviss”) were established, which started operations on July 3, 2007.

On June 14, 2007, the Saeima adopted the Law on Public Transport Services. The Law sets forth conditions for operations and organisation of public transport, prescribes sources of financing required to ensure public transport, defines the principles of financing, and regulates basic rights and duties of the passengers and carriers. As from January 1, 2008, licensing of providers of public transport services and control over quality of the services will be kept in the competence of the Commission, while the payment for service is established by organising procurement of public transport service.

## 6.10. Export Promotion Policy

The most important thing to ensure faster increase of exports is the rise of competitiveness of export-capable sectors. Hence the foreign economic policy is to be formed as balanced with other fields of national economy policy, such as improvement of business environment, innovation, education, and employment.

The Ministry of Economics elaborates and implements Latvian foreign economic policy<sup>1</sup> aimed at

stimulation of favourable proportions of exports and imports and promotion of competitiveness of Latvian companies in markets of foreign countries. The goal is reached by implementing three directions of policy: promotion of export and investment, state support instruments, and contractual provision.

### Box 6.28

#### Latvian Export Promotion Programme for 2005-2009

The Programme sets the goals of export promotion, the main tasks thereof, and the results to be achieved. Implementation of the programme is supervised by the Export Promotion Council chaired by the Minister of Economics and made up of representatives of public institutions and industry associations, as well as social partners.

The Programme is implemented in the framework of annual action plans containing 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.

The direction of promotion of exports and investment is implemented by carrying out direct measures of export promotion.

**Foreign economic representative offices of Latvia** (hereinafter Offices) constitute one of the most efficient instruments for export promotion. The Offices foster the flow of export and investment projects to Latvia, give support to Latvian companies in formation and maintenance of business contacts, provide information on market demands of the respective foreign countries, implement marketing measures of export promotion and attraction of investment abroad, identify the potential investors and business partners, and establish contacts with the aim to create interest in Latvia. 10 Offices abroad (in Germany, United Kingdom, Sweden, France, Russia, Kazakhstan, Netherlands, Denmark, Norway, and USA) are open and operating actively at present. Offices in Japan and Poland will start work in 2008. According to the Programme, it is planned to open two new Offices abroad every year. The Ministry of Economics submitted the *Informative Report on Development of the Network of Foreign Economic Representative Offices of Latvia* to the Cabinet of Ministers in November 2007 and has started work on preparation of the action plan.

The forum organised by the Ministry of Economics and LIDA twice a year took place in Riga in December 2007. In framework of the forum, Latvian entrepreneurs were introduced with export support services provided by LIDA and the Offices. Bilateral meetings of companies with leaders of Offices also took place in order to discuss interests of companies and their export opportunities.

To increase export capabilities of Latvian companies and to promote exports of Latvian goods and services, various **export support services** have been provided, among them improvement of capacity and operation of institutional base for export promotion has been ensured, information about the potential of Latvian sectors, product groups and individual companies has been distributed abroad, consultations on issues related to export have been given to entrepreneurs, pilot programmes on starting export have been carried out for entrepreneurs, market study in priority sectors has been conducted in target countries, and programmes to find co-operation partners have been carried out.

The Customer Service Department of LIDA provides an essential export support service to entrepreneurs by giving consultations on issues that involve foreign trade, start of export, selection of business partners, external marketing activities proposed by LIDA, state support programmes and other issues of interest for entrepreneurs. In addition, 21 seminars for entrepreneurs on foreign trade issues were organised in Latvia in 9 months of 2007. Cycle of seminars on export skills for entrepreneurs that want to start export and improve their knowledge is to be noted especially.

<sup>1</sup> In 2007, the Ministry of Economics has submitted the Informative Reports “On Measures and Financing Planned by the Ministry of Economics for Promotion of Exports of Competitive Products and Services in Order to Reduce the Current Account Deficit” and “On the Action Plan for Promotion of Exports of Latvian Goods and Services” to the Cabinet of Ministers. These reports give assessment of the situation and proposals of further action for implementation of harmonised measures of promotion of competitiveness and direct measures of export promotion.

**Box 6.29****Competition “Export Award of the Year”**

The competition “Export Award of the Year” founded in the framework of the Latvian Export Promotion Programme for Latvian commercial companies’ achievements in export was organised in 2007 for the third time already.

The aim of this award is to promote competitiveness of Latvian commercial companies in foreign markets, as well as increase in volume and quality of exports of products and services, assessing performance of commercial companies during the previous year and appreciating the most successful export products and services.

The award is given on the results of an open competition in three categories – product/service with the most rapid increase in export volume; the new export product/service; the most innovative solution of export of product/service.

47 applications from 33 commercial companies for participation in the competition were submitted in 2007, representing the principal export sectors – wood processing and furniture industry, metal processing and machine building, construction, development of electronics and electrotechnics, light manufacturing, food processing and confectionery, as well as chemical and pharmaceutical industry.

The winners of the 1<sup>st</sup> place in the competition are: in the 1<sup>st</sup> category “Product/service with the most rapid increase in export volume”: JSC “Lemis Baltic” (Densitometer DC-400); in the 2<sup>nd</sup> category “New export product/service”: LLC “Tilts visiem” (platform of telecommunications and multimedia); in the 3<sup>rd</sup> category “Most innovative export solution of product/service”: LLC “Elmi” (laboratory equipment of “Sky Line” series).

The jury commission decided to confer special awards of the Ministry of Economics for development of marketing materials: in the 1<sup>st</sup> category “Product/service with the most rapid increase in export volume” – to LLC “V.L.T.” (packaging of poultry eggs), and in the 3<sup>rd</sup> category “Most innovative export solution of product/service” – to JSC “Preiļu siera” (dry cheese juice).

**External marketing** is an important export promotion instrument. 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 Dusseldorf in Germany, as well as visits of the President of State to Morocco and Cyprus, Sweden and Brazil took place in 2007. More than 120 company representatives in total have participated in these visits.

In 9 months of 2007, participation of companies at 10 important international exhibitions was supported, providing marketing of companies before the exhibitions, inviting foreign companies to the stands and working in the stands together with Latvian companies (international engineering fair “Hannover Messe” in Germany, industrial exhibition “Alikanhinta-2007” in Finland, furniture exhibition “M.O.W.” in Germany, etc.). More than 60 companies in total took part at these exhibitions.

In the direction of state support instruments, sub-programmes “Entrance in foreign markets” and “Financial instruments” of the EU Structural Funds operation for 2007-2013 are planned; in framework thereof, it is envisaged to provide support to small and medium-sized commercial companies for certain export promotion activities and ensure export credit guarantees, thereby increasing access to export markets with a higher degree of risk.

**Export credit guarantee system** is a state-supported set of financial instruments for export promotion, which is envisaged for support to Latvian exporters. Political and commercial risks in transactions between exporter and buyers abroad exist in Latvian export markets, and it is possible to reduce these risks by use of state-supported export credit

guarantees. The “Law on Export Credit Guaranteeing” elaborated by the Ministry of Economics (Latvijas Vēstnesis, No. 107, 07.07.2006) and the subordinated regulations of the Cabinet of Ministers on issuance of guarantees (CM Regulation No. 39 of January 9, 2007) have been adopted at present.

Export credit guarantees will provide Latvian exporters with opportunity to receive a guaranteed credit for manufacture of a product and performance of export operations, which, in turn, will enable the exporter to invest free current assets into innovation and development. Financing will be guaranteed for the recipient of the guarantee hence lessening the commercial and political risks a number of times. Notwithstanding the adopted normative base, big interest of commercial companies and support of industry associations, financing from state budget to launch operation of export credit guarantee system in Latvia has not been granted yet. It is envisaged to attract a share of structural funds financing in the planning period of 2007-2013 for export credit guarantees from the Programme “Entrepreneurship and innovation”, Priority “Access to finances”, Activity “Investment fund”, with the total amount of LVL 108.07 million. To compare with the neighbouring countries, Estonia established its export guarantee body Kredex in 2001, and its initial financing was EEK 300 million (LVL 13.5 million). The financing was increased gradually due to big interest of commercial companies, and the actual support currently given by the state to its exporters in Estonia amounts to EEK 1 billion (LVL 44.9 million).

On the basis of the previous experience in absorption of state support programmes (SSP) and recommendations of social partners for the next planning period that will last until 2013, the **SSP “Entry in Foreign Markets”** was elaborated; provision of much wider support to entrepreneurs for export-oriented measures is planned in framework thereof. The financing available in the programme is LVL 7.1 million. In the framework of the programme,

it is planned to support: participation at international exhibitions; participation in trade missions and contact exchanges; organisation of seminars and conferences; direct visits to trade partners; development of market studies; finding strategic partners.

The goal of the **direction of contractual provision of foreign economic policy** is to ensure maximum and predictable market accessibility for

goods and services exported by Latvia. The goal of the direction is achieved with help of multilateral agreements of the WTO, enhanced bilateral and regional integration agreements of the EU, and bilateral economic co-operation agreements of Latvia with third countries. EU implements the common trade policy (see Chapter 6.2.2). The EC, among EU member states, negotiates with third party countries.

## 6.11. Protection of Consumer Rights and Market Surveillance

The system of consumer rights protection in Latvia has been gradually strengthening and developing during the recent years. Regular drafting and acceptance of normative acts regulating rights and duties and relations between consumers and producers, sellers, service providers and other stakeholders, as well as normative acts stipulating requirements for goods and services and procedure of labelling is an on-going process. At the same time, a lot of efforts are focussed on building the institutional capacity to ensure adequate market surveillance and supervision of the observance of consumer rights.

Important documents of consumer rights protection policy were developed and the normative legal base in the sphere of protection of economic interests of consumers was improved in 2007.

In order to facilitate achievement of the consumer rights protection policy goals formulated in the *Basic Guidelines of Consumer Rights Protection Policy* (approved by the Order No. 754 of October 14, 2004 of the Cabinet of Ministers), a draft *Programme of Consumer Rights Protection and Market Surveillance for 2008-2010* was prepared. It envisages continuing the started work, developing the current system for protection of consumer rights and setting priorities in this sphere in view of the achievements during operation of the *Consumer Rights Protection Programme for 2005-2007* (approved by the Order No. 274 of April 27, 2005 of the Cabinet of Ministers). Implementation of the programme after its approval by the Cabinet of Ministers will allow improving enforcement of the normative acts that ensure efficient protection of consumer rights and market surveillance, as well as to involve the society in solution of issues of consumer rights protection. *Draft Programme of Consumer Rights Protection and Market Surveillance for 2008-2010* formulates the following main directions of action:

- improvement of the normative base of consumer rights protection;
- creation of favourable business environment, implementing adequate and efficient market surveillance and supervision of normative acts of consumer rights protection;
- informing consumers and entrepreneurs on issues of consumer rights protection and promoting education of consumers;
- improving the procedures for settlement of domestic and cross-border extrajudicial disputes;

- promotion of operations of consumer rights protection societies.

Several normative acts were prepared and adopted in 2007 to transpose the Directive 2005/29/EC of the European Parliament and of the Council of May 11, 2005 concerning unfair business-to-consumer commercial practices in the internal market and amending Council Directive 84/450/EEC, Directives 97/7/EC, 98/27/EC and 2002/65/EC of the European Parliament and of the Council and Regulation (EC) No. 2006/2004 of the European Parliament and of the Council (Unfair Commercial Practices Directive). For its implementation, the Saeima adopted the *Law on Prohibition of Unfair Commercial Practices* on November 22, 2007 and will adopt draft laws “Amendments to the Advertising Law”, “Amendments to the Administrative Violations Code of Latvia” and “Amendments to the Criminal Law” by the end of 2007.

*Law on Prohibition of Unfair Commercial Practices* is aimed at ensuring protection of rights and economic interests of consumers by prohibiting the performers of commercial practices to use unfair commercial practices with regard to consumers. *Law on Prohibition of Unfair Commercial Practices* defines unfair commercial practices and regulates the competence of supervising institutions (*Consumer Rights Protection Centre* and *Health Inspectorate*). The law stipulates that commercial practice is unfair if it does not comply with professional accuracy criteria of commercial practice performer and has or may have a negative influence on economic action of such average consumer or average consumer group, which is addressed or affected by this commercial practice or if the commercial practice is misleading or aggressive. The law will come into force on January 1, 2008.

The Ministry of Economics continues work at the *draft consumer credit agreements directive* in the Working Party on Consumer Protection and Information of the EU Council of Ministers. The aim of the draft is to harmonise particular aspects of normative and administrative acts of member states in regard to consumer credit, setting clearer and stronger demands more adequate to the current situation in the financial services market in respect to information to be provided to the consumer before conclusion of a crediting agreement, as well as information to be indicated in the consumer credit agreement.

Work has been initiated on the *Draft directive* of the European Parliament and of the Council *on protection of consumers in respect to certain aspects of timeshare, long-term holiday products, resale and exchange* approved by the European Commission on June 7, 2007. The goal of the draft directive is to introduce modern, simplified and harmonised requirements in regard to long-term rental agreements and long-term holiday products, as well as exchange and resale mediation thereof, replacing the current Directive 94/47/EC.

Regulation No. 942 of November 21, 2006 of the Cabinet of Ministers “Regulations regarding Essential Requirements for Lighters and Procedures for Monitoring thereof” was enforced on March 11, 2007. The aim of the regulation is, on the basis of the European Commission Decision 2006/498/EC of May 11, 2006 Requiring Member States to Take Measures to Ensure that Only Lighters, which are Child-Resistant are Placed on the Market and to Prohibit the Placing on the Market of Novelty Lighters, to set the essential requirements for lighters and procedures for monitoring thereof, as well as establish the *Consumer Rights Protection Centre* as the responsible institution, which will perform surveillance of the lighters market. Regulation No. 547 of the Cabinet of Ministers “Amendments to the Regulation No. 942 of November 21, 2006 of the Cabinet of Ministers “Regulations regarding the Essential Requirements for Lighters and Procedures for Monitoring thereof”” was approved on August 14, 2007 and specified the regulations in accordance with the European Commission Decision 2007/231/EC of April 12, 2007 establishing the transition period until March 11, 2008, when stocks of lighters non-compliant with requirements of the Decision may be sold in EU member states.

In the sphere of safety of goods, in 2007 the Ministry of Economics has also started co-ordination of opinion in relation to the initiative launched by the European Commission to introduce reduced ignition propensity cigarettes in the EU. The Commission has prepared a draft decision that, on the basis of Article 4 of Directive 2001/95/EC, prescribes to establish basic requirements for reduced ignition propensity (so-called RIP) cigarettes and to request the European standardisation bodies to develop a standard for implementation of these requirements.

In the area of consumer contractual rights, Latvia has expressed an opinion on review of consumer *acquis* carried out by the European Commission, in the framework of which eight consumer *acquis* directives are being reviewed in order to simplify and supplement the current regulating rules in the sphere of consumer rights protection. Requirements of the mentioned eight consumer directives are transposed in Latvian normative acts. Latvia, by transposing the directives, has used the opportunity to set stronger regulation than those in Community directives in several cases, e.g., in regard to the term for the use of refusal rights. Summarising opinions of stakeholders

on problem issues of consumer *acquis* included in the *Green Paper*, the European Commission has decided on necessity to work out the *Framework Directive on Consumer Contractual Rights* in order to fully harmonise several general aspects of consumer *acquis* and focus on those issues that create barriers to cross-border trade and deter consumers from purchasing goods or services abroad. It is envisaged to harmonise such notions as “consumer”, “performer of economic activity” and “delivery”, as well as regulation of refusal rights, etc. by the mentioned legal act.

### **Supervision of consumer rights**

The *Consumer Rights Protection Centre* (hereinafter – CRPC) under supervision of the Ministry of Economics is the main co-ordinating institution, which supervises observance of the normative acts of consumer rights protection. 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. Information about consumer rights is available on the CRPC website [www.ptac.gov.lv](http://www.ptac.gov.lv), as well as on the website of non-governmental organisations for protection of consumer interests [www.pateretaja-celvedis.lv](http://www.pateretaja-celvedis.lv). In accordance with the Regulation No. 631 of August 1, 2006 of the Cabinet of Ministers “Procedure for Submission and Review of Consumer Claims Concerning Goods or Services Non-compliant with Agreement Terms”, the CRPC created and placed a database of examiners on its website where 11 examiners are registered. However, a bigger diversity for examination of various goods and services would be desirable.

In 10 months of 2007, the CRPC consulted in 24 604 cases (22 232 to consumers and 2372 to legal entities), as well as reviewed 1764 complaints and applications of consumers (hereinafter referred to as complaints) (see Box 6.30).

The number of complaints still tends to grow in the last years, which could be explained by the greater consumer awareness about their rights, e.g., 810 complaints were submitted to the CRPC in 10 months of 2005, 1002 complaints were submitted in 10 months of 2006 and 1764 complaints were submitted in 10 months of 2007.

In 2007, a tender was announced and participation agreement was concluded between the CRPC and the *National Association for Consumer Protection* on performance of particular tasks of public administration in the sphere of consumer rights protection.

**Box 6.30****Complaints and applications submitted to the CRPC in 10 months of 2007**

758 of the complaints reviewed in 10 months of 2007 were settled in favour of consumers, of which 611 were complaints for purchased goods and services non-compliant with agreement terms for the amount of LVL 258141.05. Claims in 434 complaints proved to be unjustified, 146 complaints were sent for review to other institutions in accordance with their competence. In their complaints, consumers have presented claims about:

- non-observance of the principle of legal equality of contracting parties – in 198 cases,
- provision of incomplete information – in 76 cases,
- incorrectly set payment for purchase and weight or measure – in 15 cases,
- violations of review of claims – in 257 cases,
- services that do not comply with agreement terms – in 705 cases,
- goods that do not comply with agreement terms – in 634 cases,
- other issues – in 147 cases.

Of 642 complaints about goods that do not comply with agreement terms, most were related to electric appliances (138), mobile phones (136), and footwear (95).

The biggest share of all complaints is constituted by complaints about provided services that do not comply with agreement terms (726), of which most are about construction (121), tourism (110), rent and public utilities (60), individual orders of furniture (54), and electronic communications (35) services. 47 complaints were submitted about air services, and in 25 of them air passengers asked for CRPC help in receiving compensation and assistance from air carriers, which is determined by the Regulation 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 (EEC) No. 295/91* (hereinafter – Regulation No. 261/2004). CRPC, which is responsible for supervision of observance 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 consumer complaints and legal regulation in protection of air passenger rights, amendments to the Article 88 of the Law *On Aviation* and to the Regulation No. 632 of August 1, 2006 of the Cabinet of Ministers *Bylaw of the Consumer Rights Protection Centre*, as well as proposals for new regulations of the Cabinet of Ministers were developed, which would determine the procedure according to which co-operation between institutions is ensured in considering cases resulting from violations of Regulation No. 261/2004. Proposals for amendments to the *Consumer Rights Protection Law* have been worked out as well.

**Supervision of advertising**

In 10 months of 2007, the CRPC has assessed 6817 advertisements, of them 72 – upon individual applications. Examination of cases was started on 346 occasions. In 10 months of 2007, administrative penalty was applied in 107 cases.

The number of reviewed cases has increased by 71% in 2007, as the number of employees involved in supervision of advertising has grown and skills of

employees have also increased because certified lawyers are engaged in the work. The biggest number of violations was established in advertisements of special promotions. The number of misleading advertisements has also increased.

The categories of cases reviewed most often are misleading and discriminatory advertisements (see Box 6.31).

**Box 6.31****Misleading and discriminatory advertisements**

CRPC has carried out investigations in 32 cases on misleading advertising, administrative fine was applied in 11 cases and the CRPC imposed an obligation to withdraw advertisement in three cases.

Withdrawal of advertisement was applied to those advertisements, where non-existent qualities (incredible effect) were ascribed to the respective goods. For example, information with the slogan “I will take care that 5 of your earnest wishes pertaining to money would fulfil by the end of the year” was distributed in press. CRPC established that the advertisement gives wrong declarations (statements) and misleading idea both for the society on the whole and for individual persons about opportunities to acquire financial resources or other material values, by paying LVL 0.44 as a price for two postage stamps. As during review of the case the advertiser did not submit evidence that would confirm the special abilities of person indicated in the advertisement, the advertisement was acknowledged as misleading.

Advertisements of food supplements are a characteristic type of misleading advertising. CRPC, reviewing cases on food supplement advertisements, has taken decision on prohibition of distribution of two advertisements and has imposed administrative penalty on advertiser. The main problem in this sphere is that medical properties have been ascribed to food supplements (which is prohibited) and a surprising and incredible effect (e.g., increase of breasts by several sizes, losing weight in sleep) has also been attributed to them.

CRPC also acknowledged as misleading the advertisement of air tickets distributed by airline, which did not indicate the payment for transaction to be paid in addition to the ticket price if reservation of tickets is done on the Internet. Hence the CRPC applied administrative penalty for this violation.

Violations of prohibition of discriminatory advertising have been established as well. CRPC applied administrative penalty for an advertisement, where a photo shows a dark-skinned man wearing a worker's helmet above a scarf tied in a form of turban. The photo displays a notice in broken Latvian “I want to repair your house!” in black letters on yellow background; information “Pērnavas Street 27/29. All for repairs and construction. Except imported labour force” is given under the photo. In assessment of individual components of the advertisement's content in connection with the object of the advertisement (construction goods and services offered in the advertisement), the CRPC established that the advertisement expresses discrimination against a person because of race, skin-colour, national or social origin.

**Supervision of agreements**

By November 1, 2007 the CRPC has issued 48 administrative acts on unfair and unequal terms of agreement, demanding to cease fulfilment of the unfair agreement terms concluded with the specific consumer and of agreements concluded with other consumers, as well as demanding to alter draft agreements offered to consumer.

The number of established violations of unfair terms of agreement has increased in comparison with the previous year, which is attributable to the activity of the CRPC in this area and to increased level of consumer knowledge in assuming contractual obligations. A great share of the administrative acts on unfair terms of agreement are issued in relation to agreements on purchase and management of real estate, consumer crediting, electronic communication services, purchase of various goods and provision of services, as well as various financial services.

The most frequent unfair terms in agreements with consumers are as follows:

- prescribing settlement of disputes only by the court of arbitration or by the court of arbitration at claimant's choice;
- prescribing disproportionately large 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 rights to the service provider to alter terms of agreement unilaterally;
- prescribing rights to the service provider or vendor to unilaterally keep the advance payment paid by a consumer, while not providing such opportunity for the consumer.

Decisions with regard to collective consumer interests are published since 2007 on the CRPC website [www.ptac.gov.lv](http://www.ptac.gov.lv) (in the section "Decisions of the CRPC").

**Box 6.32****Activities of the CRPC in supervision of agreements in 2007**

In 2007 the CRPC conducted inspections of altered draft agreements and service programmes of complex tourism services, as well as assessed, whether they comply with requirements of the Regulation No. 67 of January 23, 2007 of the Cabinet of Ministers "Regulations on the Procedure of Preparation and Implementation of a Complex Tourism Service, Information to be Provided to Customer, and Rights and Services of a Complex Tourism Service Provider and of a Customer". Considering the above-mentioned measures, amendments have been made to draft agreements and service programmes offered to consumers, as well as security guarantee payments have been made. At the same time, taking into account that the new regulations prescribe duty of providers of complex tourism services to submit reports on sold tourism services to the CRPC, indicating also the provider of the paid security guarantee, the CRPC carried out activities so that service providers would be informed about the necessary reports, as well as conducted additional inspections if the reports were not submitted. After these CRPC activities, 44 reports were submitted.

CRPC implemented a project of supervision of guarantee terms from April 1, 2007 to October 1, 2007. In the framework of the project, employees of the CRPC checked, whether the information included in guarantees given by guarantor complies with provisions of the Article 16 of the *Consumer Rights Protection Law*, whether the word "guarantee" is used with good reason and whether consumer is provided with complete information on consumer rights. The goal of the project was to clarify the situation in the market, offering guarantee terms, to inform entrepreneurs about correct registration of guarantee terms and to eliminate permitted violations of normative acts. Employees of the CRPC, carrying out assessment of guarantees, faced ignorance of employees of various enterprises about what is a guarantee and which terms have to be included in it, and this may frequently lead to provision of wrong information to consumers about their legitimate rights. Most entrepreneurs themselves voluntarily made changes in the guarantee terms (among them dealers of the biggest producers of electric appliances). Hence, violations in 18 guarantee terms were prevented voluntarily. 6 binding decisions in regard to violations in guarantee terms were issued, while in 1 case the entrepreneur was invited to the CRPC for consultation and promised to make changes thereafter.

CRPC implemented a project of inspections of Internet homepages from May 1, 2007 to October 1, 2007. In the framework of the project, the CRPC checked whether homepages of Internet shops include all information determined by normative acts, whether they include agreement and guarantee terms compliant with normative acts, and whether complete and true information about electric appliances offered on Internet homepages has been given. The aim of the project was to clarify the current situation in the market, ascertaining whether Internet homepages contain all information included in the normative acts regulating the distance agreement and information society service, whether homepages contain complete and true information on certain categories of goods (electric appliances), and whether homepages do not include unfair terms of agreement and the notion "guarantee" is not used unjustifiably, as well as to inform entrepreneurs on correct layout of homepages and prevent violations of normative acts. 18 homepages of Internet shops were checked. 10 merchants made changes voluntarily, incompliance were partly prevented in three cases, decision was issued in four cases, and decisions are being prepared in four cases.

During 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. Special attention is paid to KASKO insurance agreements (a study is being conducted on compliance thereof with requirements of normative acts) and agreements on electronic communication services.

CRPC currently assesses the crediting agreements offered to consumers by the merchants that do not correspond to the status of credit institution.

In 2007 the CRPC has performed protection of collective interests of consumers not only in regard to terms of agreements, but also has issued several decisions pertaining to the established violations of consumer rights with regard to violations of consumer's freedom of choice. E.g., a decision on changes of the air ticket reservation system on Internet homepage was taken on June 18, 2007. CRPC acknowledged that the ticket reservation system offered to consumers in the section that makes consumers to deactivate the automatically activated option on flight date/time change guarantee denies them full and free exercising of their choice and will, violating the consumer rights protected by the *Consumer Rights Protection Law* (Item 1 of Section 3, Part 3 of Section 4), and obligated to make the respective changes in the air ticket reservation system on the Internet homepage, henceforward offering to consumers the opportunity to choose acquisition of flight date/time change guarantee by activating the respective option themselves.

**Cross-border consumer protection**

The number of Latvian residents going abroad and the number of tourists visiting Riga has grown rapidly in the recent period. Hence, the cross-border consumer protection becomes ever more topical.

The *European Consumer Centre of Latvia* (ECC Latvia) was established as a separate department of the CRPC, co-financed by the European Commission.

**Box 6.33****Activities of the CRPC in cross-border consumer protection in 2007**

In 10 months of 2007, consumers contacted the ECC Latvia 480 times (400 consultations and 80 complaints). 49% of the received complaints pertained to air traffic services, 20% – to tourism, 10% – to clothing and footwear, 6% – to household appliances, 5% – to e-commerce, 1% – to accessories and other issues. 16% of the given consultations were related to air traffic services, 18% – to household appliances, 9% – to clothing and footwear, 11% – to e-commerce, 7% – to tourism services, 2% – to accessories, and 37% of consultations were given on EU normative acts and other services.

Mini-cards with contact information of the ECC Latvia and information about the cases when a consumer may turn to the ECC Latvia for help are available in 37 places visited by foreign tourists in Latvia, including Riga International Airport, tourism information centres, hotels, etc.

Due to the successfully initiated co-operation with the Latvian Tourism Development Agency, the brochure “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 distributing the brochures “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 on consumer rights in the EU, the ECC Latvia continues adding information to the website [www.ecclatvia.lv](http://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 has been purchased.

**Market surveillance**

CRPC has set such priority directions of market surveillance in 2007 as toys and children’s goods (cots, baby walkers, diaper changing tables, etc.), baby-proof lighters, individual means of protection, electric appliances and vehicles.

**Box 6.34****Activities of the CRPC in market surveillance in 2007**

In 9 months of 2007, the CRPC:

- carried out 2446 inspection visits to trade and service companies (1549 – in Riga and its neighbourhood; 326 – in Daugavpils, 270 – in Liepāja; 301 – in Ventspils);
- provided 387 consultations to companies;
- adopted 26 decisions on safety of goods and services;
- adopted 5 decisions on compliance of goods and services with requirements of normative acts.

**In 9 months of 2007, inspection visits were carried out and projects were implemented for the following commodity groups:**

- *individual means of protection* (implementation of the project was divided in two periods in view of seasonality – in spring when the time for use of bicycles and roller skates started, inspections of helmets and protectors of cyclists and roller-skaters were launched, while reflectors were inspected intensively in autumn).

At the beginning of summer, 30 trade sites engaged in trade of helmets and protectors were inspected and repeated inspection visits were carried out to 14 trade sites. The following most essential incompliance were established during these inspection visits: 24.6% of helmets and 14.6% of protectors were without CE marking or the marking was incompliant (in a form of sticker, easy to remove), usage instructions in the state language were not added to 46.3% of helmets and 16.6% of protectors. At the beginning of autumn, 11 sites of trade of reflectors were inspected. In the framework of the project, 14 models of reflectors were withdrawn for examination and sent for determination of their reflecting capacities. Results of examination indicate that insufficient reflecting capacity was established for 6 (almost a half) of the withdrawn samples.

The main problems that were discovered through control of the mentioned individual means of protection:

- part of entrepreneurs are not informed of that they are responsible for provision of individual means of protection in accordance with requirements of the Regulation No. 74 of February 11, 2003 of the Cabinet of Ministers “Requirements for Personal Protective Equipment, Procedures for Conformity Assessment and Market Supervision thereof”, hence the conformity assessment procedure for goods has not been carried out (there is no declaration of conformity assessment and no CE marking of type-examination certificates);
- there are no usage instructions in the state language or they are incomplete;
- there is a shortage of information about the producer of individual means of protection.

**Box 6.34 continued**

- *vehicles* (in the framework of the project for vehicles, special attention was paid to quadracycles and mini-motorcycles).

5 trade sites were inspected in the framework of the project. The most frequent incompliance – there is no CE marking or the marking is incompliant (in a form of sticker, easy to remove), there are no declarations of conformity and usage instructions in the state language.

The most essential conclusion after implementation of the project is that importers and distributors do not establish safety of a commodity and its compliance with substantial requirements of normative acts before placing the commodity into Latvian market. In most cases, the necessary documentation is demanded from producers only after inspection visits carried out by the CRPC.

CRPC has started implementation of projects of supervision for electric appliances, toys and building materials in order to check compliance of these goods with requirements of normative acts, as well as fulfilment of safety requirements, implementing inspections at testing laboratories. Results of the projects will become known at the end of this year.

Withdrawal of Mattel toys

CRPC received information on hazardous toys of US toy producer “Mattel” in the market on August 15, 2007. CRPC immediately started co-operation with the importer so that the process of withdrawal of these toys from the market took place efficiently and according to the procedure set forth by normative acts.

As indicated by information provided by the importer LLC “Rimonne Rīga”, 139 toys declared hazardous were at consumers’ disposal in Latvia, of which 60 are “Polly Pocket” play sets containing magnets, 77 Barbie “Doggy Day Care” sets and 10 “Sarge” Die Cast toy cars featured in the animation film “Cars”. Data of the company indicate that no toys from the product line “Fisher Price”, which are declared hazardous, would be at consumers’ disposal at present.

CRPC, by controlling and supervising compliance of goods and services offered in the market with requirements of normative acts and safety, is planning to focus on active co-operation with entrepreneurs, urging them to carry out voluntary measures:

- preventing non-compliance of the offered goods and provided services with requirements both of normative acts and of safety,
- withdrawing goods from sale if such action is necessary for prevention of risks that arise to a consumer through usage of the respective commodity,
- warning consumers about risks that may be posed by the respective commodity,
- recalling goods from consumers,
- providing true and complete information about commodity or service to market surveillance institutions, as well as keeping the necessary documentation to trace origin of goods.

CRPC has started preparation activities for implementation of the LV/2006/IB/EC/01 Twinning project “Strengthening Market Surveillance”. The following results are planned in its framework:

- development and implementation of procedures of information society services;
- developed procedures and planning for supervision of particular goods;
- developed guidelines to summarise statistics of accidents related to goods and services;

- professional training of personnel;
- developed guidelines for introduction of certain legislation;
- expanded framework of quality management, including the sphere of market surveillance.

State metrological supervision

The Consumer Rights Protection Centre carries out the following measures of control and supervision to ensure fulfilment of functions determined by the Law “On Uniformity of Measurements” and the related regulations of the Cabinet of Ministers:

- surveillance of the market of measuring instruments;
- state metrological supervision of measuring instruments handed over for use in the territory of Latvia in the regulated spheres in accordance to the Article 7 of the Law “On Uniformity of Measurements”;
- metrological control of pre-packed goods in places of their production and sale;
- within the existing resources, ensures establishment and maintenance of database of verified measuring instruments in compliance with requirements of the Regulation No. 981 of December 5, 2006 of the Cabinet of Ministers “Regulations on Repeated Verification, Verification Certificates and Verification Marks of Measuring Instruments”.

**Box 6.35**Activities of the CRPC in state metrological supervision in 2007

In 9 months of 2007 the following supervision activities were carried out by the CRPC:

- in order to establish compliance of measuring instruments with normative requirements, **18.8 thousand measuring instruments were subjected to state metrological supervision** in 473 companies, among them:
  - in 365 trade companies – 4429 measuring instruments;
  - in 82 production companies – 13 380 measuring instruments;
  - in 18 healthcare companies – 899 measuring instruments;
  - in 8 public administration institutions – 94 measuring instruments.

**Box 6.35 continued**

Of the inspected measuring instruments, 2.6 thousand or 13.8% of the total number were acknowledged as non-compliant with normative requirements, among them measuring instruments without the necessary certifications of conformity assessment, inadequately marked, as well as used by violating the repeated verification terms set by legislative requirements. As a result of metrological supervision, binding instructions for prevention of violations were given, administrative violation reports for non-observance of metrological requirements were drawn up for 24 natural and legal persons, and decisions were adopted in accordance to the Articles 99 and 166.<sup>15</sup> of the Administrative Violations Code of Latvia;

- the project for study of **non-automatic weighing instruments market** was implemented with a goal to clarify compliance of non-automatic weighing instruments to be sold in wholesale trade sites with the normative acts on metrological requirements, as well as eliminate the established violations in order to reduce the risk of placing in the market and handing over for use in the regulated sphere the measuring instruments non-compliant with normative requirements. In the framework of the project, employees of the CRPC inspected 10 wholesale trade companies (of which 1 company is also a maker of weighing instruments), assessing whether the wholesalers offer weighing instruments and the attached devices (among them cash systems – POS systems of trade points, hereinafter – POS systems) to consumers in accordance with requirements of the Regulation No. 180 of March 7, 2006 of the Cabinet of Ministers “Conformity Assessment Regulations for Non-automatic Weighing Instruments”, and whether the non-automatic weighing instruments are provided with the necessary certificates of conformity and have the CE conformity marking;
- **control of pre-packed goods was performed in 46 production companies**, where 226 consignments of goods were inspected (a test of statistical control was performed). Incompliances were detected in 13 companies or 28.2% of the inspected companies – 29 consignments of goods or 12.8% of the total number of inspected consignments did not comply with normative requirements regarding the actual volume of content. During the report period in total, administrative violation reports for non-compliance of the volume of content of pre-packed goods with normative requirements were drawn up for 10 legal and natural persons and decisions were adopted in accordance with the Article 99 of the Administrative Violations Code of Latvia.

CRPC constantly co-operates with metrological supervision institutions of other countries and takes part in the working groups WG2 “Implementation of the Non-Automatic Weighing Instruments Directive

90/384/EEC”, WG5 “Metrological Supervision” and WG6 “Prepackages” of the European Co-operation in Legal Metrology (WELMEC).

## 6.12. Quality Structural Policy

### 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 of conformity assessment, as well as to improve the base of normative acts in accordance with EU requirements, taking into account the needs of the national market and national economy. Hence, compliance of the products placed in the market and of the provided services, as well as uniformity of measurements are ensured, human health and life, as well as environment and consumers are protected, increase of competitiveness of entrepreneurs and reduction of obstacles to inter-state trade are promoted.

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 binding regulations of the Cabinet of Ministers deriving from the above-mentioned laws.

The main directions of the policy are:

- improvement of the conformity assessment infrastructure (including inspecting and calibration of 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 national 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 population from inaccurately conducted measurements;
- development of Latvian national standards and adaptation of international standards, maintenance of funds of standards and other related documents and dissemination of information in order to establish general and repeatedly applicable principles for solution of existing or potential issues and hence create conditions for consistency and order in a certain sphere;

- 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 promote development of Latvian national economy, the following activities were implemented in 2007:

- In 10 months of 2007 the number of the certified enterprises, where quality management systems are introduced, has reached 676 enterprises, which is by 17 enterprises more than 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 provide more operatively with the information about conformity assessment institutions that have proved their competence in accordance with requirements of the *New Approach* directives. A publication of Latvian conformity assessment institutions in the official newspaper “Latvijas Vēstnesis” is ensured;
- regulation on norms of losses permissible in the process of reloading and storage has been drafted in order to set unified requirements for the procedure, by which, in calculation of customs payments, the actually emerged losses will be taken into account and the permissible norms of losses emerged in the process of reloading, movement and storage of goods subjected to customs control will be applied;
- meetings of Latvian National Accreditation Council, Latvian National Standardisation Council and Latvian National Metrology Council have been organised;
- development and representation of Latvia’s position in EU institutions is ensured in regard to the draft Regulation of the European Commission on the requirements for accreditation and market surveillance of the European Parliament and the Council regarding trade of products and proposal for a decision of the European Parliament and the Council on a unified system of trade of products, by which the up-to-now systems of accreditation and market surveillance, as well as the *New Approach* will be improved;
- participation in the working groups and conferences of international organisations has been ensured in order to shape a unified conformity assessment policy throughout the European Union, taking into account the interests of Latvia.

In order to improve the legislative, informative and consultative base, as well as the infrastructure of the conformity assessment system, it is planned to implement the following activities in 2008:

- to improve the Latvian national metrology system in the field of conformity assessment of measuring instruments;
- to improve the Latvian National Conformity Assessment System, by amending the Law “On Conformity Assessment”;
- to improve the Latvian national standardisation system, by amending the Standardisation Law;
- to inform society about topicalities in the field of quality assurance on a regular basis in order to raise public 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 2008 in co-operation with the Latvian Association for Quality in order to popularise quality assurance as a method for improving business competitiveness.

### 6.12.2. Standardisation, Metrology, Accreditation

**Standardisation.** The LLC “Latvijas standarts” (hereinafter – LVS) was founded in 1999 as the national standardisation organisation with a goal to manage and co-ordinate activities of Latvian businesses, institutions and organisations 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. Moreover, it co-operates with international and European standardisation organisations.

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 establish Latvian fund of standards, co-operate with international and European organisations of standardisation and issue Latvian standards.

Priority directions of LVS operations in 2007 are involvement of users of standards and their finances into standardisation processes, introduction of the

system for electronic sale of standards (e-shop), translation of standards of the regulated sphere into Latvian, enforcement of provisions of the *Mandatory Copies Law*, preparation for participation at the status of full member of ISO and organising meetings of technical committees of standardisation of CEN and CENELEC in Latvia.

In order to promote involvement of users of standards and their financial means into standardisation processes, a plan for co-operation with branch associations was developed. In the framework of this plan, LVS has organised meetings with leadership of branch associations, where potential directions of co-operation were discussed.

A new technical committee of standardisation LVS/STK/50 “Tractors, self-propelled vehicles and their trailers” was founded at initiative of representatives of the Ministry of Agriculture and LLC “Sertifikācijas un testēšanas centrs” in 2007.

26 697 standardisation documents were registered in the status of LVS by October 1, 2007 among them 25 373 standards of European standardisation organisations adapted in the status of Latvian standard. 44 technical committees of standardisation (LVS/STK) and 3 working groups co-ordinated by LVS have adapted 1150 EU standards and 55 international standards and translated 85 compulsorily applicable standards into Latvian in 9 months of 2007.

The *LVS Information Fund* has provided standardisation information services to 5835 legal and natural persons. Standards are used most actively by companies of various construction sectors (39% of the sold standards) and by implementers and service providers of quality management systems (12% of the sold standards). The automatic system of electronic notification of information introduced by LVS provides a 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 9 months of 2007 this service was used by 460 permanent customers (372 customers in 2006) and 3686 regular reports were sent to them.

LVS is actively implementing the system for electronic sale of standards. Approbation of the system is currently under way and it is planned to start electronic sale of standards in December of 2007.

Standardisation work is popularised in press on a regular basis. 5 articles on topical problems of standardisation in Latvia are placed in the regular column “Standardisation” of the “Quality” magazine.

By enforcing the *Mandatory Copies Law* and expanding access to standards, LVS has established a limited availability online access to standards at the *National Library of Latvia*. At present, one can read all standards registered in the status of Latvian standard after June 20, 2006 in two reading rooms of the library.

Wider information about operation of LVS, standards and technical committees of standardisation is available on the Internet website <http://www.lvs.lv>.

**Metrology.** The state agency “Latvian National Metrology Centre” (hereinafter – LNMC) is an agency under supervision of the Ministry of Economics and operates in accordance with the Law “On Uniformity of Measurements” and Regulation No. 624 of August 1, 2006 of the Cabinet of Ministers “Bylaws of the State Agency “Latvian National Metrology Centre””. LNMC is the national metrology institution of Latvia.

The goal of the LNMC is to ensure and develop provision of credibility and traceability of measurements in the country. Its main tasks are as follows:

- 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 therein;
- to organise training in the metrology sphere.

LNMC will continue formation of the national time standard, as from August 2007 the national time standard is included in the official database of continuous comparison of time standards (Circular T) of the BIPM (*International Bureau of Weights and Measures*), hence its traceability to *Co-ordinated Universal Time* (UTC) is confirmed and standard uncertainty is defined. Considering the achievements, now, it is possible to make corrections of the time standard, which will allow reducing the standard uncertainty by approximately 30 per cent.

LNMC continues participation in several inter-laboratory comparison projects both between Latvian laboratories (project SP1-2007 “Calibration of Non-automatic Weighing Instruments”) and in international projects, e.g., projects of comparative measurements of radiation (319/RU/04, 318/RU/04), results of which are approved and will be sent to the BIPM.

513 measuring instruments were calibrated during 5 months of operation in 2006. 1210 measuring instruments were calibrated in 9 months of 2007.

LNMC has become a member of the newly established European metrology organisation EURAMET and has participated at the 1<sup>st</sup> General Assembly of this organisation. LNMC is also represented at the 23<sup>rd</sup> General Conference on Weights and Measures of the Metre Convention. Representatives of measurement divisions of the

LNMC have taken part in the work of technical committees of EUROMET and EURAMET.

Wider information about operations of the LNMC, Latvian national standards and type approval is available on the Internet website <http://www.lnmc.gov.lv>.

**Accreditation.** The state agency “Latvian National Accreditation Bureau” (hereinafter – LATAK) is a public administration institution under supervision of the Ministry of Economics, which ensures operations of the national accreditation system. LATAK is the national accreditation body.

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.

The number of accredited institutions in 2007 has increased in comparison with 2006 and 178 institutions are maintained in the system at present. In 2007, one institution was evaluated in terms of compliance with requirements of Good Laboratory Practice (GLP), considering the Regulations No. 398 of September 3, 2002 of the Cabinet of Ministers on “Requirements for Work Quality of Laboratories and Inspection of Laboratories”, and accreditation was granted to 5 medical laboratories in compliance with requirements of the standard LVS EN ISO 15189: 2007 “Medical Laboratories. Special Requirements Regarding Quality and Competence”. Evaluation of institutions was carried out and accreditation was granted in the fields of EMAS (Environmental Management and Audit System) verifiers, inspection of packing materials, certification of houses used for country tourism, certification of tourism information providers and for laboratories in 6 new fields. Revaluation of the certification institution for quality systems was performed in compliance with the

requirements of the new standard LVS EN ISO/IEC 17021: 2007 “Conformity Assessment. Requirements for Institutions that Ensure Audit and Certification of Management Systems”.

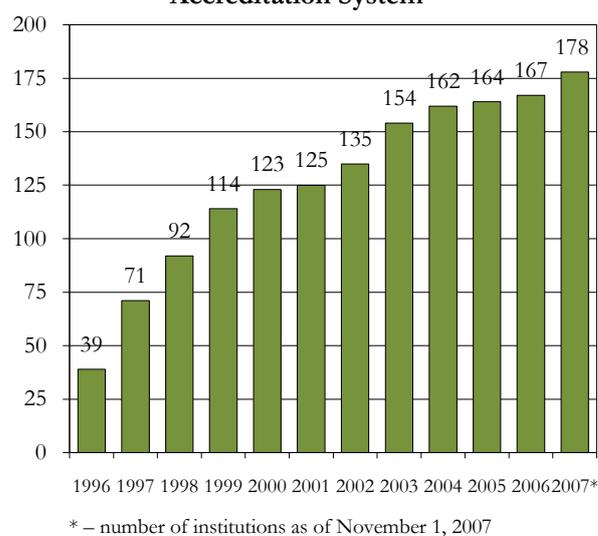
LATAK also provides accreditation services in Ukraine where 1 conformity assessment institution is accredited.

LATAK participates in the European Co-operation for Accreditation (EA) in the framework of the Multilateral Recognition Agreement (MLA) in 6 accreditation spheres.

In 2007 LATAK participated in several committees: session of Multilateral Recognition Agreement (EA MAC) committee, EA Inspection – Certification Committee (EA IC/CC), EA Laboratory Committee (EA LC), working group on medical laboratories of EA Laboratory Committee, EUROMET-EUROCHEM Technical Committee, forum on verification of greenhouse gas emissions organised by the European Commission and Forum of Accreditation Bodies (FAB) organised by the European Commission.

Figure 6.3

**Development Dynamics of the National Accreditation System**



Wider information about LATAK, accreditation procedures and accredited conformity assessment institutions is available on the Internet website <http://www.latak.gov.lv>.

## 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 process 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*), which was enforced on September 1, 2005 and

prescribes how to complete the privatisation process and land reforms and ensure completion of the use of privatisation certificates (see Box 6.36).

#### Box 6.36

##### **Law on Completion of the State and Local Government Property Privatisation and Use of Privatisation Certificates**

The *Privatisation Completion Law* prescribes:

- the term of August 31, 2006 by which every legal or natural entity could 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 activities 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 December 30, 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 deadlines 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);
- that privatisation certificates do not have an expiry term but they may only be 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 could submit applications for privatisation certificates.

In order to ensure successful and open progress of privatisation completion processes, the Cabinet of Ministers has established a procedure of how the institutions conducting privatisation and land reform have to create 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 jeopardise completion of privatisation and land reform, amendments to the *Privatisation Completion Law* were enforced on August 1, 2007. The most essential things that are settled by the amendments are as follows:

- to extend the term for review of privatisation proposals that are submitted for the period from July 1-August 31, 2006; the term set is 18 months from the moment of registration of privatisation proposals, i.e., by February 29, 2007;
- considering the large number of submitted privatisation proposals, a special term of December 30, 2008 for review of privatisation proposals was set for the local government of Riga;
- cases are established, where the Cabinet of Ministers or a local government, by denying privatisation of a real estate, is authorised not to observe the limitation set forth in the Privatisation Completion Law, namely, the three-year prohibition on alienation of the respective real estate. The limitation does not apply to the cases where the real estate is necessary: 1. for performance of commercial activity of the state or local government and will be invested in the capital company mentioned in the decision by which privatisation is denied; 2. for performance of public administration functions and thereby will be replaced by real estate owned by other person in accordance with the Law on Alienation of the State and Local Government Property; 3. for performance of public administration functions and thereby will be handed over free of charge to ownership by the state or local government respectively;
- the deferred payment (instalment) applied in purchase agreements is changed, charge for the deferred payment is set in amount of 6% annually of the outstanding share of privatisation certificates and lats, effecting payment in lats;
- restriction for the state and local governments to conclude lease agreements for a vacant land plot with building rights is excluded. At the same time, it is determined that a leaseholder will be entitled to demand alienation of such land plots if all buildings (structures) prescribed by lease agreement were built and commissioned on this land plot and ownership rights to them were corroborated in the Land Register;
- the range of persons entitled to submit application for redemption (purchase) of land handed over for use is specified, the term by which the application must be submitted is extended accordingly for these persons (by November 30, 2007), and the range of persons to be included in the land redemption register without the application for redemption (purchase) is determined;
- the procedure by which decisions on the rights to redeem (purchase) land in use are made and the procedure for conclusion of land redemption (purchase) agreements are determined;
- the terms and conditions when the rights to use land at disposal of a person expire, as well as the legal consequences are specified;
- the conditions on what land is usable as equivalent land, granting it as compensation to former landowners and their heirs, and the procedure for granting equivalent land are determined;
- the conditions on which a person loses the opportunity to transfer the privatisation certificates granted to this person to an account of a credit institution are specified and the procedure for settlement of disputes derived therefrom is established;
- the procedure and conditions are specified when, by a decision of the Cabinet of Ministers, persons acquire the rights to use privatisation certificates as means of payment instead of property compensation certificates but not later than as from July 1, 2008;
- it is determined that the disputes involving privatisation of property units owned by the state or local governments and of built-up or vacant land plots, granting and use of privatisation certificates and issues of land reform in cities and rural areas are heard by court not later than nine months from the day when application was received.

### **Privatisation of state-owned property units and land**

Privatisation of state-owned property units or land is carried out and privatisation proposals are summed up by the state JSC "Privatizācijas aģentūra" (hereinafter Privatisation Agency) under the Law "On Privatisation of Property Units Owned by the State and Local Governments".

A decision to bring a state-owned property unit (including capital shares) or vacant land plot to privatisation is made by the Cabinet of Ministers, while a decision to bring a built-up land plot (on which there are buildings or structures owned by other person) to privatisation is made by the Privatisation Agency. The decision is taken on the basis of a privatisation proposal submitted by any physical or legal person.

618 proposals for privatisation of real estate, 57 proposals for privatisation of state capital shares and 4191 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* became effective) until October 1, 2007. After August 31, 2006, the Register of Privatisation Proposals registered those privatisation proposals, which were submitted by mistake to other state and local government institutions by this date and transferred by cognisance to the Privatisation Agency later.

A natural or legal entity eligible to acquire a movable or real 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 forwarding 186 properties to privatisation and denying initiation of privatisation for 71 properties by October 1, 2007.

From April 17, 1994 to October 1, 2007, privatisation rules were approved in the statutory procedure for 2273 state property units (except land). 94 companies were transformed to public joint stock companies, issuing 439.14 million shares into public circulation. From April 17, 1994 to October 1, 2007, income from privatisation of state property units (with the exception of land, sale of shares resulting from capitalisation of debts, and alienation of capital shares) amounted to LVL 1.649 billion, of which LVL 385.688 million in cash and LVL 1.263 billion in privatisation certificates. New owners took over liabilities of the privatised state companies (enterprises) valued at more than LVL 185.7 million. The specified investments amounted to LVL 137.3 million, while the amount of investments actually invested reached LVL 259.7 million.

The Privatisation Agency carries out privatisation of state-owned land since 1997. 4380 state-owned land plots with the total area of 6604.77 hectares were privatised (purchase agreements signed) by October 1, 2007. Total sale price for the privatised state lands

reached LVL 148.42 million, of which LVL 51.81 million in cash and LVL 96.61 million in property compensation certificates. As of October 1, 2007, income from privatisation of these land plots amounted to LVL 147.89 million, of which LVL 58.30 million in cash and LVL 89.59 million in property compensation certificates.

### **Privatisation of property units and land plots owned by local governments**

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 made on the basis of a privatisation proposal submitted by any individual or legal entity.

An individual or legal entity eligible to acquire a movable or real 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, province).

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 of the *Privatisation Completion Law* is ensured by the Ministry of Economics.

From February 17, 1994 to October 1, 2007, the Ministry of Economics has reviewed and accepted for information 3120 privatisation projects for the total relative price of LVL 118.1 million (including payments in certificates for the nominal value of LVL 56.2 million).

From January 1, 1997 to October 1, 2007, the Ministry of Economics has reviewed and accepted privatisation rules in respect of 1609 built-up and vacant land plots of local governments (announcements of privatisation of built-up land plots separately as from September 1, 2005) with the total value of land plots in amount of LVL 21.6 million (of which LVL 12.6 million to be paid in property compensation certificates).

Pursuant to Item 7 of Section 5 of the *Privatisation Completion Law*, after August 31, 2006, local governments shall submit data to the Ministry of Economics once quarterly, regarding the received privatisation proposals for municipal property units and built-up and vacant land plots, decisions on forwarding 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 buildings**

Privatisation of apartment buildings in Latvia was started in 1995. The Central Apartment Building 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*” 29 045 state and local government apartment houses with 499 563 apartments or 99.58% of the total number of apartments (501 645) by September 30, 2007. 194 434 apartments have been handed over to private owners by a resolution preceding privatisation of the apartment building.

There are 429 785 state and local government apartments privatised (purchase agreements signed, or handed over to private owners preceding privatisation of the apartment building) in Latvia by October 1, 2007, constituting 85.68% of the total number of apartments. So far, apartment owners have taken over management of 9162 apartment buildings, among them 5621 local government apartment buildings and 3541 state-owned apartment buildings, where more than 50% of apartment units have been privatised.

Owners of privatised apartments can decide on the most acceptable form for management and maintenance of their apartment building: 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, 397 CSAOs have been founded in Latvia, among them 290 in seven biggest cities and 107 in districts of Latvia. The biggest number of the established CSAOs is in cities of Riga (192), Liepāja (69), and Ventspils (21) and in the district of Valmiera (34). Authorisation agreements for property management have been signed for 2778 apartment buildings.

#### Land reform

The principal goal of the 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.

The state land reform includes allocation of free land pertaining 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, which is under way in the country. According to data of the information system of the Real Estate State Cadastre, 970 488 land units are registered in the country as of October 1, 2007, of which 692 203 land units or 71.3% are recorded in the Land Register.

Allocation of urban land for the use to apartment owners or orchard users, who received the land for establishing an orchard with building rights, has been completed, and urban land commissions have reviewed conclusions concerning rights to acquire ownership of land for payment but, in accordance with the conclusions made, signing of purchase agreements is continued in compliance with Regulation No. 171 of May 6, 1997 of the Cabinet of Ministers “On

Calculation of Compensation for Former Landowners or their Heirs and on Setting Fee for Urban Land Given into Ownership”. The state JSC “Mortgage and Land Bank of Latvia” (hereinafter Mortgage Bank) has signed a total of 70 193 agreements by October 1, 2007, of which 768 agreements were signed in the 2<sup>nd</sup> and 3<sup>rd</sup> quarters of 2007. Pursuant to Item 7 of Section 32 of the Privatisation Completion Law, the Mortgage Bank has received 75 prepayments for urban land purchasable for use by October 1, 2007.

Claiming the free (unclaimed) rural land pertaining 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 November 30, 2007, 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 (purchase) land, the State Land Service included the claimant into the Rural Land Redemption Register. Claimants included in this register have to submit a land boundary plan registered in the information system of the Real Estate State Cadastre or, according to 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.

The State Land Service has received 60 858 claims in total for 95 007 land units with the total area of more than 375 700 hectares.

In the period from August 1, 2007 till November 30, 2007 when, in accordance with amendments made to the Privatisation Completion Law, several categories of persons were granted with an additional opportunity to claim for redemption of rural land allocated for permanent use, the State Land Service received 7120 claims for redemption of 8680 land units with the total area of more than 27 100 hectares.

Permanent land users and former landowners did not show notable activity in claiming for redemption of land during this additional claim period because the absolute majority of those permanent land users, who were interested in redemption of the land allocated for permanent use, took the opportunity to claim during the previous period of submission of claims, i.e., by August 31, 2006.

Claiming for redemption of rural land applied to its permanent users – individuals and legal entities, to which the local government or land commission has granted land for permanent use during the land reform by appropriate decision. Since 1993, it was possible to redeem the land granted for permanent use, and the majority of permanent land users have already done it. Since the beginning of the land reform, about 250 000 land units with the total area of 1 288 500 hectares have already been redeemed in rural areas.

As a result of assessment of archival documents at disposal of the State Land Service and alignment of

data of the information system of the Real Estate State Cadastre, 15 700 land units with the total area of more than 77 100 hectares are currently included in the Rural Land Redemption Register on grounds of a land border plan registered in the information system of the Real Estate State Cadastre. In accordance with provisions of the Privatisation Completion Law, these land units allocated for permanent use are included in the Rural Land Redemption Register automatically because the permanent land user, by commissioning a cadastral survey of the land, has shown the interest in further management of the land. Hence the number of land units included in the Rural Land Redemption Register on grounds of land boundary plans registered in the information system of the Real Estate State Cadastre might still increase.

107 500 land units with the total area of 440 000 hectares accounting for 6.8% of the total area of Latvia are claimed for redemption and data on them are recorded in the Rural Land Redemption Register on grounds of a land boundary plan.

Transfer of ownership of rural land for a payment and conclusion of land purchase agreements with the Mortgage Bank are continued. The Mortgage Bank has signed a total of 218 377 agreements, among them 5759 agreements in the 2<sup>nd</sup> and 3<sup>rd</sup> quarters of 2007, for sale of 1.611 million hectares of land, of which 26 318 hectares in the 2<sup>nd</sup> and 3<sup>rd</sup> quarters of 2007. Pursuant to Item 7 of Section 32 of the Privatisation Completion Law, the Mortgage Bank has received 155 prepayments for rural land redeemable (purchasable) for use by October 1, 2007.

Pursuant to Section 16 of the Law “On Completion of Land Reform in Rural Areas”, former landowners or their heirs may submit a claim for restoration of ownership rights to the land envisaged for completion of land reform to the Central Land Commission by

December 28, 2007. 2083 land units with the total area of 2934 hectares are registered as envisaged for completion of land reform in the information system of the Real Estate State Cadastre.

#### **Privatisation certificates**

Privatisation certificate is a state-issued dematerialised security, which 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 October 1, 2007, a total of 103.9 million privatisation certificates have been issued to 2.45 million people for the time they had lived in Latvia, including 794.5 thousand privatisation certificates granted to 41.3 thousand politically repressed persons. 7.99 million property compensation certificates were issued to 117 thousand former owners or their heirs, including 691.7 thousand certificates for property appropriated for state needs at the privatised specialised state agricultural enterprises, 4894 thousand for land in rural areas, 963.5 thousand for residential property ownership, 813.2 thousand for urban land, 461 thousand for companies and other property units, 89.8 thousand for property taken away from politically repressed persons and 83.8 thousand for property alienated in illegal manner.

1.5 thousand property compensation certificates have been granted to 65 former owners or their heirs in the first 3 quarters of 2007.

Pursuant to amendments to the *Privatisation Completion Law*, 55.9 thousand persons are entitled to transfer 1.29 million privatisation certificates to their accounts in the period from August 1, 2007 to November 30, 2007.

Table 6.6

#### **Use of Privatisation Certificates**

(by October 1, 2007)

Type of property	Number	Number of privatisation certificates (million)	incl. property compensation certificates (thousand)
Residential properties	428 thousand privatised housing units	37.57	589.8
Companies and other properties	accurate data not available	7.17	109.6
Capital shares (stocks)	accurate data not available	44.44	954.0
including:			
in public offering	128.7 million shares	37.14	820.0
Land	289 thousand land plots	15.90	5375.6
<b>Total</b>		<b>105.08</b>	<b>7029.0</b>
% of total certificates issued		93.9%	87.8%

According to the Law “On Privatisation of Land in Rural Areas”, 11 075 decisions have been taken by

October 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 8413 persons, cancelling 0.62 million property compensation certificates.

Cash compensations in the total amount of LVL 4.63 million were paid to 26.2 thousand politically repressed persons as payment for privatisation certificates by October 1, 2007.

105.03 million privatisation certificates or 93.8% of the total number of issued certificates were used for privatisation of state and local government property units by October 1, 2007 (see Table 6.6).

2.43 million privatisation certificates or 2.2% of the total number of issued certificates, including 0.17 million compensation certificates, were on

accounts of 397 thousand physical persons as of October 1, 2007.

Accounts of legal persons held 2.41 million privatisation certificates or 2.1% of the total number of issued certificates, including 0.03 million property compensation certificates, as of October 1, 2007.

In October 2007, holders of privatisation certificates could use services of 16 licensed intermediary capital companies for transactions in the market of privatisation certificates. Total monthly transactions with privatisation certificates (buying from natural persons and selling), carried out by intermediary capital companies in the 3 quarters of 2007, fluctuated from 0.07 million privatisation certificates in August to 0.20 million privatisation certificates in July.

## 6.14. Public-Private Partnership

Public-private partnership (PPP) is most often perceived as long-term contractual relations between a public entity and a private person in order to ensure performance of function of the public person in building, reconstructing or maintaining a socially important object of infrastructure or providing a public service, where the private partner, attracting resources of the private sector, assumes risks related to fulfilment of obligations set forth in PPP contract.

Although PPP has already become a solution for successful provision of public services and for development and maintenance of infrastructure worldwide, European Community Law still provides

no special definition of PPP and only gives a general explanation of PPP. The European Commission classifies PPP<sup>2</sup> as:

- purely contractual PPP (DBFO type contracts and concessions), if co-operation between the public institution and the private partner is based on a long-term contract;
- institutionalised PPP (joint ventures), if co-operation between the public institution and the private partner is carried out within a joint entity.

### Box 6.37

#### 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 can have 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 an 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).

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 entails 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 VFM<sup>1</sup> in the project.  
It provides for selecting the most economically

advantageous solution, although not always at the lowest costs. Hence, 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 have the biggest value for the invested finances. Similar approach is considered feasible in most of EU member states implementing sound PPP policy. Thereby, assessment of project's VFM in public investment projects is an essential component

<sup>1</sup> Value for money.

<sup>2</sup> EC Green Paper on PPPs and Community Law on Public Contracts and Concessions, 30.04.2004.

of initial assessment of the project. Global practice proves that medium savings through implementation of an investment project in PPP form makes up 20%, besides, PPP projects are more frequently implemented within a planned budget and time<sup>1</sup>;

- **Risk management of PPP.** In PPP projects, the public partner shares risk with the private partner, who can better manage many substantial project risks;
- **Responsible observance of budget discipline.** In particular cases the implementation of a PPP project is linked with long-term liabilities of the public entity, which in turn are related to observance of fiscal discipline.

#### **Implementation of public private partnership policy**

Promotion of PPP in Latvia was started at the beginning of 2000, when the Saeima adopted the Concessions Law and it came into force, as well as the institutional system for implementation of PPP policy and PPP projects was created.

According to the Regulation No. 238 of April 29, 2003 of the Cabinet of Ministers “Bylaws of the Ministry of Economics”, the Ministry of Economics is the leading public administration institution, which

develops the PPP policy and co-ordinates its implementation. The main goals of the Ministry of Economics in the PPP sphere are to:

- 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;
- explore resources of concessions in the country;
- co-ordinate activities of state, local governments and the private sector in the PPP sphere.

LIDA is a public institution under supervision of the Ministry of Economics, which, in accordance with the Regulation No. 746 of December 23, 2003 of the Cabinet of Ministers “Statutes of the State Agency “Latvian Investment and Development Agency””, is responsible for assisting the contracting authorities in implementation of PPP projects, elaboration and implementation of proposals for further development of PPP initiatives, providing consultancy assistance on financial and legal issues.

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 6.38**

##### **The most important normative acts regulating PPP:**

- Concessions Law (effective as of February 16, 2000);
- Public Procurement Law (effective as of May 1, 2006). According to Part 3 of the Article 67 of the law, DBFO and other PPP agreements not regulated by the Concessions Law may be concluded for up to 30 years;
- Regulation No. 700 of August 10, 2004 of the Cabinet of Ministers “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 establishing 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), which determine the basic principles and targets of PPP policy and indicators on attainment thereof;
- “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), which sets forth the following directions of action for promotion of PPP until 2009.

In order to improve 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 co-ordination of procedures for granting public construction work contracts, public supply contracts and public service contracts*), draft PPP Law is being developed. It is expected that this draft will define and regulate the main forms for cooperation between the public and private sectors, by stipulating the procedures for selecting the private partner in purely contractual and institutionalised PPPs.

In order to improve co-operation among institutions involved in PPP processes, the PPP Advisory Council was established in January 2007. The main objective of the PPP Advisory Council is to promote discussions among various actors on the current PPP developments. The decisions of the Council are of a recommending character for public institutions and local governments.

#### **Implementation of advisory support for public private partnership projects**

In order to improve understanding and knowledge in regard to PPP, the Ministry of Economics and LIDA have continued providing advisory support to contracting authorities by ensuring information on the applicable type of PPP transactions, conduct of a suitable procurement procedure, financial and

<sup>1</sup> HM Treasury research “PFI: meeting the investment challenge”, London, UK, 2003.

economic calculations and procedures for performance thereof, 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. By December 2007, more than 50 consultations were given both to the public sector and to the private sector, as well as three seminars about topical issues of implementation of PPP projects were organised.

Specifically, taking into account the topical problem with the shortage of places in pre-school educational establishments, the informative report “On construction of new pre-school education establishments” prepared by the Ministry of Economics was approved by the Cabinet of Ministers on May 15, 2007 (§42 of Protocol No. 29 of the meeting of the Cabinet of Ministers on May 15, 2007). The report contained a number of proposals for reduction of the shortages in the pre-school educational establishments, including optimisation of infrastructure of the currently available pre-school education establishments, promoting development of private pre-school education establishments, as well as made proposals concerning usage of various PPP models in construction of new pre-school educational establishments or in modernisation of the existing objects. In addition to this, standardised PPP tender documentation and methodology to address these issues had been developed.

Moreover, in order to promote wider implementation of PPP projects in the national economy, the initiated activities for implementation of the programme “Promotion of Development of Public Private Partnership in Latvia” managed by LIDA and co-financed by the Norwegian Financial Mechanism were continued in 2007. The main goal of the programme is to support state and local government institutions in their efforts to implement consistent and well-founded PPP approach in development of infrastructure and public services. In the framework of the programme, those activities will be supported, which envisage:

- development of the financial and economic calculations, including training of applicants of sub-project applications and employees involved in sub-projects by a co-operation partner;
- preparation of tender documentation, including training of applicant of a sub-project application and employees involved in the sub-project by a co-operation partner.

Ministries of the Republic of Latvia and local or district governments will have an opportunity to apply for co-financing of the Programme, constituted by the Norwegian Financial Mechanism and Latvian state

budget financing. The total planned co-financing of the Programme amounts to EUR 1 900 660.

In order to provide wide information to society about the current events and most topical issues, the developed draft normative acts and achieved progress related to PPP, the Ministry of Economics has also envisaged to create PPP website by the end of 2007, where topical information as well as all available resources about PPP at disposal of the Ministry of Economics and LIDA up to now would be published (methodological materials, standardised draft PPP agreements, etc.).

In addition, the Ministry of Economics has also envisaged to develop by the end of 2007:

- informative report on analysis of the most suitable sectors for implementation of PPP projects and the most suitable models of PPP implementation, thus promoting commencement of implementation of potential PPP projects;
- guidelines for evaluation of risks of PPP projects and their impact on financial calculations of the project, aiding to qualitative calculations of PPP projects.

#### Further priorities

Through assessment of the current situation and potential of PPP in provision of public services and in development and maintenance of public infrastructure, for the next period, the Ministry of Economics and LIDA have set forth the following main priorities in implementation of PPP:

- after adoption of the PPP Law, to develop the regulations of the Cabinet of Ministers deriving from them, as well as explanatory material about the law;
- to continue implementing the programme “Promotion of Development of Public Private Partnership in Latvia” of the bilateral financial instrument of the government of Norway “Regional Policy and Development of Economic Activities”;
- to ensure implementation of fiscal reporting framework;
- to continue providing informative support to implementers of PPP projects and organise informative seminars about PPPs;
- to organise an informative seminar for the officials of public institutions controlling the PPPs;
- to work out guidelines for evaluation of risks of PPP projects and their impact on financial calculations of the project, as well as update “Guidelines for Implementation of Contractual PPP Projects”;
- to develop general documentation samples (establishment agreement, participant

agreement, statutes, form of financial – economic calculations, etc.) of contractual and institutional PPP projects;

- to work out standardised documentation of a cycle of PPP projects in the topical sector of national economy (sector of housing).

## 6.15. Advisory Councils of the Ministry of Economics

### 6.15.1. National Economy Council

National Economy Council (hereinafter – NEC) of the Ministry of Economics is an advisory body established by 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 Regulation No. 238 of April 29, 2003 of the Cabinet of Ministers "Statutes 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 the NEC of the Ministry of Economics of May 14, 2007.

The objective of operation of the NEC is to promote establishment and implementation of a policy of favourable environment for business activity in Latvia, 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.

NEC takes part in development of strategic programming documents of national economy development, planning of sectoral development, and development and improvement of normative acts important for national economy. NEC prepares proposals and adopts recommending decisions on these issues.

NEC implements a dialogue between entrepreneurs and the Ministry of Economics and with other public institutions and non-governmental organisations.

The structure 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 coordinating body, which takes part in settlement of issues related 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 work.

NEC consists of 21 experts designated by the NEC Steering Committee, among them the Minister of

Economics, NEC chairman and representatives of Latvian entrepreneur organisations, public institutions and other organisations.

NEC is administered by the Chairman elected by members of the NEC Steering Committee from among the members in a manner of rotation order for a term of office for one year.

Operations of the NEC are organised by the Secretariat of the National Economy Council.

NEC meetings are held on average once per month.

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 institutions in order to incorporate NEC's proposals necessary for improvement of business environment into normative acts prepared by the responsible institutions.

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.

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 a part of the governmental declaration, and that the councils of experts will assess draft legal acts worked out by the ministries and will issue their opinion thereof.

**Box 6.39**

**Proposals of the NEC for improvement of business environment**

NEC estimates that, on the whole, improvements in Latvian business environment can be observed in the recent years, but taxation policy and tax administration, education of labour force, macroeconomic stability and unpredictability of changes in legal acts are still regarded as problematic areas.

NEC holds an opinion that it is necessary to reduce the time spent by entrepreneurs in settlement of tax issues with the State Revenue Service. Effective and proportionate enforcement of normative acts in tax administration must be ensured, introducing an effective system of tax penalties, so that entrepreneurs, who have committed unintentional offences, would not be subject to penalties equivalent to those imposed upon malicious tax evaders.

The State Revenue Service must provide publicly available explanations of application of normative acts on taxes.

Legislation of labour relations must be improved in the country, and more efficient use of labour force in Latvian labour market must be achieved. Competitiveness of Latvia in the sphere of acts of labour law must be raised as well.

In order to promote employment, structural problems of employment must be solved, supporting the opportunity to acquire adequate and higher qualifications in accordance with labour market requirements and facilitating labour mobility.

Undeclared employment must be reduced, which can be attained by:

- raising the minimum wage and increasing the non-taxable minimum in order to lessen the tax burden for persons with low income;
- increasing the administrative capacity of the State Labour Inspectorate through recruitment of additional staff, improvement of control over observance of Labour Law norms and raising awareness of society about issues of the Labour Law;
- strengthening the role of trade unions and employer associations in entrepreneurship through promotion of consolidation of entrepreneurs in business organisations;
- creating a favourable environment to increase reputation of socially responsible business activity.

Normative acts have to be assessed already during their development in order to identify and prevent possible violations of the 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 procurements has to be improved, achieving high transparency for state support projects.

It is necessary to complete fulfilment of contract for introduction of safe electronic signature and start its usage in order to simplify administrative requirements for entrepreneurs. Receipt of public administration services has to be simplified and accelerated, reducing the necessity to visit public administration institutions and simplifying submission of documents.

It is necessary to simplify procedures for harmonisation of construction documents and obtaining permits by improving environment of legal acts that regulate construction and reducing the number of procedures and the time to be spent for observance of various requirements.

Entry in new export markets and consolidation in the current ones must be promoted. Institutional base of export promotion and rise of its capacity, development of foreign economic representative offices, access to financial instruments and support to companies in export marketing must be ensured.

Assessment of normative acts must be carried out, considering their financial impact on entrepreneurship. Various public institutions prepare policy documents and legal acts for achievement of their political goals, which also affects business environment. In line with requirements of Latvian system of annotations, those preparing a draft legal act or a policy document must also assess the impact of the policy on business environment. Unified methodology, by which the assessment of administrative costs and obstacles to business activity would be carried out, has not been worked out in Latvia yet, and this is carried out formally at present. The standard cost model, according to which the impact of potential legal act on business environment is assessed, is applied in several European countries. It would be necessary for the responsible institutions to evaluate the opportunity to introduce the standard cost model in Latvia as well.

NEC holds a view that creation of efficient and competitive sectoral structure has to be fostered, research and development and innovation must be encouraged, especially in the private sector and measures promoting co-operation of educational, research and national economy sectors, ensuring transfer of knowledge and technologies, must be worked out and implemented.

It is necessary to raise efficiency of the education and training system, its quality and compliance with long-term labour market needs in the country. Co-operation between public administration bodies, education institutions and employers in correction of the supply of the education system in accordance with labour market needs must be strengthened. The principle of accessibility of education must be observed to ensure it in the context of life-long learning, by carrying out changes in the education system.

NEC urges to promote and achieve an increased number of students of hard and engineering sciences in order to ensure human resources necessary for economic development and also foster establishment of new businesses, hence it is necessary to create State Support Programmes for start-up of business activities. The number of businesses per 1000 persons in Latvia is among the lowest one. Due to the fact that start-up of business activities involves increased personal responsibility and costs, state support instruments for new businesses are necessary.

Entrepreneurs are among the most important "users" of legal acts and most directly face the controlling impact 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 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;
- Working Group on Stabilisation of the Macroeconomic Situation for Development of Proposals

- Related to Export Promotion, Development of Production, Reduction of the Current Account Deficit and Other Issues at the Ministry of Economics and the Ministry of Finance;
- 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 6.40****Meetings of the NEC in the 2<sup>nd</sup> half of 2007**

During the NEC meeting on June 22, 2007 the Programme for Promotion of Business Competitiveness and Innovation for 2007-2013 was assessed and the issue of the Article 94 of draft “Law on Higher Education” was considered. At the NEC meeting on August 24, 2007 the issue of real estate tax changes in 2008 was considered. At the NEC meeting on September 21, 2007 implementation of the Action Plan for 2007 of the Export Promotion Programme for 2005-2009 was considered.

The issue of involvement of Latvian companies in procurement of the Ministry of Defence in the last two years and further perspective was considered on October 25, 2007.

Meeting of NEC working group on development of proposals for amendments to normative acts for promotion of competitiveness of companies and export promotion was held on September 11, 2007. As the result, proposals for amendments to the “Law On Value-Added Tax”, “Law On Taxes and Fees”, “Law On Corporate Income Tax”, “Law On Personal Income Tax” and the Regulation No. 993 of November 14, 2006 of the Cabinet of Ministers “Procedure for Application of Norms of the Law On Value-Added Tax” were worked out and submitted to the Minister of Finance on September 21, 2007.

### 6.15.2. Council of the Small and Medium-Sized Enterprises and Crafts

Council of the Small and Medium-Sized Enterprises and Crafts is an advisory institution of the Ministry of Economics.

Council of the Small and Medium-Sized Enterprises and Crafts (CSMEC) consists of 27 representatives delegated by non-governmental organisations representing small and medium-sized enterprises (SME) and businessmen (organisations of various national economy sectors and regional organisations of SME). The Ministry of Economics participates in a status of observer.

Composition and statute of the CSMEC were approved by the Regulation No. 49 of February 16, 2004 of the Ministry of Economics.

The activities of the CSMEC have an objective 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 to promote SME development, co-operation and competitiveness of Latvian entrepreneurs in the European Union.

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), which are important for the 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 institutions and non-governmental organisations, as well as

international organisations, which affect operations and development of SME.

Meetings of the CSMEC are held on average once per month.

Work of the Council of the Small and Medium-Sized Enterprises and Crafts is led by the Chairman elected by the Council.

In between meetings of the Council, the recommending decisions are taken by the CSMEC Steering Committee, which consists of five CSMEC members nominated by participating organisations of the Council. Ministry of Economics ensures work of the Council and performs the secretariat functions.

In the 2<sup>nd</sup> half of 2007, five meetings of the Council of the Small and Medium-Sized Enterprises and Crafts have taken place, where the following most important issues were considered:

- Amount of the entrepreneurship risk state fee, claims of employees for the share of the fee to be included in the guarantee fund in 2007 and reduction of this share;
- Report on operation of the national programme “Risk capital financing”;
- Report on the European Union internal market policy;
- On the real estate tax;
- On the fixed income tax;
- Procedure and supervision of issuance of sick-leave certificates;
- EUREKA programme;
- Support to investments in development of micro and small businessmen in areas requiring special assistance;
- Energy efficiency programme and the process of its development, etc.

The Council has continued the launched positive and efficient dialogue with institutions representing entrepreneurs, 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, entrepreneurs are invited on a regular basis to assess SME development issues and the draft programming documents shaping SME development policy before 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, as well as for amendments to the “Law on Personal Income Tax” have been developed at the meetings and submitted to the responsible ministries.

In order to get more familiar with business environment in Latvian regions, 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 sought collectively.

In the visiting sessions, the main topics for discussions 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 to ensure that the non-governmental sector is competently represented in absorption of the EU Structural Funds and support programmes, CSMEC members and representatives of participating organisations are delegated to take part in the following councils and committees:

- EU Structural Funds Supervision Committee at the Ministry of Finance;
- Export Promotion Council at the Ministry of Economics;
- Advisory Council at the Ministry of Economics and the Latvian Investment and Development Agency;
- Commercial Activity Development Council of the Riga 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.

Council of the Small and Medium-Sized Enterprises and Crafts plans to solve the following issues at the meetings in the nearest future:

- On personal income tax;
- Real estate tax;
- Improvement of legal environment of business activities;

- Changes of staff structure in the public sector and the private sector, dynamics of the number of state-paid employees.
- Report about state agencies, etc.

### 6.15.3. Advisory Council of Public Private Partnership

Advisory Council of Public Private Partnership (hereinafter – 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 the use of PPP instrument, attracting private capital to build-up of public infrastructure and to public services. The decisions of the Council are of a recommending character for public institutions and local governments.

The structure of the Advisory Council of PPP was approved by the Order No. 23 of January 19, 2007 of the Ministry of Economics “*On Establishment of the Advisory Council of Public Private Partnership*”. It consists of representatives of the Economic Affairs Committee of the Saeima, Ministry of Economics, Ministry of Finance, 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, the Treasury, Latvian Association of Local and Regional Governments, Riga 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. The Council is chaired by the Minister of Economics.

The functions, tasks and rights of the Council, as well as organisation of its work were approved by the Order No. 59 of February 8, 2007 of the Ministry of Economics “*On the Statute of the Advisory Council of Public Private Partnership*”, determining that the Economic Policy Department 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 situation in the field of PPP, opportunities to implement PPP projects and the work performed 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 established as the

main issue of the meeting, as this draft law does not fully solve the issues related 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 on February 20, 2007, when proposals submitted by ministries and other institutions for amendments to the draft Concessions Law developed by the Ministry of Economics were considered.

## 7. RECOMMENDATIONS

Along with the rapid growth, economic disproportions (considerable rise of inflation rate and big current account deficit of the balance of payments) formed and intensified. The fast increase of prices and current account deficit after Latvia's accession to the European Union was mainly promoted by the substantial change of conditions in the financial and labour markets, to which the Latvian structural policy was unprepared for. Latvia is highly competitive in attraction of capital (liberal capital markets, fixed currency exchange rate policy), but it has poor capacity of efficient use of the domestic and external accruals. An insignificant amount of financial resources goes to the production sectors.

The main task of Latvian structural policy currently is to ensure change of directions of private capital flows in favour of export-oriented sectors. At the same time, the policy direction related to the task to change the economic model from exploiting advantages of cheap labour to knowledge-intensive economy is just as important. Both of these policy directions must be implemented simultaneously, because the latter is impossible without successful implementation of the former and, without change of the economic model, there is a big possibility to encounter economic stability problems again in the future.

The main spheres of the policy to change directions of private capital flows in favour to export-oriented sectors relate to improvement of business environment thus the production of goods and provision of export-capable services would be an attractive and safe way to invest capital.

The change of the economic model from exploiting advantages of cheap labour to knowledge-intensive economy includes a set of several complex measures related to promotion of transfer of knowledge and technologies into production in order to ensure production of higher value added products.

**Considering the abovementioned, in our opinion, the most important and urgent tasks of the economic policy are as follows:**

– **in reduction of administrative burden:**

- to improve the process of registration and tax administration of entrepreneurship in order to simplify and accelerate start of business activity;
- to promote development of e-government and e-services in order to increase availability and efficiency of public services. Establishment of the state mega-system ("register of registers") must be completed; *ex ante* and *ex post* audit of all legislation with the goal to identify all harmonisations and registrations that require references from other public institutions must

be carried out, and it has to be ensured that this can be done automatically and in e-environment; e-signature has to be introduced within all public bodies, and functionality of e-signature must be expanded;

- to improve the flow of state-level official statistical information and mutual harmonisation of the statistical indicators to be included in public registers and other information systems in order to exclude repeated enquiry of information from respondents. The proportion of electronically submittable reports must be increased, developing the opportunities for respondents to submit reports in an electronic form;
- to implement optimisation of the regulating and control institutions of the construction sector in order to ensure transparency of the construction process and improve control thereof. The number of procedures and time necessary for harmonisation of documentation of construction projects must be diminished;
- to reduce costs related to employment and regulated by various legal acts and create incentives for entrepreneurs for more active involvement of various social groups in the labour market, by reviewing regulations of the labour market. The number of days in sick-leave certificates paid by employers must be reduced from 14 to 10 days, and more active involvement of various social groups (disabled persons, persons after childcare leave, ex-prisoners) in the labour market must be promoted by various incentives for employers. Norms allowing employers and employees within the sector to agree on rules that regulate the content of labour relations (general agreement) must be included in the *Labour Law*;
- to improve the process of real estate registration by uniting the procedures – introducing the one-stop-shop principle in real estate registration, reducing the number of days and procedures necessary for the registration;
- **in implementation of tax policy and tax administration promoting entrepreneurship:**
  - to increase efficiency of operation of the *State Revenue Service*, continuing transformation of SRS to institution that helps entrepreneurs;
  - to keep improving the normative acts regulating tax administration, so that also the degree of guilt would be taken into account in imposition of punitive sanctions;
  - by introducing changes in the tax system, to ensure comprehensive assessment of the

- influence of the expected changes on entrepreneurship and national economy, as well as create preconditions to improvement of competitiveness of Latvian entrepreneurs in the domestic market;
- to improve the system of tax allowances in order to foster restoration of fixed assets by modernisation of production;
- to increase the non-taxable minimum not subjected to personal income tax, by bringing it as close as possible to the subsistence level in the long term;
- to establish a taxation system, which would create preconditions to financial involvement of employees in development of companies;
- **in ensuring competition and setting administratively regulated prices:**
  - to fight the most important competition violations as effectively as possible, making amendments to the *Competition Law* (the draft law is submitted to the Saeima for review at present). Adoption of the amendments to the *Competition Law* will allow to establish and prevent serious violations that substantially affect competition situation in the market (prices, access to goods or services) and the number of investigations in this area will grow after the amendments will be enforced;
  - to conduct analysis of entry barriers and competition level in the sectors that ensure goods and services domestically (with the exception of exports) and that have a comparatively high level of concentration;
  - to create a single body for regulation of public services in order to introduce a public services regulation model most suitable to the situation of Latvia;
- **in promotion of business start-ups and access to finances:**
  - to encourage formation and development of new enterprises in Latvian regions, providing them with the necessary infrastructure and consultative services in order to facilitate start-up of business. Business incubators must be created in various Latvian regions and support to the new enterprises formed in them must be provided;
  - to pay more attention to allocation of funding for development of business activity in early stages (measures for access to pre-seed and seed capital, opportunities to get loans on preferential terms) and access to finances in the form of risk capital, as well as co-financing for entrepreneurship development projects requiring special assistance. Informative and consultative support to SMEs and business beginners must be ensured in order to promote awareness of entrepreneurs access to funding in different stages of company development;
  - to create an investment fund in order to carry out introduction of financial support instruments in a co-ordinated way;
  - to support investment in development of micro and small businesses in areas requiring special assistance in order to promote business start-ups and investment in these regions;
- **in export promotion:**
  - to introduce an export credit guarantee system in order to increase access to markets with higher degree of risk and promote exports of Latvian origin goods and services outside the European Union;
  - to increase work efficiency of foreign economic representative offices of the state and improve integration of the system, expanding the network of these offices and ensuring co-ordinated representation of economic interests of Latvian entrepreneurs abroad;
  - to expand export support services in order to foster diversification of exports and consolidation in the existing markets;
  - to ensure observance of interests of Latvian entrepreneurs in multilateral and bilateral/regional talks in order to promote improvement of contractual conditions in third party countries;
- **in establishing flexible labour market:**
  - to encourage economic activity of population, increasing the labour supply and using the local resources more efficiently. It is necessary to facilitate involvement of young people in the labour market in order to give an opportunity to employ young people more flexibly, promote employment of young people with special needs, retaining the allowance in case the young person works, and more flexible return to work for new mothers. It is advisable to give the employer the right of choice to determine a shorter trial period, setting the maximum of 6 months as stipulated by the law. It is advisable to form labour courts that would allow settling labour disputes more efficiently and faster. It is advisable not to obligate the employer to cover costs related to payment for study leave, covering the expenses from the state budget instead;
  - to solve structural problems of employment, supporting aspirations to acquire adequate and higher qualification in accordance with labour market requirements and facilitating labour mobility, especially improving the transport infrastructure;
  - to reduce undeclared employment, diminishing the tax burden on employment and raising administrative capacities of the State Labour Inspectorate, recruiting additional personnel, improving the control over observance of

- labour law requirements, raising society's awareness about labour law issues, strengthening the role of trade unions and employer associations in entrepreneurship, and encouraging entrepreneurs to unite in entrepreneur organisations in order to create favourable environment for increasing reputation of socially responsible business activity;
- to work out the policy of economic migration in order to reduce the labour outflow and ensure controllable recruitment of labour force that meets long-term goals of Latvian economic development;
  - to improve the regulation system of the labour market demand and supply, inter alia, ensuring preparation of medium-term and long-term forecasts of the labour market;
  - **in ensuring efficient, safe and sustainable energy supply:**
    - to promote the use of renewable energy resources in electricity generation and heat supply considering the available resources and potential in the country hence reducing dependence on imported energy resources;
    - to develop projects of base power stations, choosing those types of power stations that will ensure guarantees and sustainability of resource supply, as well as increase self-provision of the state with energy;
  - **in improvement of energy efficiency:**
    - to implement the state support programme for promotion of renovation of apartment houses, carrying out energy audits and renovation projects of dwelling houses and, at the same time, raising interest and responsibility of co-owners in renovation of residential buildings;
    - to implement the Measure “Energy Efficiency of Home” of Priority “Providing High-Quality Environment for Life and Economic Activity” of Operational Programme “Infrastructure and Services” of the EU Structural Funds for 2007-2013, carrying out measures for improvement of heat steadiness of apartment houses and social residential buildings;
    - to integrate the energy efficiency policy into other sectoral policies (tax, transport, regional policies);
  - **in establishing knowledge-intensive economy:**
    - to foster co-operation between scientists and entrepreneurs, creating *Competence Centres* in order to promote co-operation between the research and industrial sectors in implementation of industrial research, new products and technologies, as well as creating *Technology Transfer Contact Points* and *Technology Transfer Centres* in order to develop the necessary scientific competence in higher education establishments and scientific institutes;
    - to support business activities with high value added, promoting investments in fixed assets and current assets;
    - to support development of new products and technologies, encouraging entrepreneurs to conduct industrial research, introduce new products, services and technologies into production, and strengthen the industrial property rights;
    - to support recruitment of highly skilled employees;
    - to plan wider activities of education and confidence-building for young people – potential businessmen – and promote interoperation of hard science students and business students through common measures.

Consistently implemented structural policy will promote change of the economic model from exploiting advantages of cheap labour to knowledge-intensive economy, which will be a base for raising the 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.