

**Ministry of Economics  
Republic of Latvia**

**ECONOMIC  
DEVELOPMENT  
OF LATVIA  
REPORT**

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Dear reader,

We offer for your attention the 25th **Report on the Economic Development of Latvia** prepared by specialists 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, just like the previous ones, evaluates the economic situation in Latvia and progress of reforms as well as offers economic development forecasts.

It is to be noted with satisfaction that fast economic growth is already observed in Latvia for some years. In the period of 2001-2005, Latvian GDP increased annually by 8.1% on average, it went up by 10.2% in 2005 and 12% in 2006 (according to our evaluation). Such indicators of development are the highest in EU. Fast GDP growth reduces our country's backwardness from the old EU member states.

I am convinced that economic growth in Latvia will remain at a high level also in 2007. The rapid development of national economy is ensured by stable dynamics of the domestic demand and increased foreign trade. Dynamics of domestic demand is steady and ensured by growth of income, stability of the financial system, expansion of credit opportunities, accession to NATO and EU, and formation of positive future expectations. Investments continue to grow rapidly, encouraging modernisation of production and transition to new, more productive technologies.

Ensuring sustainability of development of Latvian economy as well as its competitiveness requires to promote faster growth of productivity and to perform reorientation from labour-intensive economy to knowledge-based one. Hence the priority of the Ministry of Economics is development of competitiveness, including entrepreneurship promotion, innovation policy, export promotion, and fostering competition.

The Ministry of Economics will continue fostering development of innovation in 2007. Measures will be carried out to promote transfer of knowledge and technologies as well as strengthen co-operation links between the sectors of education, research and business. It is very essential for promotion of a targeted course of economic development based on a competitive knowledge-oriented model of economy.

We have to use the opportunities provided for Latvia by its accession to EU and the available financial support from the EU Structural Funds. *Entrepreneurship and Innovation Programme*, which will be directly oriented to promotion of entrepreneurship and development of innovation and scientific potential, will be worked out in the new planning period. Along with implementation of activities financed from the EU Structural Funds, increase of public financing for research and development will be continued, raising it by at least 0.15% of GDP annually, so that it would reach 1.5% of GDP by 2010, which is defined as a target in the *National Lisbon Programme of Latvia for 2005-2008*.

At the same time, in 2007 the Ministry of Economics will continue the started activities to ensure attractive business environment and development of small and medium-sized enterprises in Latvia, promote export and entry in new markets and consolidation in the current ones, foster safe, balanced and high-quality supply of energy to consumers, ensure completion of the privatisation and land reform process, and improve protection of consumer rights.

It is also important to assess all opportunities how to increase the energetic independence of Latvia and ensure provision of the country with the necessary energy resources in the next years.

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

The Cabinet of Ministers has not assessed all issues addressed in the Report, hence many conclusions on 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 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.



Jurijs Strods,  
Minister of Economics

December 2006

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## Abbreviations

### **Abbreviations**

CEE	Central and Eastern Europe
CEES	Common European Economic Space
CHP	Thermal power station
CIS	Commonwealth of Independent States
CRPC	Consumer Rights Protection Centre
CSB	Central Statistical Bureau
CSMEC	Council of the Small and Medium-Sized Enterprises and Crafts
DDA	Doha Development Agenda
DPI	Producer price index for products sold in the domestic market
EC	European Community
ECB	European Central Bank
EDIS	External Decentralised Implementation System
EEA	European Economic Area
EMU	European Monetary Union
ERDF	European Regional Development Fund
ERM II	European currency rate mechanism
ESA	European System of National Accounts
ESF	European Social Fund
EU	European Union
EU-15	European Union before enlargement on May 1, 2004
EU-25	European Union after enlargement on May 1, 2004
FCMC	Financial and Capital Market Commission
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FTA	Free Trade Agreement
GDP	Gross domestic product
GVA	Gross value added
HPS	Hydroelectric power station
ICT	Information and communication technologies
IMF	International Monetary Fund
ISPA	Instrument for the Structural Policies for Pre-accession
IT	Information technologies
IUVI	Import unit value index
JSC	Joint stock company
LEPP	Latvian Export Promotion Programme
LGA	Latvian Guarantee Agency
LIDA	Latvian Investment and Development Agency
LLC	Limited liability company
ME	Ministry of Economics of Latvia
MLBL	Mortgage and Land Bank of Latvia
NATO	North Atlantic Treaty Organisation
NEC	National Economy Council

NGO	Non-governmental organisation
OECD	Organisation for Economic Co-operation and Development
PHARE	The Economic assistance programme of European Union for countries of Central and Eastern Europe
PIP	Public Investment Programme
PPI	Producer price index
PPP	Public and private partnership
R&D	Research and Development
ROA	Ratio of profit against losses to assets
ROE	Ratio of profit against losses to capital and reserves
RSE	Riga Stock Exchange
SAPARD	Special Assistance Programme for Agricultural and Rural Development
SJSC	State Joint Stock Company
SME	Small and medium-sized enterprises
SOLVIT	Efficient Solving of Internal Market Problems
TSO	Transmission System Operator
ULC	Unit labour costs
UN	United Nations
USA	United States of America
VAT	Value added tax
WTO	World Trade Organisation
XPI	Producer price index for exported products

#### **Measures**

EUR, EURO	Euro, single currency of the EMU
GBP	British pound
LVL	Latvian lats (national currency of Latvia)
SDR	Special drawing rights, IMF approved currency
USD	US dollar

#### **Conventional designations**

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

## 1. Economic Situation: Brief Overview

Reforms implemented in Latvia and integration in the EU have left a positive impact on economic development of the country. **Latvia has shown the highest economic growth rates in the EU.** Since 2001 the average annual growth of gross domestic product in Latvia was 8.1%, in 2005 GDP increased even faster by 10.2%. Rapid economic growth of Latvia continues in 2006 as well. GDP in the first 3 quarters of this year has increased by 11.9% in comparison with the respective period of 2005. The high growth rates are achieved due to stable dynamics of domestic demand and increase in exports.

**Economic activity increases in all major sectors of the national economy.** The biggest contribution to the growth in the recent years is made by service sectors. Increase in domestic demand especially promotes development of trade, hotels and restaurants, which in total has grown by 12.7% on average every year in the period of 2001-2005. Financial intermediation and real estate transactions, rent, computer services and other commercial services in total grew by 8.7% on average annually in the mentioned time period. Trade, hotels and restaurants as well as financial intermediation and commercial services continue growing rapidly in 2006 as well (by 18.5%, 12.8%, 12.9% and 17.6% respectively in 9 months of this year).

The dynamics of domestic demand is steady and ensured by the growth of income, stability of the financial system, expansion of credit opportunities, accession to NATO and EU, and formation of positive future expectations. It is expected that increased household income and spread of consumer loans will foster further growth of domestic trade (especially non-food consumer goods) and other market services but the growth rates will be lower than up to now. Big opportunities for growth lie ahead for the tourism sector that has developed very fast in the recent years.

Manufacturing also contributes substantially to the growth. In the period of 2001-2005, output of manufacturing has grown by 7.6% on average every year, which is almost at the same level as the average growth of national economy. In these years, the biggest contribution to industrial growth was made by wood industry, machine building and metalwork production.

In 9 months of 2006, output of manufacturing exceeded the level of the respective period of the previous year by 6.8%. Growth rates were high in production of textile articles, chemical industry, and production of electrical machines and appliances. The rapid growth of these sectors was mainly due to expansion of export opportunities. In other sectors, growth rates remained at the previous level or slightly decreased. Growth of wood processing is slow. Modernisation and reconstruction of production and usage of resources from EU funds will raise productivity and competitiveness of the sector, hence it is expected that industry will continue developing dynamically.

Growth rates of agriculture lag behind the overall growth rates of national economy. Growth in agriculture was 6.9% in 2005 but output of the sector decreased by 6.1% in 9 months of 2006 due to unfavourable weather conditions. Further development of agriculture will depend on adjustment of agricultural production facilities and products to EU standards and quality criteria and on the external demand. Latvia's accession to the EU ensures more equal competition opportunities for farmers on the EU internal market, while the support from EU funds facilitates modernisation of agriculture and diversification of agricultural activities.

Rapid rise of investment has a favourable influence on development of construction. In the period of 2001-2005, output in construction has grown by 11.9% on average every year. The output grew by 15.5% in 2005 and by 14.8% in 9 months of 2006. Construction of streets and roads, residential and commercial buildings, hotels, industrial and other objects grows fast. The construction sector is expected to maintain high development rates also in the future due to development of mortgage lending, increased economic activity and investment as well as implementation of projects financed from EU funds.

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

On the whole, the transport and communications sector has grown by 9.6% on average annually in the period of 2001-2005 and by 9.8% in 9 months of 2006. After accession to the EU, cargo transportation has increased especially fast and passenger transport services are growing, among them air transport services.

The Ministry of Economics forecasts that **GDP in Latvia will grow by 12% in 2006**.

For maintain stable macroeconomic environment, **the Bank of Latvia implements *de facto* policy of fixed national currency exchange rate**. This reduces uncertainty, eliminates exposure to currency risk and gives entrepreneurs a stable base for planning and price determination. As from January 1, 2005, the national currency lat (LVL) is re-pegged from the SDR currency basket to the euro at the rate EUR 1 = LVL 0.702804. Change of the LVL peg was determined by Latvia's plans to join the European Exchange Rate Mechanism II (ERM II) and, after fulfilment of required criteria, to join the Economic and Monetary Union (EMU).

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

Table 1.1

### Latvia: Key Indicators of Economic Development

	2003	2004	2005	2006 e	2007 f
(growth against the preceding year, %)					
Gross domestic product	7.2	8.6	10.2	12.0	9.0
Private consumption	8.2	9.5	11.4	17.0	12.0
Public consumption	1.9	2.1	2.7	3.0	3.0
Gross fixed capital formation	12.3	23.8	18.6	18.0	15.0
Exports	5.2	9.4	20.7	11.0	10.0
Imports	13.1	16.6	13.5	16.0	10.0
Consumer prices	2.9	6.2	6.7	6.5	6.5
(in % of GDP, unless indicated otherwise)					
Central government budget fiscal balance	-1.6	-1.1	-1.2	-0.3	-1.4
Central government debt	14.4	14.5	12.1	10.2	10.0
Current account balance	-8.1	-12.9	-12.4	-18.5	-18.0
Foreign direct investments (flows)	2.7	4.6	4.6	7.5	7.0
Unemployment rate (15-74 years)	10.6	10.4	8.7	7.3	6.0

e – estimation; f – forecast

**Relatively high inflation rate has been observed in the last years.** Faster growth of inflation in 2004 was mainly due to a combination of several one-time factors (rise of administratively regulated prices, harmonisation of indirect tax rates, inflation expectations related to Latvia's accession to the EU, and high world oil prices). High rate of inflation remained in 2005 and 2006 mostly due to increased world fuel prices and second-round inflation (inertia). High domestic demand stimulated by the marked increase of wages of the previous years and high growth rates of crediting, strengthened the second-round inflation effect of the previous year. Relatively high rate of inflation is also expected in 2007 because an essential increase of administratively regulated prices and raising the excise tax rates on tobacco products and fuel are envisaged. Inflation will decrease gradually in medium-term period, as the influence of the mentioned price-raising factors will go down and the government will carry out inflation reduction measures.

Due to the growing domestic demand and in order to hold down the credit growth rate, the Bank of Latvia raised the refinancing rate by 0.5 percentage points in March and November of 2004 and in July and November of 2006 to 5.0% and increased the reserve requirement from 3% to 4% in July

2004, to 6% in August 2005 and to 8% in December 2005. All government deposits in LVL were transferred from commercial banks to the Bank of Latvia in August 2006.

However, the impact of such measures in Latvia is limited by the fixed exchange rate regime and several specific factors such as low share of loans granted to residents in GDP, relatively easy access by banks to foreign resources, and relatively big share of loans granted in foreign currencies in the credit structure.

**The budget deficit in Latvia is low and does not exceed the reference level set in Maastricht criteria.** The budget deficit in 2005 was lower than planned, i.e., in the amount of LVL 105.2 million or 1.2% of GDP (according to the methodology of the ESA 95 European System of National Accounts, in 2005 Latvia had a budget surplus in the amount of 0.1% of GDP).

Situation report of the Treasury on execution of the state budget indicates that the fiscal deficit of the state budget in 2006 amounted to LVL 31.4 million or 0.3% of GDP, while the fiscal deficit of the state budget planned in the Law "Amendments to the Law on the State Budget for 2006" was LVL 161.9 million or 1.5% of GDP. In 2007 the Saeima has approved the state budget with a deficit in the amount of LVL 177.8 million or 1.4% of GDP.

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

**One of the main economic development risks in Latvia is a relatively high current account deficit** caused by high domestic demand and steep growth of investment in particular. Strongly negative trade balance is the main reason for the current account deficit. Slightly less than one-third of this balance is covered by the positive balance of services because there is a high share of transit services in the economy.

In 2005 the current account deficit amounted to 12.4% of GDP and was by 0.5 percentage points lower than in 2004. However, in 9 months of 2006 the negative balance of current account balance worsened in comparison with the respective period of 2005 and amounted to 19.3% of GDP. The increase in the negative balance of current account was caused by increased ratio of the negative balance of goods and incomes against GDP, which was not compensated by increased ratio of the positive balance of services and current transfers against GDP.

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

It is forecasted that faster growth of exports mostly promoted by structural reforms will gradually bring down the current account deficit in the medium term. However, the demand for imports will remain relatively high due to further modernisation of national economy and its growing openness. It should be noted that, after accession to the euro zone, the risks related to negative current account deficit (risk of a currency crisis) will almost completely disappear, as stability of the currency and keeping of foreign currency reserves will become the competence of the European Central Bank.

**EU is the main trading partner of Latvia.** Trade with EU member states has been constantly expanding since restoration of Latvia's independence, and currently 75% of Latvian exports and imports are linked to the EU. In 2005 most of Latvia's foreign trade turnover was made up by trade with Lithuania (12.7% of the total amount), Germany (12.6%), Estonia (9%), Russia (8.3%), Sweden (6.1%) and Poland (5.9%).

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

In 10 months of 2006 the value of exported products exceeded the level of the respective period of the previous year by 14%, while imports increased considerably faster by 29.8%. In this period, exports to CIS countries increased fastest and their value was by almost one-third higher than in January-October of the previous year, with substantial increases in exports of foodstuffs, chemical products and various machines and equipment. Exports to EU member states grew by 11.4% and the biggest contribution to this growth was made by increased exports of foodstuffs and machines and equipment.

**With the economic growth, income of the population is also growing.** The real income of employees in the period from 2000 till 2005 has increased by 33.0%, but in 2005 alone – by 9.7%. Data on the average wage in the 3<sup>rd</sup> quarter of 2006 indicate a rather rapid increase of it. The

average net monthly wage in September 2006 was by 23.3% higher than in September 2005, as the real wage increased by 16.4%.

Increase of old-age pensions in 2005 was also considerable. The old-age pension in December 2005 was by almost 12% on average higher than in December 2004, while in September 2006 it amounted to LVL 96.04 and exceeded the average pension in September 2005 by 19.1%.

It should be noted that the growth of population's income is uneven. Growth of old-age pensions is slower than growth of the income of employees. The Gini index measuring inequality in distribution of income within the country has gone up from 0.34 in 2000 to 0.36 in 2004.

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

**Economic development in Latvia during the last years makes a positive impact on the situation in the labour market.** In current years, the number of employed people goes up by 1-2% annually (by 4.2% in the 1<sup>st</sup> half of 2006), while the unemployment rate is diminished from 14.4% in 2000 to 8.7% in 2005 and 6.2% in the 3<sup>rd</sup> quarter of 2006.

Although the population of working age diminishes, the number of economically active persons increases and the employment rate grows. In the last five years (2001-2005) the employment rate has increased by 6.1 percentage points. In 2000 the employment rate in Latvia was 4.9 percentage points lower than the EU average, while in 2005 it lagged behind by mere 0.5 percentage points.

Female employment in Latvia is higher than the EU average and this difference tends to grow, as the female employment rate in Latvia exceeded the EU rate by 2.1 percentage points in 2002 and by 3 percentage points in 2005. Male employment in Latvia tends to increase every year but still lags behind the average EU rate (by 6.7 percentage points in 2002 and 3.7 percentage points in 2005).

Rapid economic growth in 3 quarters of 2006 also promoted essential increase in the number of employed people (by 7.2% in the 3<sup>rd</sup> quarter of 2006 in comparison with the respective period of 2005).

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

**The economic growth potential is best characterised by the growth of investments.** In 2005 investments in fixed assets were carried out in a twice bigger amount than in 2000. The amount of investments carried out during this period has increased by 15.7% annually.

As regards growth of investments and their share in GDP, Latvia has one of the highest indicators among EU member states. Investments are promoted by several factors, especially such as financial stability, continuous improvement of business environment, high domestic demand, rather low real interest rates, influx of foreign capital, etc. At the same time, a relatively low tax burden and increased sale of manufactured products due to the growing demand made a positive impact on the financial situation of companies, thereby increasing opportunities to make investments.

In 2005 and 2006 a high investment level was retained in national economy. Investments in the fixed assets increased by 18.6% in 2005, but in 1<sup>st</sup> half of 2006 – 15.8%. The investment process was favourably affected by the improvement of access to finances and by the high growth rates.

At the end of September 2006, foreign direct investments (FDI) accumulated in Latvia amounted to LVL 3639.6 million or 34% of annual GDP volume. The volume of incoming FDI in the last five years equalled to 3.4% of GDP on average and their inflow increased after Latvia's accession to the EU. In 2005 they amounted to 4.6% of GDP and covered almost 15% of investments in fixed assets.

In the sectoral structure of accumulated FDI, investments in service sectors make a bigger share. In 2005 and 1<sup>st</sup> half of 2006 the biggest FDI growth was in the energy sector and financial services.

The volume of foreign direct investments accumulated in Latvia per capita was LVL 1502.2 or USD 2682.5 at the end of June 2006.

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

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

## 2. Development of World Economy<sup>1</sup>

Development of world economy continued at a high pace in the 1st half of 2006, fulfilling or even exceeding forecasts. Rapid growth of US and euro zone countries at the beginning of the year and growth rates of Japan in the 2nd half of the year have to be stressed especially. Bigger contribution to global growth is also given annually by developing countries, especially China.

Inflation determined by growth of oil prices as well as various other factors, e.g., inflation expectations in USA, have to be mentioned above all as the negative factor that affected growth this year. Prices of oil and metal products set new records this year, and this negatively affected big producers. Central banks of several countries (e.g., US Federal Reserve System and ECB) set stronger monetary policies by raising interest rates. Exchange rate of US dollar against the euro also decreased.

Total growth for 2006-2007 is forecasted slightly faster than in the previous year (see Table 2.1).

Table 2.1

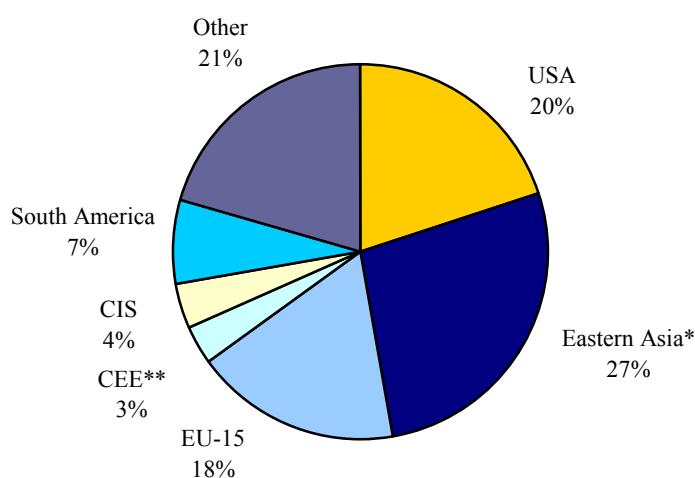
**GDP Growth**  
(percentage against the preceding year)

	2001-2003 on average	2004	2005	2006 f	2007 f
World	3.3	5.3	4.9	5.1	4.9
USA	1.6	3.9	3.2	3.4	2.9
Japan	0.8	2.3	2.6	2.7	2.1
EU	1.6	2.4	1.8	2.8	2.4
CIS	6.5	8.4	6.5	6.8	6.5

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

Figure 2.1

**The World GDP Ratio by Groups of Countries in 2005**  
(structure, GDP by purchasing power units)



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

\* Japan, China, South Korea, Malaysia, Singapore, Thailand, Philippines

\*\* Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Malta, Poland, Romania, Serbia and Montenegro, Slovakia, Slovenia, Turkey

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

Rapid economic growth of the **United States** forecasted at the beginning of 2006 slightly slowed down in the 2nd half of the year. Weak private consumption, rise of interest rates, growth of fuel prices and poor increase in employment are mentioned as the cause. Investment in equipment and software was at a surprisingly low level, while the growth of exports and decrease of imports provided a positive stimulus.

Increase of growth rates in USA during 2006 is forecasted as 3.4%, while growth forecasts of 2007 are slightly reduced to 2.9%.

1st quarter of 2006, as usual, was very favourable for the economy of **Japan** and was followed by declines of growth rates in the next quarter. Decline of public investment and decrease of exports are mentioned as the cause for decrease of growth rates. However, this year on the whole is considered successful for Japan, mainly due to growing private domestic demand. The growth was also encouraged by private investment and private consumption as well as by increase of loans issued by banks.

The growth of Japanese economy in 2006 in total is forecasted at the level of 2.7%, which is slightly more moderate than forecasted beforehand, while the growth in 2007 is forecasted at the level of 2.1%.

Table 2.2

### Main Macroeconomic Indicators of the Developed Countries (percentage)

	GDP growth			Consumer price changes			Investment (% of GDP)			Current account deficit (% of GDP)			Budget deficit (% of GDP)		
	USA	EU	Japan	USA	EU	Japan	USA	EU	Japan	USA	EU	Japan	USA	EU	Japan
2004	3.9	2.4	2.3	2.7	2.1	0.0	19.3	19.7	22.7	-5.7	0.3	3.8	-4.6	-2.9	-6.3
2005	3.2	1.8	2.6	3.4	2.2	-0.6	19.7	20.2	23.2	-6.4	-0.4	3.6	-3.7	-2.5	-5.6
2006 f	3.4	2.8	2.7	3.6	2.3	0.3	20.2	20.6	23.9	-6.6	-0.5	3.7	-3.1	-2.4	-5.2
2007 f	2.9	2.4	2.1	2.9	2.4	0.7	20.4	20.9	24.3	-6.9	-0.5	3.5	-3.2	-2.2	-4.9

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

Economic growth in the **old EU member states** was at a rather good level in the first quarters of 2006, mainly due to domestic demand and partly to investment. Increase in investment volumes like the growth of consumption, employment and wages are forecasted in 2006.

Annual growth in total is forecasted at the level of 2.4%, which is slightly more than forecasted half a year ago. Growth rates will slightly decrease to 2% in 2007.

Beginning of 2006 was rather successful for economy of **Germany**. Growth was mainly due to the increasing domestic demand, growing investment and substantial incomes from the world football championship finals tournament that took place in the summer. Low rise of wages and decline of employment rate are mentioned as negative factors.

Growth in Germany in 2006 on the whole is forecasted as rather good (by 2%), while in 2007 a slightly more moderate growth (by 1.3%) is forecasted.

Growth in **France** in the 1<sup>st</sup> half of 2006 was at a rather good level, like as in Germany. Growth was affected positively by improvement of trade balance and growth of employment, while it was hindered by rapidly growing oil product prices and unfavourable fluctuations of the euro exchange rate.

Growth in France in 2006 on the whole is forecasted at a rather good level in the amount of 2.4%, mostly due to domestic demand, while the growth in 2007 is forecasted as slightly more moderate (2.3%).

In the 1<sup>st</sup> half of 2006 the growth in the **United Kingdom** was rather high (about 3%), mainly due to domestic demand. Inflation remained at a rather low and stable level, while the employment rate already exceeds the one set in the Lisbon Programme, as a low unemployment rate remains. Growth was hindered by low private consumption rates.

Growth forecasts for 2006 in total and for 2007 in the United Kingdom are similar and rather positive (by 2.7%), and the growing domestic demand is mentioned as the main cause.

Growth rates in the **new EU member states and candidate countries** are still at a rather high level. Domestic demand based on rapid capital influx in the region as well as the usual crediting boom are still mentioned as the main driving force.

Growth rates may remain at a rather high level in the future on the basis of the steadily growing domestic demand and increasingly bigger integration in the markets of the old member states. High current account deficits are considered as growth risks for the new EU member states (with the exception of some countries, e.g., Czech Republic, Poland and Slovenia); according to experts, the growth may also be affected unfavourably by fluctuations in international currency markets.

According to IMF calculations, the growth in region in 2006 on the whole will remain the same as in 2005 (by 5.4%), while in 2007 it will slightly decrease to 5%.

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)			
	2004	2005	2006 f	2007 f	2004	2005	2006 f	2007 f	2004	2005	2006 f	2007 f
Total	6.6	5.5	5.4	5.0	6.3	4.9	5.4	4.7	-5.7	-5.2	-5.7	-5.4
Estonia	7.8	9.8	9.5	8.0	3.0	4.1	4.6	3.8	-13.0	-11.0	-12.0	-11.7
<b>Latvia</b>	<b>8.6</b>	<b>10.2</b>	<b>11.0</b>	<b>9.0</b>	<b>6.2</b>	<b>6.7</b>	<b>6.6</b>	<b>6.5</b>	<b>-12.9</b>	<b>-12.4</b>	<b>-14.0</b>	<b>-13.7</b>
Lithuania	7.0	7.3	6.8	6.5	1.2	2.7	3.6	3.3	-7.7	-6.9	-7.5	-7.4
Czech Republic	4.2	6.1	6.0	4.7	2.8	1.8	2.9	3.3	-6.0	-2.1	-1.9	-1.6
Hungary	5.2	4.1	4.5	3.5	6.8	3.6	3.5	5.8	-8.6	-7.4	-9.1	-8.0
Poland	5.3	3.4	5.0	4.5	3.5	2.1	0.9	2.3	-4.2	-1.4	-1.7	-1.9
Slovakia	5.4	6.1	6.5	7.0	7.5	2.7	4.7	3.6	-3.6	-8.6	-7.7	-5.9
Slovenia	4.2	3.9	4.2	4.0	3.6	2.5	2.5	2.3	-2.1	-1.1	-2.0	2.3
Cyprus	3.9	3.7	3.5	3.8	2.3	2.6	3.0	2.3	-5.7	-5.8	-4.6	-3.5
Malta	-1.5	2.5	1.6	1.8	2.7	2.5	2.9	2.8	-9.6	-13.1	-12.5	-12.0
Turkey	8.9	7.4	5.0	5.0	8.6	8.2	10.2	7.2	-5.2	-6.4	-6.7	-5.8
Bulgaria	5.7	5.5	5.6	6.0	6.1	5.0	7.4	3.8	-5.8	-11.8	-12.4	-12.2
Romania	8.4	4.1	5.5	5.5	11.9	9.0	7.8	5.7	-8.5	-8.7	-10.9	-11.1

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

The convincingly highest growth rates among EU member states are still maintained in the **Baltic States**, which is stimulated by successful macroeconomic policies and broad structural reforms. Like in the previous periods, domestic demand remains at high level, which is stimulated by rapid increase of loans granted to individuals. Rapid growth is still observed in the market of real estate prices. For these reasons, high current account deficit of the balance of payments still maintains in the Baltic States.

Growth rates in the Baltic States in 2006 on the whole are still forecasted at a very high level, and the growth in Lithuania and Estonia may reach 6.8% and 9.5% respectively. In 2007 the growth may slightly stabilise to 6.5% and 8% respectively.

In 2006 the growth in the group of **Commonwealth of Independent States (CIS)** was at a rather good level like in the previous year. Growth was still affected positively by high consumer goods prices, which left an effect on stable export incomes. Growth in several countries was also affected positively by the increase of domestic demand, and investment volumes that were stagnating recently have also

started increasing slightly. Owing to several countries of the region (mostly oil product exporter countries), impressive current account surpluses are still observed.

Growth rates in 2006 on the whole are forecasted at a still high level (6.8%). Similar growth (6.5%) may also remain in 2007. It is recommended for the region on the whole to pay bigger attention to ensuring stability of financial sectors and to the growing inflation rates.

Table 2.4

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

	2004	2005	2006 f	2007 f
GDP growth	8.4	6.5	6.8	6.5
of which in Russia	7.2	6.4	6.5	6.5
Consumer prices	10.3	12.3	9.6	9.3
of which in Russia	10.9	12.6	9.7	8.5
Current account balance (% of GDP)	8.1	8.8	10.1	9.4
of which in Russia	9.9	10.9	12.3	10.7

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

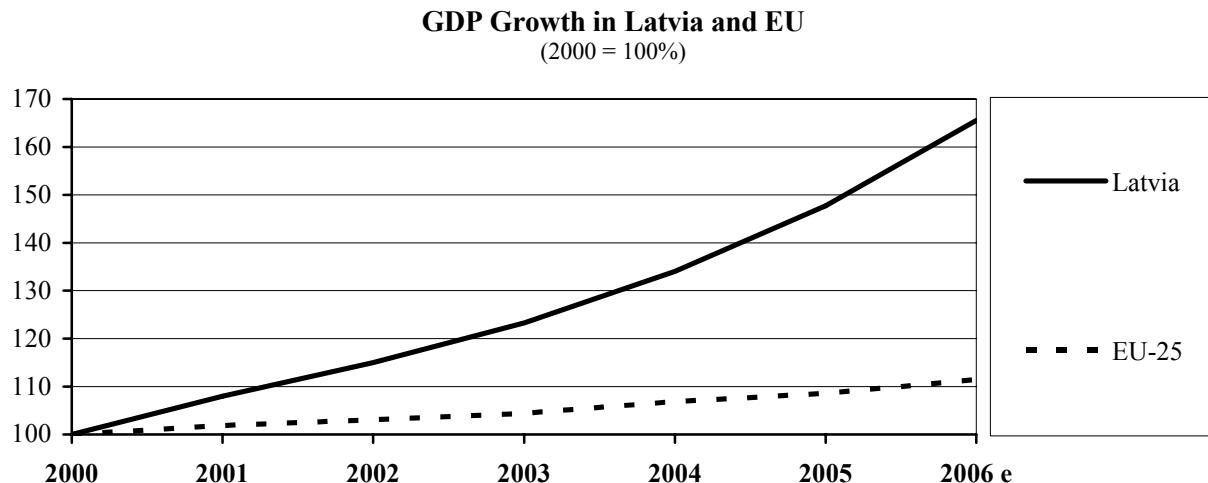
**Global growth is still projected rather positively, i.e., its rates are slightly higher than the previous forecasts. Growth of the United States slowed down a bit, while economies of EU member states recovered and the growth rates of Japan maintained. However, the developing countries with rapidly growing markets are considered the main contributors to growth. On the whole, global growth in 2006 and in 2007 is projected in the amount of 5.1% and 4.7% respectively, which is slightly more optimistic than half a year before.**

## 3. Growth and Productivity

### 3.1. GDP Dynamics and Productivity

Rapid economic growth is observed in Latvia for several years. In the last five years (2001-2005) GDP went up annually by 8 per cent on average.

Figure 3.1



Source: Eurostat

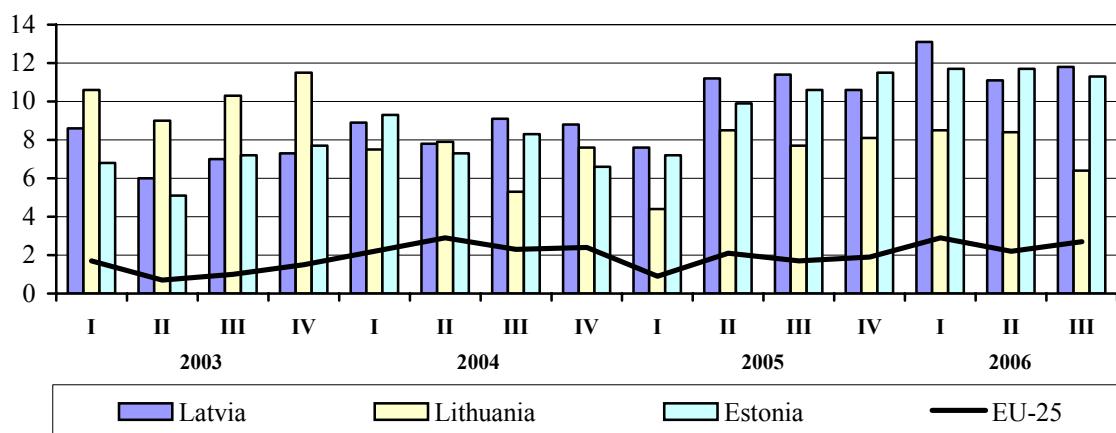
e – estimation by the Ministry of Economics for Latvia; by Eurostat for EU-25

Growth was especially fast in 2004 and 2005 (by 8.6% and 10.2% respectively). Also the results of the first 3 quarters of 2006 (GDP growth by 11.9% in comparison with the respective period of the previous year) indicate that the fast growth trends are still maintained. The steady growth is ensured by stable dynamics of the domestic demand and ability to expand export markets.

Although the average growth of EU member states has been rather slow in the last years, the growth rates of the new EU member states are high and steady, especially of the Baltic States, including Latvia. Besides, the GDP growth in 2005 and 2006 (according to provisional data on 3 quarters of the year) was the most rapid in Latvia.

Figure 3.2

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



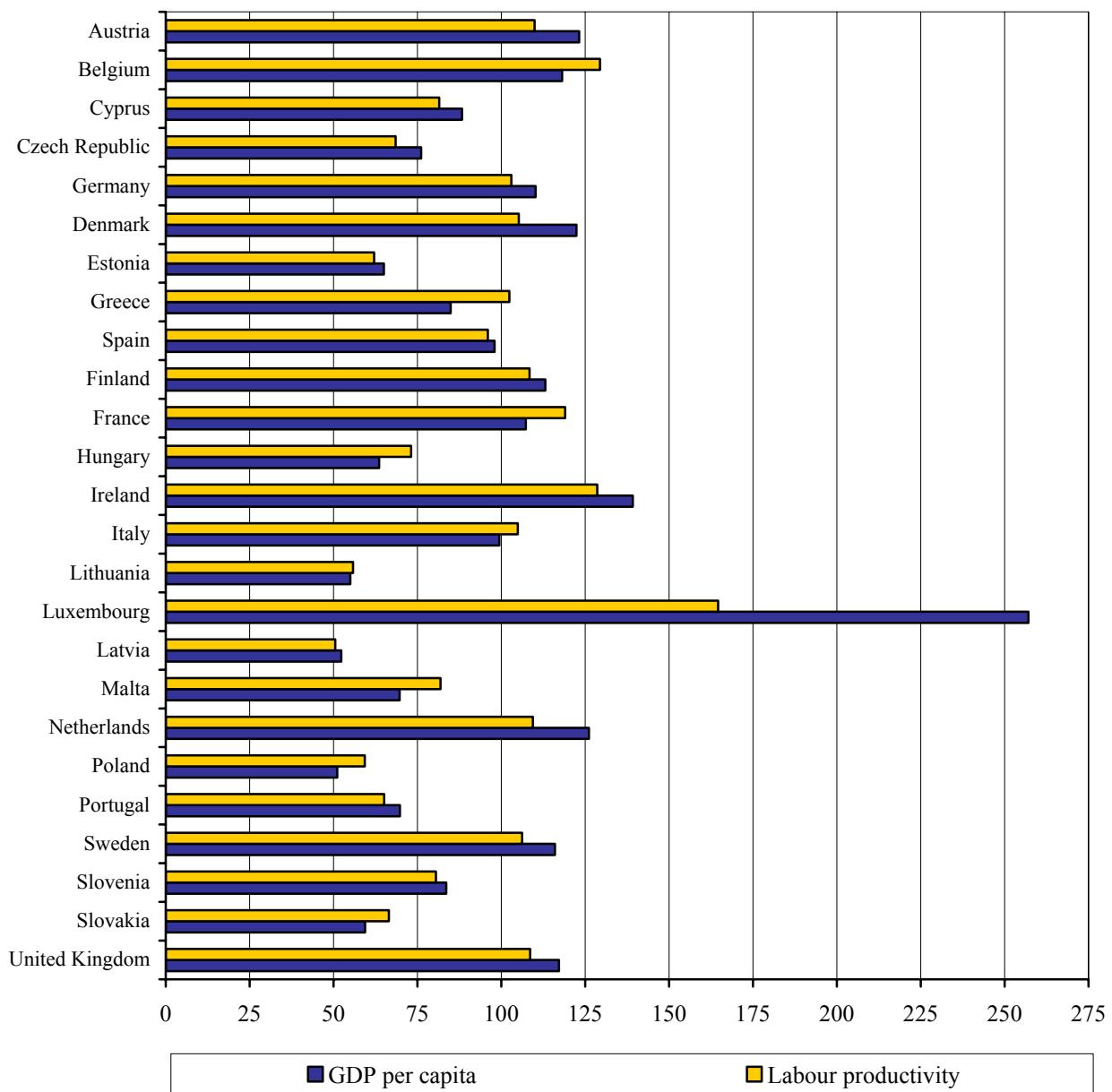
Source: Eurostat

In 2006, GDP capita in purchasing power standards was 52.3% of the EU average (according to the estimation by *Eurostat*). In comparison with 2000, the backwardness from the average EU level was reduced by 17 percentage points.

Figure 3.3

### GDP per Capita and Labour Productivity in 2006

(EU-25 = 100, in purchasing power standards)



Source: estimation by *Eurostat*

In this period, the real volume of GDP per capita has increased almost 1.7 times in Latvia and by 11.5% on average in EU-25.

Increase of Latvian GDP was mainly fostered by the productivity growth and, to a smaller extent, by the increase of employment. In 2005, the volume of GDP per person employed in Latvia compared to the EU average was almost at the same level as GDP per capita.

The rate of productivity growth has increased in the last two years. Productivity increased by 7.5% in 2004 and by 8.6% in 2005, and by 5% on average annually in the period of 2001-2003.

Table 3.1

**Productivity by Sectors of Economy – Value Added per Person Employed**

	Annual average real changes in the period of 2001-2005 (%)	Level in current prices (LVL per person employed) in 2005
Primary sectors	7.7	2978
Manufacturing	8.6	6276
Electricity, gas and water supply	6.2	13062
Construction	1.6	5543
Trade, hotels and restaurants	9.2	8960
Transport and communications	5.7	12849
Other services	4.8	13141
Public services*	1.7	5288
<b>Total economy</b>	<b>6.5</b>	<b>7751</b>

\* Public administration with healthcare and education

Productivity is increasing faster in manufacturing and trade. However, its level in these sectors still lags behind the indicators of several service sectors. For example, the productivity level in financial services is 3 times higher than in manufacturing and 2.5 times higher than in the economy on average.

## 3.2. GDP Expenditure

### 3.2.1. Aggregate Demand

The main impulse to the fast growth in the last years is a stable domestic demand, with the exception of 2005 when a bigger role was played by export growth, while a considerable increase of domestic demand was maintained at the same time.

Table 3.2

### Expenditure of Latvian GDP (percentage)

	2004			2005			2006 e		
	structure	growth rates	contribution to growth	structure	growth rates	contribution to growth	structure	growth rates	contribution to growth
Gross domestic product	100	8.6	8.6	100	10.2	10.2	100	12.0	12.0
Private consumption	63.0	9.5	6.0	62.4	11.4	7.3	63.4	17.0	10.9
Public consumption	19.6	2.1	0.4	17.7	2.7	0.5	16.1	3.0	0.5
Gross fixed capital formation	27.5	23.8	6.6	29.8	18.6	5.9	32.1	18.0	6.1
Inventories	5.6	-	0.7	4.4	-	-4.0	8.9	-	-1.0
Exports	44.0	9.4	3.8	48.1	20.7	8.4	45.5	11.0	4.9
Imports	-59.7	16.6	-8.9	-62.4	13.5	-7.7	-66.0	16.0	-9.4

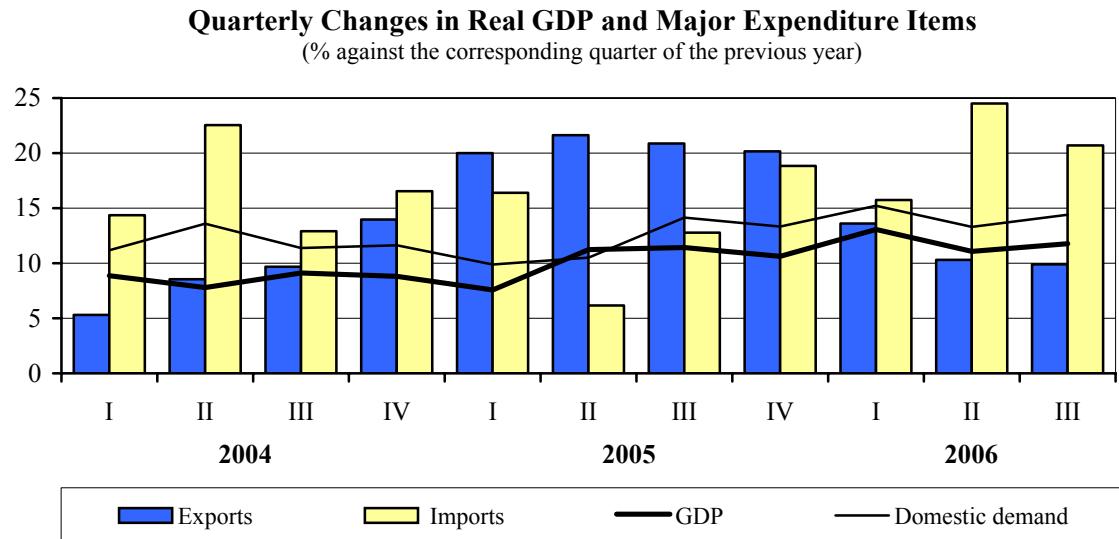
e – estimation by the Ministry of Economics

Exports of both the goods and services rapidly increased and the export-import balance of Latvia improved in 2005. The volume of private consumption increased, which was favourably affected not

only by the annual increase of wages but also by opportunities for individuals to get consumer credits and loans for acquisition and repair of housing for acceptable interest rates. Private consumption in 2005 exceeded the level of the previous year by 11.4%. The favourable financial situation (low interest rates on loans, development of mortgage crediting) encourages investment as well. Investments in fixed assets in 2005 were considerably bigger (by 18.6%) than in the previous year.

High growth indicators are also in 2006 but the domestic demand plays a bigger role in the growth, although the expansion of export opportunities was important (see Figure 3.4).

Figure 3.4



### 3.2.2. Private and Public Consumption

In the recent years, the disposable income of households<sup>1</sup> in Latvia amounts to 57-60% of GDP but the final consumption expenditures exceed 62%, therefore the net savings are negative (see Table 3.3).

Table 3.3

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

	2003	2004	2005 e	2006 e
Disposable income of households (changes in % against the preceding year)	13.3	17.8	16.9	18.6
Final consumption expenditures of households (changes in % against the preceding year)	11.5	17.2	19.2	25.0
Net savings in % of disposable income	-4.3	-3.8	-6.0	-11.7
Net savings in % of GDP	-2.6	-2.3	-3.5	-6.6

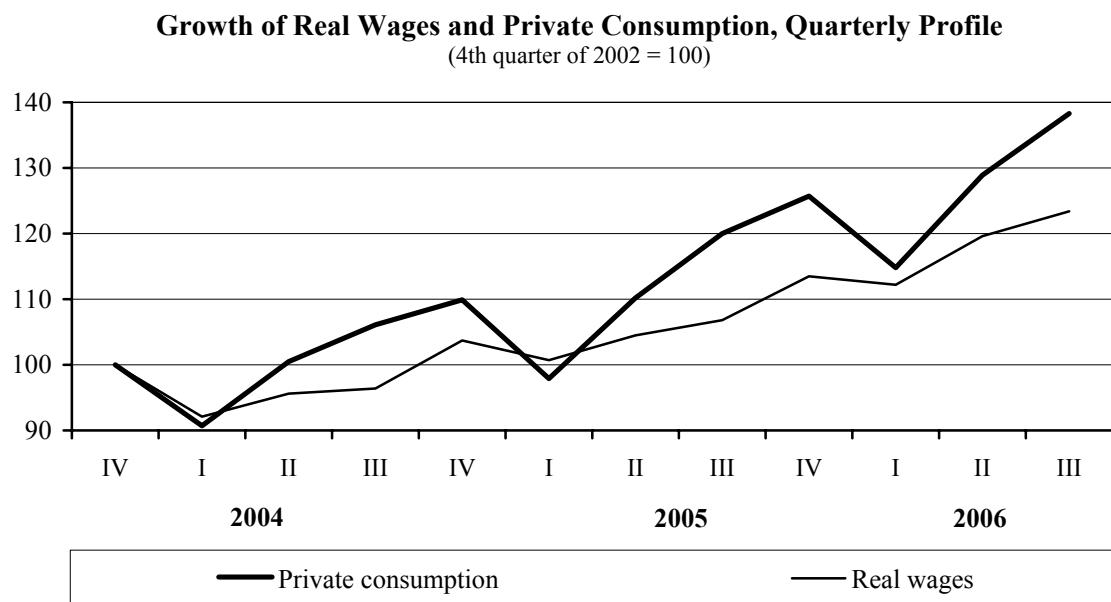
e – estimation by the Ministry of Economics

Dynamics of the disposable income and the final consumption expenditures shows that, in the last two years (2005 and 2006), consumption expenditures grow faster resulting in rapid increase of the debt of households against the income.

Differences in growth of real wages and private consumption in 2005-2006 suggest that, with increase of wages, households afford to spend more and more, to a great extent raising the domestic demand.

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

Figure 3.5



In 2005 the disposable monthly income of households per household member increased by 9% on average in comparison with 2004 and reached LVL 110.3<sup>1</sup>. On average 65.4% of the household income was constituted by the pay for work while retirement pensions and social benefits made up 18% of the income. Consumer price index in 2005 amounted to 6.7%, so the real purchasing power of households increased by mere 2.3%.

Household consumption expenditures increased to LVL 128.05 per month in 2005, which exceeded the disposable income by LVL 14. One-third on average of the household expenditures is spent on food and non-alcoholic beverages. Consumption expenditures were higher in urban households (in the amount of LVL 141.69), while in rural households they amounted to LVL 99.29.

Although the growth rates of private consumption considerably exceed the total growth rates, the growth of public consumption is much more moderate and does not exceed 3% (see Chapter 4.1.3). Therefore, the changes of final consumption expenditures by years are almost at the same level as GDP growth rates. Investment is the part of GDP expenditure with the most rapid growth rate.

### 3.2.3. Investment

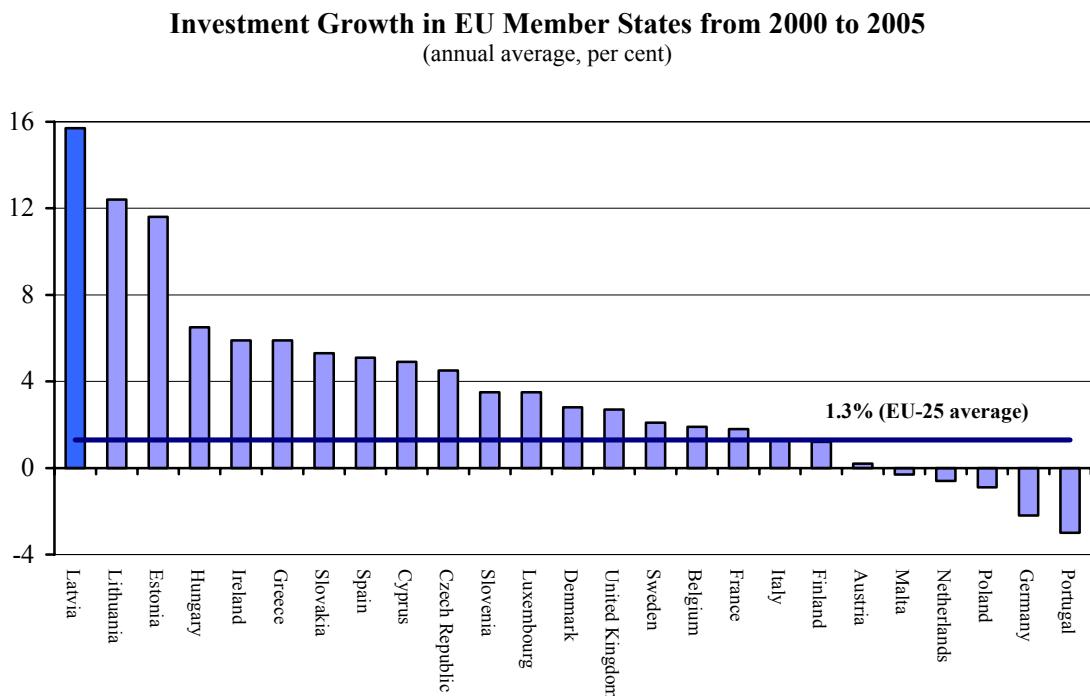
Volume and dynamics of investment is one of the factors that ensure the economic growth of Latvia. In 2000-2005, investment in Latvian economy increased annually by 15.8% on average. Investment growth rates exceed GDP growth rates several times, thereby their share in GDP increases every year. In the last five years the share of investment in GDP constitutes 26.5% on average, so more than quarter of the national income is annually used for investment.

As indicated by *Eurostat* data, growth of investment (gross fixed capital formation or fixed investment) in EU member states in the last five years has slowed down more than three times (from 4.6% to 1.3%) in comparison with the previous 5-year period, mainly due to the low growth rates or even decrease of investment in the old EU member states. Investment dynamics of almost all new EU member states still exceeds the EU-15 average several times. It has to be noted that investment dynamics is the fastest in the Baltic States, including Latvia.

The rapid investment dynamics is ensured by several factors, especially such as the stability of the financial sector, continuous improvement of business environment, high domestic demand, rather low real interest rates, inflow of foreign capital, etc. At the same time, relatively low tax burden and increased product sales due to growing demand positively affected the financial position of companies hence increasing opportunities of investment for own resources.

<sup>1</sup> According to the data of household budget survey

Figure 3.6



Source: Eurostat, Annual Macroeconomic data base, [http://ec.europa.eu/economy\\_finance](http://ec.europa.eu/economy_finance)

High investment growth rates also continued in the 1st half of 2006 when they exceeded the level of the 1st half of the previous year by 15.8%.

Table 3.4

#### Gross Capital Formation

	2001-2005 (average per year)	2005	1st half of 2006
Real growth			
<b>GDP</b>	<b>8.1</b>	<b>10.2</b>	<b>12.0</b>
Gross capital formation	16.9	5.1	33.7
– gross fixed capital formation	15.8	18.6	15.8
% of GDP			
<b>Gross capital formation</b>	<b>29.8</b>	<b>34.2</b>	<b>37.9</b>
– gross fixed capital formation	26.0	29.8	29.1
– changes in inventories	3.8	4.4	8.8

Volume of the investment in the private sector increases every year. In 2000 the investment in the private sector constituted slightly more than half of investment in Latvian national economy, while in 2005 its share already reached 71%, which was mainly due to faster investment growth rates in the private sector in comparison with the investment in the public sector.

The investment in the private sector more than doubled from 2001 to 2005 or increased by 26.3% annually on average, while the investment in the public sector<sup>1</sup> has increased by 40% in 4 years (by 8.8% on average annually).

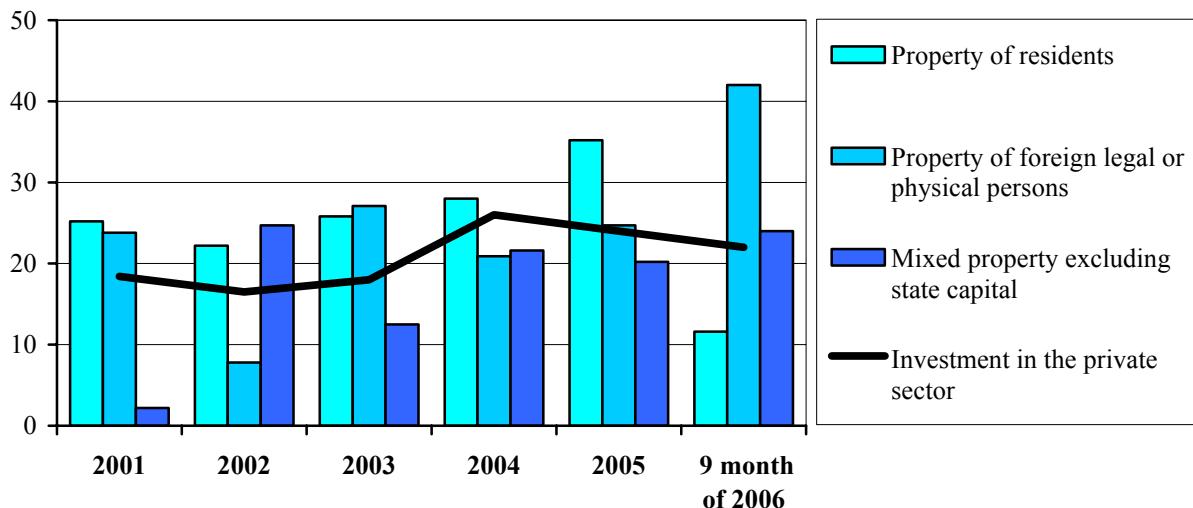
<sup>1</sup> The public sector includes enterprises and organisations of the central and local governments, business companies with the share of central or local governments or their enterprises in equity capital in the amount of 50% or more, social and religious organisations and enterprises owned by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

In 9 months of 2006, the investment in the public sector went down by 3% as compared to the respective period of the preceding year, while the investment in the private sector rose by 23% and constituted 70.8% of the total volume of investments in Latvian economy.

Investments in companies owned by residents and in companies owned by non-residents increased differently (see Figure 3.7).

Figure 3.7

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



\* estimated using the quarterly data

Since 2001 the investment in companies owned by residents increased by 35.1% on average per annum and made up 43.7% on average of the investment in the private sector or 29.4% of the total investment. The investment in companies owned by non-residents constituted 17% of the investment in the private sector, growing annually by 26.5% on average. In 9 months of 2006, the investment in companies owned by non-residents grew considerably faster than in the previous years (by 42 per cent).

**Sectoral structure of investment<sup>1</sup>.** Along with the rapid growth of investment, certain changes have also been observed in the sectoral structure of investment. In the last five years (2001-2005) investment dynamics in production sectors was almost 1.5 times faster than in services. In this period, the investment in production sectors grew by 149% (by 20.1% on average annually), while the investment in services increased by 88% (by 13.5% on average annually). Such development trends determined that the share of production sectors in the sectoral structure of investment is increasing gradually. In 2005 the investment in production sectors made up 34% of the total investments in Latvian economy.

In 2004-2005, growth of the investment in services was especially fast in such sectors as “hotels and restaurants”, “real estate transactions” and “education”. Investment in these sectors increased by almost 50% on average annually. Rapid investment dynamics also remained in 9 months of 2006.

In the 1st half of 2006 the investment in service sectors grew by 30%, while the investment in production sectors was slightly lower than in the respective period of the preceding year, which was mainly determined by the decrease of investment volume in manufacturing (by 7%).

It has to be noted that investment volumes in manufacturing increased rapidly during the previous two years since Latvia's accession to the EU (by 27% on average annually), and investment in this sector in 2005 was 1.5 times higher than in 2003. Hence, although the investment in manufacturing in 9 months of 2006 was slightly lower than in the respective period of the preceding year, its volume is considerable.

Food industry and wood processing have the leading positions in terms of investment volumes in manufacturing. The share of these two sectors in the investment in manufacturing was 51.1% in 2005

<sup>1</sup> Investment in distribution by sectors is presented according to the non-financial investment statistics that does not include all investment in fixed assets.

but increased to 57.7% in 9 months of 2006 due to big investment volumes in wood processing companies. Investment in food industry went down by 21.1% in this time period. In the last five years, investment grew especially fast in such sectors as metal production (by 68% on average annually), production of other non-metallic products (63%), and production of radio, television and communication equipment (61%). Investment in production of machines and equipment was four times higher than in 2000. In 9 months of 2006, investment grew rapidly in production of finished metal articles (by 114%), production of motor vehicles, trailers and semi-trailers (by 116%), and manufacture of pulp, paper and paper products (by 92%).

Table 3.5

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

	Growth			Structure		
	Average 2001-2005	2005	9 months of 2006*	Average 2001-2005	2005	9 months of 2006*
Primary sectors	33.7	34.1	-6.2	4.3	5.3	4.4
Manufacturing	19.3	27.6	-7.0	16.1	16.7	16.2
Electricity, gas and water supply	14.1	-3.4	-0.5	8.7	7.8	9.2
Construction	24.1	40.9	18.0	3.4	4.3	5.4
Trade	11.8	9.5	20.0	15.6	14.6	16.5
Transport and communications	4.5	16.3	-3.0	17.7	14.2	13.6
Other commercial services	23.0	26.5	87.6	20.1	22.3	25.8
Public services	14.9	11.8	6.6	14.1	14.9	8.9
<b>Total</b>	<b>15.5</b>	<b>18.2</b>	<b>14.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

\* estimated using the quarterly data

Table 3.6

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

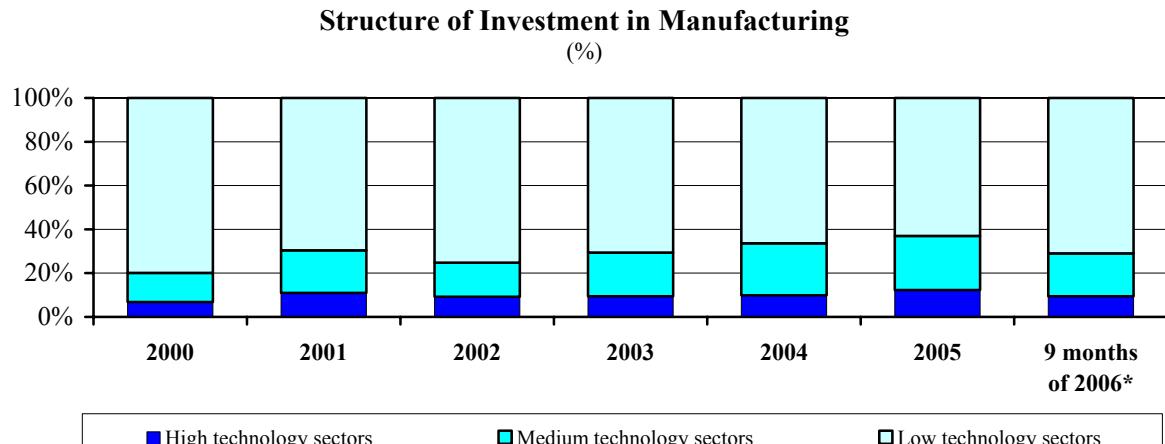
	Growth rates			Structure		
	Average 2001-2005	2005	9 months of 2006*	Average 2001-2005	2005	9 months of 2006*
Food industry	16.6	13.8	-21.1	28.6	27.0	20.9
Light industry	3.3	25.9	27.8	5.9	3.5	5.0
Wood processing	11.7	19.9	39.0	27.3	24.2	36.6
Paper industry and publishing	15.6	51.7	35.8	7.0	7.4	8.0
Chemical industry and related industries	25.0	1.6	-21.7	6.0	5.6	5.2
Production of other non-metallic mineral products	38.6	10.1	-14.0	5.9	7.8	6.6
Production of metals and metal articles	35.8	53.7	-31.4	7.0	7.9	6.9
Production of machines and equipment	36.1	96.9	-43.6	7.3	9.8	7.0
Other industries	39.2	67.2	-31.8	4.9	6.8	3.9

\* estimated using the quarterly data

Since 2000 on the whole, the investment in manufacturing sectors of high and medium technologies grows the fastest. Investment in these sectors more than doubled in the last five years, while the investment in low technology sectors in 2005 has increased by 33.2% in comparison with 2000. Such trends may indicate certain capital saturation in low technology sectors and drain of their development potential, which is also greatly affected by producer price competition pressure from cheap labour countries.

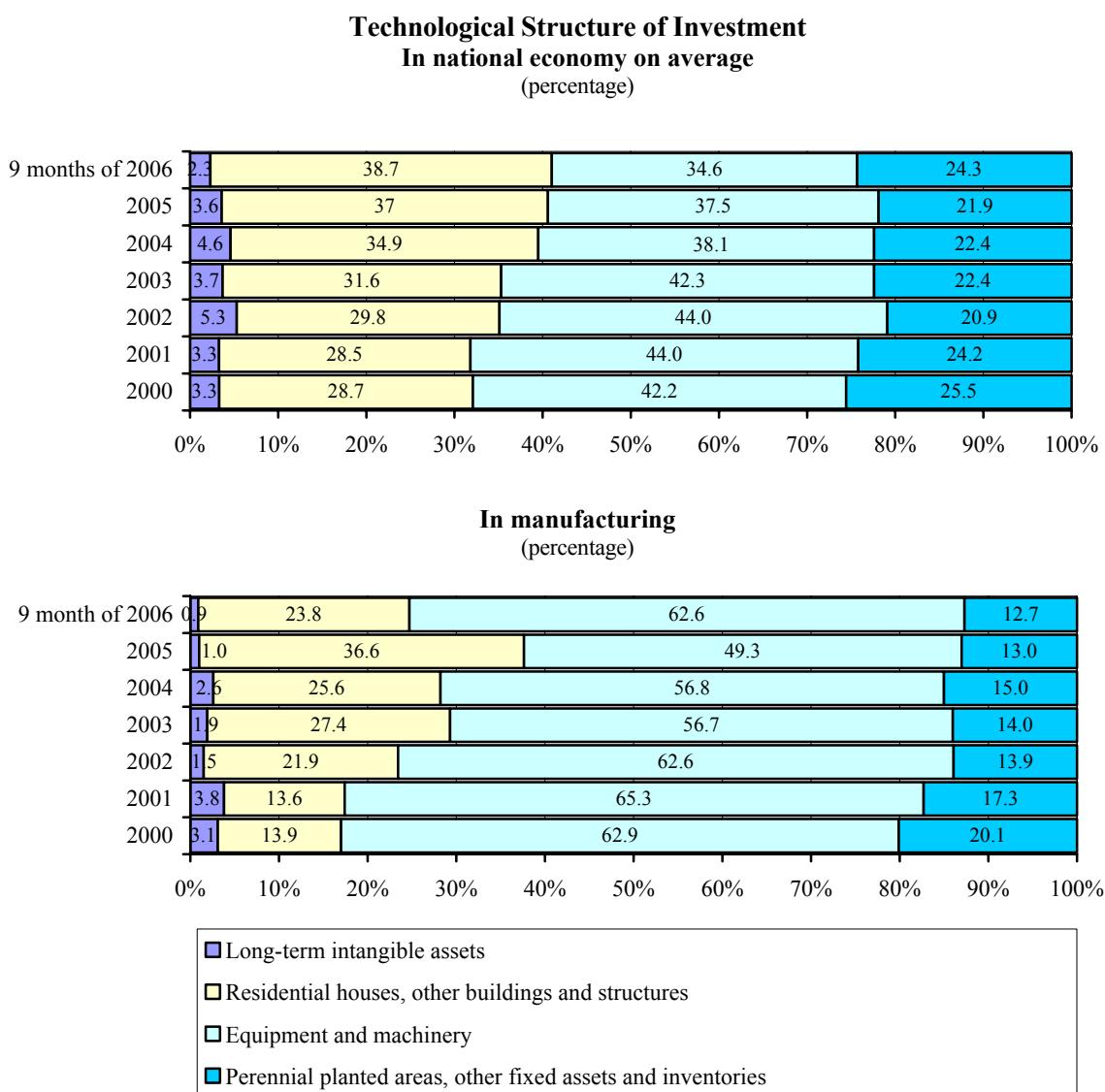
However, statistical data indicate that low technology sectors were more attractive for investors in 9 months of 2006, as the investment in these sectors increased by 12.1%, while the investment in high and medium technology sectors were by 30.4% lower than in 9 months of the preceding year.

Figure 3.8



\* estimated using the quarterly data

Figure 3.9



The share of residential houses, other buildings and structures in the **technological structure** of investment increased especially fast in the last two years, which was greatly affected by development of mortgage crediting in Latvia. The share of long-term intangible assets in investment is still small.

The share of technological machinery and equipment in the total investment amounts to 41% on average in the last five years, and almost one-fourth of this investment is allocated for acquisition of transport vehicles and is not directly linked with the production process. One-third of the investment is channelled to construction and renovation of buildings.

The technological structure of investment is greatly affected by production specifics and the structure of the existing fixed assets. The average share of equipment and machinery in the manufacturing investment structure is by 16.4 percentage points higher than in the economy on average, while the average share of investment into houses and buildings in the manufacturing investment structure during 2000-2005 was by 6 percentage points lower than in the economy on average. Entrepreneurs in manufacturing invest increasingly more in buildings during the recent years. New premises are being built and old ones renovated for production needs. This was greatly determined by improved access to financial resources and indicates a new development phase in manufacturing. Investment in equipment and machinery grew faster in 2006 than in the previous year, and as a result its share in the total investment increased to 62.6%. This was greatly determined by increased load of production capacities and by necessity to restore the existing capacities for retaining and increase of competitiveness.

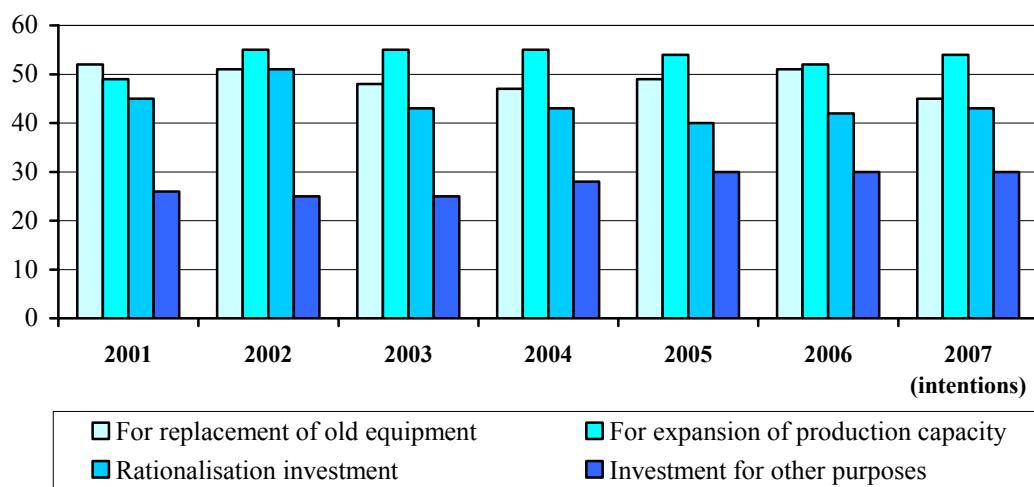
In 2006 the average load of production capacities in industry was 72% and exceeded the average rate of 2000 by 11 percentage points.

As the volume of production capacities increases, their quality is being increased gradually. As the results of business survey indicate, since 2002 the investors in industry preferred investment for expansion of production capacities more than for replacement of old equipment. Investment for mechanisation and automation of production is also increasing gradually.

Since 2002, investment in manufacturing is mostly made for expansion of production capacities. In 2006 such investment was made by 52% of the surveyed companies. Big investment is still being made for replacement of old equipment. The number of companies planning to invest for mechanisation and automation of production also increased. Such investment was made by 42% of the surveyed companies in 2006 (43% of them are planning to make such investment in 2007). Investment for increase of labour safety and environmental protection grows every year. In 2006, such investment was made by 30% of manufacturing companies.

Figure 3.10

#### Types of Fixed Investment in Manufacturing Companies (percentage of surveyed companies)



It is expected that investment volumes in Latvian national economy will continue growing in the immediate future as the current state of affairs remains. The growing domestic and external demand in conditions of high load of capacities can create additional stimuli for investment also in the future. Results of business surveys indicate that Latvian entrepreneurs also plan to increase investment in industry by 3% in 2007.

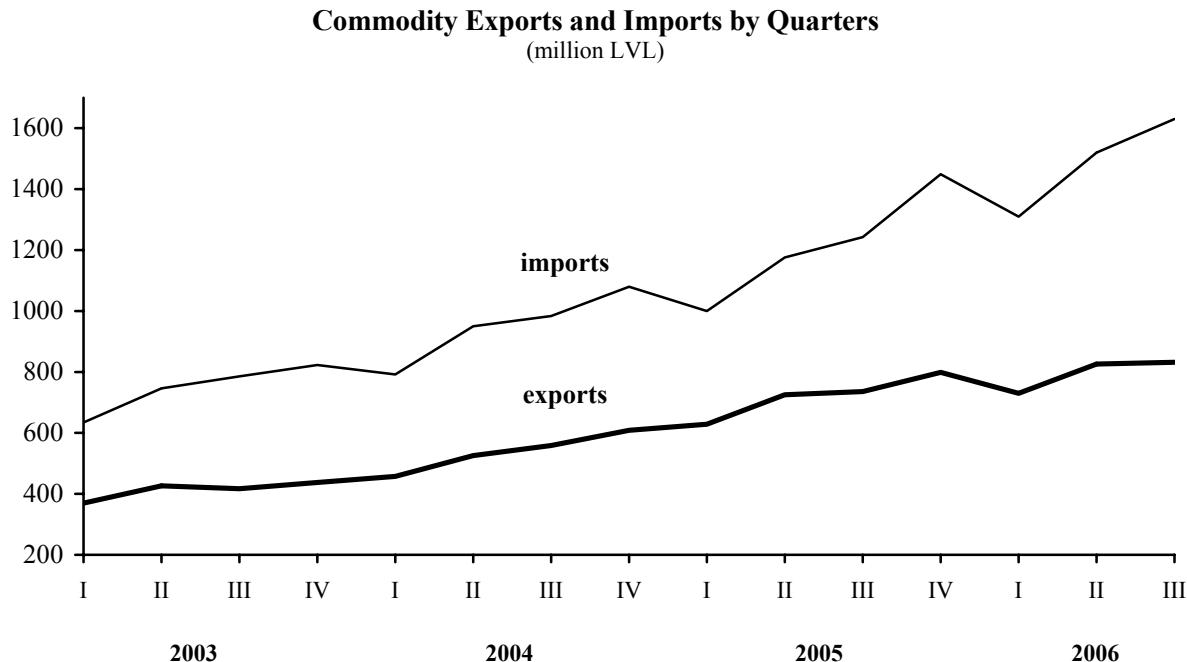
Taking into account that the information provided in the previous years by the surveyed company managers about intentions of investment volumes in the next periods was very prudent in comparison with the actual execution (i.e. several times lower than the actual execution), the investment growth rates planned in 2007 may be regarded as pessimistic.

### 3.2.4. Exports and Imports

#### Exports and imports of commodities

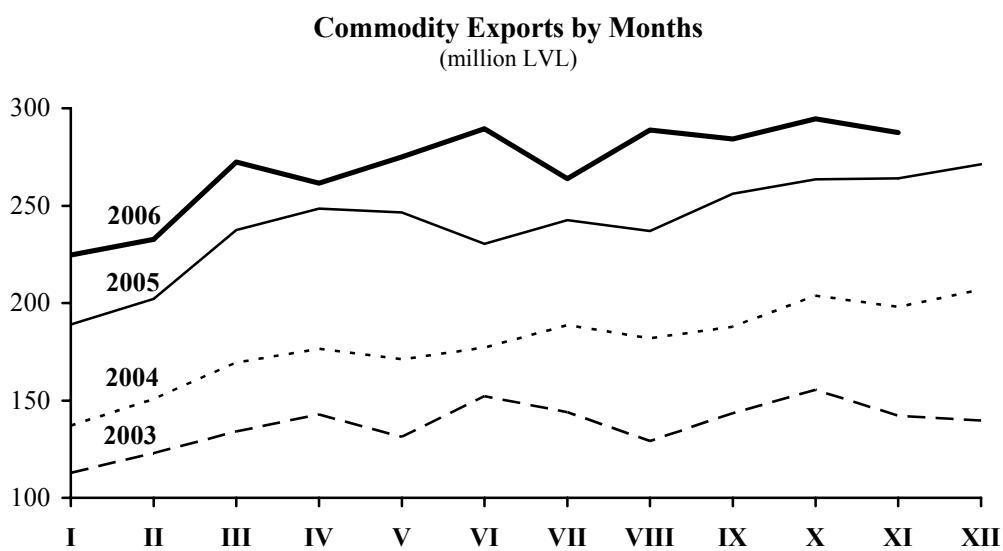
Exports of Latvian commodities in January-November 2006 grew at a more moderate pace than in the previous year by 13.7% in current prices, while imports increased much faster by 29.3%. As usual, imports increased especially fast in the 2nd quarter (see Figure 3.11).

Figure 3.11



In 3<sup>rd</sup> quarter of 2006 the **commodity exports** were favourably influenced by the fast rise of the export unit value that exceeded the value of the respective period of 2005 by 10.8%, as the euro exchange rate increased and world prices grew in several groups of goods, especially mineral products.

Figure 3.12



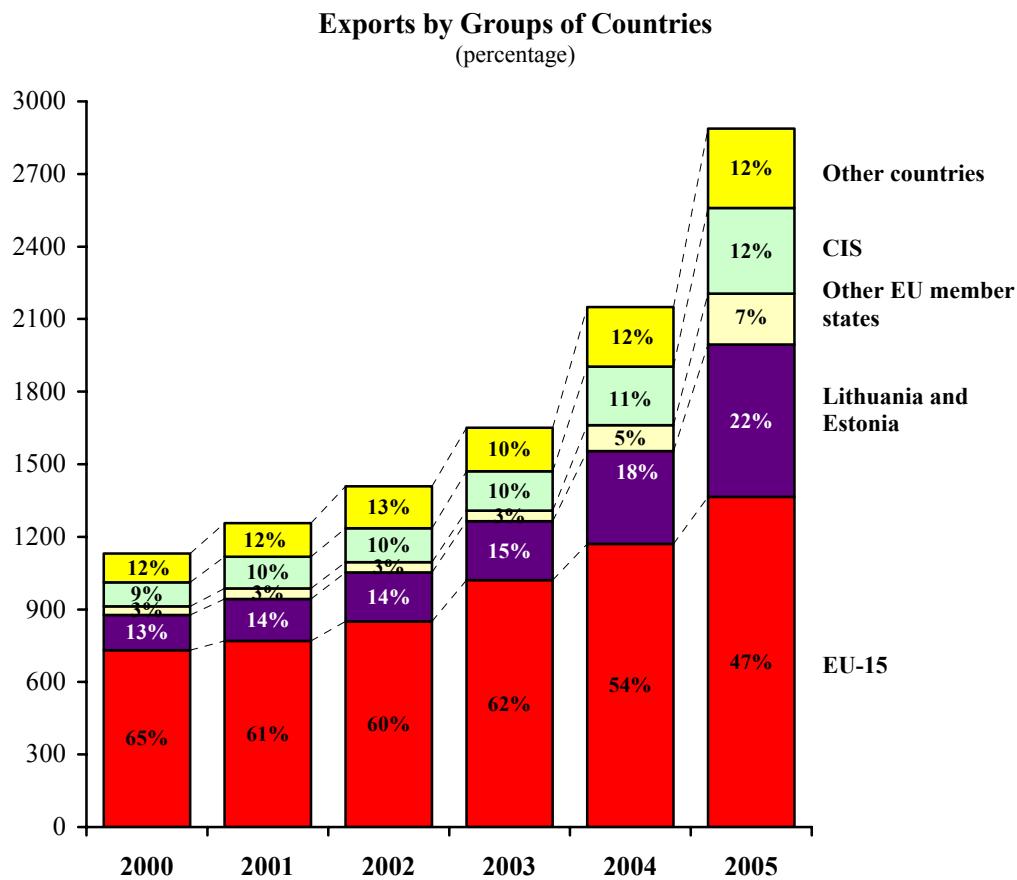
Commodity exports in 2006 went up in almost all groups of goods, especially metal-working products, which accounted for almost 30% of the total growth of exports. Exports of mineral products, which had increased very fast the previous year, considerably decreased (mostly to EU member states), and exports of wood products slightly diminished (see Table 3.7).

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

Table 3.7

	2005		January-November 2006	
	structure (%)	increase against 2004 (current prices, %)	structure (%)	increase against January-November 2005 (current prices, %)
<b>Total</b>	<b>100.0</b>	<b>34.3</b>	<b>100.0</b>	<b>13.7</b>
including:				
wood and wood products (IX)	24.8	9.5	22.4	1.0
metals and metal articles (XV)	13.1	25.1	15.3	31.4
light industry products (VIII; XI-XII)	9.3	10.3	8.9	6.9
agricultural and food products (I-IV)	12.2	68.5	13.2	26.9
products of chemical industry and allied industries. plastics (VI-VII)	8.0	37.6	9.8	38.7
machinery (XVI)	9.3	59.2	9.5	18.0
mineral products (V)	9.2	132.4	5.6	-31.2
transport vehicles (XVII)	3.9	104.4	5.9	75.7
other commodities (X; XIII-XIV; XVIII-XXII)	10.2	25.9	9.4	3.6
<b>Total (million LVL)</b>	<b>2888.2</b>		<b>2974.7</b>	

Figure 3.13



Exports to **EU member states** in January-November 2006 were by 11% bigger than in the previous year. Like the total Latvian exports, also exports to EU member states increased in almost all groups of commodities with the exception of mineral products and wood products. The biggest growth in exports to EU member states was provided by metal-working products (42% of the total exports to EU member states).

Exports to the **CIS countries** in January-November 2006 continued increasing at especially rapid pace by 33.5%, mainly due to increased exports of machinery and metals and metal articles (21% and 14% respectively of the total growth of exports to the CIS countries). Only exports of mineral products decreased slightly (by 0.2%).

Increase of **commodity imports** in January-November 2006 was observed in all groups of commodities and the biggest one was in groups of transport vehicles and machinery which accounted for 23% and 17% respectively of the total increase of imports. Imports of food products increased at a slightly more moderate pace in the mentioned period.

Figure 3.14

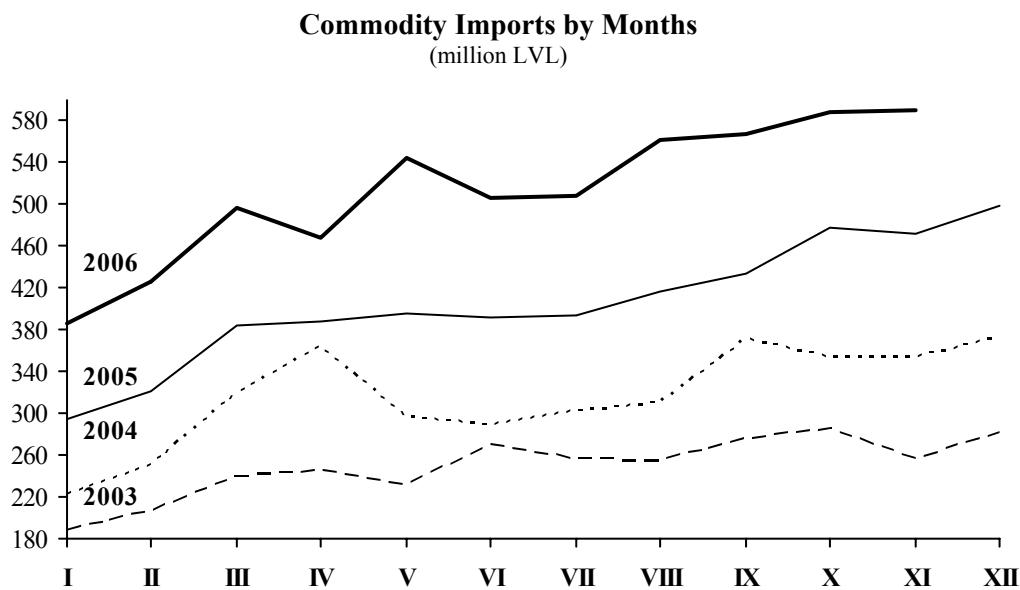
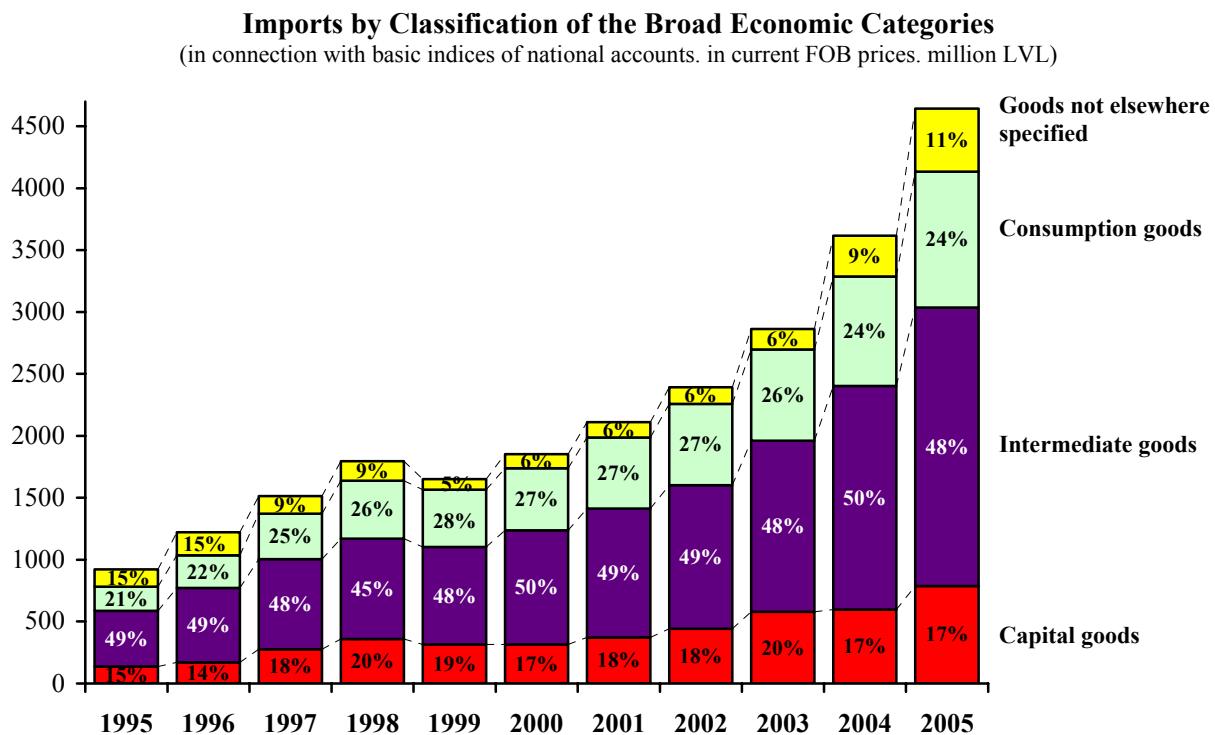


Table 3.8  
Imports by Main Groups of Commodities  
(CIF prices)

	2005		January-November 2006	
	structure (%)	increase against 2004 (current prices, %)	structure (%)	increase against January-November 2005 (current prices, %)
<b>Total</b>	<b>100.0</b>	<b>27.9</b>	<b>100.0</b>	<b>29.3</b>
including:				
wood and wood products (IX)	2.9	24.5	2.5	10.4
metals and metal articles (XV)	9.2	15.2	9.6	34.0
light industry products (VIII; XI-XII)	6.0	12.2	6.0	24.5
agricultural and food products (I-IV)	11.6	27.2	11.0	23.6
products of chemical industry and allied industries. plastics (VI-VII)	13.5	22.1	13.5	28.1
machinery (XVI)	19.9	28.1	19.1	25.3
mineral products (V)	15.5	56.3	14.0	16.3
transport vehicles (XVII)	10.7	26.4	13.4	62.9
other commodities (X; XIII-XIV; XVIII-XXII)	10.7	27.1	10.9	34.1
<b>Total (million LVL)</b>	<b>4866.9</b>		<b>5648.8</b>	

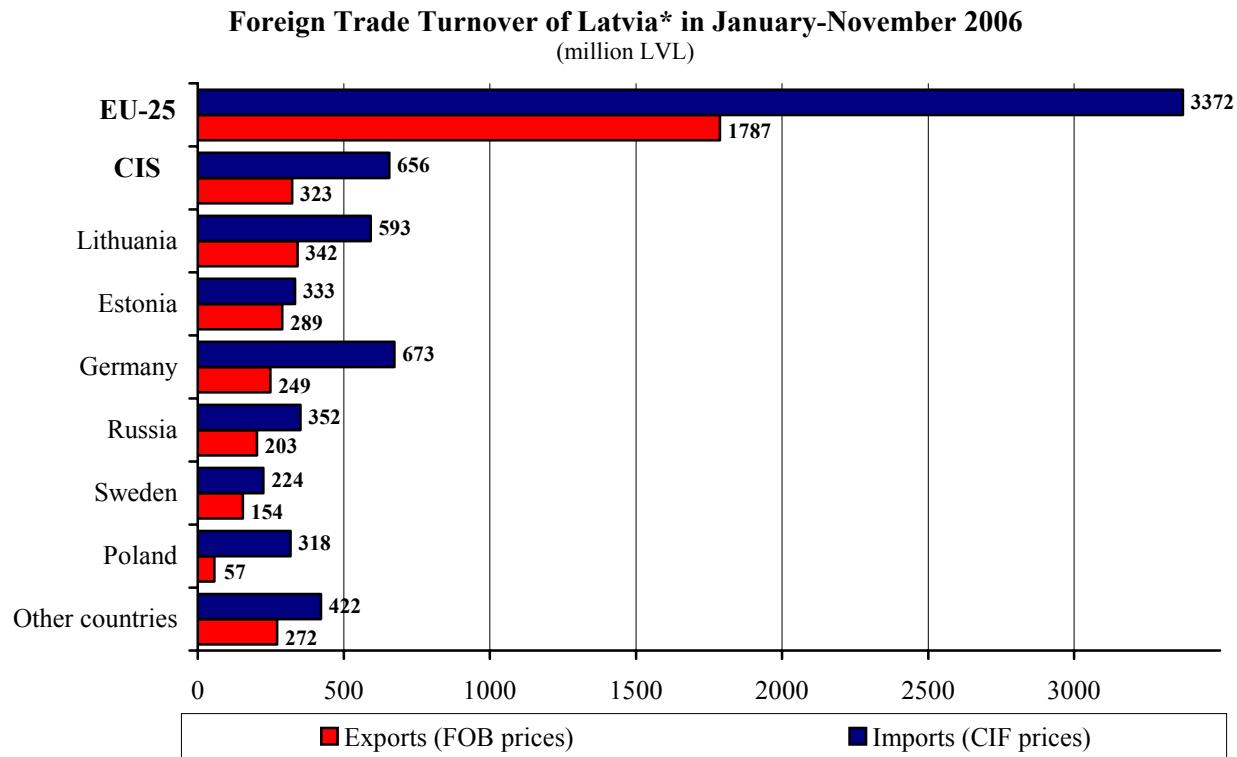
As viewed by classification of the broad economic categories, the imports have not changed substantially during the last four years (see Figure 3.15).

Figure 3.15



The biggest **trading partners** of Latvia in January-November 2006 were Lithuania (14% of the total foreign trade turnover), Germany (14%), Estonia (9%), Russia (8%), Sweden (6%) and Poland (6%).

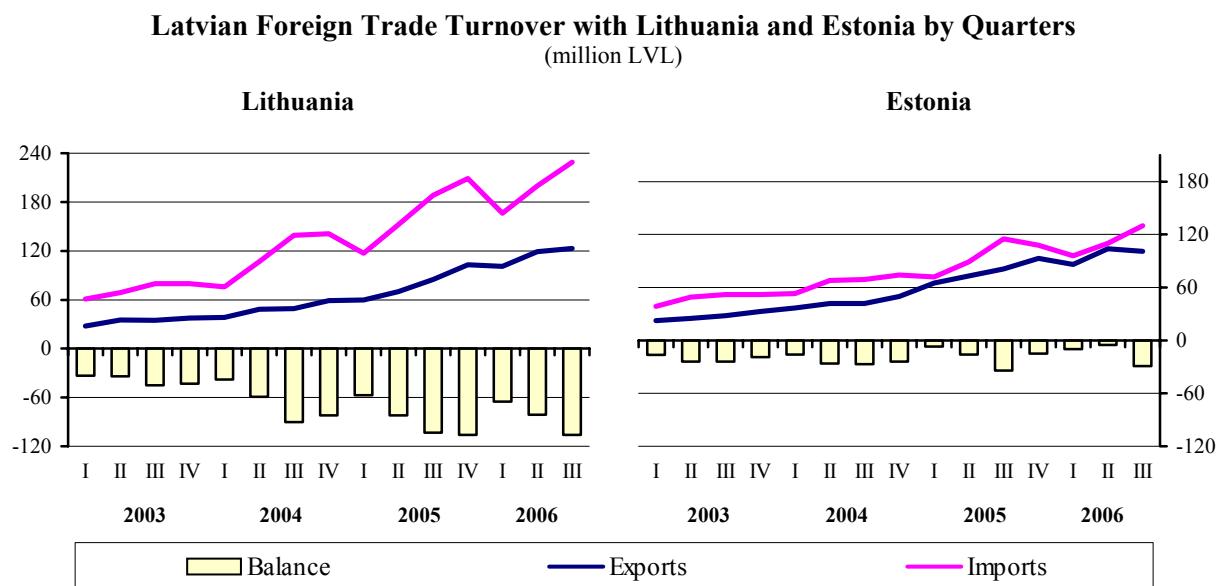
Figure 3.16



After accession to the EU foreign trade of Latvia with **Lithuania** and **Estonia** still continues growing rapidly. In comparison with the period before accession to the EU, Latvian foreign trade with

these countries has increased more than twice during two years. However a considerable negative balance still remains although the share of the negative balance stays at about the same level. considering the rapid increases of trade volumes (see Figure 3.17).

Figure 3.17



As Figure 3.17 shows the negative balance of foreign trade with Lithuania (in January-November 2006 imports exceeded exports by 41%) is bigger than with Estonia (14%). The main groups of commodities exported to Estonia and Lithuania are food and chemical industry products while the main imported commodities are mineral products and transport vehicles.

In January-November 2006 exports to Lithuania increased rapidly (by 54%) and the biggest contributions were made by the groups of transport vehicles and agricultural and food products. Imports from Lithuania in this period grew at a more moderate pace by 24%.

Growth rates of exports and imports in trade with Estonia in January-November 2006 were similar (32% and 23% respectively). Transport vehicles dominate in the growth of exports while transport vehicles and products of chemical industry dominate in the growth of imports.

#### Exports and imports of services

The clearly negative balance of commodity trade of Latvia is partly covered by the positive balance of services (see Table 3.9). According to the data of the balance of payments, the balance of services has slightly improved in January-September 2006 as exports of services went up by 29% but imports increased at a slightly more moderate pace by 19%.

Table 3.9

#### Exports and Imports of Services in January-September 2006

	Million LVL			Structure (%)		Changes against January-September 2005 (%)	
	exports	imports	balance	exports	imports	exports	imports
<b>Services – total</b>	1104.1	782.7	321.4	100	100	25.2	23.7
including:							
Transport services	599.6	257.1	342.5	54.3	32.8	19.2	23.4
– sea transport	230.9	61.8	169.1	20.9	7.9	7.7	29.5
– air transport	79.5	90.9	-11.4	7.2	11.6	39.4	26.0
– other transport	289.2	104.5	184.8	26.2	13.4	24.8	17.9
Travel	209.1	286.5	-77.4	18.9	36.6	44.4	18.9
Commercial services	279.9	226.2	53.8	25.4	28.9	27.3	32.3
Other services	15.4	12.9	2.5	1.4	1.6	11.6	5.9

More than half of the exports of services are made by the revenues from transit haulage. The 1st half of 2006 was rather successful for the transit business as cargo turnover in ports increased and volumes of rail transport services 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 gradually becomes similar to the amount of expenses by Latvian travellers abroad.

Figure 3.18



### 3.3. Contribution of Sectors

#### 3.3.1. Structure and Dynamics of the Economy

The structure of Latvian economy in sectoral profile has changed in favour of service sectors in the last years. The share of service sectors in the value added has increased to 73.8% in 2005 from 71.8% in 2000. Construction, trade services, transport and communications have grown faster than other sectors of the economy in terms of both the value added and the number of employees.

Table 3.10

**Structure of the Economy (%)**

	By value added		By number of employees	
	2000	2005	2000	2005
Primary sectors	4.7	4.4	14.5	11.5
Manufacturing	13.7	12.8	17.9	15.8
Electricity, gas and water supply	3.6	2.6	1.9	1.6
Construction	6.2	6.3	5.9	8.8
Trade, hotels and restaurants	17.9	22.1	17.7	19.1
Transport and communications	14.1	15.0	8.3	9.4
Other commercial services	23.0	22.6	12.4	13.0
Public services	16.8	14.2	21.4	20.8
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

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

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

In the last five years (2001-2005), increasing trade (wholesale and retail) contributed to almost one-third of the growth. The contribution by manufacturing is by one-half less and also lags behind the contribution by the transport and communications sector.

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

Table 3.11

	GDP Growth (%)		Contribution to growth	
	2005	Average 2001-2005	2005	Total 2001-2005
Primary sectors	6.8	4.6	0.3	1.1
Manufacturing	6.3	7.6	0.9	6.0
Electricity, gas and water supply	2.3	4.4	0.1	0.8
Construction	15.5	11.9	1.1	4.6
Trade, hotels and restaurants	17.2	12.7	3.5	14.4
Transport and communications	16.2	9.6	2.3	8.6
Other commercial services	8.1	7.8	1.8	9.8
Public services	2.7	2.8	0.4	2.4
<b>GDP</b>	<b>10.2</b>	<b>8.1</b>	<b>10.2</b>	<b>47.7</b>

Two-thirds of the total demand of the *transport and communications* sector is determined by the domestic demand that is stable and has increased faster than the external demand in the recent years. This refers especially to communications as well as supporting and auxiliary types of transport activity, such as warehousing, parking services, and operation of travel agencies. The external demand for transit services is unstable. Due to the discriminatory attitude of Russia since 2002 as regards the transit of oil products through Ventspils port, total amount of cargo sent to ports declined. As from 2004, the situation has improved mostly due to increased cargo turnover of other Latvian ports.

The significant growth rates in the transport and communications sector in 2004-2005 were ensured by increased transportation both of cargo and of passengers as well as by development of the communications industry. In cargo transportation, the amount of cargo transported by motor vehicles grew substantially and contributed most to the overall growth. Contributions by railway transport and port services to the growth of the sector were smaller. Passenger transport services increased substantially, especially in air transport.

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

Table 3.12

### GDP Growth in 3 Quarters of 2006 (% against the respective quarter of the preceding year)

	Growth rates				Contribution to growth*			
	1st quarter	2nd quarter	3rd quarter	Total in 3 quarters	1st quarter	2nd quarter	3rd quarter	Total in 3 quarters
Primary sectors	4.1	-3.0	-3.9	-1.7	0.1	-0.1	-0.2	-0.1
Manufacturing	8.8	4.3	7.8	6.8	1.3	0.6	1.0	0.9
Electricity, gas and water supply	10.7	0.6	7.7	6.7	0.4	0.0	0.1	0.2
Construction	17.5	16.1	12.2	14.8	1.1	1.1	1.1	1.1
Trade, hotels and restaurants	17.3	18.4	18.6	18.1	4.4	3.7	4.2	4.0
Transport and communications	6.0	10.9	12.1	9.8	0.9	1.8	1.9	1.6
Other commercial services	17.4	14.7	16.3	16.1	4.5	3.4	3.5	3.8
Public services	2.9	4.3	1.7	3.0	0.4	0.6	0.2	0.4
<b>Total</b>	<b>13.1</b>	<b>11.1</b>	<b>11.8</b>	<b>11.9</b>	<b>13.1</b>	<b>11.1</b>	<b>11.8</b>	<b>11.9</b>

\* contribution of the added value of sectors to the growth is calculated against the total value added

In 3 quarters of 2006, growth was even faster than in the previous year, as high growth rates remained in most service sectors and industrial production volumes increased more rapidly than in the previous year. High growth rates are in almost all sectors of the economy, especially in construction, transport and communications, and trade services.

The high growth rates in 3 quarters of the year allow to forecast that the average growth in 2006 may reach 12%.

### 3.3.2. Manufacturing

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

Table 3.13

#### Growth of Manufacturing\* (per cent)

	Average annual growth in 2001-2005	Growth in 2005	January-November 2006 / January-November 2005
<b>Manufacturing – total</b>	<b>7.6</b>	<b>6.3</b>	<b>5.2</b>
Food industry	5.7	5.1	5.3
Light industry	1.7	8.7	8.2
Wood processing	7.6	2.7	-0.5
Paper industry and publishing	3.7	11.7	9.0
Chemical, rubber and plastic industry	11.0	15.4	19.9
Manufacture of other non-metallic mineral products	13.5	24.1	4.9
Production of metals and metal articles	7.7	2.7	9.4
Production of machinery and equipment	14.0	3.1	0.8
Production of electrical and optical equipment	17.5	6.5	9.5
Production of transport vehicles	-3.7	6.5	-5.5
Other industries	9.4	4.2	6.7

\* 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, the growth rate of manufacturing decreased, as certain time passed until companies accommodated themselves to the new trade conditions. Considerable growth resumed in May 2005.

Table 3.14

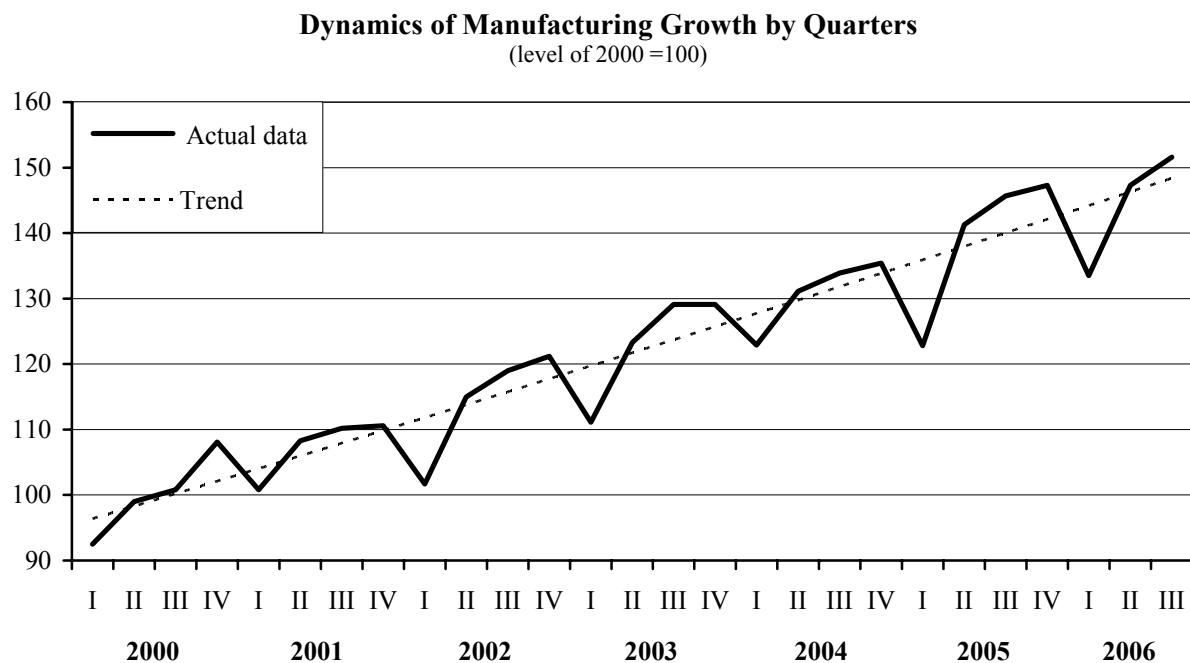
#### Structure of Manufacturing (%)

	By value added 2005	By number of employees 2005	Share of exports in sector's sales, 2005*
<b>Manufacturing – total</b>	<b>100</b>	<b>100</b>	<b>51.5</b>
Food industry	19.8	21.4	24.2
Light industry	7.6	13.8	78.9
Wood processing	23.0	20.2	67.5
Paper industry and publishing	8.5	7.4	21.1
Chemical, rubber and plastic industry	7.5	5.2	53.2
Manufacture of other non-metallic mineral products	5.6	3.6	26.1
Production of metals and metal articles	9.4	7.5	71.7
Production of machinery and equipment	3.7	4.4	73.4
Production of electrical and optical equipment	5.1	3.9	63.2
Production of transport vehicles	3.7	4.1	78.3
Other industries	6.0	8.5	62.5

\* according to operational statistics

In 2006, growth was faster in sectors where sales markets are relatively less linked to export. Wood processing that is one of the principal Latvian export sectors has poor growth indicators for two consecutive years already, and in 2006 it even showed a little decrease of production volumes.

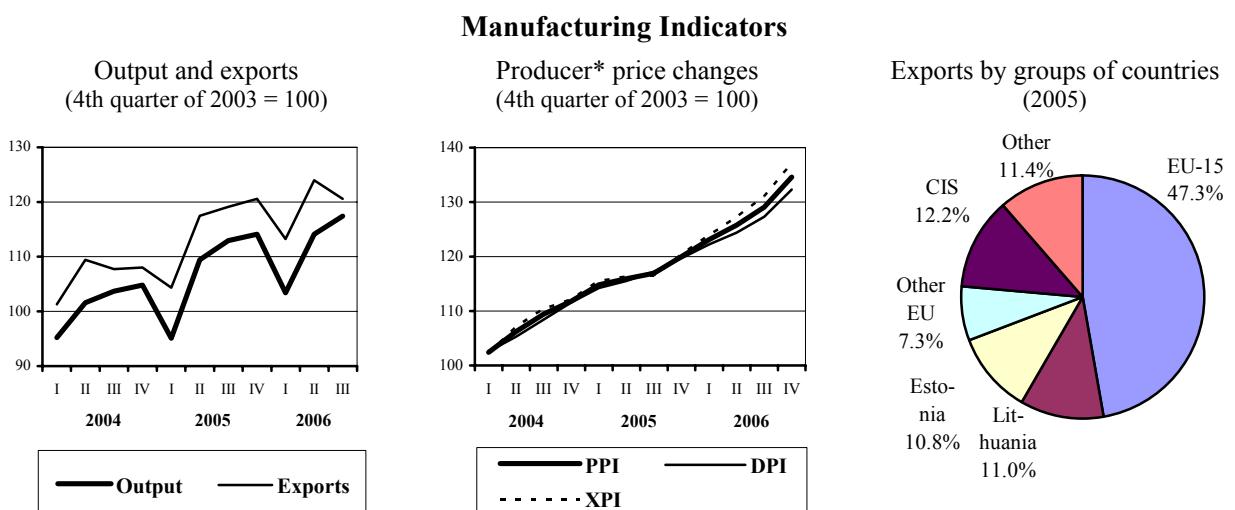
Figure 3.19



Manufacturing growth trend on the whole is equable without marked accelerations or declines. Decreased growth of particular sectors is compensated by increased growth rates in other sectors. In almost all sub-sectors of manufacturing industry, the results of 2006 in comparison with 2000 show increased volumes of production (with the exception of production of transport vehicles). After accession to the EU, growth rates increased substantially in paper industry and publishing, chemical industry, production of construction materials, and production of electrical and optical equipment. In other sectors, growth rates remained at the previous levels or slightly decreased.

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

Figure 3.20

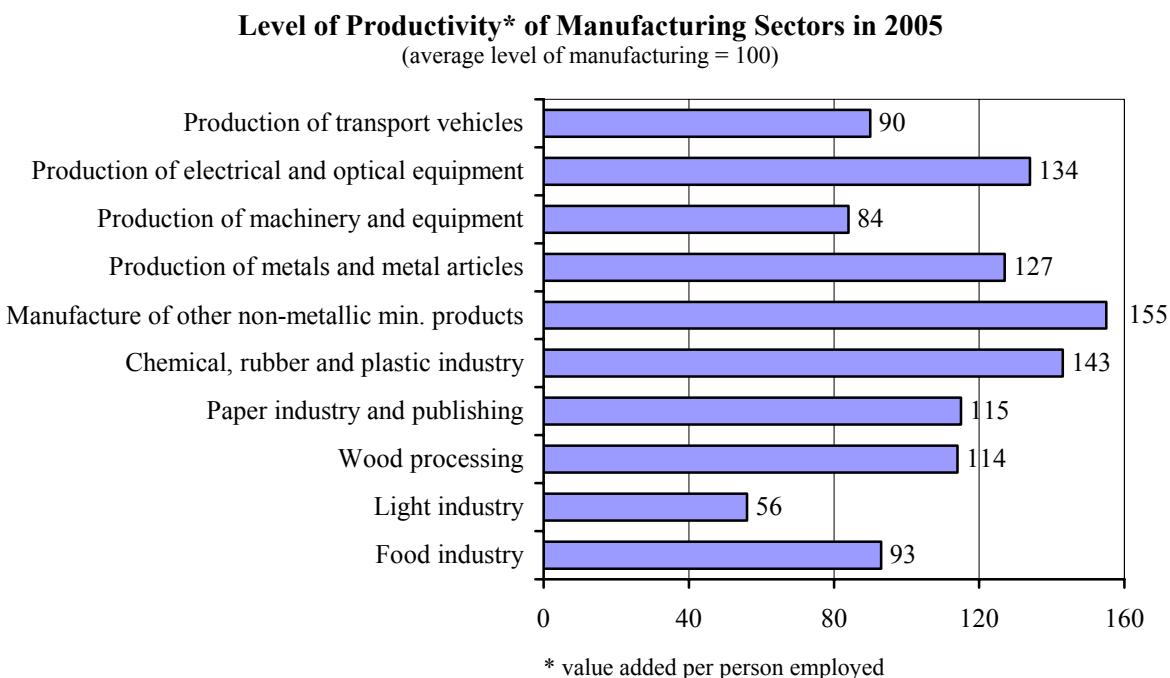


\* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Producer prices have increased considerably in all sectors during the last three years, besides the prices for exported products have increased slightly faster than prices for domestically sold products.

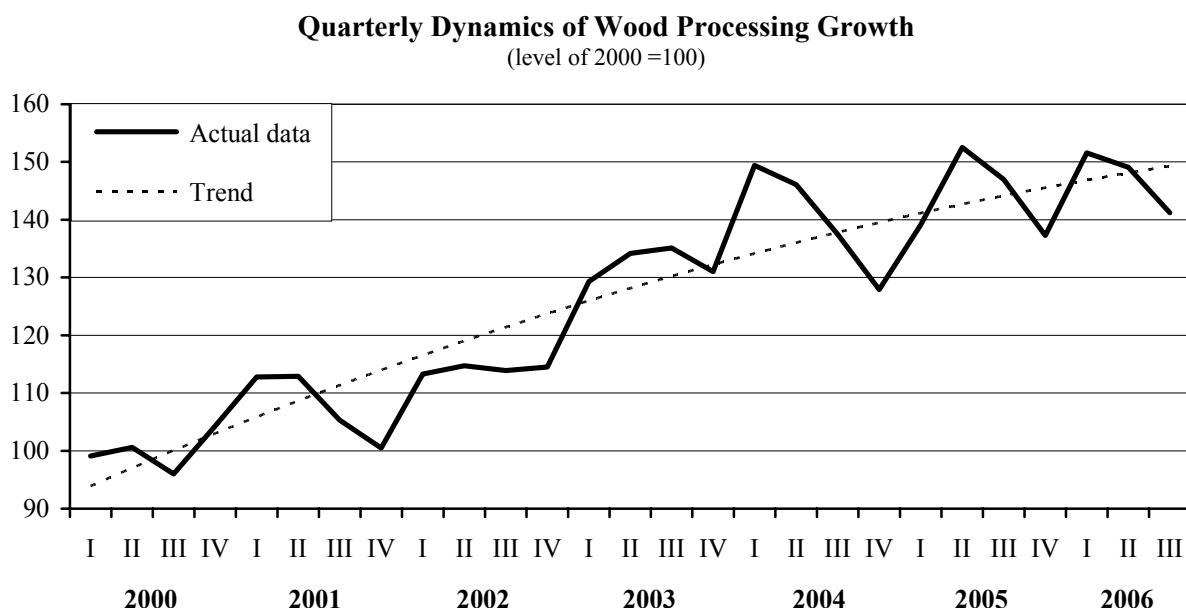
Among the aggregated sectors, level of productivity is the highest in production of construction materials (manufacture of other non-metallic mineral products) and chemical industry but is relatively low in majority of machinery sectors. Only textile industry has lower productivity.

Figure 3.21



**Wood processing** is one of the biggest sectors of Latvian industry. Its value added makes up almost a quarter of the total value added of manufacturing. This sector has shown the fastest growth since restoration of Latvia's independence, nearly tripling its output in this period. However, the growth of this sector has become more moderate in the last two years. High share of exported products (almost 70% of the production output) is characteristic for the wood processing sector.

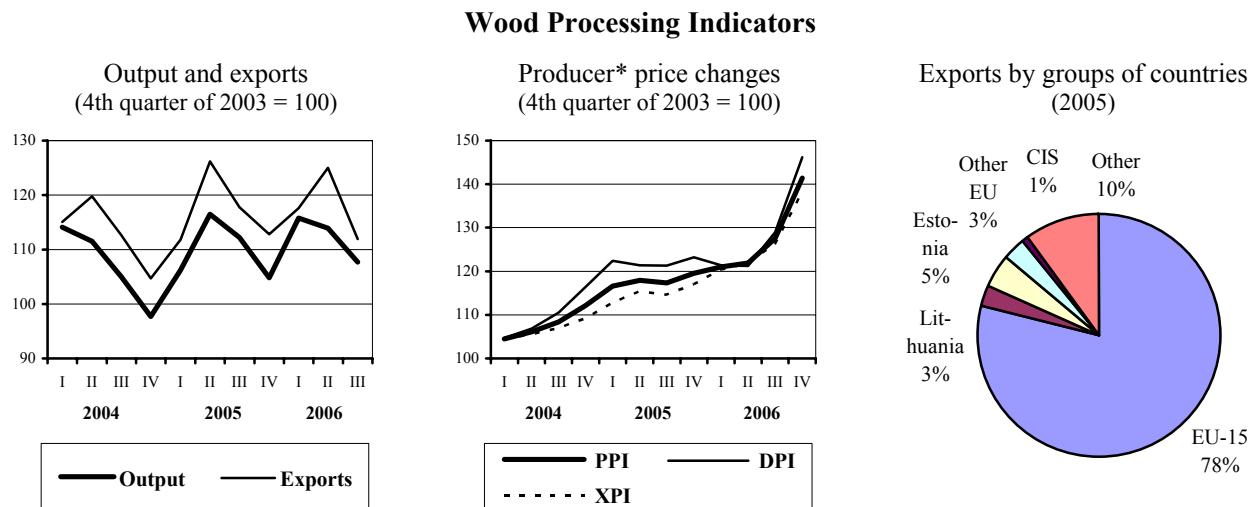
Figure 3.22



There was almost no growth in the sector during the last two years, as demand for wood processing products in Europe decreased considerably. Production outputs in 2006 little exceeded the

level of 2004. Decreased exports of wood processing products to the EU-15 countries were slightly compensated by the rapid growth of exports to Estonia and Lithuania as well as other new EU member states.

Figure 3.23

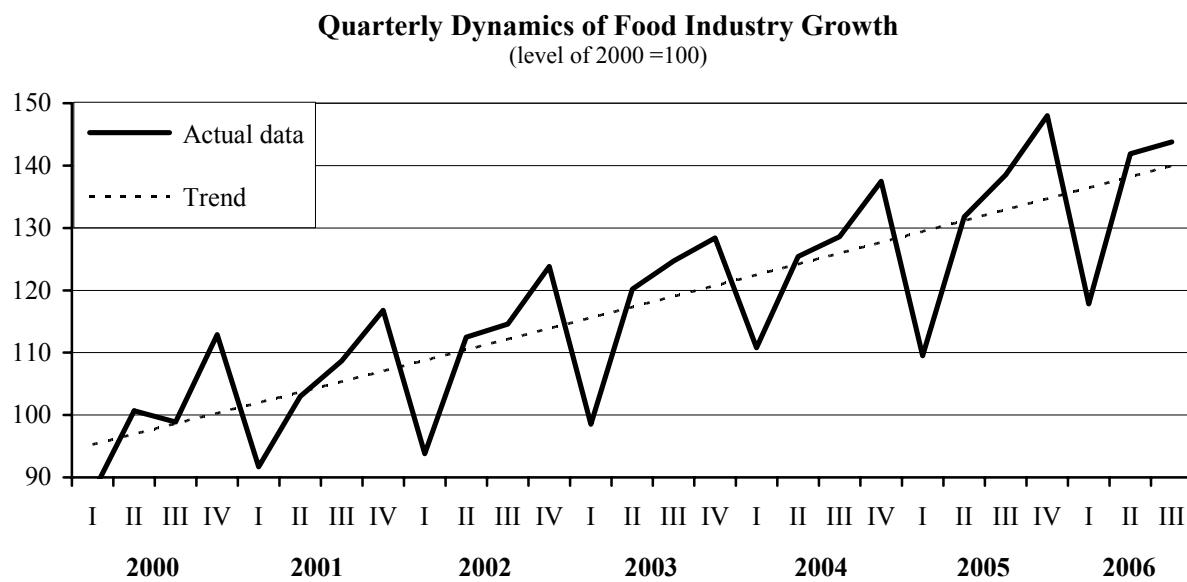


\* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Producer prices in wood processing in 2004-2005 grew faster for products sold in the domestic market due to the rise of the domestic demand. Prices for exported products grew faster at the beginning of 2006, favourably affecting the export of products.

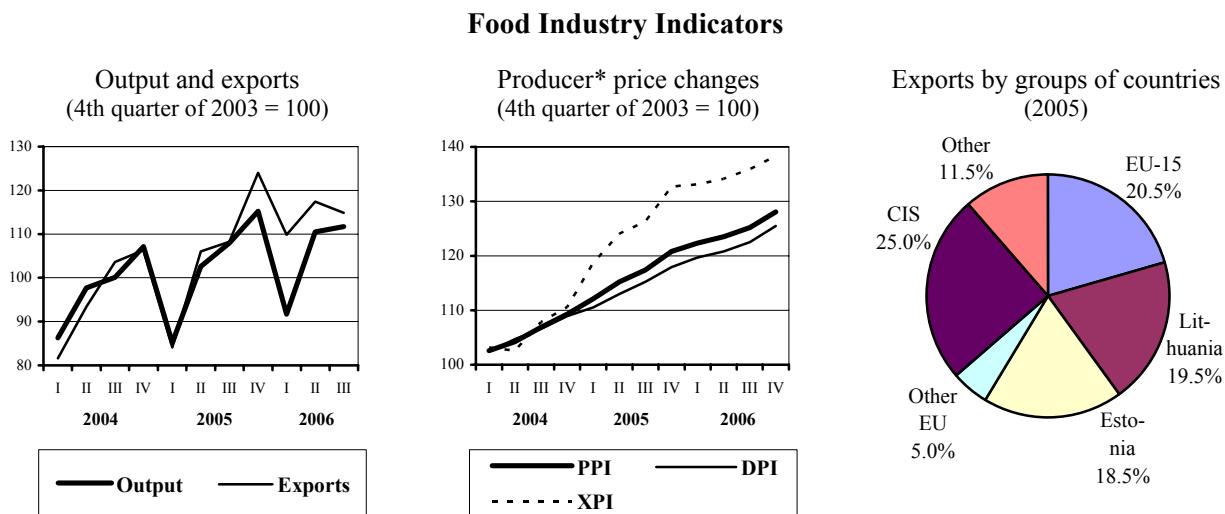
**Food industry** is the second biggest sector in Latvian manufacturing and accounts for one-fifth of the value added in manufacturing.

Figure 3.24



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.

Figure 3.25

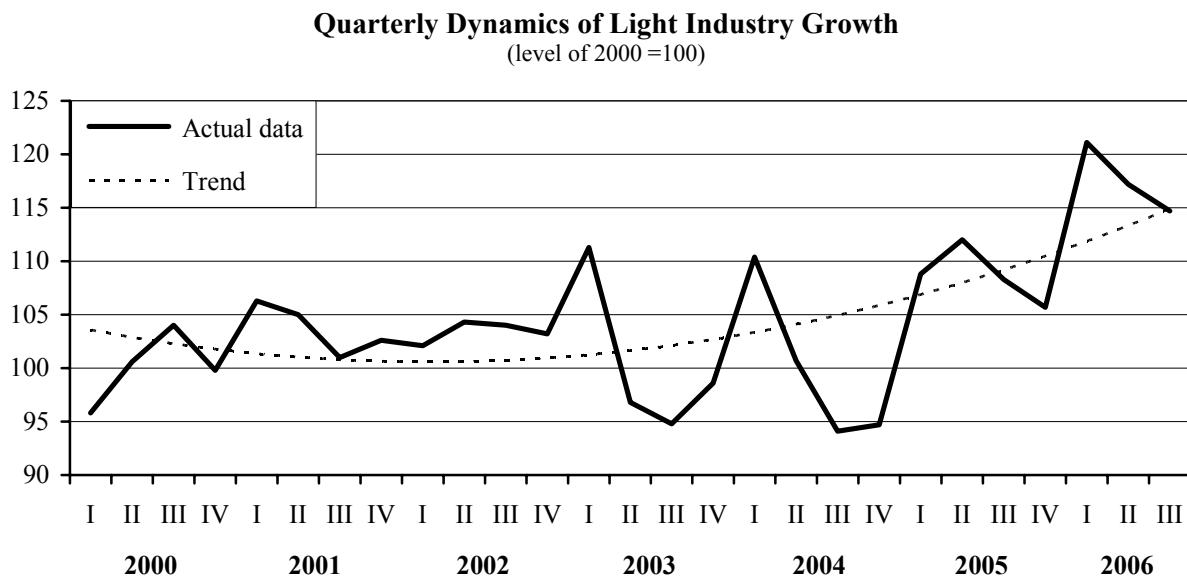


\* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

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

**Light industry** (production of textile and leather products) makes up less than 8% of the total value added of manufacturing. Only about one-fifth of the light industry output remains in Latvia. Most of the output (three-fourths of exports) is being exported to EU member states.

Figure 3.26

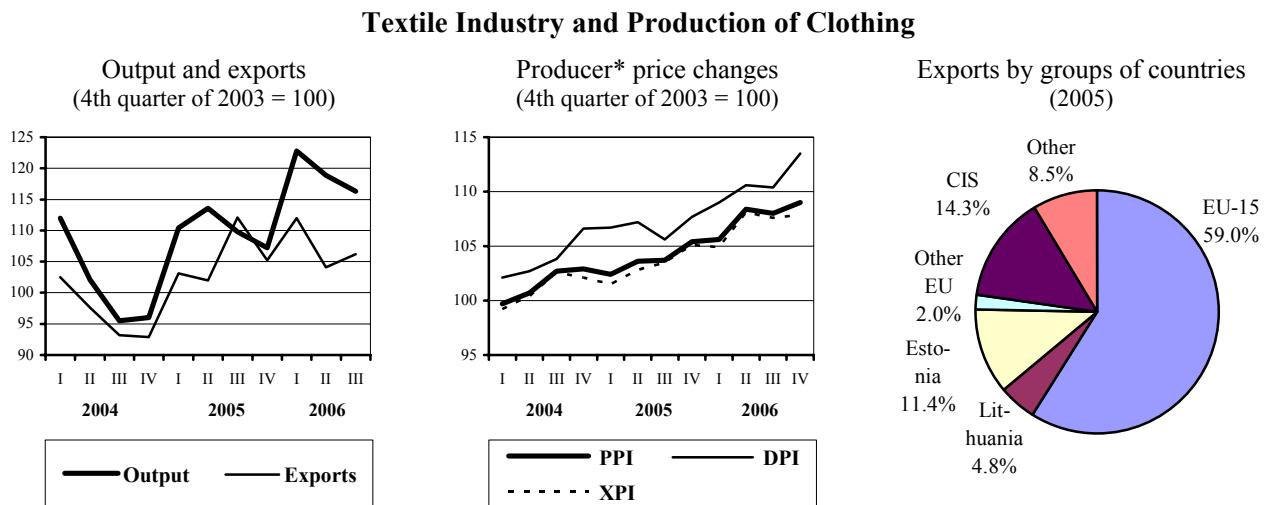


By 2005, the outputs and exports of the *textile industry* have not increased, and they even decreased in production of clothing. Growth of outputs only resumed in 2005 and continued faster in 2006.

Although the main sales markets for Latvian textile industry are in EU member states, due to the weak demand in EU member states and high competition in the sector, it is hard for Latvian producers to expand production outputs despite the rapid rise of prices in the last years. Narrowing of the exports to the EU is partly compensated by the growth of exports to CIS countries.

As already mentioned, growth is observed in 2006. Output of 11 months exceeded the previous level by 8.2%, mainly due to grown demand in the domestic market and increased exports to CIS countries as well as Lithuania and Estonia. Exports to the old EU member states did not increase in this period.

Figure 3.27



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

As from 2005, **paper industry and publishing** is characterised by rather fast growth, mainly due to increased exports and rapid rise of export prices. Main sales markets for exported products in this sector are Lithuania and Estonia, whereas opportunities to expand into markets of other EU member states are weak.

Figure 3.28

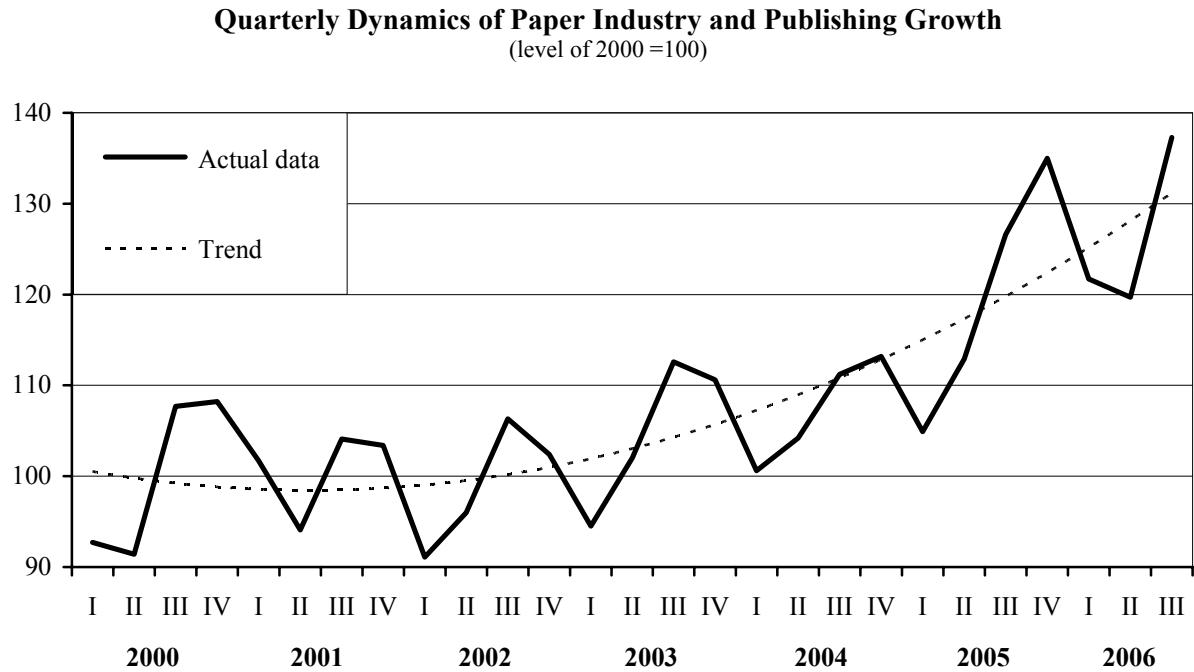
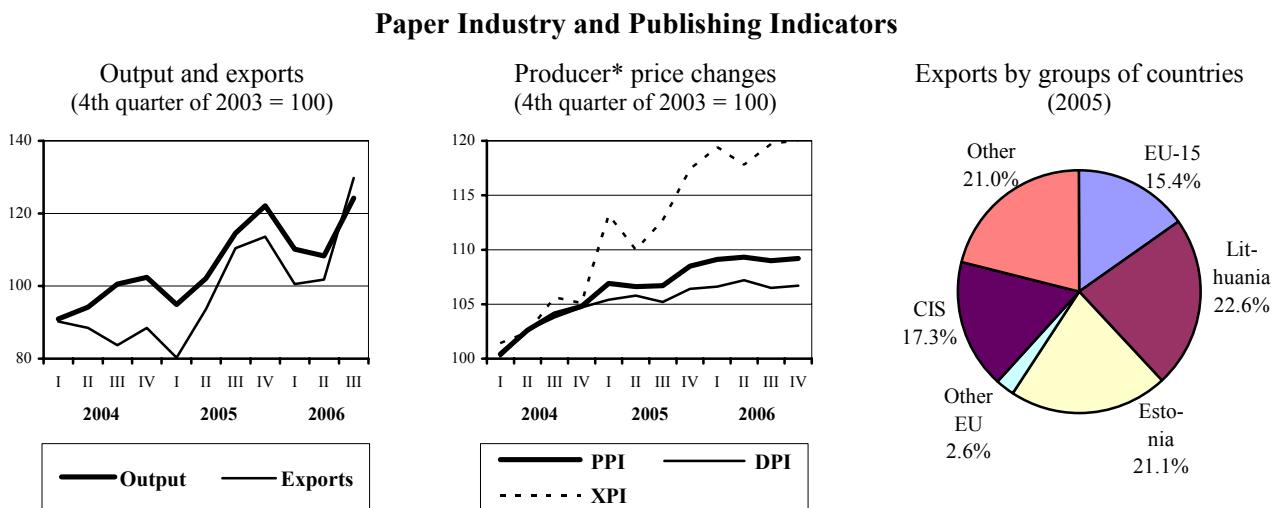


Figure 3.29

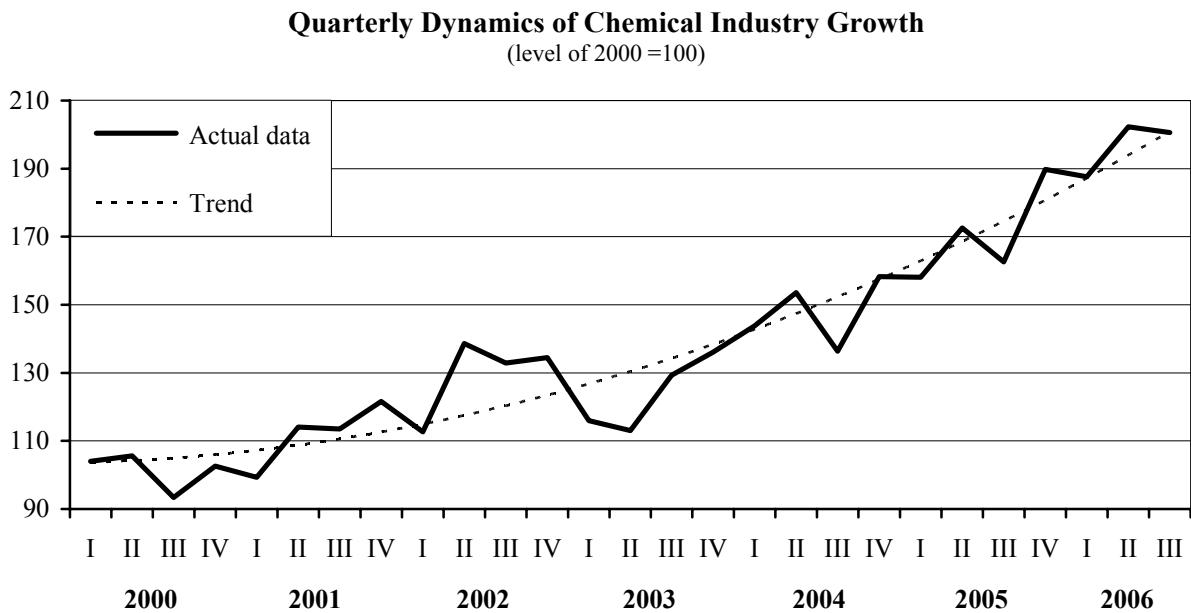


\* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Until 2005 the growth of export prices was much slower than the average price growth as a relatively big share of exports is linked with CIS countries and other countries outside the EU, and trade conditions with these countries worsen due to the low exchange rate of the US dollar that is one of the main currencies of account in these directions of trade. In 2006, a rapid rise of prices for exported products continued.

**Chemical industry** in Latvia has stable traditions, highly skilled specialists, long history of producing a wide range of products both for final and for intermediate consumption, and a good base for research. For that reason, stable growth is observed in this sector since 2004. Chemical industry accounts for approximately 7.5% of the total value added of manufacturing.

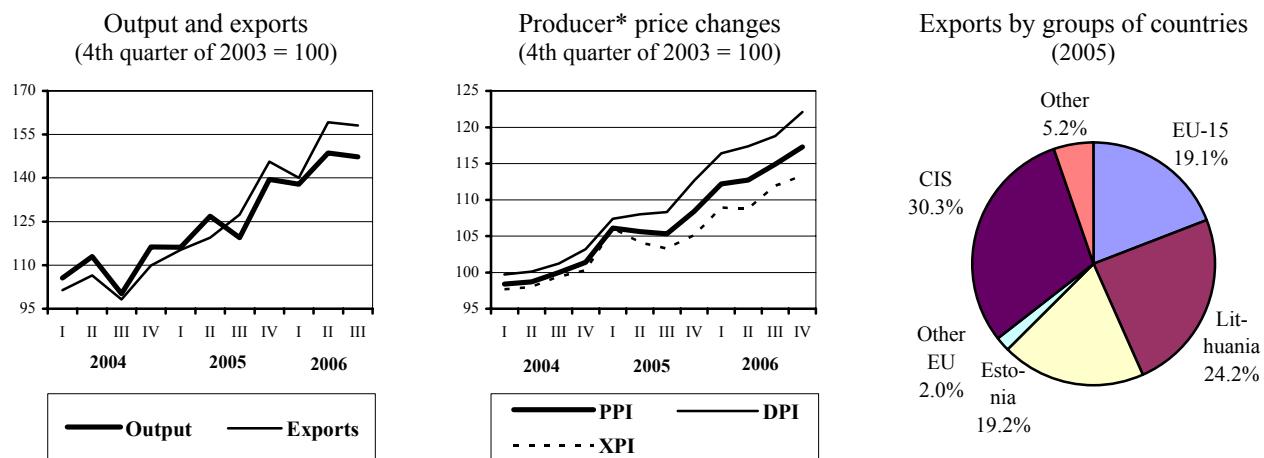
Figure 3.30



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

Figure 3.31

### Chemical, Rubber and Plastic Industry



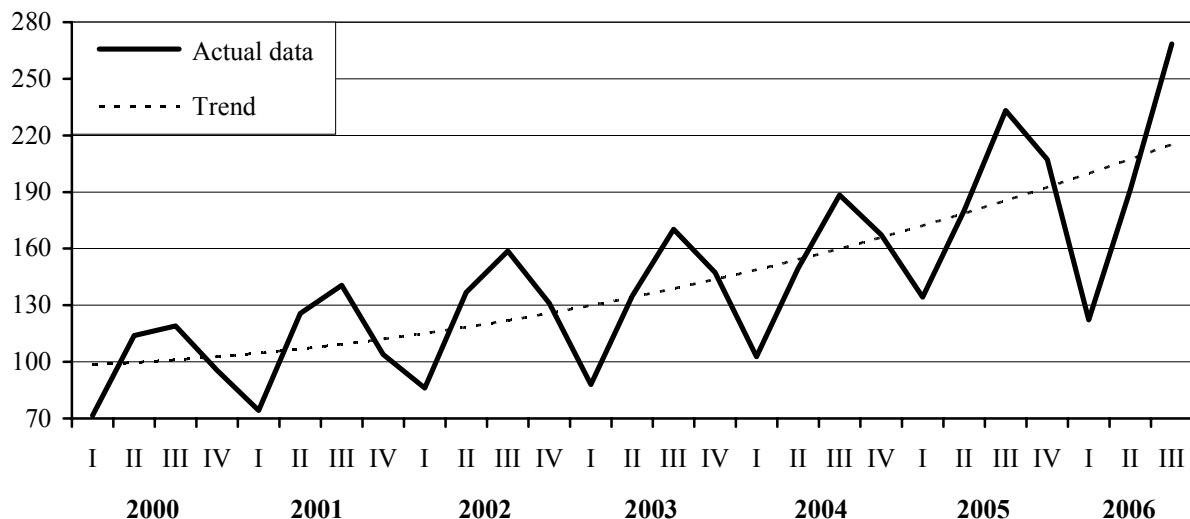
\* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Growth of the sector has been steady in the last 3 years. There have been periods of decline, for example, after the considerable growth of production volumes in 2002 they fell in 2003 and rapidly grew again by almost 20% in 2004 greatly due to increased demand in CIS countries. Growth rate is also high in 2006 – by almost 20% (according the results of 11 months), mainly due to expanded exports to CIS countries and increased demand in the domestic market.

**Manufacture of other non-metallic mineral products** (mostly construction materials) has very unstable growth rates. After steep growth by 15.3% in 2002, the growth was more moderate in 2003 (by 5.4%) but was rather fast again in 2004 and 2005 (by 12.5% and 24.1% respectively), while growth rate was lower again in January-November 2006 – by 4.9% (January-November 2006 over the respective period in 2005).

Figure 3.32

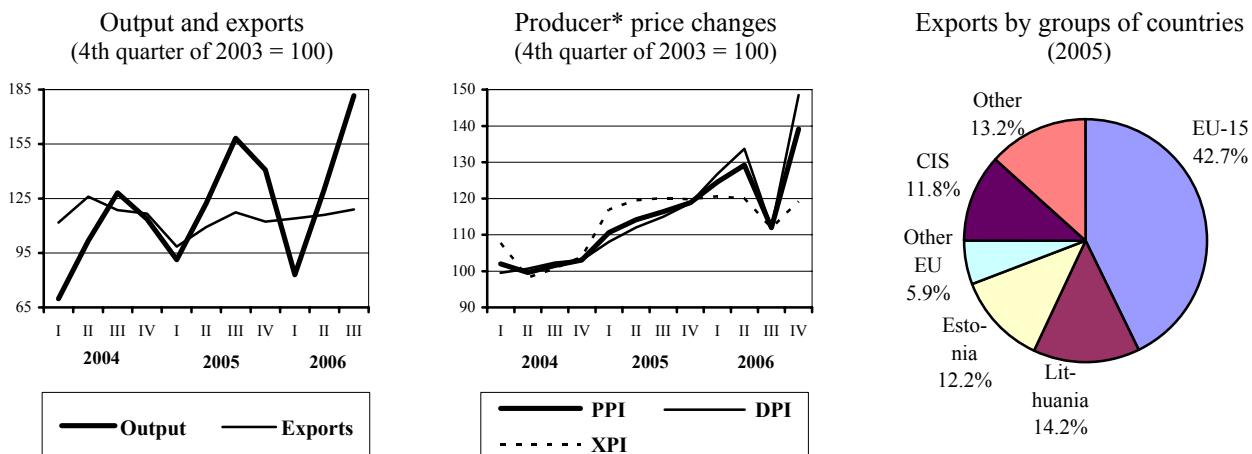
### Quarterly Growth Dynamics of Manufacture of Other Non-Metallic Mineral Products (level of 2000 =100)



Increase of the domestic demand is the main incentive for growth of the sector. As the domestic demand increased, prices for products sold in the domestic market rose rapidly while prices for exported products practically did not increase.

Figure 3.33

### 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

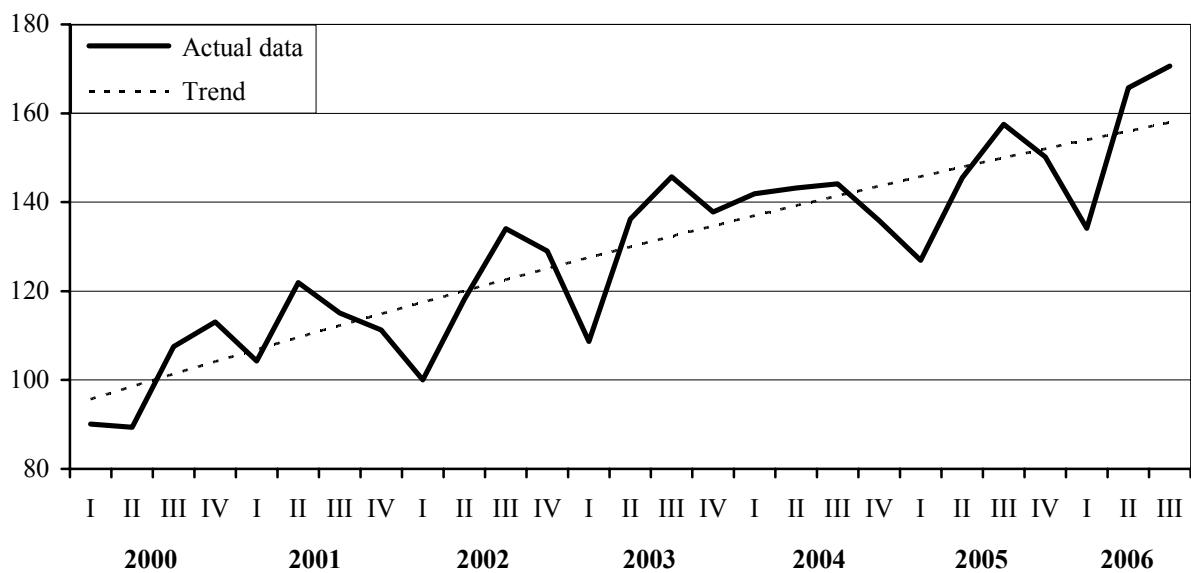
Production volumes fell in the 1st quarter of 2006 mainly due to unfavourable climatic conditions that reduced the domestic demand, while they increased substantially in the 2nd and 3rd quarters of 2006.

Sectors of **production of metals and metal articles** constitute about one-tenth of the total value added of manufacturing. Exports account for almost three-fourths of the total output of these sectors. The domestic market share tends to expand recently. Development of construction has resulted in increased demand for finished metal articles.

Figure 3.34

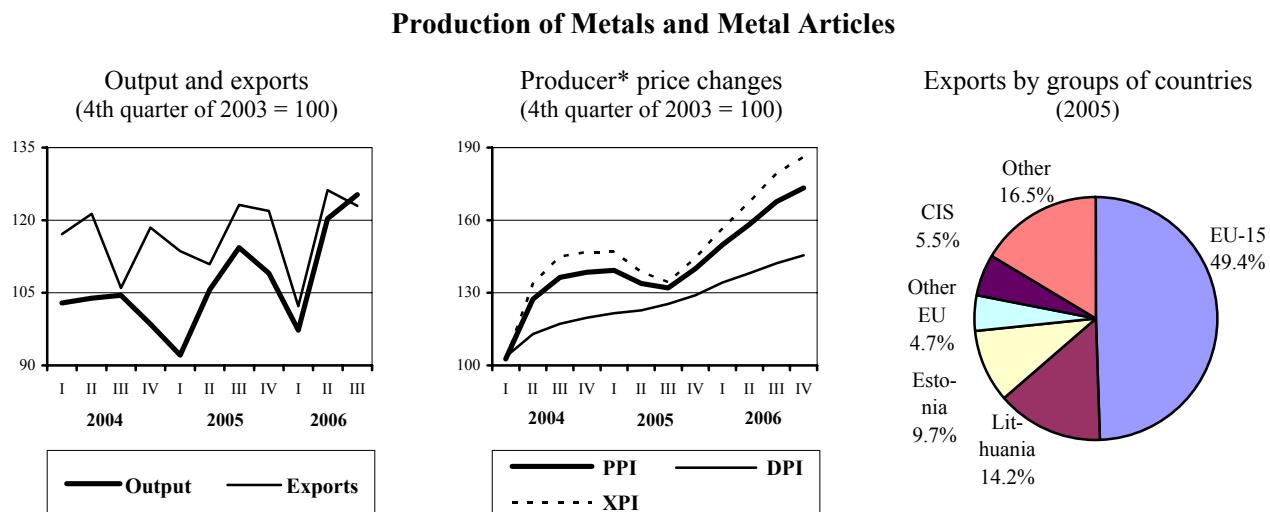
### Quarterly Growth Dynamics of Production of Metals and Metal Articles

(level of 2000 =100)



Average growth in the sector reached almost 7.7% in 2002-2003. 2004 was unfavourable year for the sector with decreased production volumes due to decline of exports and growth only resumed in the 2nd quarter of 2005. Production volumes in 2006 exceeded the level of the previous year by 9.4% (according to results of 11 months).

Figure 3.35



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

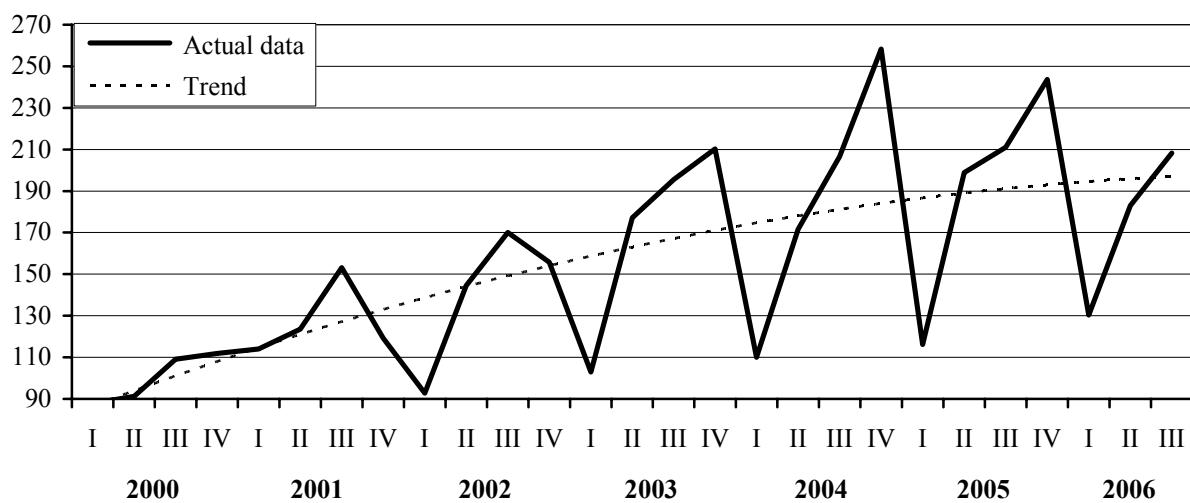
Producer prices in the sector have substantially increased in the last years both for domestically sold and for exported products, and the increase was considerably faster for exported products.

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

**Production of machinery and equipment** is a rapidly growing sector, and its production volumes have almost doubled in the last five years. It is a pronouncedly export-oriented sector, as three-fourths of the products are being exported.

Figure 3.36

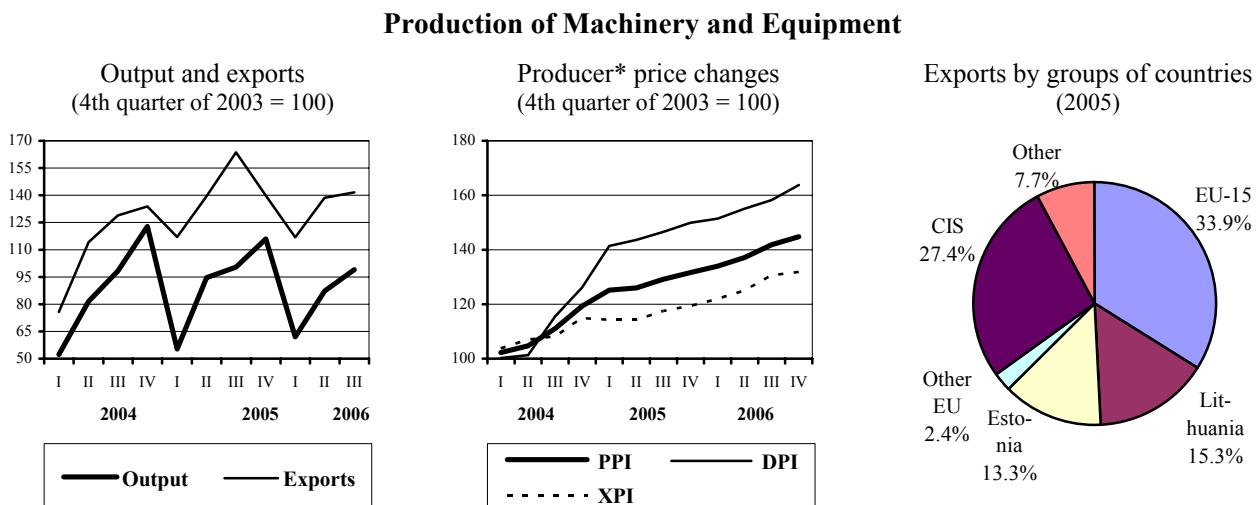
#### Quarterly Growth Dynamics of Production of Machinery and Equipment (level of 2000=100)



Growth of the sector was especially fast in 2001-2004 when its annual growth rates exceeded 10%. After accession to the EU, the growth of the sector is not so rapid. Output of January-November 2006 is practically at the level of the respective period in the preceding year (increase by 0.8%).

The main sales markets of the sector are EU member states, and almost half of the exports to the EU are to Lithuania and Estonia. Relatively big export share of the sector is related to markets of CIS countries.

Figure 3.37



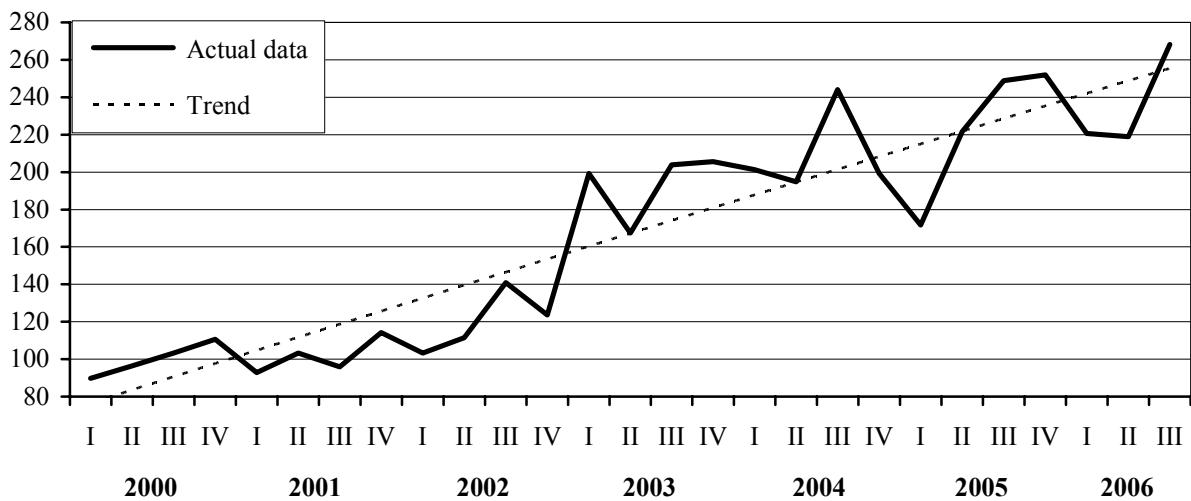
\* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

With increased demand in the domestic market, prices for products sold domestically have gone up rapidly in the last years, while the price increase for exported products was more moderate.

**Production of electrical and optical equipment** has developed rapidly in the recent years. Production volumes of the sector have almost doubled in the last five years.

Figure 3.38

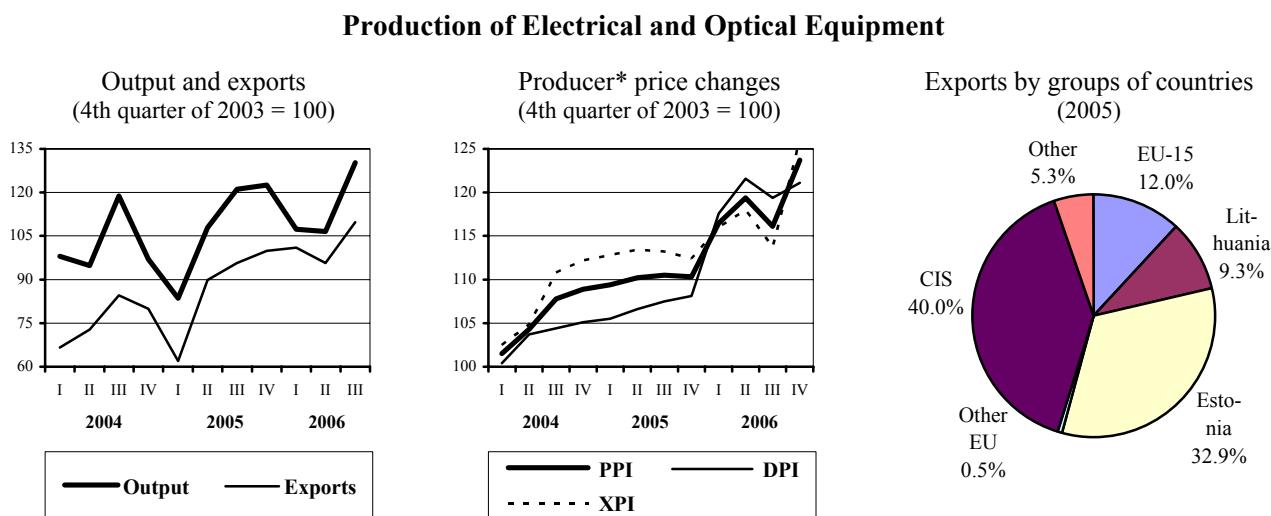
### Quarterly Growth Dynamics of Production of Electrical and Optical Equipment (level of 2000 =100)



After accession to the EU, growth of the sector slowed down but remained at a stable level (6-8%). Production volumes of the sector in January-November 2006 were by 9.5% bigger than in the respective period of 2005.

The sector has not managed to enter into markets of the developed countries but has stable trade partners in CIS countries and Estonia.

Figure 3.39



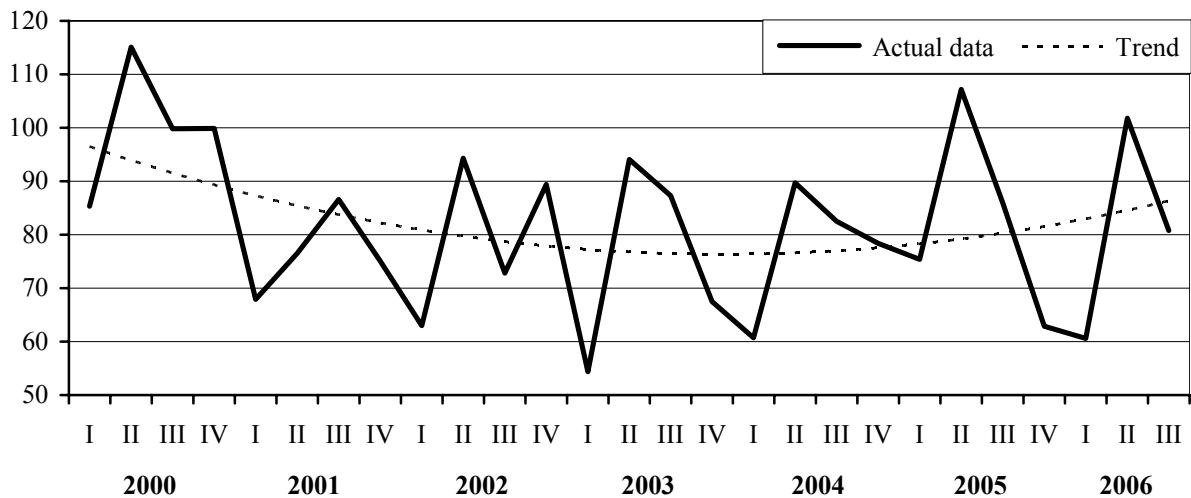
\* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

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

**Production of transport vehicles** is the only manufacturing sector that does not manage to increase production volumes, and they are lower by almost one-fifth in comparison with 2000. The volumes were slightly raised since 2004 after decreased output in the previous years, but in 2006 they were lower than in 2005.

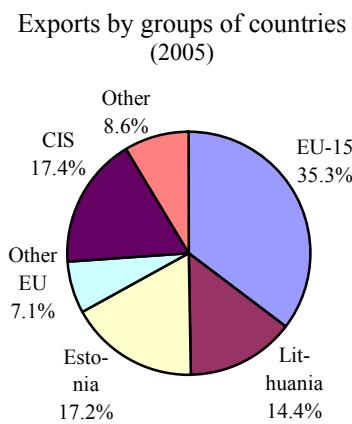
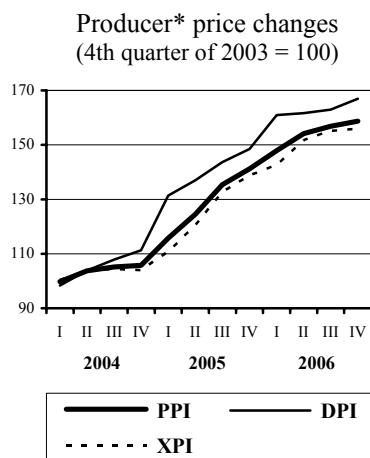
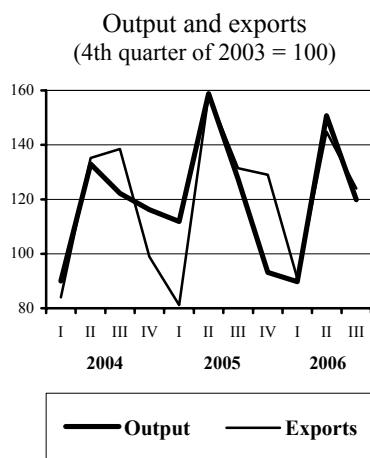
Figure 3.40

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



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

**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 share of products sold domestically in the total sales of products increases year by year, and accordingly prices of products sold in the domestic market rise faster.

### 3.3.3. Energy Sector

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

In 2005 the total energy consumption of Latvia was 204 PJ, and 60.4% of this consumption was ensured by imports of energy resources mostly from Russia (natural gas comprising 32.7%, heavy oil – 1.6%, other oil products – 26.6%, coal – 1.5%). Among local energy resources, wood was used the most (firewood, remainders of woodworking, wood chip, wood briquettes and granules), comprising 29.1% of the total energy consumption. Share of the electricity generated by Latvian HPPs and wind power stations in the total energy consumption was 6%.

Table 3.15

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

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

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

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

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

In 2005 the state JSC Latvenergo generated 64.5% of the required electricity, 30.5% was supplied by other countries and 5% was purchased from small producers of electricity. In comparison with the preceding year, the electricity consumption has increased by approximately 3.7%.

Table 3.16

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

Components of electricity supply	2000	2001	2002	2003	2004	2005
<b>Total electricity supply</b>	<b>5.922</b>	<b>6.163</b>	<b>6.323</b>	<b>6.608</b>	<b>6.786</b>	<b>7.051</b>
<b>Electricity generation – total</b>	<b>4.136</b>	<b>4.280</b>	<b>3.975</b>	<b>3.975</b>	<b>4.689</b>	<b>4.903</b>
of which:						
HPP <sup>2</sup>	2.799	2.801	2.433	2.216	3.044	3.267
CHP <sup>3</sup>	1.163	1.246	1.238	1.363	1.225	1.278
other CHP	0.150	0.198	0.263	0.298	0.306	0.254
small HPS	0.020	0.032	0.030	0.050	0.065	0.058
wind generators	0.004	0.0034	0.011	0.048	0.049	0.046
<b>Imports of electricity</b>	<b>1.786</b>	<b>1.883</b>	<b>2.348</b>	<b>2.633</b>	<b>2.097</b>	<b>2.148</b>

<sup>1</sup> Source: state JSC Latvenergo, Ministry of Economics, CSB

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

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

Some key conclusions from the Informative Report “*On Situation in the Electricity Supply of Latvia*” of the Ministry of Economics are presented below:

- Ministry of Economics in co-operation with representatives of energy companies, scientists, economists and representatives of associations has drafted the policy planning document “Guidelines of Energy Sector Development for 2007-2016”. The guidelines include the governmental policy, development targets and priorities in the energy sector both in medium-term and in long-term;
- In the period after 2009, the current excess capacity generated by energy systems of the neighbouring countries will diminish and Latvia’s opportunities to ensure import of electricity will decrease;
- The present development of situation in the Baltic energy supply indicates that an optimal future solution for basic capacities of electricity supply is represented by construction of a new nuclear power plant unit in Lithuania, using the current infrastructure of the Ignalina nuclear power plant;
- Riga CHP-1 is a positive gain for both the state and Riga city. The State Loads Centre has new basic capacities of 144 MW, and the centralised heat supply system of the right bank of the Daugava river in Riga has a new safe source of heat energy;
- Recently conducted studies on the security of Latvia’s electricity supply indicate that the co-generation plant projects that are already completed, under implementation or to be started (the new Riga CHP-1; construction of Imanta CHP; reconstruction of Riga CHP-2) or participation in construction of a nuclear power plant in longer term are insufficient for safe electricity supply of the country. Necessity of one more new basic power plant in Latvia is seen rather clearly. In view of the evident necessity to diversify the energy supply structure of Latvia, this plant would use solid fuel (obviously, coal), admixing biofuel in it;
- Transit electric lines between Lithuania and Kaliningrad region are unburdened after starting the new 1st energy unit of Kaliningrad CHP-2. As a result, heightened voltage levels (especially in Liepāja and Klaipeda units) create problems for transmission system operators (TSOs) of Latvia and Lithuania. Transmission grid links in Belarus and Russia are being unburdened, creating bigger opportunities for Latvia to import electricity from Russia. However, incomes of Latvian and Lithuanian TSOs for maintenance of electricity grid and compensation of electricity losses from Russian electricity transit to Kaliningrad region will decrease;
- Transmission grid will be able to ensure the necessary electricity flows in normal (standard) regimes if its renovation will take place in the current amounts.

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

The biggest consumers of natural gas are CHPs and heat supply enterprises of Latvenergo (61%), industry (21%) and other consumers (18%). Riga region accounts for 80% of the total natural gas consumption in Latvia. Natural gas is not used at all in Latgale region, with the exception of Daugavpili 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 metalurgs"), while in Zemgale region it amounts to 4% (in Jelgava city and Bauska district).

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

Oil products have an important place in Latvian market of energy resources; their market share is slightly lower than 30%, including the share of heavy fuel in oil fuel balance amounting to approximately 6%. The biggest consumers of heavy oil are heat supply (66.7%) and industry (14%). Complying with above-mentioned requirements of EU Directive 1999/32/EC, the Cabinet of Ministers adopted Regulation No. 125 "Regulation on the Limitation of Sulphur Content in Certain Liquid Fuels" on March 2, 2004. It is expected that the heat supply companies that used heavy oil for heat generation will replace this type of fuel with other energy resources.

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

*Solid fuels* used in Latvia are coal imported from CIS and local fuels (firewood and peat). The forecast of firewood consumption depends on the extent to which regions will manage to change from the extensive use of firewood to its rational use. In the total fuel consumption, the share of firewood is already quite substantial and has reached 29-30%. The biggest consumers of firewood are households (48.7%), heat supply companies (24.8%), industry (mainly wood processing companies) and other consumers (29.5%). Firewood and coal are used evenly across all regions of Latvia. Use of peat in the energy sector keeps decreasing.

## 3.4. Development of Regions

By the Cabinet of Ministers Instruction No. 271 of April 28, 2004 "On Statistical Regions of the Republic of Latvia and Administrative Units Included in them", Latvia was divided into six statistical regions (see Table 3.17).

Table 3.17

**Area, Population and Population Density of Latvia's Statistical Regions at the Beginning of 2006**

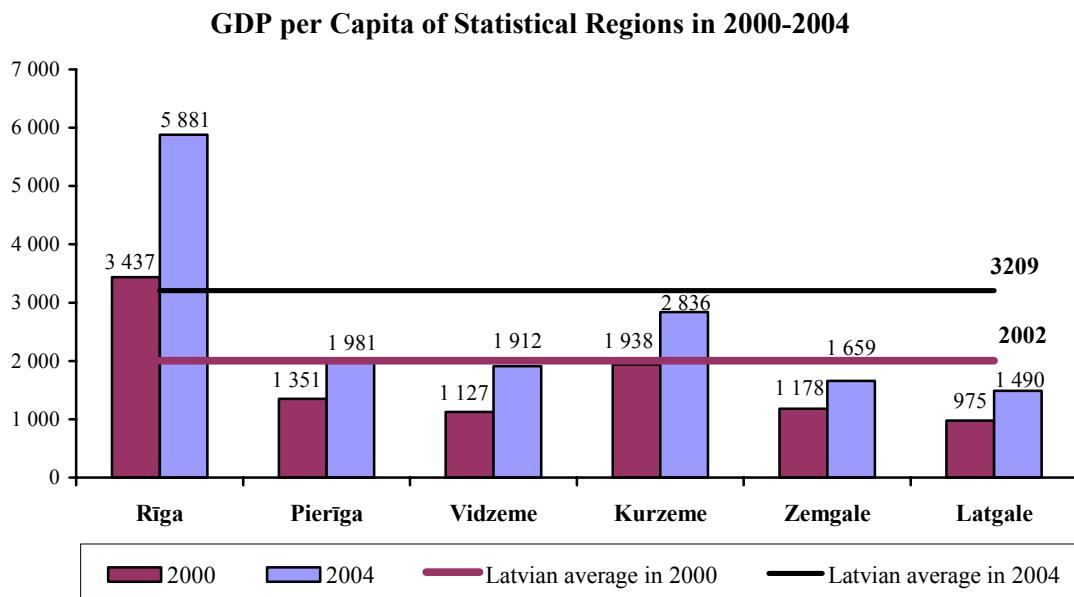
	Area (% of the total)	Population (% of the total)	Number of inhabitants per km <sup>2</sup>
<b>Latvia</b>	<b>100</b>	<b>100</b>	<b>35.5</b>
Riga	0.5	31.7	2 368.4
Pierīga	15.7	16.1	36.4
Vidzeme	23.6	10.6	15.9
Kurzeme	21.1	13.4	22.7
Zemgale	16.6	12.5	26.7
Latgale	22.5	15.7	24.7

Analysis of data on **GDP by regions** leads to a conclusion that its growth is faster in the most developed regions. There is an essential difference between Riga and other regions of Latvia (see Figure 3.42), while the differences of GDP level (GDP per capita) and growth dynamics between other regions are not so pronounced.

Level of production is very low in Pierīga, Vidzeme, Zemgale and Latgale regions, and GDP per capita of these regions in 2004 did not even reach the average of Latvia in 2000. In 2004, only Kurzeme region was close to the average.

In 2004 the biggest part of Latvian GDP (almost 60%) was produced in Riga. The second biggest region by contribution to GDP was Kurzeme (11.9%).

Figure 3.42

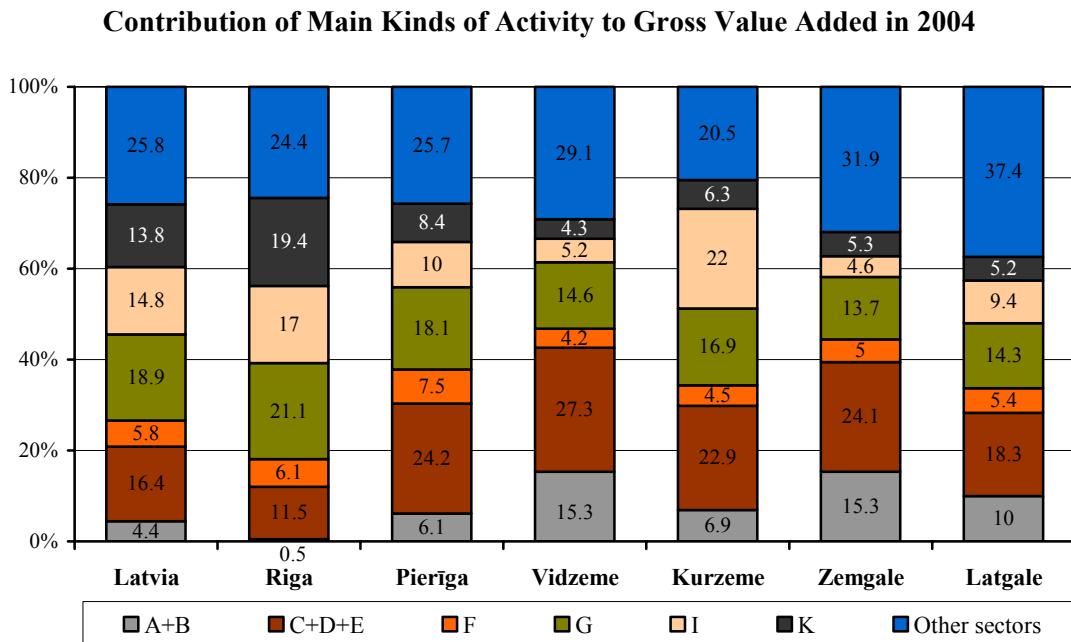


Riga was the most developed city, exceeding the Latvian average GDP per capita by 83%, and was followed by Ventspils (70%). This indicator was the lowest in Daugavpils district (LVL 859 in 2004) and was 6.8 times lower than the one in Riga.

In 2000-2004, the growth of GDP per capita was the fastest in Ventspils district (2.8 times), Madona district and Saldus district (2 times).

The trend remains the same that regions with a relatively low GDP per capita have a bigger share of public services and industry in the total economic activities (see Figure 3.43). The share of industry and public services in Vidzeme, Zemgale and Latgale regions was bigger than a half of the total value added, while in Latgale region this share was more than one-third. Substantial part of the total value added in Riga is made by financial services (7.3%) that are not developed in other regions. The shares of the value added of transport and communications and industry is traditionally high in Kurzeme region.

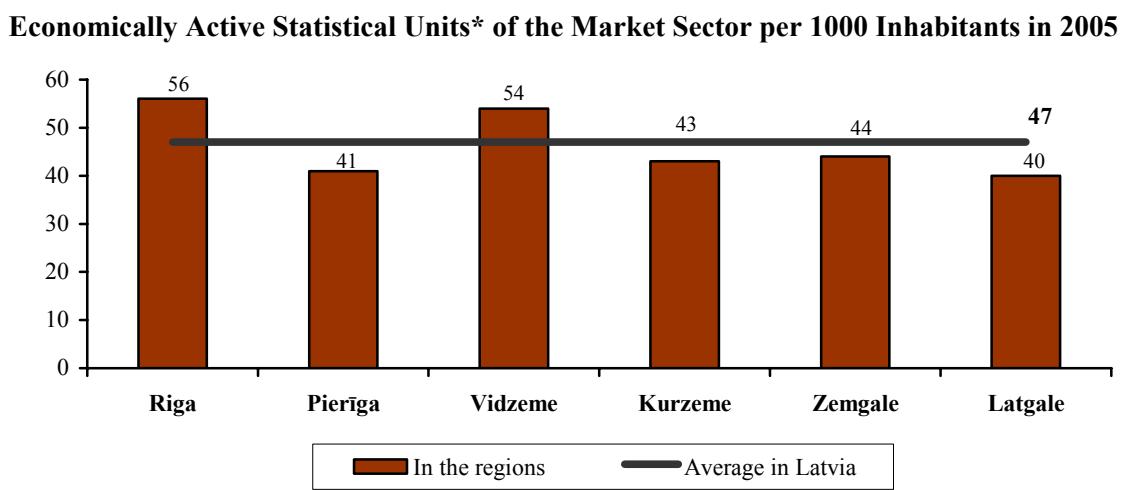
Figure 3.43



A+B – agriculture, forestry and fisheries; C+D+E – manufacturing industry; F – construction; G – trade; I – transport and communications; K – commercial services.

The number of **active statistical units** (self-employed persons, sole proprietors, commercial companies, peasant and fishermen's farms) is growing gradually in Latvia. This indicator is approximately the same in Pierīga, Kurzeme, Zemgale and Latgale regions (40-44 units per 1000 inhabitants). In Riga and Vidzeme regions, this indicator is higher than the average in the country. There is a high number of registered commercial companies in Riga (39 units per 1000 inhabitants). In Vidzeme, the number of self-employed persons is relatively higher and the number of peasant and fishermen's farms is absolutely higher (27 and 14 units per 1000 inhabitants respectively).

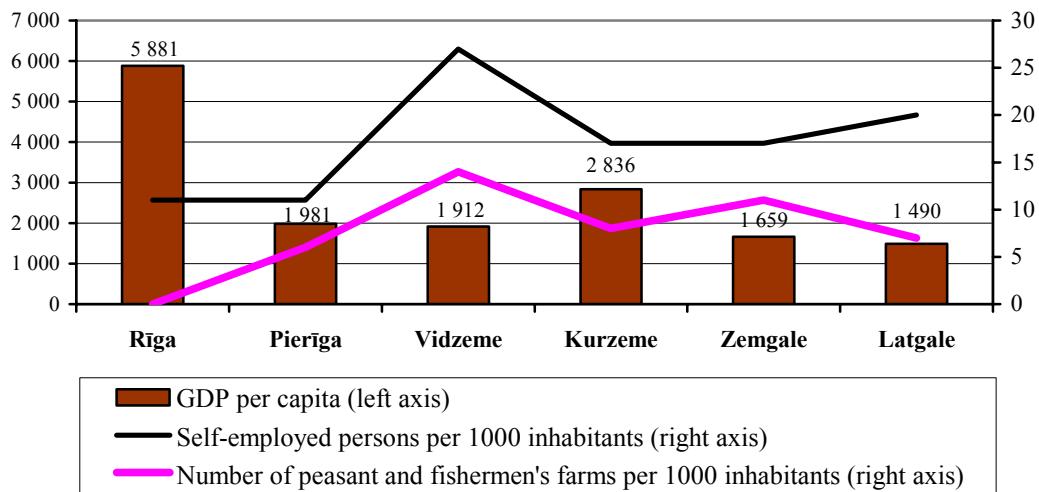
Figure 3.44



\* Statistical units of the market sector are: self-employed persons, sole proprietors, commercial companies, peasant and fishermen's farms.

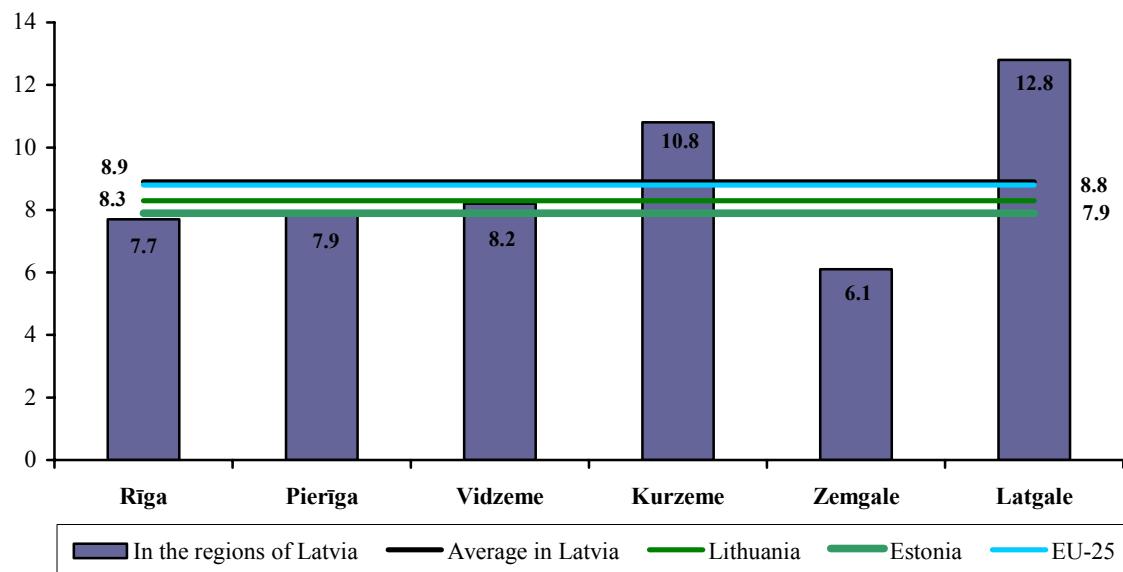
Although a high number of active statistical units is registered in Vidzeme region, GDP per capita is low in this region because the contribution of self-employed persons and peasant and fishermen's farms to formation of GDP is relatively small (see Figure 3.45).

Figure 3.45

**GDP per Capita, Self-Employed Persons and Peasant and Fishermen's Farms by Regions in 2004**

**Unemployment rate** in Latvia was 8.9% in 2005 and had decreased by 1.5 percentage points in comparison with 2004. Rapid economic growth of the country in 2005 fostered creation of workplaces and the unemployment rate decreased in many Latvian regions. Unemployment fell sharply in Zemgale to 6.1% (by 4.7 percentage points) and in Riga to 7.7% (by 2.6 percentage points), while in Pierīga and Vidzeme it decreased by 1.1-1.2 percentage points (see Figure 3.46).

Figure 3.46

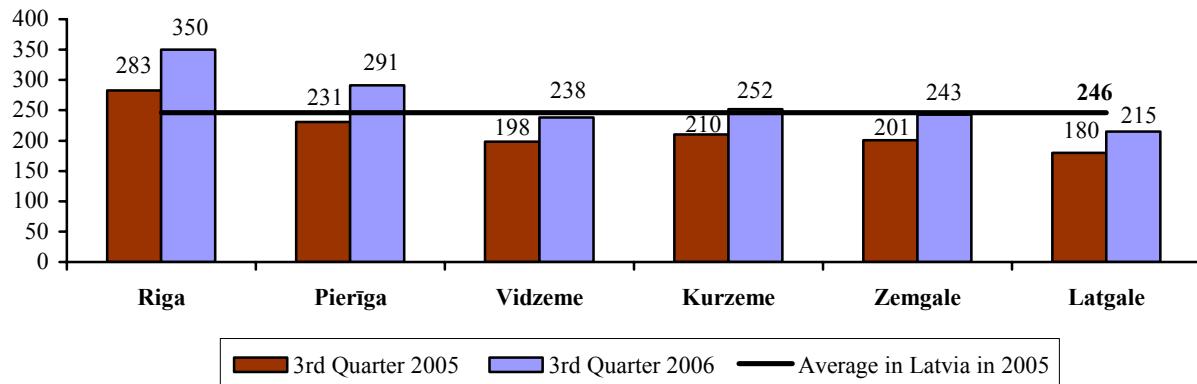
**Unemployment Rate\* in 2005**  
(%, by data of random survey of labour force)

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

Along with the growth of demand for labour force and increase of its productivity, **wages** also grow. In 2005 it grew most rapidly in Riga (by 18.0%). Growth of wages was also substantial in Pierīga, Zemgale and Vidzeme (by 17.0%, 15.0% and 15.0% respectively). Wages in Kurzeme and Latgale increased at a more moderate pace (by 12.0%). The highest wages are paid in Riga, while the lowest ones are paid in Latgale (see Figure 3.47).

Figure 3.47

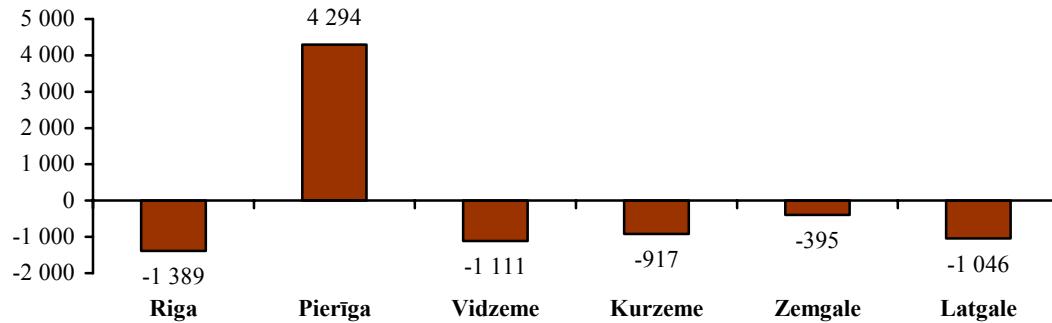
**Average Monthly Gross Wages and Salaries at the Main Job in 3<sup>rd</sup> Quarter 2006**  
 (average per month, LVL)



The long-term negative **net migration** is higher in regions with lower payment for work, such as Vidzeme and Latgale (see Figure 3.47), however, it was highest in Riga in 2005. High negative migration balance of Riga may be explained by the fact that people buy real estates in Pierīga (vicinity of Riga) and probably register their residence in them, as the highest and the sole positive net migration was only observed in Riga district and Ogre district (3795 and 377 persons respectively). However, this may also be a short-term effect, and the negative net migration may substantially diminish in the next years. It has to be noted that not all people arriving from other regions register their residence, so the data may incompletely reflect the real situation.

Figure 3.48

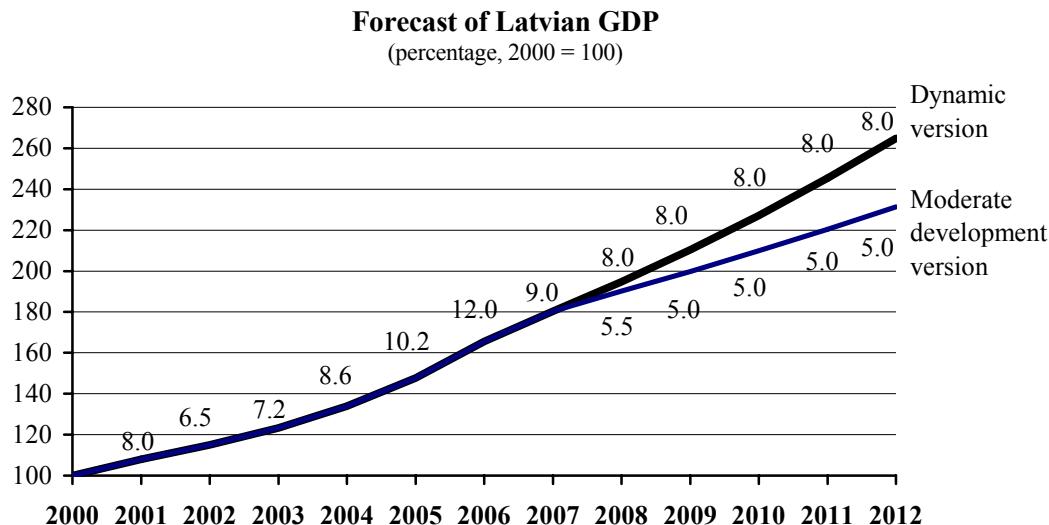
**Net Long-Term Migration of Population in 2005**



### 3.5. Forecasts

The Ministry of Economics has developed two versions of economic development forecasts for the medium-term period (until 2012): for the dynamic development scenario, where economic development in the medium-term maintains the current high development rates or slightly lower ones (dynamic version), and for the slower development scenario, where economic growth slows down due to decreased external and domestic demand (moderate development version).

Figure 3.49



### **Development prospects in 2007**

It is foreseen that the current trends of development will be in progress in 2007 as well, namely, the stable domestic demand and expansion of export possibilities.

According to forecasts, the private consumption and GDP will increase at the same rate. This will be ensured by the growing incomes of population both through the increase of wages and the expansion of opportunities to use consumption credits and mortgage loans.

Investment will increase faster than the private consumption, which will be affected by the growth of previous years and the positive future expectations of entrepreneurs as well as the good crediting conditions. Investment growth will also be stimulated by the opportunities to use EU funds, which will increase both the public and private sector investments.

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

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

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

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

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

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

Table 3.18

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

	2006	2007	2008-2012 * (annual average)
<b>Gross domestic product</b>	<b>12.0</b>	<b>9.0</b>	<b>5.1 / 8.0</b>
Primary sectors	-1.3	5.0	3.2 / 5.0
Manufacturing	7.0	8.0	5.2 / 10.2
Electricity, gas and water supply	6.8	3.0	2.0 / 3.0
Construction	14.1	13.0	6.7 / 15.0
Trade, hotels and restaurants	18.2	13.0	6.4 / 7.1
Transport and communications	10.7	9.0	5.7 / 7.8
Other commercial services	16.5	9.0	4.8 / 8.4
Public services	2.5	2.5	2.0 / 2.5

\* Scenario I in the numerator, Scenario II in the denominator

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

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

### **Development prospects in 2008-2012**

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

Table 3.19

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

	2006		2007		2008-2012 * (annual average)	
	structure	growth rate	structure	growth rate	structure (in 2012)	growth rate
<b>Gross domestic product</b>	<b>100</b>	<b>12.0</b>	<b>100</b>	<b>9.0</b>	<b>100</b>	<b>5.5 / 8.0</b>
Private consumption	63.4	17.0	64.6	12.0	68.9 / 66.1	6.0 / 7.7
Public consumption	16.1	3.0	15.2	3.0	14.1 / 13.1	2.5 / 2.8
Gross fixed capital formation	32.1	18.0	34.8	15.0	33.6 / 34.3	6.0 / 7.1
Changes in inventories	8.9	–	5.7	–	1.7 / 0.0	–
Exports	45.5	11.0	45.0	10.0	44.7 / 48.4	6.5 / 9.6
Imports	-66.0	16.0	-65.3	10.0	-63.0 / -62.0	6.0 / 9.8
Export-import balance	-20.5	–	-20.3	–	-18.2 / -13.5	–

\* Scenario I in the numerator, Scenario II in the denominator

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

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

## 4. Macroeconomic Stability

### 4.1. State Finances

#### 4.1.1. Fiscal Policy and Public Debt

The government of Latvia implements a fiscal policy aimed at balanced economic growth and stability of state finances.

Main priorities of the government for 2005-2008 in the fiscal policy area<sup>1</sup> are to fulfil the Maastricht fiscal criteria and ensure efficiency of the budget spending by:

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

In order to reach the mentioned goals, the ministries gradually introduce the strategic planning, hence formation of budget is being based on the financing of action policy goals and results. On August 22, 2006 the Cabinet of Ministers adopted draft concept “*On Introduction of the Strategic Planning and Medium-Term Budget Planning in the Public Administration*”, which prescribes development of budget law for one year, at the same time also developing a resource framework for three years. It is envisaged to introduce a medium-term 3-year budget planning, starting with the budget planning for 2008. Making the necessary amendments and other changes to normative acts is currently under way.

Since 2000 the fiscal deficit of the general government consolidated budget in Latvia has been lower than 3% of GDP allowed by the Maastricht Treaty (see Table 4.1). Continuing gradual reduction of the budget deficit, it is forecasted that Latvia will achieve a balanced budget in 2010.

Table 4.1

#### General Government Consolidated Budget

	2002	2003	2004	2005	2006 e
Revenues (million LVL)	1874.0	2107.4	2522.2	3199.8	4029.1
(% of GDP)	32.5	33.0	34.0	35.8	36.7
Expenditures (million LVL)	2022.0	2212.5	2599.6	3297.8	4127.6
(% of GDP)	35.1	34.6	35.1	36.9	37.6
Net loans (million LVL)	-17.5	-2.7	1.0	7.3	-67.2
Fiscal balance (million LVL)	-130.5	-102.4	-78.4	-105.2	-31.4
(% of GDP)	-2.3	-1.6	-1.1	-1.2	-0.3
Fiscal balance according to the ESA 95					
(% of GDP)	-2.3	-1.2	-0.9	0.1	....

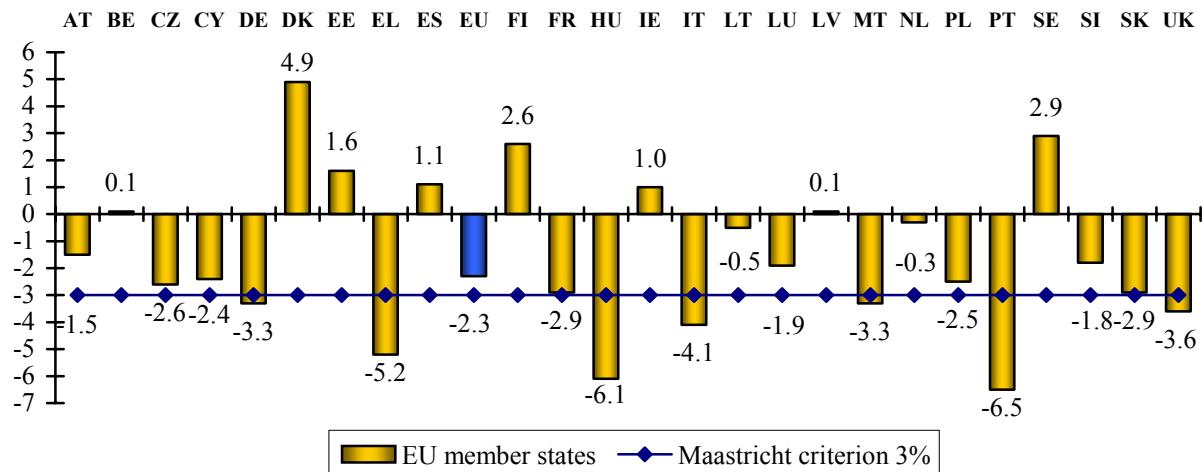
e – evaluation by the Ministry of Finance

<sup>1</sup> Defined in the *National Lisbon Programme of Latvia for 2005-2008*.

As seen in Figure 4.1, in 2005 the average level of the budget deficit in the EU was 2.3% of GDP<sup>1</sup> (2.7% of GDP in 2004, 3% of GDP in 2003). On the whole, public finances improved in 18 EU member states and deteriorated in 7 member states in 2005. In 2005 the biggest general government deficits as percentage of GDP were observed in Hungary (-6.5%), Portugal (-6%), Greece (-5.2%), and Italy (-4.1%). Eight EU member states showed general government surplus in 2005, among them Latvia where the budget surplus amounted to LVL 11.7 million or 0.1% of GDP according to the methodology of the ESA 95 European System of National Accounts.

Figure 4.1

### General Government Budget Deficit in EU Member States in 2005 (% of GDP)\*



\* According to the methodology of the ESA 95 European System of National Accounts.

AT – Austria, BE – Belgium, CZ – Czech Republic, CY – Cyprus, DE – Germany, DK – Denmark, EE – Estonia, EL – Greece, ES – Spain, EU – EU-25 member states, FI – Finland, FR – France, HU – Hungary, IE – Ireland, IT – Italy, LT – Lithuania, LV – Latvia, MT – Malta, NL – Netherlands, PL – Poland, PT – Portugal, SE – Sweden, SI – Slovenia, SK – Slovakia, UK – United Kingdom

Operational report of the Treasury on execution of the state budget indicates that the fiscal deficit of the state budget amounted to LVL 31.4 million in 2006 (including donations and gifts not planned in the budget) or 0.3% of GDP. The budget for 2006 was directed at rise of the social welfare level, integration in the EU and NATO, and efficient absorption of granted EU funds resources in the full amount, at the same time balancing the public support to social needs of the society.

The Saeima has approved the state budget for 2007 with a fiscal deficit in the amount of LVL 177.8 million or 1.4% of GDP. Revenues in the amount of LVL 4.2 billion and expenditures in the amount of LVL 4.4 billion are planned. Increase of state budget expenditures in 2007 in comparison with the plan for 2006 exceeds LVL 914.9 million or 26.3%. Tax revenues in the consolidated budget in 2007 are forecasted as by LVL 577.5 million or 21.9% higher than in 2006.

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

<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 showings calculated according to this methodology are set after the so-called principle of accrual basis but the general government budget deficit calculated by the Ministry of Finance of Latvia is set after the cash principle, and that is why they slightly differ.

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

By implementing a socially responsible policy, the minimum monthly wage was increased from LVL 80 to LVL 90 as from January 1, 2006 and to LVL 120 as from January 1, 2007, the monthly minimum not subject to personal income tax was raised from LVL 26 to LVL 32 as from January 1, 2006 and to LVL 50 as from January 1, 2007, and the monthly allowance for dependent person was increased from LVL 18 to LVL 22 as from January 1, 2006 and to LVL 35 as from January 1, 2007.

**Tax policy** of Latvian government envisages decreasing the tax burden on entrepreneurship in order to promote economic development and ensure competitiveness of the economy. In order to achieve this goal, the following measures have been taken:

- the rate of social security contributions is reduced from 38% in 1996 to 33.09% in 2003;
- the corporate income tax rate is lowered from 25% in 2001 to 15% in 2004;
- the real estate tax rate is brought down from the maximum level of 4% in 2000 to 1.5%.

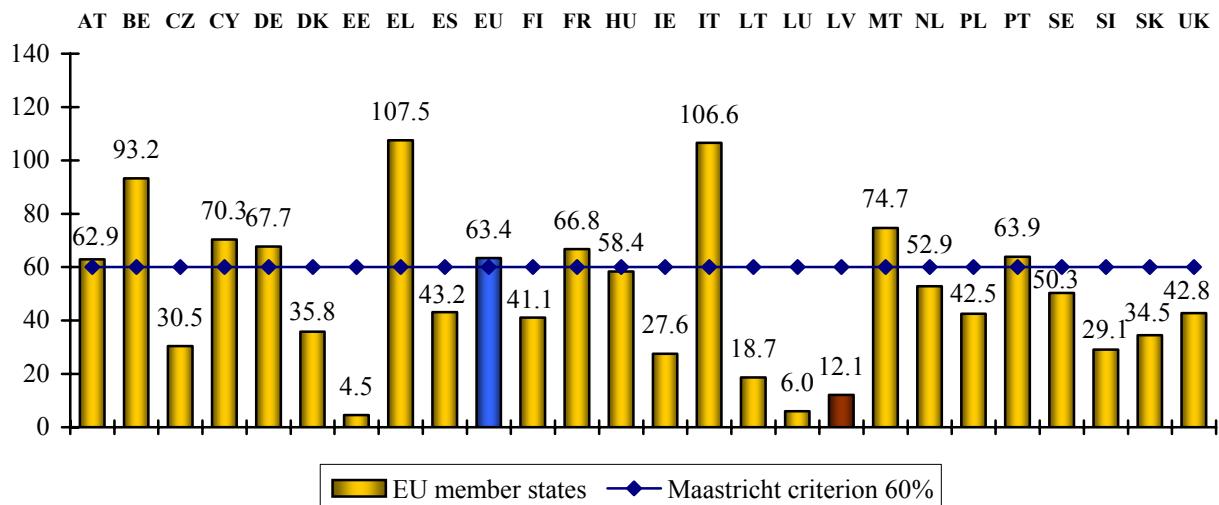
Due to the reduction of tax rates, the tax revenues in percentage of GDP have dropped from 32.9% in 1998 to 28.5% in 2005. Meanwhile, the tax base has been broadened, excluding taxable exemptions and improving administration of revenues.

On February 14, 2006 the government conceptually supported a proposal to gradually decrease the personal income tax rate to 15%.

The level of the **central government debt** in Latvia is the third lowest in the EU (see Figure 4.2). In 2005 the EU average level of the central government debt was 63.2% of GDP<sup>1</sup>. In 2005 the highest central government debt in percentage of GDP was observed in Greece (107.5%), Italy (106.6%) and Belgium (93.2%), while the lowest general government debt in percentage of GDP was registered in Estonia (4.5%), Luxembourg (6.0%), Latvia (12.1%) and Lithuania (18.7%).

Figure 4.2

#### Central Government Debt in EU Member States in 2005 (% of GDP)\*



\* According to the methodology of the ESA 95 European System of National Accounts.

AT – Austria, BE – Belgium, CZ – Czech Republic, CY – Cyprus, DE – Germany, DK – Denmark, EE – Estonia, EL – Greece, ES – Spain, EU – EU-25 member states, FI – Finland, FR – France, HU – Hungary, IE – Ireland, IT – Italy, LT – Lithuania, LV – Latvia, MT – Malta, NL – Netherlands, PL – Poland, PT – Portugal, SE – Sweden, SI – Slovenia, SK – Slovakia, UK – United Kingdom

In the last years, the central government debt in Latvia has increased from LVL 571 million at the end of 2000 to LVL 962 million at the end of 2005, while it has decreased in percentage of GDP from 12% to 10.8% of GDP respectively (see Table 4.2).

<sup>1</sup> According to the methodology of the ESA 95 European System of National Accounts.

Table 4.2

**Dynamics of Central Government Debt**  
(end of period, million LVL)

	2002	2003	2004	2005	2006*
<b>Central government debt</b>	<b>756.1</b>	<b>846.3</b>	<b>975.0</b>	<b>962.3</b>	<b>949.3</b>
including:					
<b>internal debt</b>	<b>291.6</b>	<b>426.7</b>	<b>423.0</b>	<b>421.7</b>	<b>363.5</b>
of which:					
short-term debt	37.9	52.7	73.0	70.1	36.7
medium-term debt	253.6	224.1	224.1	209.2	112.8
long-term debt	–	97.0	125.8	141.4	213.4
currency debt	–	52.7	–	0.6	0.6
<b>external debt</b>	<b>464.5</b>	<b>419.6</b>	<b>552.0</b>	<b>540.7</b>	<b>585.8</b>
of which:					
loans	209.2	137.6	133.1	122.0	165.4
Eurobonds	255.3	282.1	418.8	418.7	420.4
	(% of GDP)				
<b>Central government debt</b>	<b>13.1</b>	<b>13.2</b>	<b>13.2</b>	<b>10.8</b>	
of which:					
<b>internal debt</b>	<b>5.1</b>	<b>6.7</b>	<b>5.7</b>	<b>4.7</b>	
<b>external debt</b>	<b>8.1</b>	<b>6.6</b>	<b>7.4</b>	<b>6.0</b>	

\* end of September 2006

In order to ensure financing of the central government budget deficit, the state attracts resources from internal and external capital markets, using a variety of financial instruments. Up to now Latvia has tapped 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). The opportunities to use the instrument of Eurobonds in 2007 are being evaluated. Volumes of borrowings and their maturity terms will depend on state budget execution indicators, situation in the financial market, central government debt portfolio indices and other influencing factors.

#### 4.1.2. General Government Consolidated Budget Revenues

In 2005 and 2006, the budget revenues increased faster than GDP, and their volume as a percentage of GDP is growing. In 2005 the general government consolidated budget revenues amounted to LVL 3199.8 million or 35.8% of GDP. In 2006 they were LVL 4029.1 million or 36.7% of GDP (provisional data).

Table 4.3

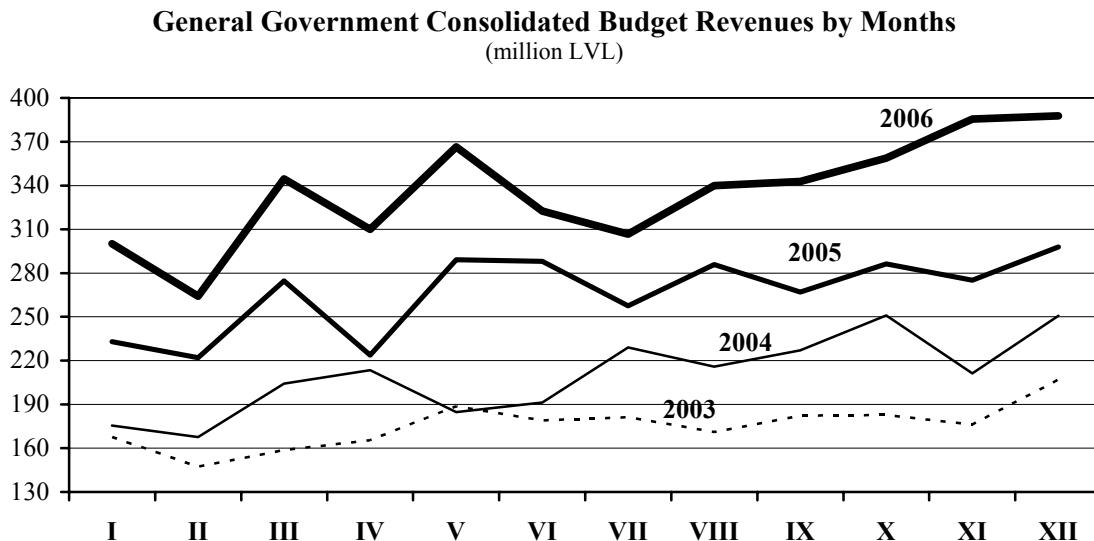
**General Government Consolidated Budget Revenues**  
(% of GDP)

	2001	2002	2003	2004	2005	2006 e
<b>Revenues</b>	<b>32.5</b>	<b>32.5</b>	<b>33.0</b>	<b>34.0</b>	<b>35.8</b>	<b>36.7</b>
<i>I Tax revenues</i>	<i>27.8</i>	<i>27.8</i>	<i>27.9</i>	<i>27.3</i>	<i>28.5</i>	<i>30.4</i>
<i>1. Indirect taxes</i>	<i>10.1</i>	<i>10.1</i>	<i>10.8</i>	<i>10.0</i>	<i>11.3</i>	<i>12.0</i>
– value added tax	6.7	6.7	7.2	6.6	7.6	8.5
– excise tax	3.1	3.1	3.3	3.2	3.5	3.3
– customs duties	0.3	0.3	0.3	0.2	0.2	0.2
<i>2. Income taxes and property taxes</i>	<i>8.2</i>	<i>8.3</i>	<i>8.0</i>	<i>8.4</i>	<i>8.4</i>	<i>8.9</i>
– corporate income tax	1.9	1.9	1.5	1.7	2.0	2.3
– personal income tax	5.4	5.5	5.7	5.9	5.7	6.0
– property taxes	0.9	0.9	0.8	0.8	0.7	0.6
<i>3. Social security contributions</i>	<i>9.2</i>	<i>9.2</i>	<i>8.8</i>	<i>8.6</i>	<i>8.4</i>	<i>9.1</i>
<i>4. Other taxes</i>	<i>0.3</i>	<i>0.2</i>	<i>0.3</i>	<i>0.3</i>	<i>0.4</i>	<i>0.4</i>
<i>II Non-tax revenues</i>	<i>4.7</i>	<i>4.7</i>	<i>5.1</i>	<i>6.7</i>	<i>7.3</i>	<i>6.3</i>

e – estimation by the Ministry of Economics

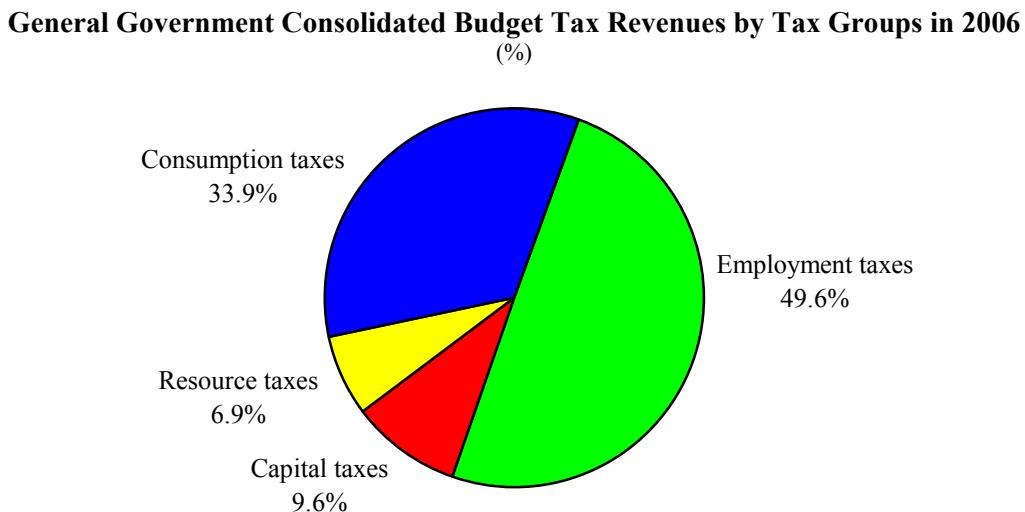
In 2006 the general government consolidated budget revenues exceeded the volume of the previous year by 25.9%, among them tax revenues increased by almost 29.6%. The most substantial increase was shown by corporate income tax revenues (by 40.5%), value added tax revenues (by 37.4%) and social security contributions (by 27.6%).

Figure 4.3



Considering the structure of tax revenues by separate tax groups, which comprise taxes depending on their influence on production factors and consumption, it should be noted that in 2006 the share of employment and consumption taxes has increased but the share of resource and capital taxes has decreased.

Figure 4.4



Almost half of all tax revenues or 15.1% of GDP is the collection of **employment taxes** (social security contributions and personal income tax).

Social security contributions in majority of the new EU member states are twice higher than the collection of personal income tax, while in the group of EU-15 countries they are approximately the same. In 2006 the social security contributions in Latvia amounted to almost LVL 1 billion, 1.5 times exceeding the collection of personal income tax. Besides, among the new EU member states, flat personal income tax rate is applied only in the Baltic States, while the other ones apply progressive personal income tax rate.

As from January 1, 2006 the non-taxable minimum was increased and tax allowances for dependent persons were raised. High tax burden on low wages still remains. For example, in 2006 it amounted to 37.8% for the minimum wage (for the employed without dependent persons).

The rapid growth of the collection of employment taxes in 2006 (by 31.5%) was mainly due to the increase of average pay for work in national economy (by 21.3% in the first 3 quarters of the year in comparison with the respective period of the preceding year) and the total increase of the number of employed persons (by 5.2% respectively).

The second biggest group of taxes is **consumption taxes** (value added tax, customs duties and excise tax on alcohol, tobacco, non-alcoholic beverages, coffee, and passenger cars).

82% of all taxes in this group are value added tax revenues. VAT rates are very strictly regulated in EU member states. Two types of rates are allowed – standard rate not lower than 15% and two reduced rates not lower than 5%. As from January 1, 2003, along the standard VAT rate of 18%, also a reduced rate of 5% is applied in Latvia. This reduced rate may be applied to pharmaceuticals, infant food, press publications, guest accommodation and utilities. As from January 1, 2007, a VAT rate of 5% will be applied to electricity and natural gas supplies for population and to hairdressing services.

It should be noted that the average VAT rate is slightly higher in the new EU member states (20.2% in 2003) than in EU-15 countries (19.6%). The lowest standard rate of 15% is applied in Cyprus and Luxembourg, while the highest VAT rates are in Sweden and Denmark (25%) as well as in Finland and Poland (22%).

Collection of the value added tax increased considerably in 2006 due to rapid rise of the domestic demand and to high inflation and was by 37.4% bigger than in the previous year.

Excise tax revenues on tobacco products in 2006 are by 15% higher than in 2005. Growth of the excise tax revenues is also expected in 2007, which can be explained by increased excise tax rate on tobacco products.

The share of customs duties in the total tax revenues decreases every year. In 2006, customs duties amounted to mere 0.6% of the total tax revenues. Essential changes in customs duty revenues are related to the fact that, as from May 1, 2004, customs duties are not applied to transportation of goods within the EU but the customs tariffs set by the EU are applied to goods imported from countries outside the EU.

**Capital taxes** (corporate income tax and property taxes) amounted to 9.7% of all taxes in 2006.

Collection of the corporate income tax rapidly increases in the last years. Collection of this tax in 2006 was by 40.5% bigger than in 2005. Along with the fast economic growth, profit of entrepreneurs increases. Corporate income tax rate in Latvia (15%) is among the lowest in the EU. Only Ireland has a lower rate (12.5%).

Immovable property tax revenues increase at a slower pace (by 7.7% in 2006). Faster growth of the volume of property tax revenues is expected in 2007, which is related to application of the cadastral value to buildings, thereby expanding the tax base.

The group of **resource taxes** comprises two taxes, namely, the excise tax on oil products and the natural resource tax; the excise tax makes the biggest share in the group (95.2% in 2006). Proportion of these taxes in the total tax revenues has decreased in 2006.

Collection of the excise tax on oil products has increased in 2006 and exceeds the level of the preceding year by 16%. Excise tax revenues on oil products constitute almost two-thirds of the total collection of excise tax.

Payments of natural resource taxes are directly linked with economic activities of Latvian companies and environmental loads caused by them. Hence, there are both the conditions that foster increase of tax revenues (growth of economic activities) and the conditions that decrease tax revenues (environmental protection measures carried out by companies and local governments). Collection of this tax in 2006 was by 14.5% bigger than in 2005.

#### 4.1.3. General Government Consolidated Budget Expenditures

General government consolidated budget expenditures increased by 25.2% in 2006 in comparison with the previous year, while their amount as a percentage of GDP grew from 36.9% in 2005 to 37.6% in 2006.

In 2006, current expenditures and transfers to the private sector went up by 24%, while capital expenditures increased by 63%.

Figure 4.5

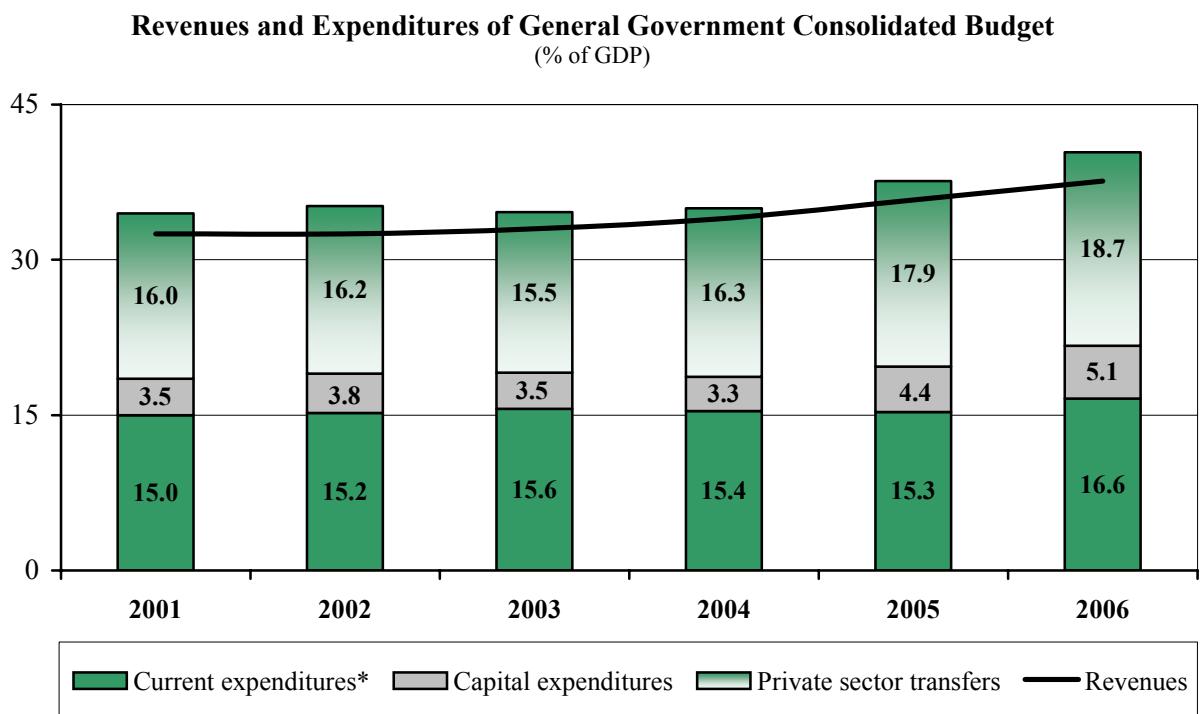
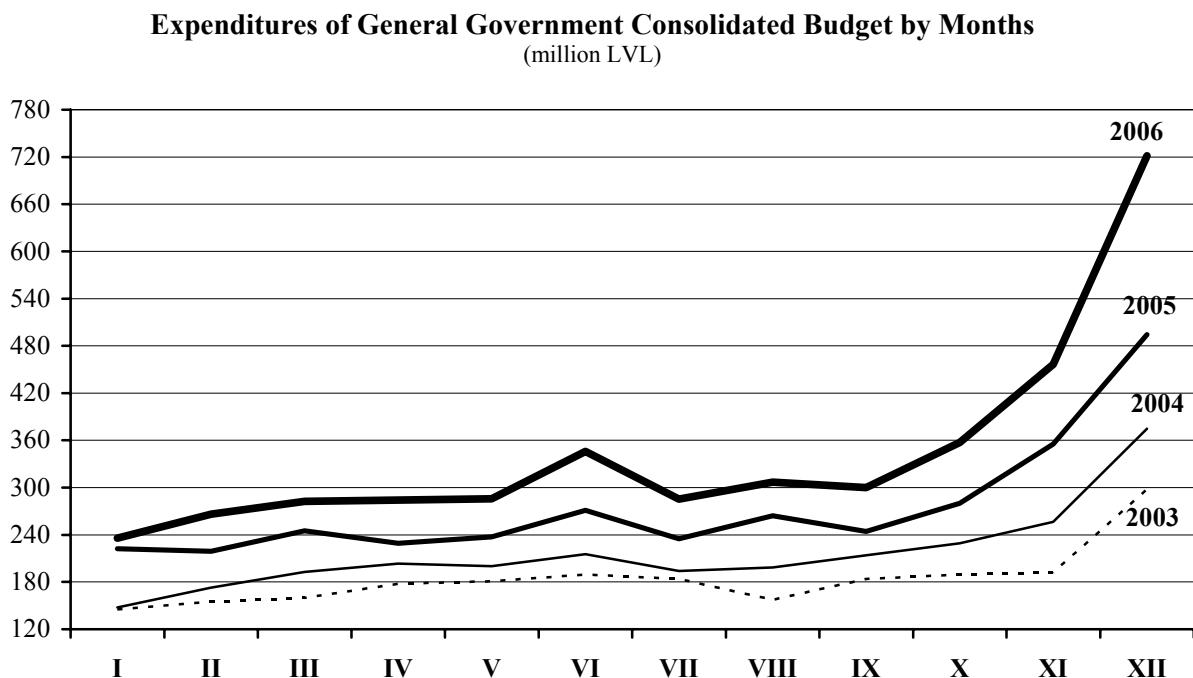


Figure 4.6



In 2006, expenditures for transport and communications increased most rapidly – almost 1.5 times, due to use of the EU structural funds in construction and reconstruction of roads. Big contribution to the growth of the total budget expenditures was made by the increase of expenditures for education and social security and welfare.

Table 4.4

**Expenditures of General Government Consolidated Budget**  
(percentage)

	2005		2006		2006
	structure	of GDP	structure	of GDP	Changes against 2005*
<b>Expenditures – total</b>	<b>100</b>	<b>36.9</b>	<b>100</b>	<b>42.0</b>	<b>24.6</b>
general government services	7.8	2.9	9.6	4.0	76.9
Defence	3.3	1.2	3.7	1.5	55.3
public order and safety, law enforcement	5.8	2.2	5.4	2.3	28.8
education	15.4	5.7	14.0	5.9	23.0
healthcare	9.3	3.4	9.3	3.9	41.5
social security and welfare	25.5	9.4	22.5	9.5	18.0
housing and community amenity, environmental protection	5.8	2.1	5.3	2.2	26.6
recreation, sports, culture and religion	3.3	1.2	3.2	1.4	36.6
agriculture, forestry and fisheries	8.9	3.3	6.6	2.8	4.3
transport and communications	7.1	2.6	7.6	3.2	32.6
other economic activity	3.1	1.2	2.6	1.1	10.5
other expenditures not classified in major groups	4.7	1.7	10.1	4.3	-1.0

\* by current data

Share of the public demand in the total domestic demand is one-fifth on average. The public demand is made up by the public consumption or public services (whose value is determined by the volume of provided public services) and public investment, which is capital investment for budget resources.

Table 4.5

**Public Demand**

	% of GDP			Real growth against the preceding year (%)		
	2003	2004	2005	2003	2004	2005
<b>Public demand</b>	<b>23.2</b>	<b>21.4</b>	<b>20.0</b>	<b>2.9</b>	<b>3.6</b>	<b>6.3</b>
Public consumption	21.4	19.6	17.7	1.9	2.1	2.7
Gross fixed capital formation	1.7	1.9	2.3	13.0	17.4	34.8

Share of the public demand in the total consumption decreases in the last years. The public demand made up 21.4% of the domestic demand in 2003 and 18.2% in 2005. The value of public services increases considerably slower than GDP and consumption. Public investment (see Box 4.1) grows much faster, especially after Latvia's accession to the European Union.

**Box 4.1**

**Public investment planning**

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

Such development of the Public Investment Programme was useful, as public expenditures were planned together and lucidly for measures that fostered efficiency and raised quality of further expenditures related to provision of specific services of central and local governments as well as encouraged activity of business in certain regions or local governments of the country.

**Box 4.1 continued**

Since 2000 when EU pre-structural funds became available for Latvia, a parallel procedure of public expenditure planning and principles for investment measures co-financed from the mentioned funds were established gradually. Separate procedure of planning strengthened with Latvia's accession to the EU, which henceforth ensured a considerable financial support from EU structural funds. This procedure of planning is determined by a separate policy planning document and legal acts.

Thereby the priority to focus maximum attention to attraction of EU structural funds' resources became clear. Hence the public expenditures for investment started to be channelled mainly to financing of those measures that are planned with co-financing from EU structural funds. Since 2005, the Public Investment Programme began to lose its initial importance because state budget expenditures for investment no more were planned by observing the previously set procedure and principles.

In September 2006, the Cabinet of Ministers approved the concept "On Introduction of Strategic Planning and Medium-Term Budget Planning in Public Administration", that determines the necessity of medium-term budget planning and sets the planning principles. In regard to public investment, the mentioned concept determines the necessity of public investment accounting in order to improve planning of budget commitments, ensure preparation of the respective information for international organisations, and assess efficiency and usefulness of the implemented public investment projects, prescribing that the Public Investment Programme lists the investment, for which funding is allocated by the annual law on the state budget. This means that the programme contains the measures co-financed from EU structural funds, which are also financed from the state budget.

In order to improve the total planning system, making it more focussed and more lucid, a clear link of strategic planning with public budget planning has to be established. If to consider public investment as investment aimed at promotion of economic development, raising the level of society's welfare, improvement of infrastructure and development of environment, its planning has to be basically conducted in the framework of the strategic plan (medium-term operation strategy) of each sectoral ministry in accordance with the respective policy planning documents and the National Development Plan. In order to strengthen such policy and budget planning in the area of investment, it is necessary to develop according amendments to regulations that regulate preparation of operation strategy of institutions, consequently, to the Cabinet of Ministers Regulation No. 111 of March 12, 2002 "On Internal Order of the Cabinet of Ministers", prescribing that ministries in their operation strategies plan and allocate sectoral investment financed from the state budget and expenditures for earmarked subsidies for investment to local governments along with other expenditures.

Expenditures for earmarked subsidies for investment to local governments, in accordance with the Cabinet of Ministers Instruction No. 275 of April 27, 2005 "On Priority Lines of Action in Formation of Public Investment Policy of Ministries in 2006-2010", are planned by ministries in those areas that correspond to the implemented policy.

In order to set unified requirements for all ministries whose competence includes the specific local government operation areas in accordance with the mentioned instruction, the Ministry of Regional Development and Local Government is tasked (Protocol No. 43 of the Cabinet of Ministers meeting of August 22, 2006, Paragraph 44, Item 2) with drafting the Cabinet of Ministers regulations that determine the procedure of assessing earmarked subsidy applications for investment to local governments, allocation of the earmarked subsidies and supervision of their utilisation.

## 4.2. Prices

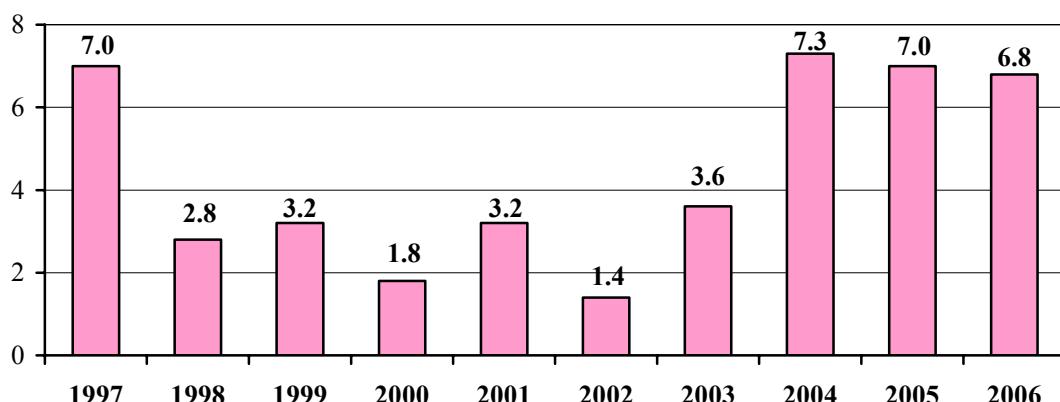
### 4.2.1. Consumer Prices

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

In 2004 and 2005, prices in Latvia grew at a fast pace that was among the highest in EU member states.

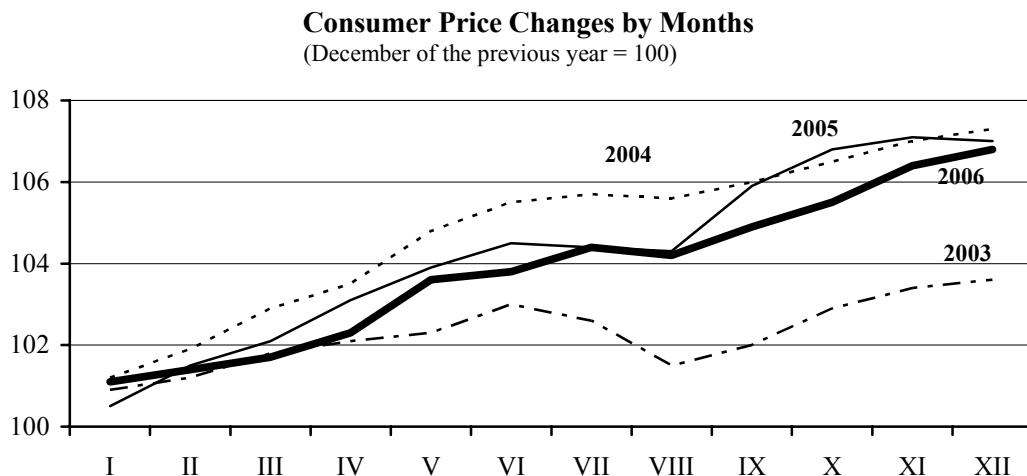
Figure 4.7

**Consumer Price Changes**  
(12-months inflation, per cent)



In 2006 the growth of prices was lower than in the previous two years but still at a relatively high level. Approximately 60% of the growth was made by core inflation and 20% of the growth was related to the increase of administratively regulated prices (mostly due to rise in prices of heat energy and gas).

Figure 4.8

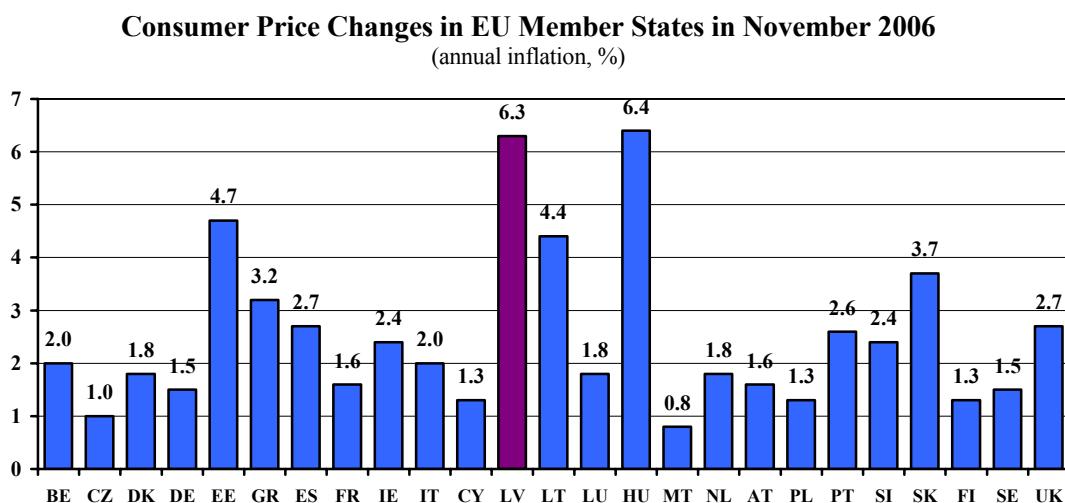


The high growth of prices in 2006 on the whole was determined by two main factors:

- *the 2nd round effect of the sufficiently high inflation rate (inflation spiral) of 2004 and 2005*, which was fostered both by high volumes of mortgage crediting and by substantial increase of wages;
- *the rise of administratively regulated prices*. Tariffs for natural gas supply rose as from January 2006 (by 19.1%) and May 2006 (by 18.1%). Heat energy prices rose by 18.1% during the year (month against month). Payment for electricity increased in March 2006 (by 6.7%).

As already noted, consumer price inflation in Latvia in the last three years was among the highest among EU member states. At the end of 2006, only Hungary had higher consumer price inflation.

Figure 4.9

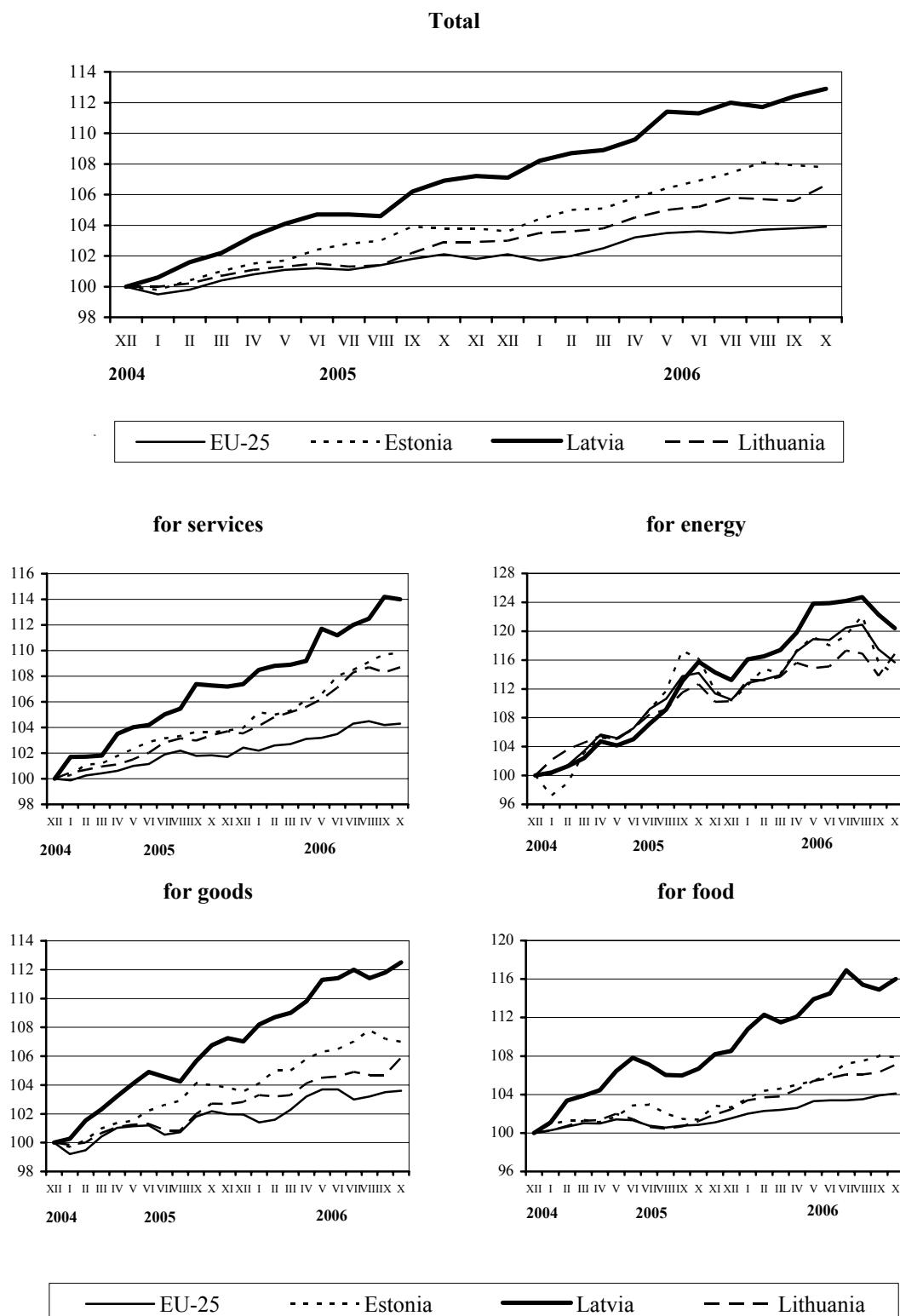


Source: Eurostat

It was lower in the neighbouring countries Lithuania and Estonia, amounting to 3.5% and 4.0% respectively (see Figure 4.9). Rise of prices in Latvia was observed in practically all groups of goods and services, especially for food products. In one year, energy prices also grew faster in Latvia (by 4%), in Lithuania and the EU in total they increased by 3.7% and 1.2% respectively, while energy prices in Estonia decreased by 2% in one year.

Figure 4.10

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



Source: Eurostat

The Ministry of Economics forecasts the average growth of consumer prices for 2007 as 6.5%, which is by approximately 0.3 percentage points lower than the level of 2006 (provisional evaluation by the Ministry of Economics).

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

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

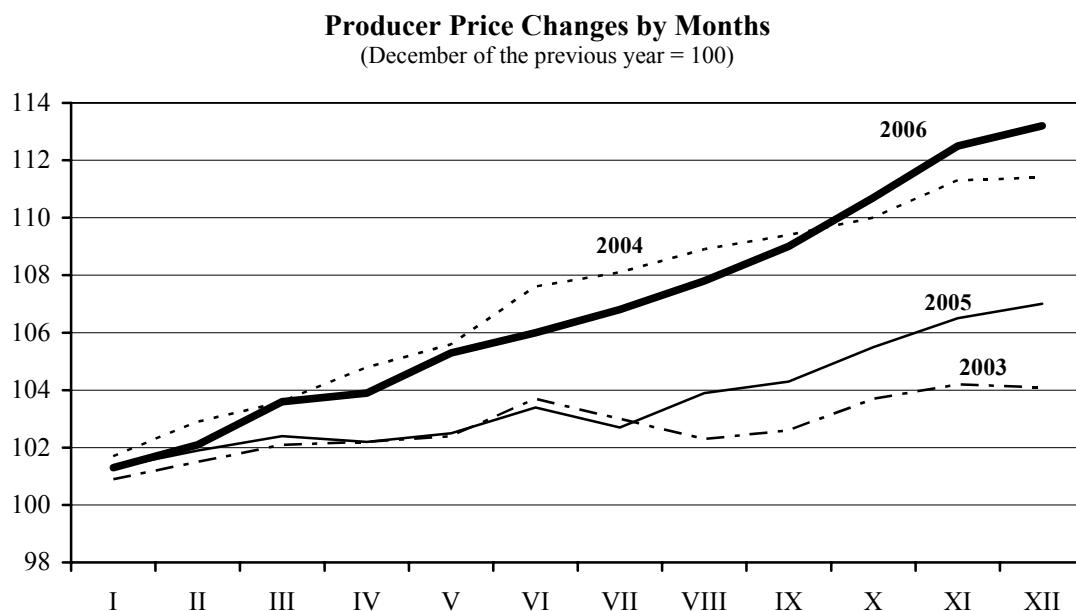
#### 4.2.2. Producer Prices

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

In 2004, producer prices went up much faster by 11.4% (December over December). In 2005, the producer price growth was already more moderate (by 7%). However, as to the data for 2006, the increase of producer prices is much faster than in the respective period – by 13.2% in comparison with December of the previous year, which is the highest price growth in the last 10 years; this was mostly due to increased prices in production of wood and wood products (except furniture) and to increased tariffs for electricity, gas, steam and hot water supply.

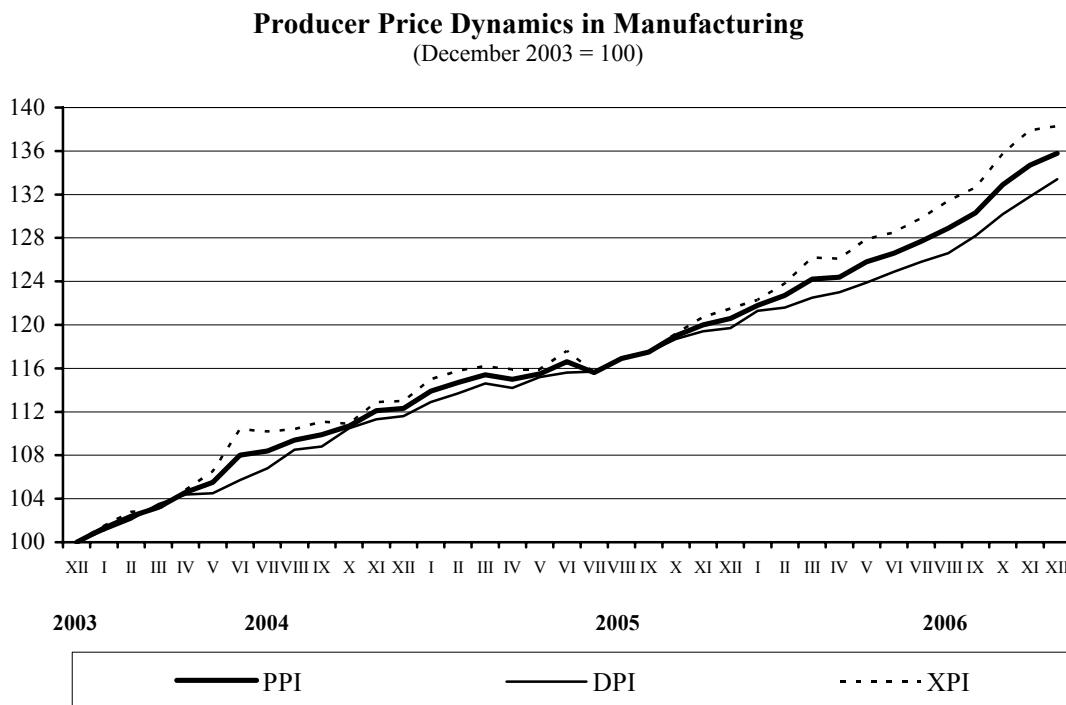
Latvia being a country with a small and open economy, producer prices largely depend on changes of foreign trade prices that are determined by world prices of the respective products and currency rate fluctuations. As world prices and/or currency rates change, incomes from export and expenses on import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

Figure 4.11



During the year (November 2006 over November 2005), prices for manufacturing products sold in the domestic market rose slower (by 10.4%) than prices of exported manufacturing products (by 14.3%).

Figure 4.12



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

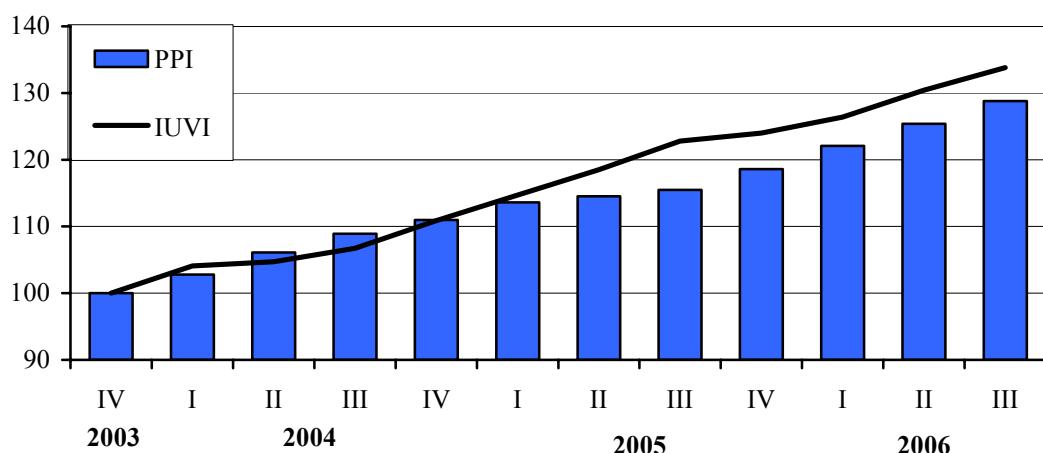
The growth of prices for products sold domestically was triggered not only by the rising domestic demand, but also by the growth of export prices, as supply of some products in the domestic market fell.

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

Figure 4.13

### Import Price Dynamics in Comparison with Producer Price Dynamics

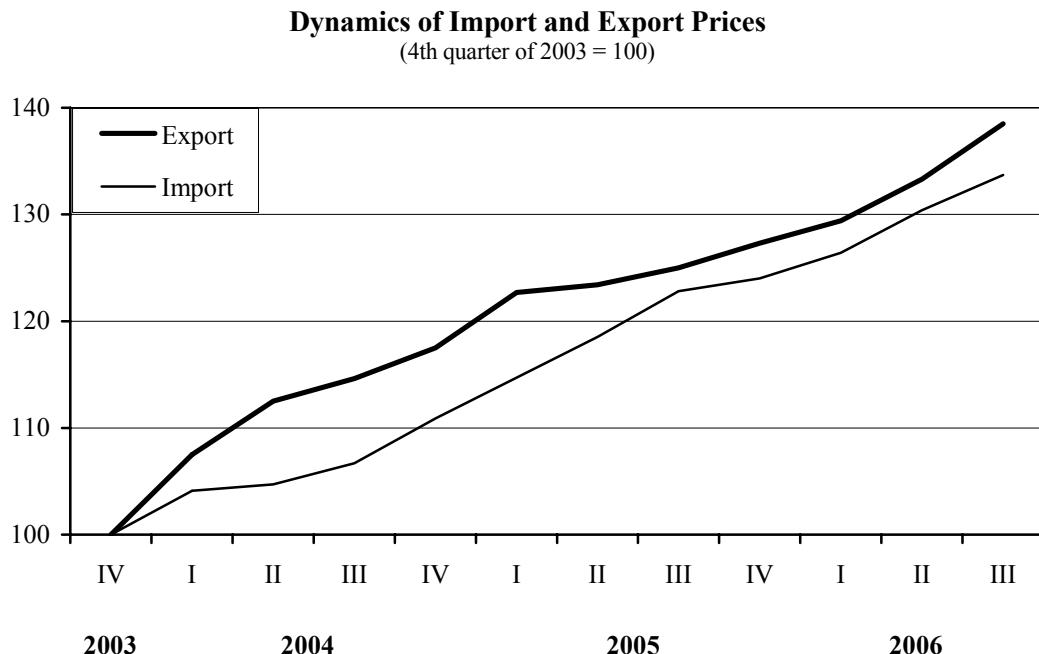
(4th quarter of 2003 = 100)



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

Rise of producer prices lags behind in comparison with the import price dynamics. The faster increase of import prices was greatly determined by the rise of fuel prices.

Figure 4.14



Increase of the export unit value in 2005 and 3 quarters of 2006 was almost at the same level as for the import unit value, however, slightly exceeding it. Therefore, trade conditions remained unchanged in this period.

## 4.3. Balance of Payments

### 4.3.1. Current Account

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

Trade balance deteriorated considerably in 2004 (see Table 4.6), as the imports of goods increased more rapidly than the exports due to the growing domestic demand and stockpiling of goods before the accession to the EU, as well as several one-time bulky purchases of investment goods, and as a result the current account deficit of the balance of payments reached almost 13%.

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

Data of the first 3 quarters of 2006 indicate deterioration of the current account due to the growth of the trade deficit.

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

As seen in Figure 4.15, in the recent years the level of savings against GDP in Latvian economy has not essentially changed and amounts to approximately 20%. In contrast, the level of investment in the economy is high, especially after accession to the EU.

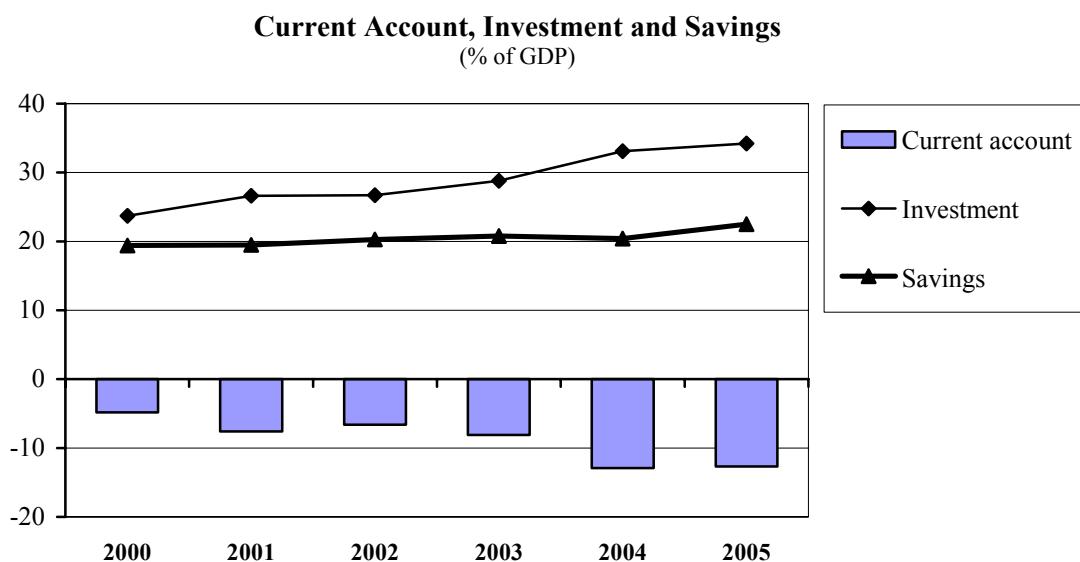
Table 4.6

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

	2003	2004	2005	2005	2006
				January-September	
<b>A. Current account</b>	<b>-8.2</b>	<b>-13.0</b>	<b>-12.7</b>	<b>-11.6</b>	<b>-19.3</b>
Trade balance	-17.8	-20.3	-19.2	-17.9	-24.0
<i>exports</i>	28.3	30.7	33.9	34.6	31.6
<i>imports</i>	-46.1	-50.9	-53.1	-52.5	-55.6
Balance of services	5.2	4.4	3.9	3.9	4.1
Net income	-0.2	-2.1	-1.2	-1.5	-2.3
Current transfers, net	4.7	5.0	3.8	3.9	3.0
<b>B. Capital account</b>	<b>0.7</b>	<b>1.0</b>	<b>1.3</b>	<b>1.4</b>	<b>1.3</b>
<b>C. Financial account</b>	<b>8.2</b>	<b>14.2</b>	<b>16.7</b>	<b>16.2</b>	<b>29.1</b>
Direct investment	2.3	3.9	3.8	4.3	7.0
<i>abroad</i>	-0.4	-0.8	-0.8	-1.0	-0.9
<i>in Latvia</i>	2.7	4.6	4.6	5.3	7.9
Portfolio investment	-2.0	1.7	-0.7	-2.5	-1.2
<i>assets</i>	-2.6	-0.2	-1.6	-3.9	-2.9
<i>liabilities</i>	0.6	1.9	1.0	1.4	1.7
Other investment	7.8	9.0	14.1	14.8	23.2
<i>assets</i>	-6.1	-12.9	-2.7	1.5	-8.8
<i>liabilities</i>	13.9	21.9	16.8	13.3	32.0
<b>D. Net errors and omissions</b>	<b>-0.1</b>	<b>0.6</b>	<b>-2.0</b>	<b>-1.3</b>	<b>-0.4</b>
<b>E. Reserves</b>	<b>-0.6</b>	<b>-2.9</b>	<b>-3.3</b>	<b>-4.7</b>	<b>-11.0</b>

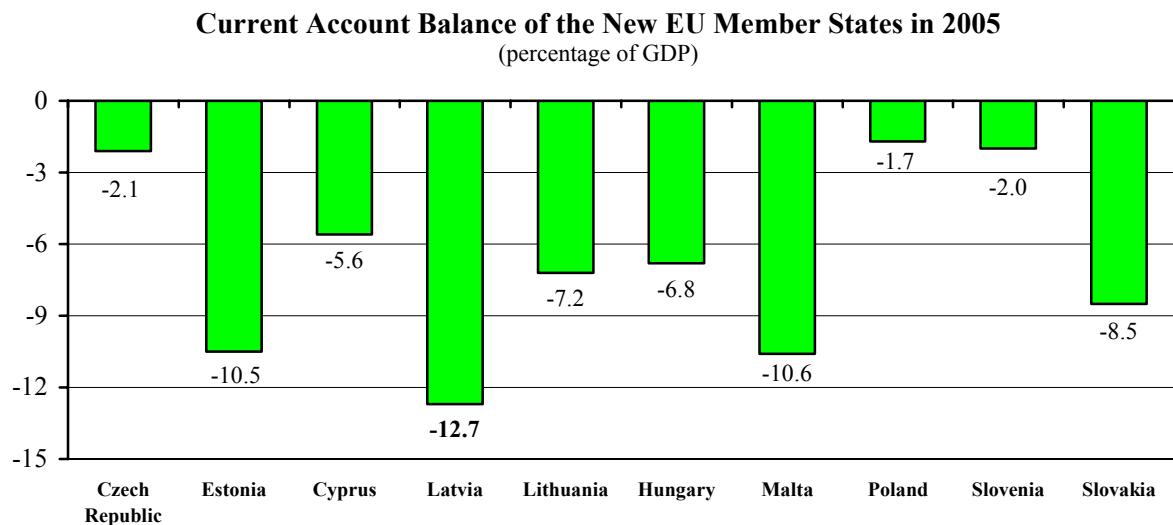
Thus, the imbalance between domestic savings and investment (the current account deficit) is a regular phenomenon in Latvian economy during the last years of the rapid growth. Until now it has not caused problems for stability of the economy, as the deficit is mostly covered by non-debt flows. Moreover, faster growth of investment in comparison with the growth of other domestic demand items increases the productive capacity of Latvian economy and hence improves the competitiveness of economy.

Figure 4.15



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

Figure 4.16



Source: Eurostat

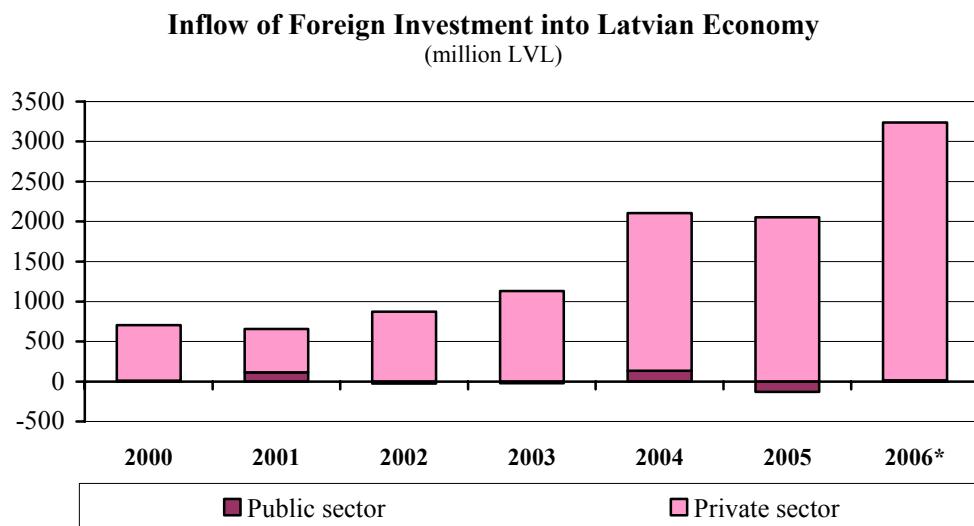
In 2005 the Latvian current account deficit against GDP was the highest among the new EU member states (see Figure 4.16). No country was with a positive current account balance, and the lowest current account deficit was in Poland.

### 4.3.2. Financial Flows

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

Enhanced inflow of foreign capital, ensured by liberalisation of financial flows, started in Latvia at the beginning of transition. There are no limitations to conversion of the national currency in Latvia. Foreign companies may freely withdraw their investment and profit after paying taxes. Also every resident of Latvia is free to use financial services of any foreign company. There are no restrictions for transactions with securities and stock. Buying and selling of real estate is not restricted, either.

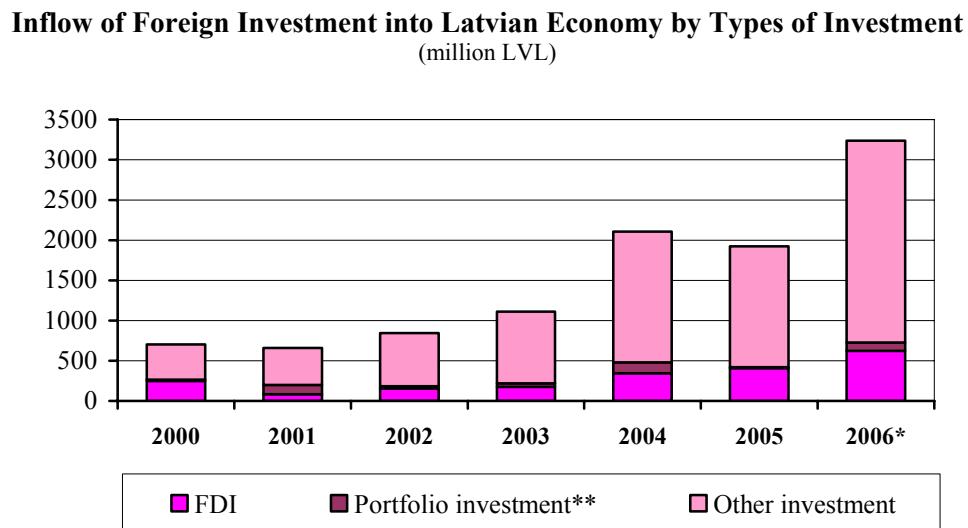
Figure 4.17



\* data of 2006 are for January-September

Foreign investment is mainly drawn in by the private sector. In 2004 and 2005 the flows markedly exceeded the level of the previous years, while in the first 3 quarters of 2006 the inflow considerably exceeded the volume of 2005. The majority of economists consider that the reason for success in terms of attracting foreign investors to East European countries and Baltic States is the progress reached in macroeconomic stabilisation, implemented structural reforms and commitment to continue these reforms in the future, strong national currencies, and accession to the European Union. Therefore the majority of the new EU member states have credit ratings favourable for investment.

Figure 4.18



\* data of 2006 for January-September

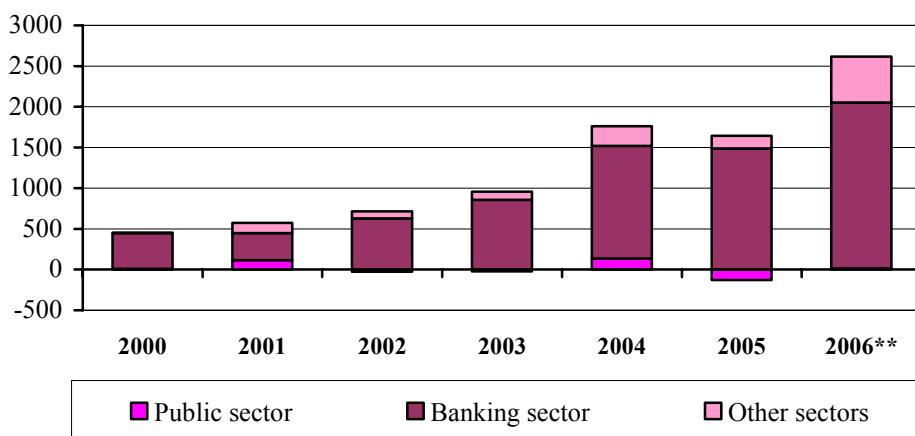
\*\* portfolio investment with financial derivatives

Inflow of foreign direct investment in 2005 was at the level of the previous year and covered 36% of the negative current account balance. In 9 months of 2006 the inflow of foreign direct investment into Latvian economy increased considerably and covered 41.2% of the current account deficit. The majority of economists consider that the reason for success in terms of attracting foreign investors to East European countries and Baltic States is the implemented structural reforms and commitment to continue these reforms in the future, strong national currencies, and accession to the European Union. Therefore the majority of the new EU member states have credit ratings favourable for investment.

The share of portfolio investment in the incoming financial flows is small and does not exceed 10% in the last three years.

Figure 4.19

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



\* excluding foreign direct investment

\*\* data of 2006 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 September 2006, the attracted capital exceeded GDP by 39.7%, while the debt of Latvia to the rest of the world was 112.0% of GDP, including the central government debt (6.2%). The amount owed to Latvia by the rest of the world equalled to 72.5% of GDP.

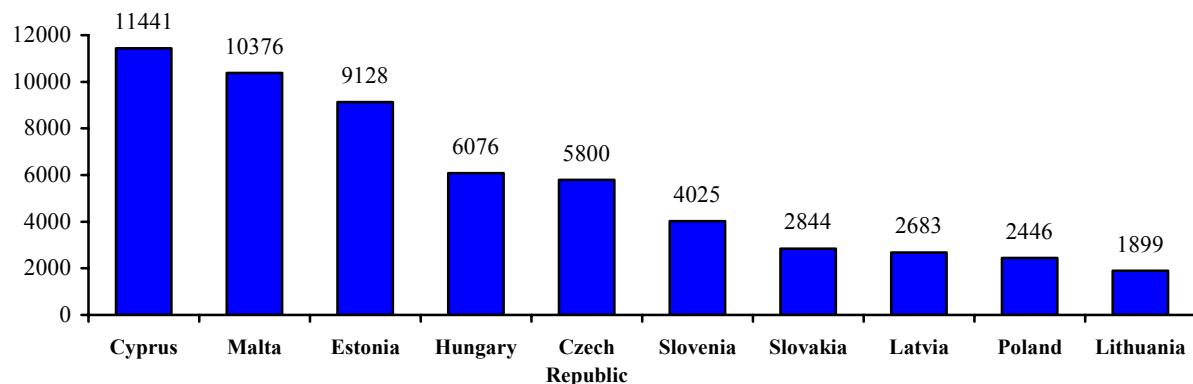
#### 4.3.3. Foreign Direct Investment

Attracted foreign capital is one of the most important financial sources for investing in fixed assets. According to Latvian savings–investment balance, the level of domestic investment in Latvia during the last five years exceeded the level of national savings by almost 10 percentage points, which means that the attracted foreign capital covered 30% on average of the funding for investment in fixed assets. It should be noted that the share of direct investment is the biggest in the structure of the attracted capital.

By the end of September 2006, foreign entrepreneurs had invested USD 2878.1 per capita into Latvia in the form of direct investment. Latvia took the 8th place among the new EU member states by this indicator in 2005.

Figure 4.20

**FDI Stock per Capita in the New EU Member States**  
(end of 2005, USD)



Source: UNCTD, World Investment Report 2006

At the end of September 2006, the FDI stock amounted to LVL 3639.6 million or almost 34% of GDP, and the volume of the FDI inflow in the last five years amounted to 13% on average of the investment in fixed assets.

With Latvia's accession to the EU, the volume of the FDI inflow has increased considerably. During two years after the accession, foreign entrepreneurs have invested into Latvian economy in the form of direct investment almost as much as in the period from 1999 to 2003. The volume of the FDI inflow into Latvia in 9 months of 2006 was LVL 622.5 million (USD 1096.2 million) or 1.5 times bigger than in 2005 in total.

Investment of developed countries dominates in the geopolitical structure of the FDI stock. FDI stock of development countries increased by 17.2% in 9 months of 2006 and constituted 72% of the total FDI stock in Latvia at the end of September 2006. Investment of EU member states equalled to 74.6% of the total FDI stock.

Figure 4.21

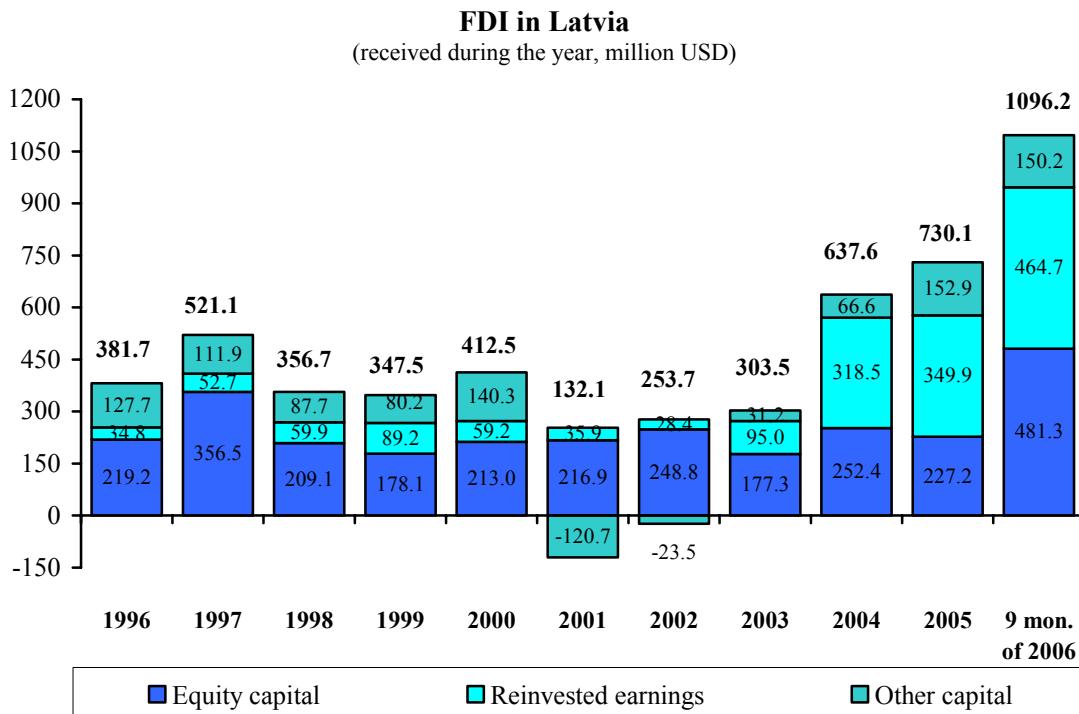
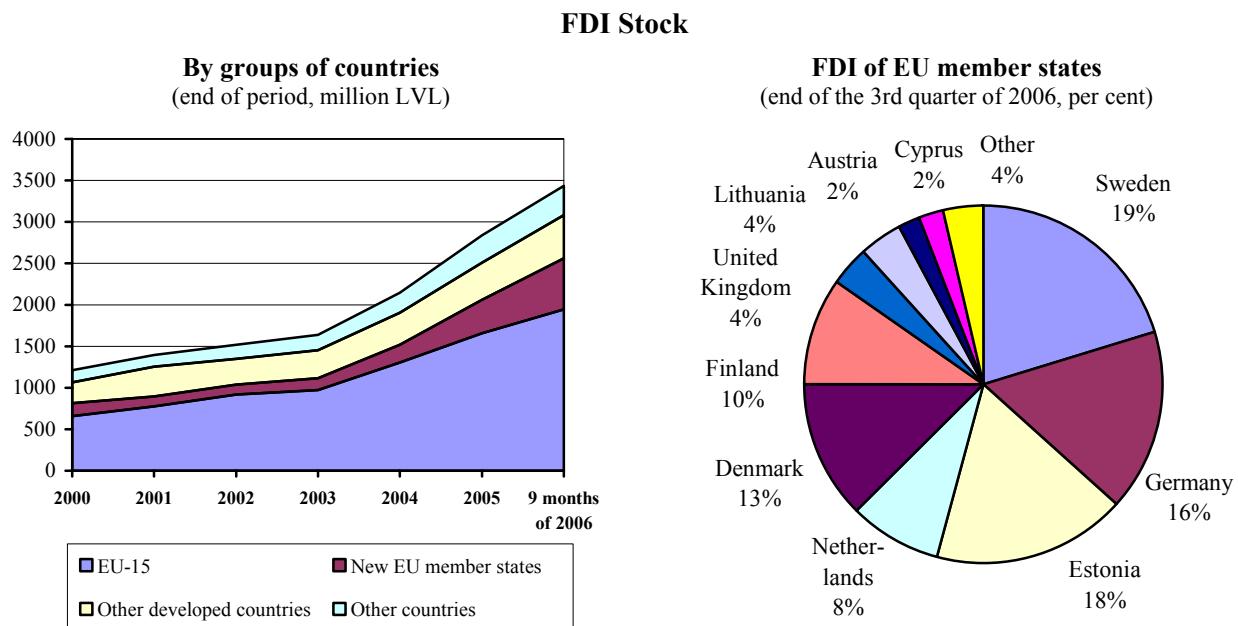


Figure 4.22



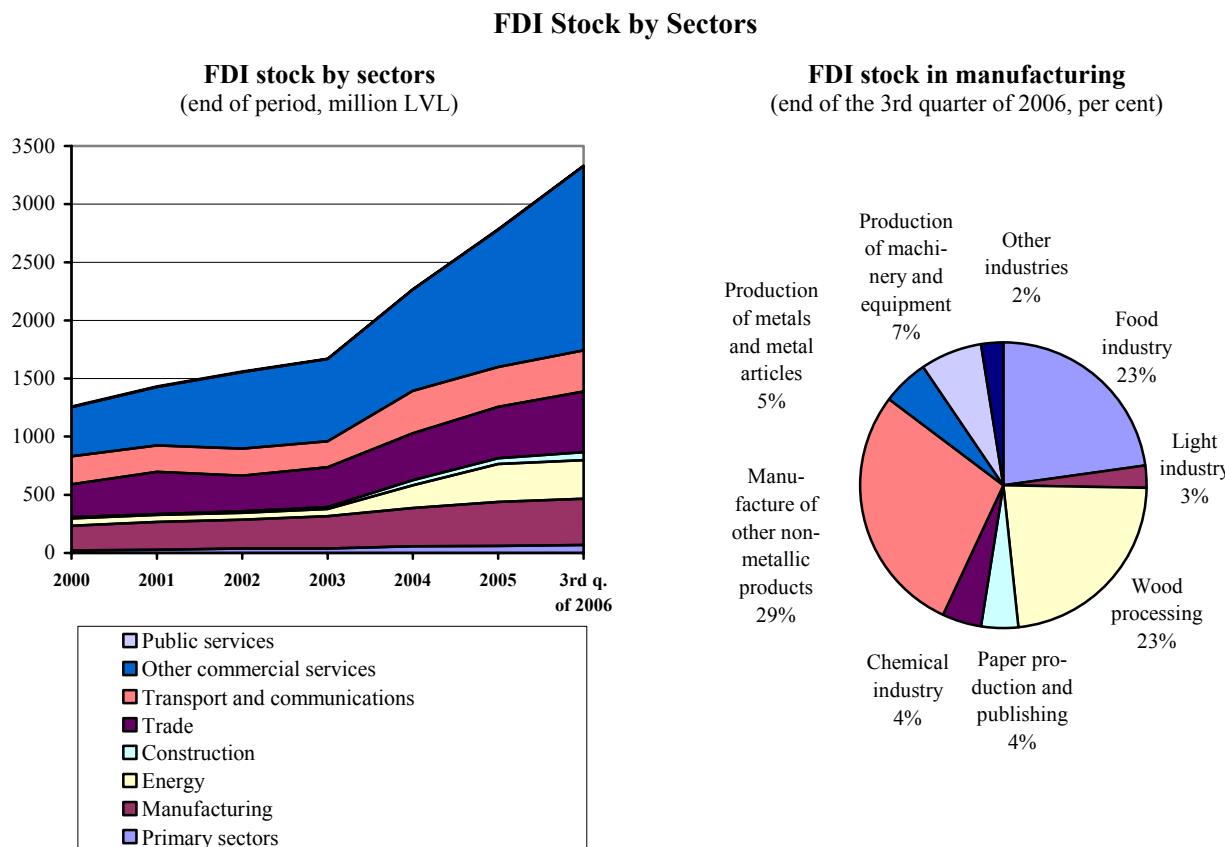
Investors from the new EU member states have become more active since 2004. In 2004 and 2005, the FDI stock of these countries increased by 52.5% and 83.2% respectively. High growth rates also remained in 9 months of 2006 (by 52.6%). At the end of the 3rd quarter of 2006 the FDI stock of the new EU member states constituted 17.9% of the total FDI stock or 24% of the FDI stock of EU member states in Latvian national economy. Among the new EU member states, Estonia has marked leader positions (74% of the FDI stock of the new EU member states). It also should be noted that Lithuanian investment has increased by 38.6% in 9 months of 2006 and constituted 31% of the FDI stock of the new EU member states.

According to data of the Bank of Latvia, the biggest amounts of investment are received from Sweden, Estonia, Germany and Denmark. FDI stock of these four countries made up almost 50% of the total FDI stock in Latvian economy at the end of the 3rd quarter of 2006. Markedly dominant sectors exist in all mentioned countries (except Denmark). So, Swedish FDI was focused in the sectors of financial services (42%) and commercial services (29%). Almost 70% of Estonian FDI is in the financial services. German entrepreneurs have mainly invested in the energy sector (45% of German FDI stock in Latvian economy).

At the end of 2005, the highest share in the sectoral structure of the FDI stock belonged to the commercial services sector (21.5% of all FDI). At the end of September 2006, the leading positions were made by financial services, which were mainly affected by considerable FDI inflow into the financial services sphere. FDI stock in the financial services sector has increased by 47% in 9 months of 2006.

In 9 months of 2006, high FDI growth rates remained in such sectors as construction (by 40.3%), hotels and restaurants (by 35.2%), real estate transactions (by 20.9%), extractive industry (by 18.3%), and agriculture (by 15%). On the whole, one has to conclude that the FDI growth rates in production sectors in 9 months of 2006 were almost four times slower than in service sectors and the share of these sectors in the total FDI stock at the end of September 2006 constituted 26% or by 3 percentage points less than at the end of 2005.

Figure 4.23



Like in other sectors, also in manufacturing the inflow of foreign capital in the form of direct investment since the beginning of 2004 was faster than in the period from 2000 to the end of 2003. FDI stock in manufacturing increased by 4.7% in 3 quarters of 2006, and the share of this sector in the total volume of FDI stock constituted 12% at the end of September.

More than 70% of the total FDI in manufacturing is attracted by three manufacturing sectors: food industry, wood processing and manufacture of other non-metallic products. They are low and medium-low technology sectors, whose comparative advantages in the attraction of capital are mostly related to relatively low accessibility of labour and natural resources.

FDI in low technology sectors practically did not increase in 2006 and its share in the total FDI stock in manufacturing decreased from 57.4% at the end of 2005 to 55% at the end of September 2006.

FDI in medium technology sectors increased most rapidly (by 11.3%), including by 13.8% in medium-low technology sectors and by 1.7% in medium-high technology sectors. The share of FDI in medium technology sectors was 44.5% at the end of September 2006.

Investment in high technology sectors is small (0.4% of FDI in manufacturing at the end of September 2006) and did not increase in 2006.

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. More than 46 visits of potential foreign investors with direct participation of LIDA have taken place in Latvia in the 1st half of 2006. LIDA has identified 16 potential investment projects with the total investment of EUR 300 million. 6 investment projects with the total investment of about EUR 10 million are implemented with direct participation of LIDA in the 1st half of 2006, hence creating about 210 new jobs. Half of the mentioned jobs are created in Latvian regions.

One of the most important priorities for operation of LIDA in the sphere of investment attraction is attraction of the projects that offer knowledge-based and technology-based projects without the necessity to hire a considerable amount of unskilled labour force. Projects of such type would also have a nature of long-term viability.

## 4.4. Financial and Capital Markets<sup>1</sup>

### 4.4.1. Monetary Policy and the Exchange Rate

The Republic of Latvia 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 instructions of the government or governmental institutions. The Bank of Latvia performs its functions under supervision of the Saeima.

Since the middle of February 1994 the Bank of Latvia had unofficially pegged the exchange rate of the lats (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 lats to the SDR basket is replaced with the peg to the euro (1 EUR = LVL 0.702804). The change of the lats’ peg was determined by Latvia’s plans to join the European Exchange Rate Mechanism II (ERM II) and, after fulfilment of required criteria, to join the Economic and Monetary Union (EMU)<sup>4</sup>.

As from May 2, 2005 Latvia has joined the ERM II with the already existing exchange rate of the lats against the euro, namely, 1 EUR = LVL 0.702804. Latvia will have to participate in the ERM II for at least two years, fulfilling the Maastricht criterion on exchange rate stability. During this period, the Bank of Latvia has to reach full compliance with the European Central Bank (ECB), adjusting the monetary policy instruments.

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 lats’ fluctuations, which was habitual to the financial market, has existed since pegging the lats to the SDR in 1994 and was kept when the lats was pegged to the euro on January 1, 2005.

On July 21, 2005 the Cabinet of Ministers adopted decision to establish the Management Committee for Introduction of the Single Currency of the European Union in Latvia with a task to develop the plan of measures required to ensure successful joining the euro zone by Latvia. The timetable for introduction of the euro, approved by the Cabinet of Ministers, envisages that Latvia will join the EMU on January 1, 2008. Taking into account that the target set by the government has become

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

<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.

unachievable due to high inflation, the situation is being assessed and a new target date for joining the EMU will be set.

On March 6, 2006 the Cabinet of Ministers approved the *Latvia's National Euro Changeover Plan* that prescribes carrying out several measures in regard to adjustment of normative acts, adjusting and ensuring technical operation of the normative base for money and payment system, financial system, public debt management, budgetary accounting and statistics, business environment and consumer protection, taxes and social security, as well as for informing 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 the changeover to the euro, the responsible institutions and terms for implementation of the defined activities. At present, the *Communication Strategy for Euro Changeover in Latvia* and the *Communication Action Plan for Euro Changeover* have been developed and approved by decision of the Steering Committee of the euro introduction project.

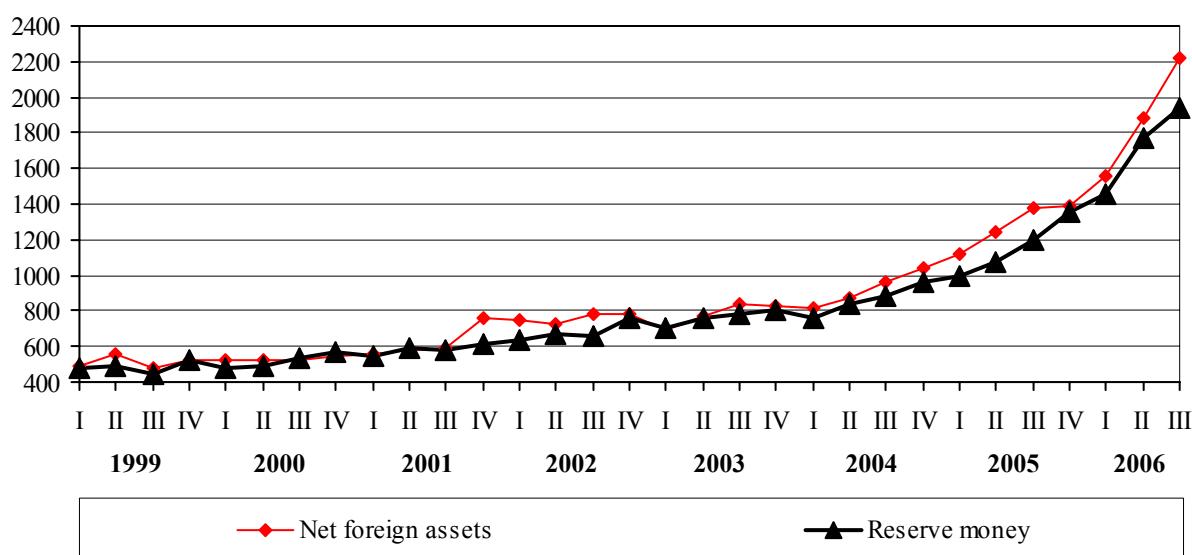
It must be noted that introduction of the euro in Latvia will be an issue of EU multilateral relations, affecting the common interests of all EU member states. Therefore the timetable for introduction of the euro, approved by the Cabinet of Ministers, will only get an official status after completion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

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

In order to keep a fixed exchange rate, it is necessary to have a sufficient amount of foreign reserves. Up to now no problems had been experienced in this area in Latvia. Net foreign reserves of the Bank of Latvia constantly cover the reserve money (see Figure 4.24), and their amount equals to the value of goods and non-factorial services imported by the country in 3-4 months.

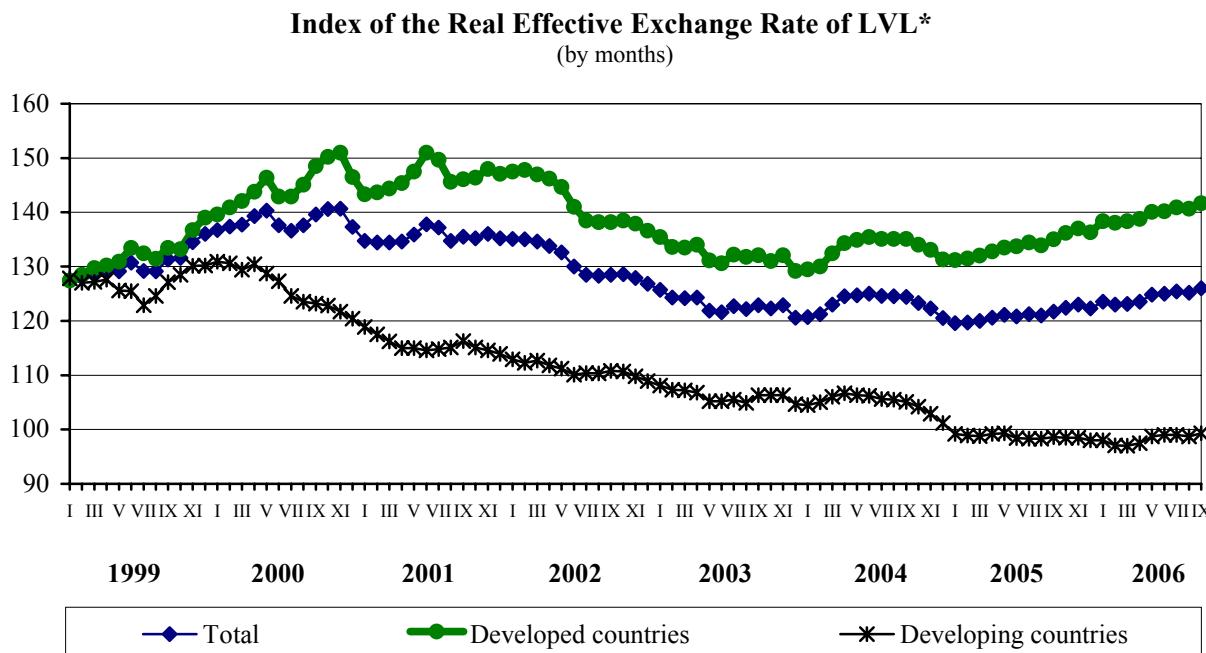
Figure 4.24

**Net Foreign Assets of the Bank of Latvia and Reserve Money, Quarterly Profile**  
(million LVL, end of period)



The coverage of reserve money (currency in circulation and deposits in the Bank of Latvia) with net foreign assets was 114.6% at the end of September 2006. Net foreign assets of the Bank of Latvia have gone up by 60.5% in comparison with the end of September 2005.

Figure 4.25



\* 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).

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 4024 million at the end of September 2006 (USD 2355 million at the end of 2005, USD 2019 million at the end of 2004, USD 1535 million at the end of 2003).

The Bank of Latvia calculates the real effective rate of the lats<sup>1</sup> against the currencies of 13 countries that are the main trading partners of Latvia<sup>2</sup>. It shows the relative competitiveness of Latvian exports in the world markets (see Figure 4.25).

Comparing with 2000 and 2001, the exchange rate of the lats has depreciated with regard to currencies of both the developing and the developed countries. However, in the last years it tends to appreciate with regard to currencies of the developed countries due to relatively high inflation. Decline of the real effective rate of the lats is favourable for Latvian exporters.

#### 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 (see Table 4.7).

22 banks and three branches of foreign banks operated in Latvia in the 2nd half of 2006. Also credit institutions or their branches, which are registered in European Economic Area (EEA) countries and have submitted applications to the *Financial and Capital Market Commission*, may provide banking services in Latvia. 100 notifications from EEA countries about willingness of banks of these countries to start providing financial services in Latvia without opening a branch were received by the end of 2005. By the end of 2005, four Latvian banks received licences from financial sector supervision bodies of EEA countries for starting provision of financial services in EEA member states without opening branches, and two Latvian banks opened branches in these countries.

<sup>1</sup> Real exchange rate of the lats encompasses changes of the nominal rate of the lats 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.

Table 4.7

## Participants of the Financial and Capital Market\*

	31.12.2003.			31.12.2004.			31.12.2005.		
	Number	Assets, million LVL	Share in total assets, %	Number	Assets, million LVL	Share in total assets, %	Number	Assets, million LVL	Share in total assets, %
Banks	23	5717	96.08	23	7850	96.49	23	10943	96.41
Insurance companies	19	141	2.37	17	156	1.92	17	189	1.67
Investment management companies	8	4	0.07	10	2	0.02	10	8	0.07
Investment funds	16	27	0.45	15	36	0.44	17	76	0.67
Investment plans**	7	26	0.44	19	48	0.59	22	82	0.72
Private pension funds	5	2	0.03	5	2	0.02	6	1	0.01
Savings-and-loans companies	28	4	0.07	32	5	0.06	34	6	0.05
Other	-	29	0.49	-	37	0.46	-	45	0.4
<b>Total</b>		<b>5950</b>	<b>100</b>		<b>8136</b>	<b>100</b>		<b>11350</b>	<b>100</b>

\* Data of the *Financial and Capital Market Commission*

\*\* Investment plans are made for the 2nd level of the pension system (resources of the state-funded pension scheme)

The banking system of Latvia has stabilised during the process of biggest bank mergers and takeovers in 1998-2001. Almost all banks are in private hands (at the end of 2005 the state owned 10.6% of the total paid-up equity capital of banks). Only the *Mortgage and Land Bank of Latvia* is fully owned by the state. Foreign shareholders owned 58.6% of the total paid-up equity capital of banks at the end of 2005 (57.8% at the end of 2004, 53.9% at the end of 2003). Nine banks were subsidiaries of foreign banks (their market share in the total bank assets was 52.7%).

The market share of the five biggest banks has not changed substantially in the last years and amounted to 67.3% of the total assets, 75.7% of loans and 69.6% of deposits at the end of 2005.

Total amount of bank assets reached LVL 10.9 billion at the end of 2005<sup>1</sup>, growing by 39.4% during the year, while the amount of issued loans went up by 58.9% and the volume of attracted investment increased by 21.7%. To a great extent, this growth occurred due to the rapid development of crediting and improved efficiency of banking activity. Credit portfolio of banks is dominated by loans issued to companies. However, a substantial growth is observed in loans issued to households.

Commercial banks operate with profit. In 2005 the total profit of the banking sector reached LVL 193.1 million<sup>2</sup> (for comparison: this profit amounted to LVL 116 million in 2004). According to operative data, in 11 months of 2006 the profit of banks was LVL 219.2 million or by 23.3% more than in the respective period of 2005. Return on assets (ROA)<sup>3</sup> reached 2.1% at the end of 2005, while return on equity (ROE)<sup>4</sup> reached 27.1% (1.7% and 21.4% respectively at the end of 2004, 1.4% and 16.7% respectively at the end of 2003)<sup>5</sup>. The volume of services provided by Latvian banking sector is still substantially smaller than in the developed countries, hence this sector has great potential for the future growth. Moreover, a considerable part of Latvian population has not yet started to use banking services.

17 insurance companies operated in Latvia in the middle of 2006, of which five were life insurers and 12 provided non-life insurance. In Latvian financial and capital market, the share of insurance companies in the total assets is slightly below 2 per cent.

Total of gross premiums written in the insurance market reached LVL 156 million in 2005, which was by 19.1% more than in 2004, while the volume of paid gross indemnities was LVL 67.5 million or by 19.3% more than in 2004. Total of gross premiums written by insurance companies amounted to LVL 147.7 million in 3 quarters of 2006, which was by 29% more than in 3 quarters of 2005, and the volume of paid gross indemnities reached LVL 70.6 million or by 42% more than in 3 quarters of 2005.

<sup>1</sup> Bank assets reached LVL 14.3 billion at the end of the 3rd quarter of 2006.

<sup>2</sup> Non-audited data.

<sup>3</sup> ROA – ratio of profit/losses to assets.

<sup>4</sup> ROE – ratio of profit/losses to capital and reserves.

<sup>5</sup> At the end of September 2006, return on assets was 1.9% while return on equity was 24.5%.

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. 256 notifications by insurance supervision bodies of 22 European Economic Area countries on the intention of insurers licensed in these countries to use the principle of service provision freedom in Latvia were received by September 30, 2006. Also four notifications about opening a branch in Latvia were received. Three notifications by Latvian insurers on the use of the principle of service provision freedom in EU member states were sent to insurance supervision bodies of EU member states.

**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 2005, market capitalisation of Latvian companies at Riga Stock Exchange (RSE)<sup>1</sup> was LVL 1492 million or 16.8% of GDP (LVL 849 million or 11.5% of GDP at the end of 2004, LVL 608 million or 9.6% of GDP at the end of 2003). 45 companies were listed on the stock exchange at the end of 2005.

Activity of RSE is increasing gradually. RSE index RIGSE reached 676 points (January 1, 2000 = 100) at the end of 2005 (414 points at the end of 2004, 288 points at the end of 2003). 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.

At the end of June 2002, RSE shareholders accepted a proposal from the HEX Group (owner of Helsinki Stock Exchange) and signed a contract on the sale of 92.98% of RSE shares. As a result of the deal, the HEX Group has become the biggest owner of RSE group. RSE group comprises unified stock exchange and depository like in Finland and Estonia where stock exchange and depository are unified, too. The new group will be incorporated in the Baltic branch of the HEX Group.

The Finnish securities trader HEX Group, which is also the owner of the only licensed stock exchange in Latvia (RSE), has merged its operations with Swedish company OM, which is a leading developer of information technologies for financial markets of the world. The merged OMHEX group started its operations on September 4, 2003, creating the biggest securities market in Northern Europe and offering access to approximately 80% of stock markets in the Nordic countries. This merger can provide the necessary technological means for integration of Latvian capital market into unified markets of the Nordic countries.

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

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

In accordance with the *Law on Deposit Guarantees*, the maximum guaranteed amount of compensation to one depositor for a deposit in one bank is being increased gradually (LVL 9000 as from January 1, 2006). The law stipulates that the compensation will reach LVL 13 000 by January 1, 2008. As from January 1, 2003, the compensation is also guaranteed to legal persons in the same amount as to physical persons.

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<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.

LVL 34.5 million were accumulated in the Deposit Guarantee Fund at the end of 2005. It has to be noted that, since the fund started operating, its resources have not been used to pay the guaranteed compensations because no case of the inaccessibility of deposits in banks or savings-and-loans companies has occurred in Latvia during this period of time.

In order to guarantee protection of insured persons in Latvia, Protection Fund for the Insured was established in 1999. The *Investor Protection Law* is in force since 2002, which stipulates that investors are entitled to receive compensation if investment service providers (banks and brokerage firms) cannot honour their commitments.

#### 4.4.3. Deposits and Loans

Stability of the banking sector, growing welfare of population and increasing economic activity predetermine stable growth of the basic monetary indicators of the banking system of Latvia. The growth of monetary indicators, which had been observed in the previous years, was also retained in 2006. In October 2006 compared with October 2005 the broad money M2X had increased by 41.8%, while currency in circulation had increased by 22.6% and the volume of deposits had grown by 46.4%. At the same time also loans to companies and individuals continued growing (by 58.7%) (see Table 4.8 and Figures 4.26 and 4.27).

Table 4.8

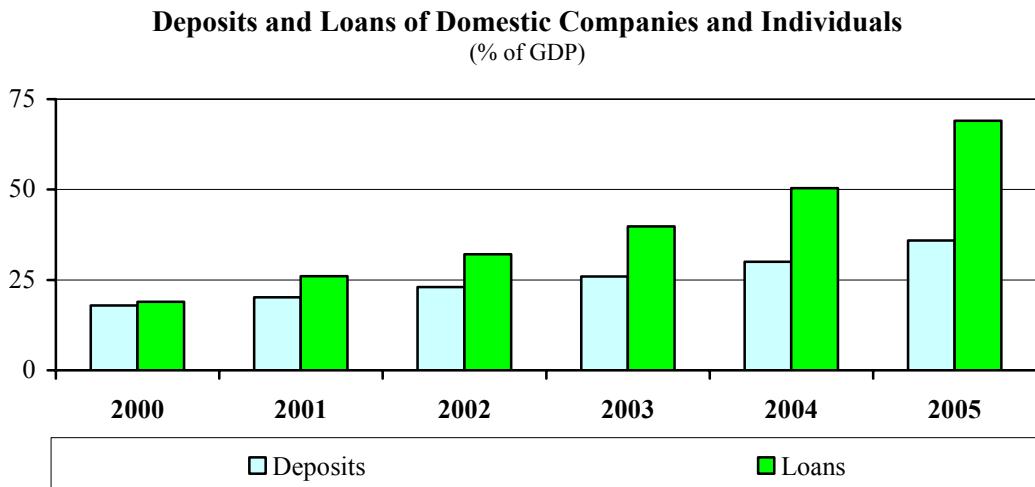
#### Monetary Indicators of the Banking System of Latvia (end of period)

	2002	2003	2004	2005	2006*
(million LVL)					
Net foreign assets	352.1	75.4	-231.0	-1326.6	-2028.1
Net domestic assets	1512.8	2183.4	3098.8	5311.2	6901.0
Domestic loans	2004.3	2822.0	3948.1	6441.3	8470.4
to government (net)	154.7	250.2	173.4	266.3	-121.0
to companies and individuals	1849.6	2571.8	3774.7	6175.0	8591.4
Other assets (net)	-491.4	-638.6	-849.3	-1130.1	-1569.4
Broad money M2X	1864.9	2258.7	2867.9	3984.7	4872.9
Currency in circulation (less vault cash balance)	543.1	601.1	645.4	786.4	892.5
Deposits of individuals and companies of which:	1321.8	1657.7	2222.5	3198.3	3980.4
demand deposits	776.8	941.7	1295.6	2020.2	2537.6
time deposits	545.1	716.0	926.8	1178.1	1442.8
(changes against the preceding period, per cent)					
Domestic loans of which:	39.8	40.8	39.9	63.1	31.5
to companies and individuals	36.5	39.0	46.8	63.6	39.1
Broad money M2X	21.0	21.1	27.0	38.9	22.3
Currency in circulation (less vault cash balance)	11.9	10.7	7.4	21.8	13.5
Deposits of individuals and companies	25.1	25.4	34.1	43.9	24.5
GDP (in current prices)	10.3	11.0	16.0	20.1	...

\* end of September 2006

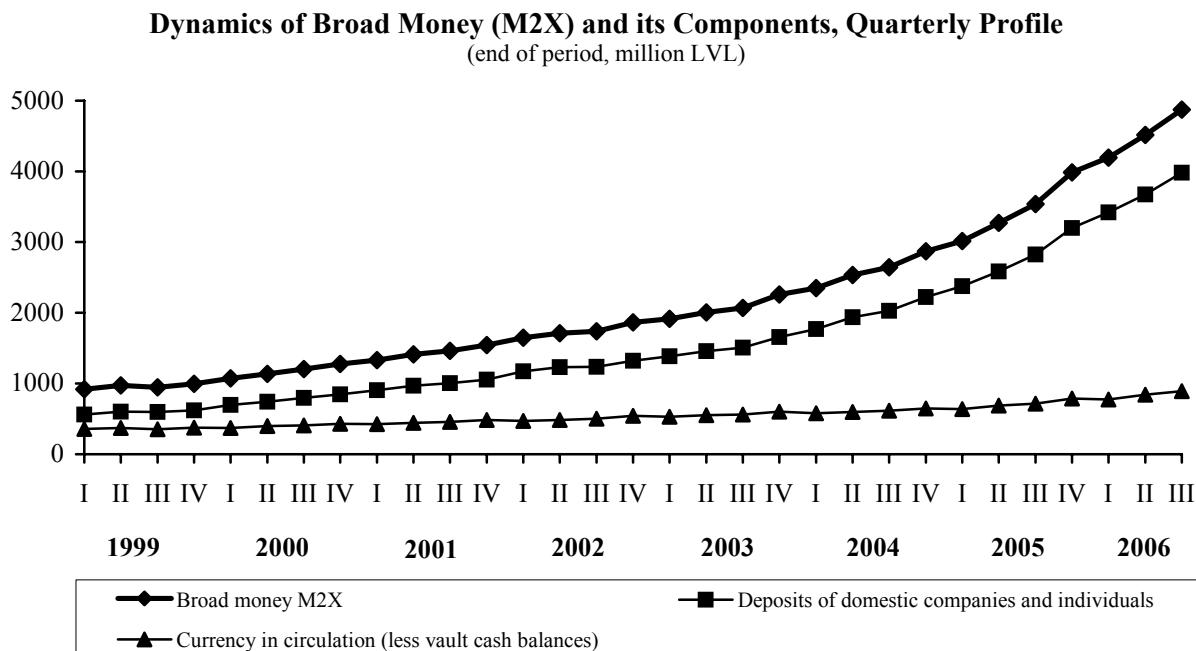
Although volumes of both the deposits and granted loans have considerably increased in recent years, their share in GDP (see Figure 4.26) is still substantially lower than in the developed countries.

Figure 4.26



The share of **deposits** of companies and individuals in GDP amounted to 36% in 2005. In 2005 the volume of deposits of companies and individuals increased by 44%. 60% of all deposits drawn by residents were deposits in LVL, whereas the rest was deposited in foreign currencies. Dominant role in deposits is played by demand deposits whose share in the total deposit structure was 71% at the end of 2005. The volume of deposits of companies and individuals continued growing in 2006 as well (it increased by 25% in 9 months of this year).

Figure 4.27



Deposits of non-residents constitute slightly less than a half of the total volume of deposits. Their share in the total deposits is shrinking (from 54% at the end of 2004 to 47% at the end of 2005). 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*.

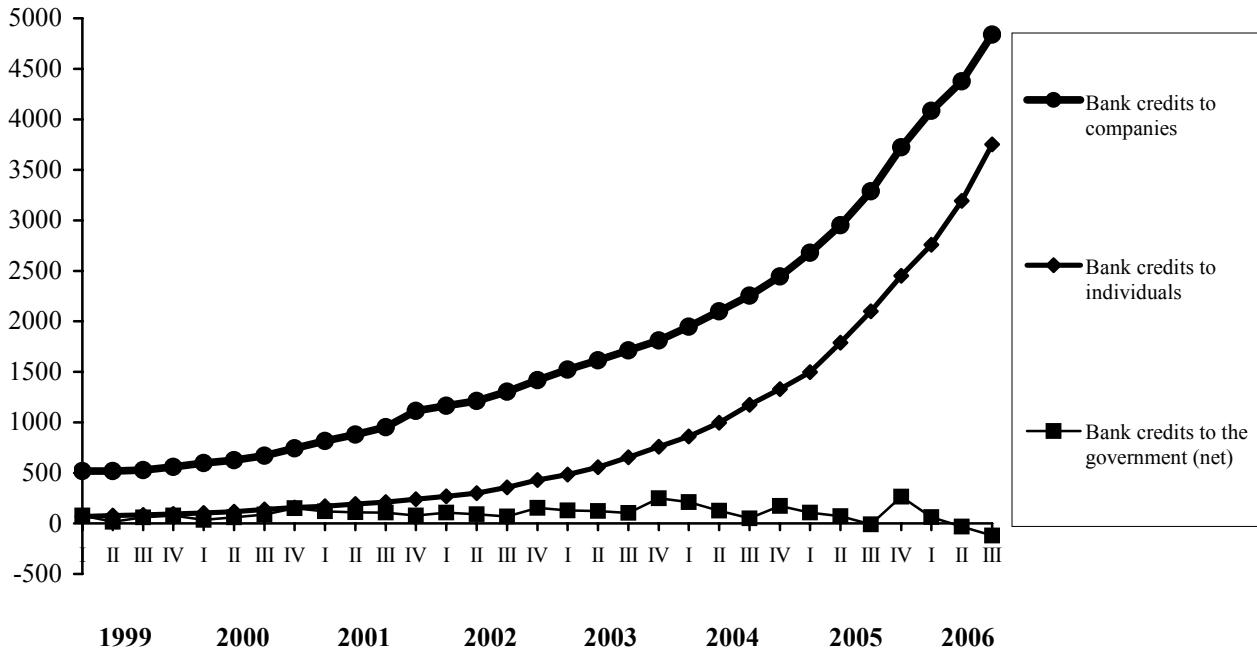
In 2005 the share of **loans** to companies and individuals in GDP was 69%<sup>1</sup>. In the last years, the volume of loans has increased by 37-50% annually and it increased by 64% in 2005 and by 39% in 9

<sup>1</sup> To compare: in euro zone, the proportion of loans against GDP was 98% at the end of 2003.

months of 2006. Both the enlivened economic activity and the reduction of credit risks have encouraged the growth of crediting.

Figure 4.28

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



At the end of 2005, 89% of total issued loans had been granted to resident borrowers, of which credits to households constituted 39% (90% and 43% respectively at the end of September 2006). 30% of total loans granted to resident borrowers were loans in LVL. The share of loans issued in lats and US dollars in the credit portfolio is gradually decreasing, while the share of loans issued in euros is increasing and amounted to 59% of the credit portfolio at the end of 2005.

Some positive changes have taken place concerning the loan term and the quality of credit portfolio. The share of short-term loans in the total structure of loans is decreasing, whereas the share of long-term loans is increasing (see Figure 4.29). The share of long-term loans in the total credit portfolio was 51% at the end of 2005.

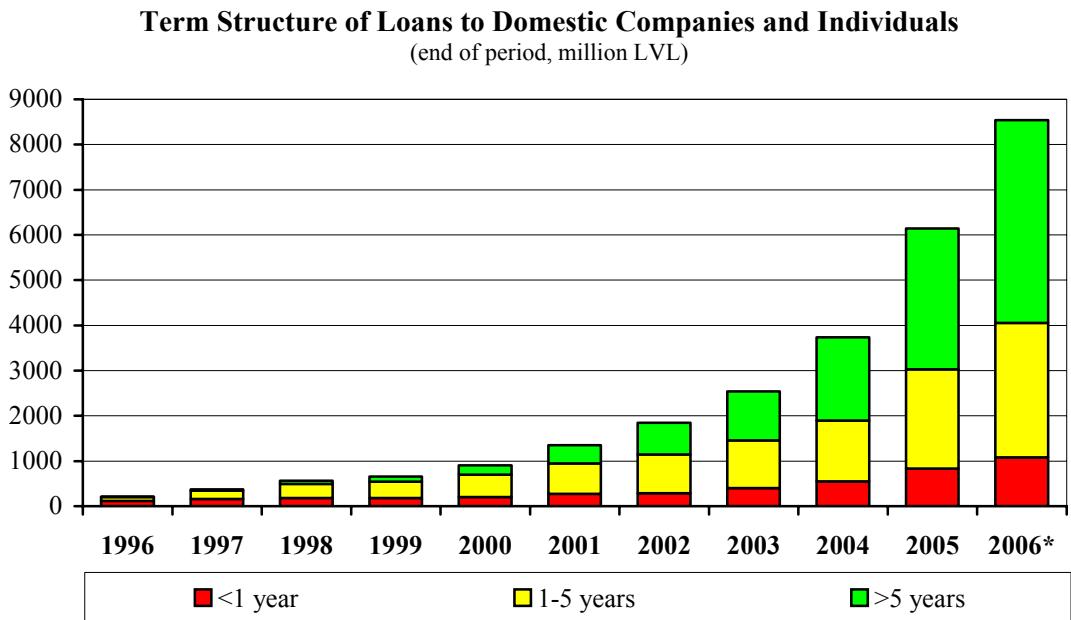
While the amounts of crediting are increasing, the quality of loans is not decreasing. At the end of 2005 the quality of loans issued by banks was as follows: 98.8% of all issued loans were evaluated by banks as standard loans, 0.5% were evaluated as the loans under supervision, and only 0.7% were evaluated 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.

At the end of 2005 the biggest amounts of loans had been granted to the following national economy sectors: real estate transactions (24.5% of total domestic loans), financial mediation (19.2%), trade (14.2%), extractive and manufacturing industries (12.9%).

From the end of 2002 to the end of 2005, the balance of long-term loans increased most rapidly in the sector "Real estate transactions, lease, computer services, science and other commercial services" (7.4 times), in construction (3.6 times), agriculture and fisheries (3.1 times), financial mediation (2.9 times), and extractive and manufacturing industries (2 times). In 2005 crediting grew fastest in real estate transactions (2.2 times), financial mediation (by 79%) and construction (by 70%). Similar trends were observed in 2006 as well (see Figure 4.30).

<sup>1</sup> To compare: 1.1% of issued loans were evaluated as generating no income at the end of 2004, 1.4% at the end of 2003, and 2% at the end of 2002; this indicator equalled to 2.8% at the end of 2001, 5% at the end of 2000, 6% at the end of 1999, 7% at the end of 1998, and 10% at the end of 1997.

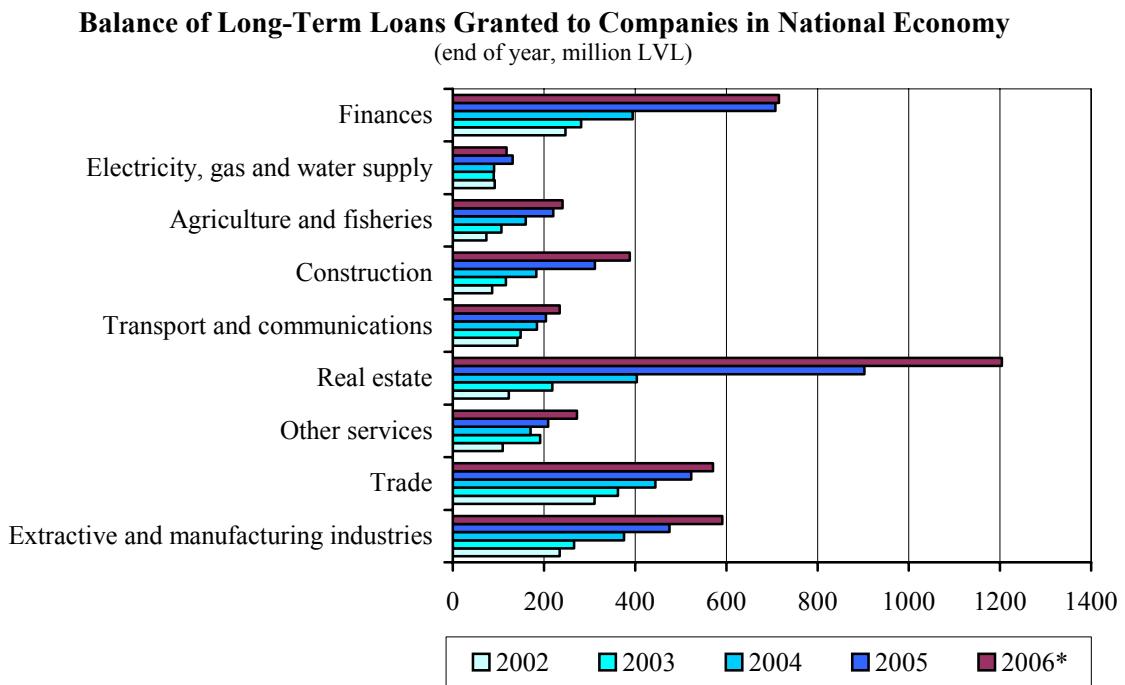
Figure 4.29



\* end of September 2006

Mortgage crediting develops rapidly. The volume of issued mortgage loans rose by 103.1% in 2005. The share of mortgage loans in credit portfolios of banks has grown from 17% at the end of 2001 to 37% at the end of 2004 and 46% at the end of 2005. At the end of September 2006, the share of mortgage loans in credit portfolios of banks had increased to 49.5%. The share of commercial loans (to increase current assets of companies) in the total credit portfolios of banks was 27% at the end of 2005, while the share of industrial loans (for acquisition of fixed assets and financing of long-term investment projects) amounted to 19%.

Figure 4.30



\* end of June 2006

Responding to the rising domestic demand, the Bank of Latvia raised the refinancing rate by 0.5 percentage points in March and November of 2004 and in July and November of 2006 to 4.5% and

increased the reserve requirement ratio from 3% to 4% in July 2004, to 6% in August 2005 and to 8% in December 2005, in order to slow down the rapidly growing lending.

In order to unify conditions of mutual competition between banks and slow down the rapidly increasing borrowing by Latvian banks in foreign banks, as from January 24, 2005 the Bank of Latvia included bank commitments to foreign banks and foreign central banks with set term or warning term on withdrawal till 2 years in the base of compulsory reserves. On March 14, 2006 the Council of the Bank of Latvia took decision to expand the base of compulsory reserves, keeping the norm of reserves at the previous level of 8%. As from May 24, 2006 the requirements on compulsory reserves are also applied to bank commitments with set term above 2 years. In August 2006 all deposits of the government in LVL were transferred from commercial banks to the Bank of Latvia.

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 low share of loans granted to resident borrowers in GDP, 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.

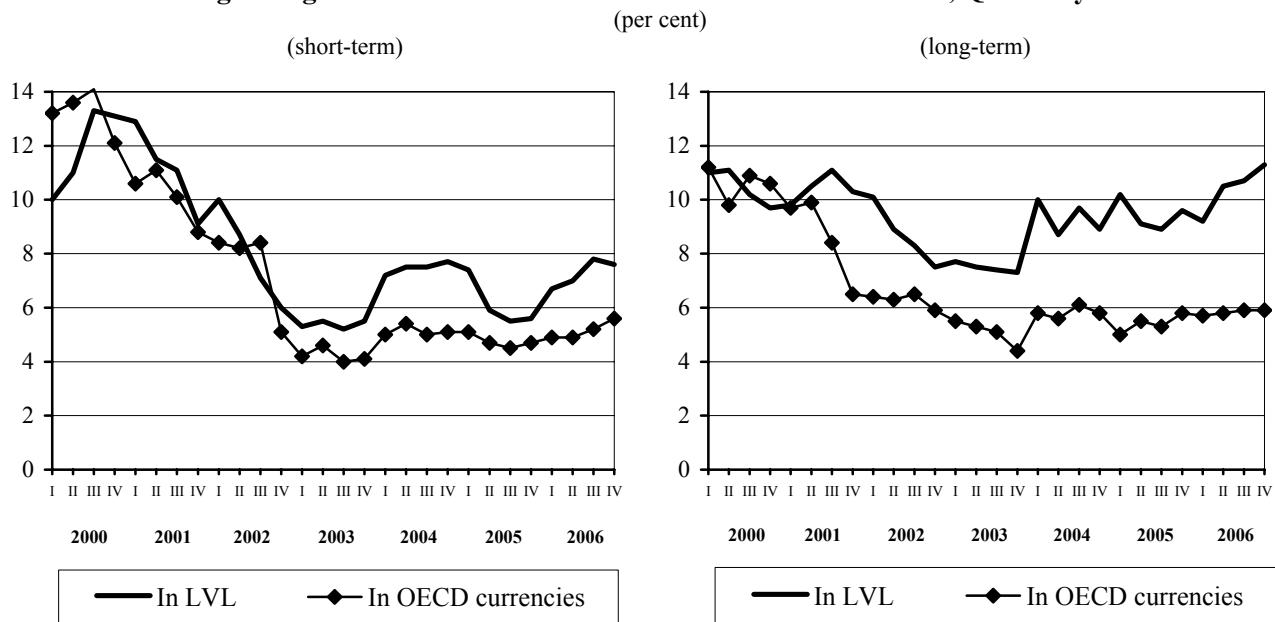
The dynamics of loan interest rates is shown in Figure 4.31.

In October 2006, the average weighted annual interest rate for short-term loans in LVL to companies and individuals was 8.3%, the rate for long-term loans in LVL was 11.3%, while the respective rates for loans in OECD currencies were 5.6% and 5.9%<sup>1</sup>.

The average weighted annual interest rate for short-term deposits in LVL was 3.4% in October 2006, the rate for long-term deposits in LVL reached 4.7%, while the respective rates for deposits in OECD currencies were 3.6% and 4.0%.

Figure 4.31

#### Average Weighted Interest Rates on Loans in Credit Institutions, Quarterly Profile



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

## 5. Labour Market

### 5.1. Employment and Unemployment

Rapid economic development in the recent years has made a positive impact on the situation in Latvian labour market. Although the population of working age (15-64 years) continues decreasing, the number of economically active persons increases and the employment rate grows (see Table 5.1).

Table 5.1

#### Key Indicators of Employment and Unemployment<sup>1</sup>

Indicators	2000	2004	2005	3 quarters of 2006
Population in the age of 15-64 years (thousand)	1600.3	1587.3	1583.8	1580.4
Economically active persons in the age of 15-64 years (thousand)	1074.7	1105.5	1100.8	1122.4
Employed persons (thousand)	917.6	988.2	1003.6	1041.4
Participation rate (%)	67.2	69.6	69.5	71.0
Employment rate (%)	57.3	62.3	63.4	65.9
Unemployed (job seekers) (thousand)	158.3	118.6	99.1	82.1
Unemployment rate (%)	14.4	10.4	8.7	7.1

<sup>1</sup> In the table and further in the text, indicators of employment are given for persons in the age of 15-64 years and indicators for unemployment are given for persons in the age of 15-74 years.

<sup>2</sup> Share of registered unemployed persons in the economically active population from 2002 is according to the new methodology.

In the last six years (2000-2005) the **employment rate** has increased by 5.8 percentage points. In 2000 the employment rate in Latvia was by 4.9 percentage points lower than the EU-25 average, while in 2005 the employment rate in Latvia reached 63.4%, which was by 1 percentage point higher than in 2004 and lagged behind the EU-25 average by only 0.4 percentage points.

The Lisbon Strategy has set a target to achieve the average EU employment rate of 70% by 2010. This target is already achieved by Denmark, Sweden, Netherlands and the United Kingdom. Cyprus, Austria, Finland, Portugal and Ireland have reached an intermediate target of achieving the employment rate of 67% by 2005.

The employment target of Latvia, set in the National Lisbon Programme of Latvia (see Chapter 6.1) for 2010 is 67%, i.e., it lags behind the level set by the EU by 3 percentage points.

Figure 5.1



Source: Eurostat, Structural Indicators, 27.12.2006.  
e – estimation of the Ministry of Economics

Female employment in Latvia is still higher than the EU-25 average and this difference tends to grow, as the female employment rate in Latvia exceeded the EU-25 average rate by 2.1 percentage points in 2002 and by 3 percentage points in 2005. This can be explained by the low proportion of manufacturing in Latvian economy and by a bigger share of the sectors with higher proportion of women in the number of employed persons (trade, restaurants and other services).

Male employment in Latvia tends to increase every year, but still lags behind the average EU-25 rate (by 6.7 percentage points in 2002 and 3.7 percentage points in 2005). According to Eurostat data, the male unemployment decreased by 1.5 percentage points in 2005 in comparison with 2004 and was 9.1%. Female unemployment decreased by 1.5 percentage points in 2005 in comparison with 2004 and comprised 8.7%. The total unemployment rate in Latvia was 8.9% in 2005.

Male employment exceeded the female employment rate by 7.9 percentage points in 2004, while in 2005 this difference slightly increased to 8.3 percentage points, as the male employment grew faster.

Male employment increased by 0.3 percentage points in 2004 and by 1.2 percentage points in 2005. Female employment rose by 0.6 percentage points in 2004 and by 0.8 percentage points in 2005.

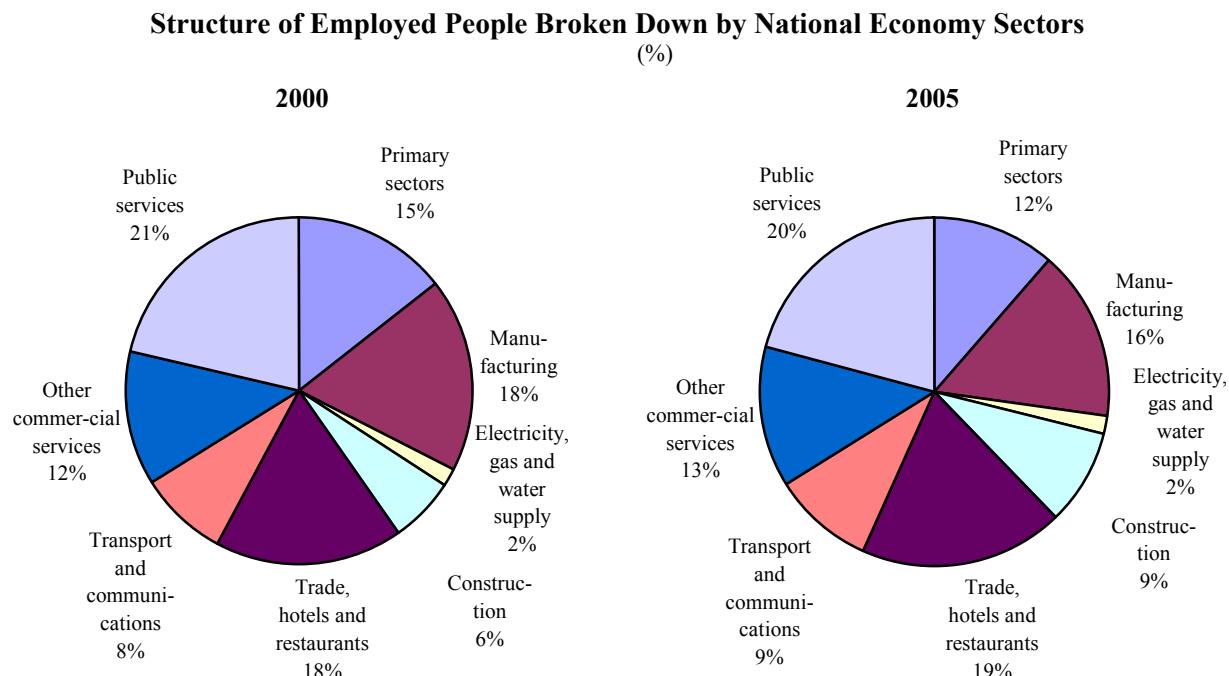
Employment rates in Latvian regions are still very different<sup>1</sup>. Employment rate in Rīga increased by 1.4 percentage points in 2005 compared to 2004 and reached 69.3%, in Pierīga it grew by 1.6 percentage points to 65.3%, while employment rates in Vidzeme and Zemgale regions increased by 3 and 1.8 percentage points respectively and reached 62.5% and 61.1% respectively. Employment rate in Kurzeme region did not change in 2005 as compared with 2004 and still was 62%, while it decreased by 0.6 percentage points in Latgale region, reaching 53%.

Of all employed persons in 2005, 70.4% were employed in cities and 29.6% were employed in the countryside. It has to be noted that the proportion of the employed in cities grows every year, but the proportion of the employed in the countryside decreases.

Number of employed persons has notably increased since 2000 (by 9.4%). However, the growth of employment is notably lower than the growth of GDP. These processes are objective for Latvian economy, given the low level of its productivity. Therefore, also further growth of economy will mostly be oriented to productivity growth and less to the growth of the number of employed people.

The structure of employed people broken down by national economy sectors has slightly changed during the last five years (see Figure 5.2). The number of employed people in service sectors has increased faster, especially in trade and communications, while the number of employed persons in agriculture and industry has decreased.

Figure 5.2



Source: Eurostat

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

In 2005 Latvia took the 16th place among the EU member states in terms of the employment rate, while the **unemployment** rate indicators in Latvia were among the worst in the EU. Only Spain, Germany, Greece, France, Slovakia and Poland had higher unemployment rates than Latvia.

Still, an undeniable progress is reached in the last years, as the unemployment rate in comparison with 2000 has decreased from 14.4% to 10.4% in 2004 and to 8.7% in 2005 (according to the data of Labour Force Survey, CSB).

The highest unemployment still remains in Latgale region. At the end of 2005 it reached or exceeded 25% in two districts of Latgale: Ludza (27%) and Rēzekne (25%) districts. The high unemployment is determined by poorly developed business activity, poor self-employment and insufficient traffic infrastructure.

The lowest rates of unemployment in 2005 are in Rīga city, Rīga district and Ogre, Saldus and Tukums districts (4.1%, 5.2%, 4.8%, 5.2%, and 5.6% respectively).

The share of long-term unemployed people (who have not been able to find a job during one year) in the total number of unemployed people was 46.0% in 2005 and 43.8% in 2004.

The majority of all unemployed people are representatives of simple low-skilled professions, while the highest employment rate is among the people with higher education (84.7% of people with higher education were employed in 2005).

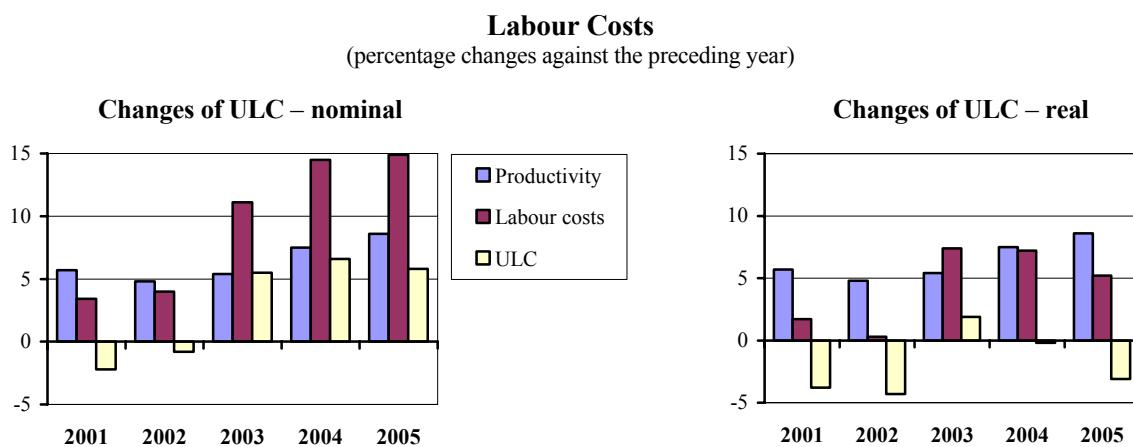
In 2005 the majority of the unemployed was among the persons in the age of 35-54 years. The share of the pre-pension age unemployed in the total number of unemployed persons increases every year, which is mostly related to the increase of pension age according to the law on pensions.

The number of unemployed people decreases not only due to the increase of the employment rate. In the last years after Latvia's accession to the EU, labour outflow takes place to some old EU member states, where labour markets are open to the citizens of the new EU member states. Therefore, shortage of labour force in several sectors is starting to develop in Latvian labour market.

## 5.2. Labour Costs

Labour costs per production unit constitute one of the indicators characterising competitiveness both for the country on the whole and for separate sectors. In the recent years, as the real labour costs<sup>1</sup> in Latvia grow slower than productivity, real labour costs per production unit (ULC – real) decrease. Nominal labour costs<sup>2</sup> grow faster than productivity (see ULC – nominal).

Figure 5.3



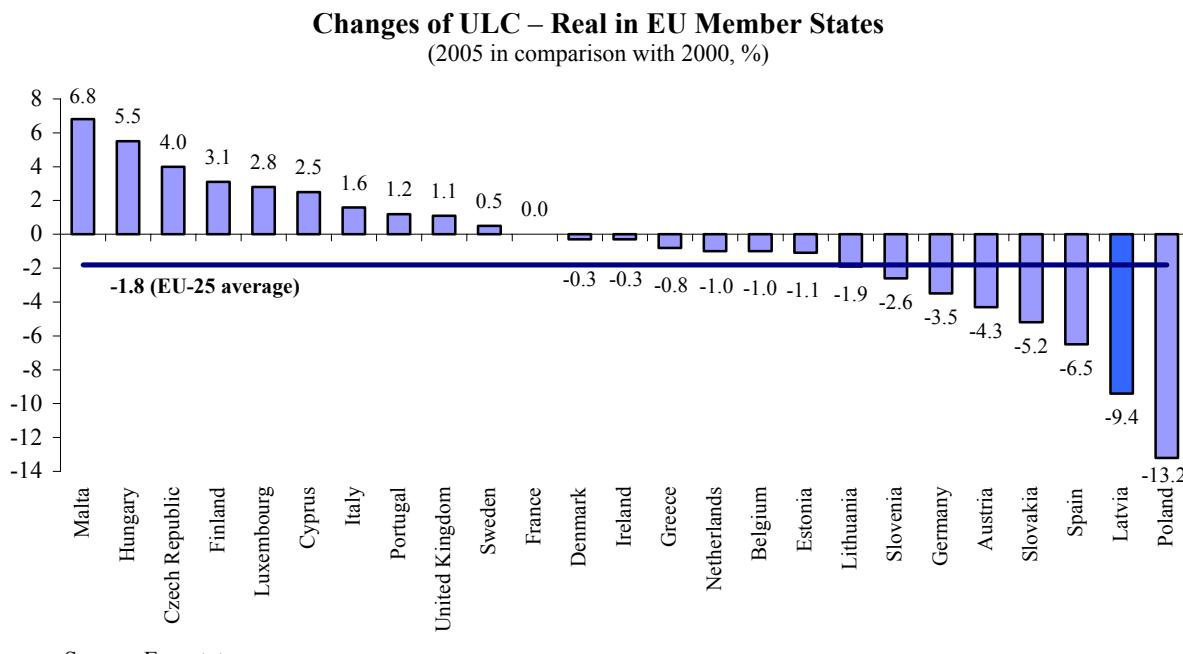
It should be noted that similar trends are observed in other EU member states as well. In the period from 2000 until 2005, ULC – nominal in EU member states grew by 10.1%, while in Latvia it

<sup>1</sup> corrected by producer price index or deflator

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

increased by 15.6%. ULC – real has decreased during the five years (by 1.8% in the EU on average and by 13.2% in Latvia). This indicates changes of price competitiveness between EU member states.

Figure 5.4



Source: Eurostat

Since 2000, Latvia has relatively improved its position in term of price competitiveness in comparison with other EU member states. However, it should be noted that the biggest progress was achieved in the period from 2000 until 2002, when productivity growth rates exceeded wage increase rates several times and inflation rates were low; as a result, the real ULC in 2002 decreased by almost 8% in comparison with 2000. Already in 2003 the real ULC grew by 2%, which may be explained partly by the so-called cyclic factors, i.e., slow adaptation of wages to changes of economic activities. As statistical data show, the dynamics of wages was rather moderate until 2003. Growth of production volumes continued several consecutive years and promoted increase of demand in the labour market as well as rise of wages. Besides, the rise of wages in 2003 was also affected by the increase of minimum wage from LVL 60 to LVL 70. To a certain extent, the rise of wages was also affected by the social tension in the society, which expressed itself in strikes of public sector employees (teachers and medics), and by consolidation of trade union positions.

High growth rates of the nominal wage remained in 2004 and 2005 as well (by 14.5% and 14.9% respectively), exceeding the productivity dynamics more than two times. However, these changes are less affected by cyclic factors than by the structural ones that are related to convergence processes.

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

- general economic growth that is mainly based on the productivity growth and, in the last two years, also on the employment growth;
- rise of the general level of prices, which is greatly related to the price convergence;
- increase of wages (wage convergence), which is greatly affected by the growing competition in Latvian labour market after accession to the EU.

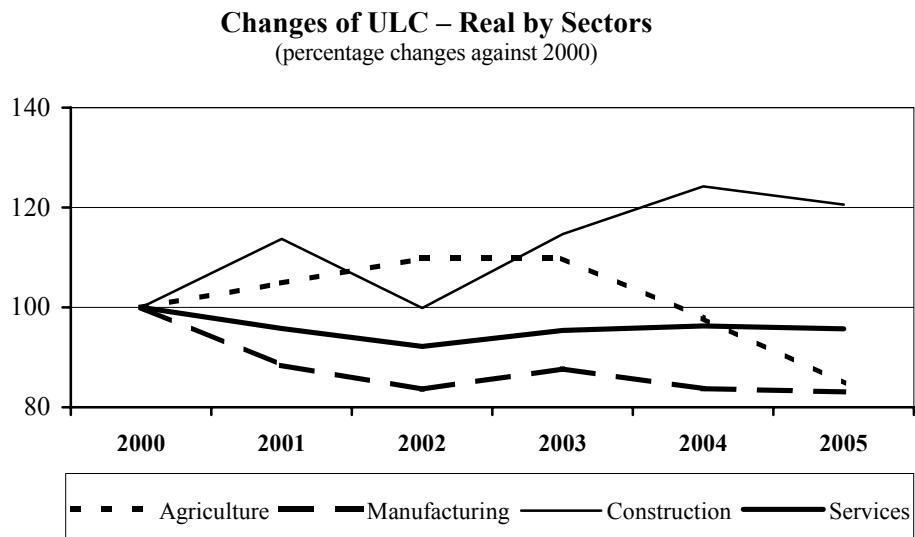
The mentioned factors differently affect labour costs per production unit; the productivity growth reduces labour costs per production unit but the increase of wages raises these costs.

Therefore, the rapid growth of nominal labour costs per production unit in 2004 and 2005 was mainly determined by the rapid increase of wages. Increase of wages was affected by two main conditions. Firstly, the demand for labour force increased due to the rapid economic growth, and, secondly, opening of labour market in such highly developed countries as Ireland and the United Kingdom increased competition in Latvian labour market (labour supply decreases due to growing emigration), which creates a big pressure on wages. Wages of the employed in Latvia are very low in comparison with the EU average indicators; in majority of sectors, these wages make 15-20% of the EU

average. Therefore, increase of wages objectively may occur faster than dynamics of the productivity and price convergence processes.

Dynamics of labour costs per production unit differs by sectors. As can be seen, labour costs per production unit in 2005 exceed the level of 2000 in almost all sectors, with the exception of construction. Labour costs per production unit in construction in 2005 were by 20.6% bigger than in 2000, which was greatly due to ULC growth in 2003-2005.

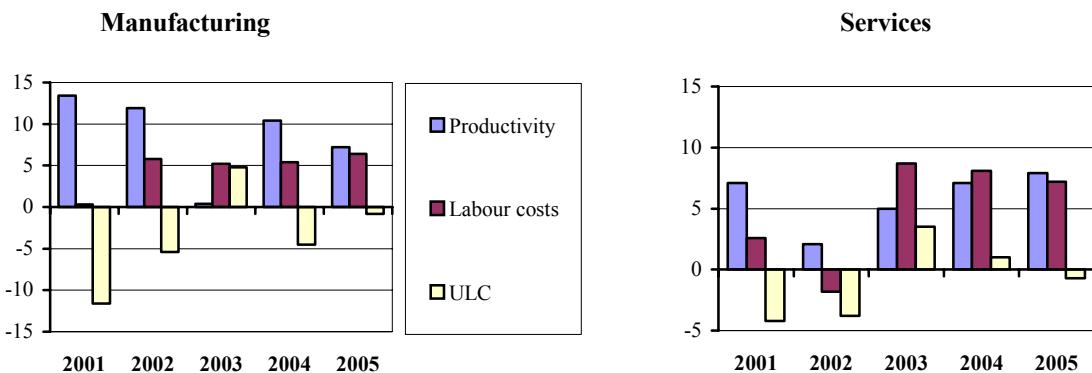
Figure 5.5



Source: Eurostat

Figure 5.6

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



Since 2003, labour costs increased every year both in services and in manufacturing. Increase of wages in manufacturing is compensated by productivity growth and labour costs per production unit are decreasing. Such compensation is not so typical in service sectors and labour costs per production unit increased, slightly decreasing in 2005.

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

### 5.3. Employment Policy

Latvian employment policy is closely related to the employment policy of the EU. The Treaty on European Union has a definite goal to promote economic and social development and high employment rate. In order to fulfil this, member states and the Community work out a co-ordinated strategy in the field of employment (see Box 5.1).

#### Box 5.1

##### **EU strategy in the field of employment**

In March 2000 in Lisbon the European Council accepted 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-pension age population of 55-64 years).

However, the economic development and employment rates in the first half of the decade markedly lagged behind the planned ones. In order to ensure achievement of Lisbon goals, in spring of 2005 the European Council decided to start a new governance cycle of the Lisbon Strategy. For this purpose, the European Commission developed and the European Council accepted (in July 2005) the Integrated Guidelines package by merging the hitherto separate Broad Economic Policy Guidelines and Employment Guidelines. In order to achieve fulfilment of the main targets of the European employment strategy, three priority lines of action are formulated:

- attraction and retaining more people in employment, increase of labour supply and modernisation of social protection systems;
- improvement of mutual adaptation of employee and business interests;
- increase of investment in human capital through better education and skills.

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

*National Lisbon Programme of Latvia for 2005-2008* (hereinafter Programme) envisages to reach or substantially approach the targets formulated in the European Employment Strategy and achieve the employment rate of 67% in 2010 (see Chapter 6.1).

The Programme sets the following priorities of Latvia's employment policy:

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

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 constitute the set of employment policy measures of the Programme.

During the last years, indicators of labour market in Latvia improved due to rapid economic development, improvement and diversification of active labour market measures and other factors.

In order to include and keep a bigger number of inhabitants into employment, **active labour market measures** are launched widely. In 2005, 180 thousand unemployed people were involved in these measures, which was 2.3 times more than in the previous year, among them long-term unemployed people by 79% more. The majority of these measures were aimed at rise of their competitiveness in the labour market, improving professional training and raising skills, involving in paid temporary jobs, and other factors. Increasingly bigger attention is paid to inclusion in the labour market of those population groups that have difficulties to find and start work. In 2005, with ESF support in the framework of the National Programme "*Support to Implementation of Active Employment Measures*", the State Employment Agency (SEA) implemented projects for training, retraining and raising skills of the long-term unemployed, unemployed returning to the labour market after childcare leave, disabled, pre-pension age job seekers, young people without work experience, persons after serving their time in detention facilities, and representatives of other groups. More than one-third of these unemployed have found work after the training.

In order to promote **youth employment**, the Professional Career Counselling State Agency (PCCSA) gives individual and group consultations in choice of education and profession, determination of professional suitability, and career planning. In order to solve the current problems of unemployed

young people with integration in the labour market, young people are prioritarily involved in active employment measures organised by SEA.

Several European Social Fund (ESF) projects were implemented in 2005, whose implementation will increase opportunities of young people to get included in the labour market. Implementation of projects of the ESF open projects tender "*Ensuring Work Practices for Unemployed Young People*" (27 projects) was started and a repeated tender of projects was also announced.

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

Task of heightening the awareness of employers about observance of **gender equality** principles in companies and inclusion of women into employment is topical in Latvia. Women often leave work or cannot start working due to inflexible work organisation, lack of childcare institutions or other reasons. This accounts for considerable difference between female and male employment rates (about 8%). At the same time it has to be noted that a marked difference between female and male wages also exists. Labour force surveys carried out by CSB in 2005 indicate that 42.4% of women were employed in low-paid work (under LVL 100, after taxes), which is 1.7 times more than among the employed men.

Due to the growing globalisation of economy, rapid development of technologies and negative demographic processes, an increasingly bigger attention to **issues of flexicurity** (labour market flexibility and employment security) is paid in the European employment strategy. In this regard, in March 2006 the European Council asked member states to pay bigger attention to implementation of reforms in labour market and social security policies. It is necessary to achieve that labour contracts are sufficiently flexible and correspond to interests of both the employer and the employee. In case of necessity, the active labour market policies have to efficiently encourage transition from one workplace to another or from the status of unemployed person to employment. Life-long learning systems have to be improved, which would allow the employee to be employed during all his capacity for work. At the same time, a modern social security system has to be established, which would give an adequate assistance to people in case of unemployment and would promote mobility and faster return to the labour market.

It is important to ensure continuous rise of the skill level of employed people, modernisation of work organisation, balance of opportunities of at-work and out-of-work lives, safety at work, gender equality, etc. At present, the level of labour quality in Latvia falls behind the situation in EU member states in many aspects. Only 7.6% of the employed in the age of 25-64 years participated in professional training activities or attended some educational establishment in 2005. A Lisbon target is to achieve involvement of at least 12.5% of employees into life-long learning by 2010. Number of people injured in accidents at work is still high (136 cases per 100 000 employed) and is still among the highest among ES member states. It is partly due to the long working week that amounts to 42.8 hours on average; it is slightly longer in mere four other member states. Number of the people suffering from occupational diseases tends to grow. However, it has to be noted that trade unions, strengthening their influence in the sphere of labour protection and safe working environment, keep increasing the number of trustees on labour protection issues.

New **system of labour protection services** has come in force as from January 1, 2006, which is aimed at ensuring quality of labour protection services and setting unified criteria for assessment of their competence. In order to improve the working environment and reduce the number of accidents in comparatively more dangerous sectors, the types of commercial activity are defined, where the employer has to compulsorily involve a competent institution in the field of labour protection.

Latvia has a relatively high **rate of undeclared employment**, especially in construction, manufacturing, agriculture and transport services, which reduces social security benefits and does not allow to diminish the burden of labour taxes. In order to address this problem more intensively and stimulate population to be engaged in the formal economy, net wages for low-paid workers are being

increased, raising the minimum wage and increasing the amount of non-taxable minimum, state control institutions are being strengthened and co-operation with social partners (trade unions and employer associations) is being activated.

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

The Lisbon Strategy envisages that at least 85% of young people in the age of 20-24 years will complete secondary education by 2010. In the previous year, this indicator slightly exceeded 77% in the EU on average (according the preliminary calculations by Eurostat) while in Latvia it was close to 80% and is forecasted to exceed 85% in 2010.

The Programme for 2005-2008 envisages improving the adaptability of educational system and students to the changing requirements of the labour market. For this purpose, material and technical provision of professional education establishments is being modernised and a set of measures to ensure practice for students is being established, using also financing from EU funds. Modernisation of practical teaching system and mastering of skills in national economy sectors important for regions is started. In order to raise prestige of engineering sciences, natural sciences, medicine and other fields necessary for development of Latvia, a bigger attention is paid to development and implementation of an information campaign and to raising the number of study places financed from the state budget in these fields. Life-long learning strategy is being developed and the system of professional orientation is being improved.

At the same time, gradual improvement of availability of education at all levels is taking place and measures to reduce the number of students who do not graduate or do not achieve professional qualification are being implemented, creating pedagogical correction programmes, applying educational services to socially excluded population groups, etc. In 2003, education ministers of EU member states agreed about the necessity to achieve reduction of the number of students who do not graduate or do not continue learning from 16% of the total number of young people (in the age of 18-24 years) to at least 10% by the end of the decade. This indicator in Latvia equalled to 12% in 2005 and is forecasted to be lower than the EU average indicator in 2010.

The European Commission, assessing the process of implementation of the Programmes of member states, noted that a considerable progress in implementation of measures promoting employment is achieved in Latvia on the whole. However, in the further work, a bigger stress has to be put on faster increase of labour force in employment and strengthening of professional skills of the employees. For this purpose, it is recommended to improve the regional mobility of population and to increase compliance of education and professional training with labour market demands, also efficiently using the life-long learning system. Besides, in further implementation of the Programme, it would be important for Latvia to simplify the administrative formalities for hiring and layoff of employees, promote education in the field of business, improve and develop active labour market policies, and ensure and improve access by parents to childcare institutions.

## 6. Economic Policy and Priorities of Structural Policy

### 6.1. National Lisbon Programme of Latvia for 2005-2008

#### 6.1.1. Targets and Priorities of the Programme, Process of Its Implementation

On October 19, 2005 the Cabinet of Ministers approved the National Lisbon Programme of Latvia for 2005-2008 (hereinafter the 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 achieving the Lisbon Strategy goals, indicates the main lines of action and activities to solve the problems as well as performance indicators for achieving the goals.

National Lisbon Programme of Latvia for 2005-2008 prescribes that Latvian GDP per capita has to reach 51% of the EU average by 2008 and 54% by 2010 (see Figure 6.1). In order to reach this goal, annual GDP growth of 6-8% has to be ensured in 2005-2008.

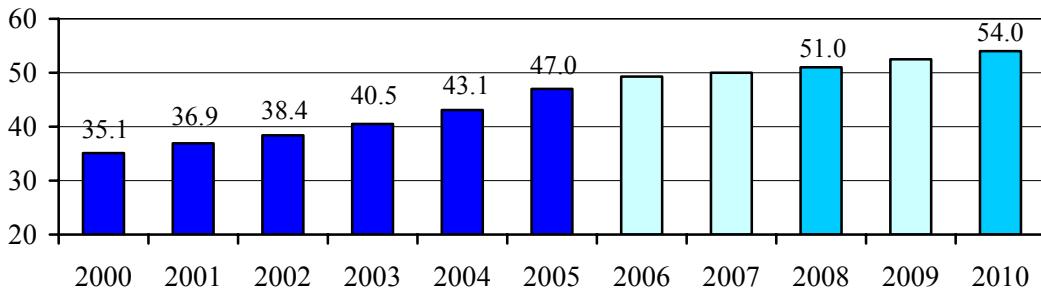
Latvia has defined 23 performance indicators for the medium-term period.

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

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

Figure 6.1

**GDP per capita\***  
(% of EU-25 level in purchasing power standards)



\* 2000-2005 – fact, 2006-2010 – forecasts and targets

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 so 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.

On October 10, 2006 the Cabinet of Ministers supported the *Report on Progress in Implementation of the National Lisbon Programme of Latvia for 2005-2008* (hereinafter the Report).

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

The Report was developed by the Ministry of Economics and evaluates the progress in achieving the Lisbon Strategy goals. As noted in the Report, the progress of implementation of the Programme indicates that the principal goals set in it are achievable. GDP grew by 10.2% in 2005 and by 12% in the 1st half of 2006, which is faster than prescribed by the Programme.

Latvia has a goal to maintain a stable **macroeconomic environment** that is a necessary precondition for ensuring growth and workplaces. At present, the comparatively high inflation and imbalance of the external sector have to be assessed carefully although the current influence of these processes on the development of national economy still does not require fast and cardinal interference.

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 the ministries and, in accordance with it, base the budget formation on financing the action policy goals and results;
- to promote coherent increase of wages and labour productivity in order to disallow additional economic instability, at the same time taking into account the consequences of inflation;
- to ensure successful accession of Latvia to the euro zone.

The main activities to be carried out in the area of fiscal policy, which are envisaged in the *National Lisbon Programme of Latvia for 2005-2008* in order to fulfil the Maastricht fiscal criteria and ensure efficient budget spending, are being implemented successfully on the whole. The fiscal consolidation successfully carried out already in the previous years was continued in 2005, which ensured that the reference value of the Maastricht criterion is not exceeded. The general government budget surplus in 2005 (according to the ESA 95 methodology) amounted to 0.2% of GDP (notification data of April 2006). The level of the general government debt in Latvia is remaining among the lowest in the EU and is expected to remain considerably below the gross government debt volume criterion in the medium-term as defined in the Maastricht Treaty.

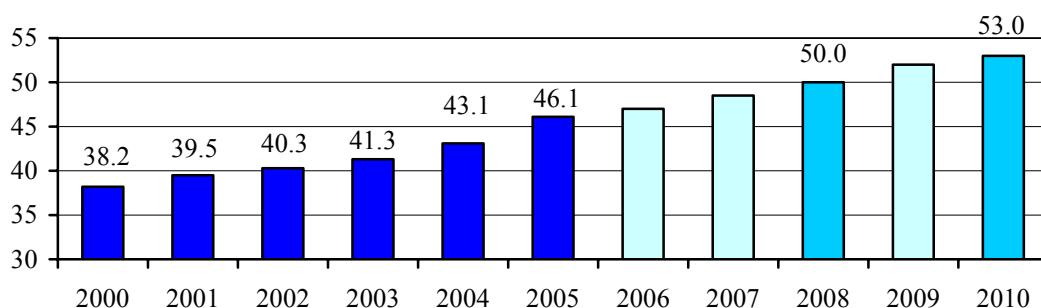
In order to ensure purposeful development and efficient spending of the government budget resources, the ministries gradually implement the strategic planning, and, in the result, budget formation is being based on financing the action policy goals and results.

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

In order to prevent additional economic instability, the Programme prescribes increase of wages achieved mainly by promoting economic development (growth of entrepreneurship and labour productivity), investing in development of human resources, especially education. The Programme envisages that labour productivity (see Figure 6.2) will reach at least half of the EU average in 2008.

Figure 6.2

**Labour Productivity\***  
(GDP in purchasing power standards (PPS) per employee, % of EU-25 level)



\* 2000-2005 – fact, 2006-2010 – forecasts and targets

One of the main goals of the government is introduction of the single EU currency – euro in Latvia. Precondition for achievement of this goal is macroeconomic stability that would promote further economic growth. Measures for maintaining the macroeconomic stability are described in detail in the Convergence Programme of Latvia for 2005-2008 approved by the government in November 2005.

Taking into account that implementation of the goal set by the government to join the euro zone by January 1, 2008 is problematic due to growing inflation, the situation is being assessed and a decision for further action will be taken.

In order to provide the technical and legal base for introduction of the euro on the national level, an appropriate organisational structure of the euro introduction project was established in summer 2005 and the Cabinet of Ministers approved the Latvia's National Euro Changeover Plan on March 6, 2006, which foresees implementation of several measures related to adjustment of normative acts for adjusting the normative base and ensuring the technical operation of money and payment systems, financial system, public debt management, budgetary accounting and statistics, business environment and consumer protection, taxes and social security, as well as for informing the society.

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

From a long-term perspective, sustainability of public finances will be mostly affected by the population ageing process resulting in decreased number and proportion of the able-bodied people and in increased demographic load. Initial calculations of financial sustainability show that the population ageing will have an impact on Latvian society, national economy and public finances but, due to the implemented pension reform, this impact will not create insurmountable consequences. The low level of Latvian public debt, with the expenditure pressure growing, also provides certain flexibility to the government, preserving the stability of public finances.

However, it has to be noted that the population ageing creates new challenges for the healthcare system. Breakdown of healthcare expenditure by age groups clearly shows that the biggest costs fall on older people whose number will significantly increase in the next 50 years. Long-term care expenditure in Latvia is currently quite low, determined both by the limited central and local government resources to be spent for these purposes and by traditions and values of the society. At the same time, health of other demographic groups has to be ensured as well, because the overall sickness rate is high. The government is working out an efficient healthcare system based on a long-term perspective.

Changes in the public finance policy will be required in the future in order to adjust the budget to a substantially different demographic situation. As the demographic load will increase in a more distant future, GDP growth based on growing labour productivity will play a decisive role in the rise of living standards of all population groups. Therefore it is important to ensure training of Latvia's main resources, namely, human resources, in accordance with labour market requirements and create an inclusive labour market.

Economy based on **knowledge and innovation** is a precondition for development and competitiveness of the Latvian economy. Essential drawbacks hindering development of knowledge-based economy are the low public and private sector investments in research and development, poorly developed innovation system, incompatibility of educational structure with long-term labour market requirements, low level of internet availability.

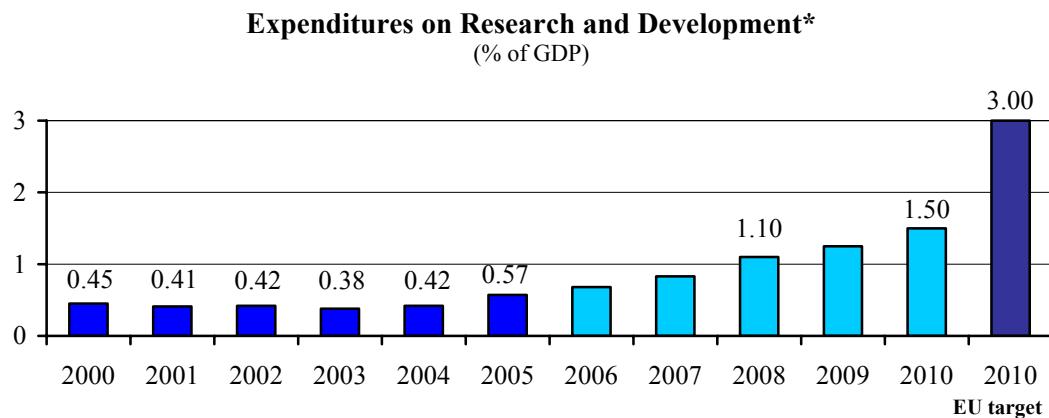
In order to stimulate knowledge and innovation, the main tasks of the Programme in 2005-2008 are as follows:

- 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 (see Figure 6.3). 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 financing for scientific activity set out by the normative acts, in order to ensure attraction of private investment as much as possible, improving conditions of financing for research commissioned by public administration bodies and market-oriented research. Essential modernisation of scientific infrastructure in research institutes and higher educational establishments and reorganisation of state science institutes are envisaged.

Figure 6.3



\* 2000-2005 – fact, 2006-2010 – forecasts and targets

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

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

In 2006 Latvia continued implementing the Programme “Support to Development and Improvement of Applied Research Infrastructure” and supporting the development of technology transfer contact points at higher education institutions.

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

The Programme envisages several measures for improvement of innovation support structures in order to promote transfer of knowledge and technologies and encourage development of new products and technologies. The target is to increase the number of innovative enterprises to 32% of all enterprises in 2008 and raise the number of national patents to 95, of which 24 are international ones.

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

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

The government has set several tasks for faster development of the information society. The first thing to be ensured is free competition in the market of information and electronic communication

services, and a lot is already done in this regard. Progress is reached regarding the increase of the number of internet users. Internet was used at least once a week by 27% of Latvian inhabitants in 2004 and by 36% in 2005. Introducing the current policy, good distribution of telecommunications has been achieved, legal acts related to ICT have been adjusted, main registers and the most essential information systems have been formed, integration of information systems of public administration and establishment of online services are being developed.

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

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

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

The main problems hindering business development in Latvia, especially SME, are the encumbered receipt of funding, various administrative obstacles, lack of adequate information and shortage of skilled labour force. Guarantee and investment instruments are insufficiently developed at present. Latvian enterprises, working with EU directives on quality, lack information on product standards and new production methods. Product quality assessment instruments are not available in Latvia.

Small progress is only observed in improvement of the state road network. However, road deterioration is high and carrying capacity of transport network is insufficient in several segments.

Economic activities in the regions outside Rīga increase at markedly slower pace than in Rīga and its neighbourhood. One of the reasons is too slow administrative territorial reform and that is why a big number of economically and administratively weak local governments, which are unable to ensure fulfilment of all municipal functions, exist protractedly in Latvia.

In the Programme, the following main tasks have been set as priority directions for creation of favourable and attractive environment for investment and jobs in 2005-2008:

- to promote entrepreneurial culture, lessen administrative obstacles and burden, create supportive environment for SME;
- to strengthen supervision of competition and ensure effective competition in public services;
- to improve and develop the transport infrastructure, increase the number of connections with other European infrastructure networks;
- to speed up the administrative territorial reform;
- to ensure effective, safe and sustainable energy supply, supporting decisions of the 2006 Spring European Council.

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

The Action Plan for Improvement of Business Environment of 2006 solves problems in construction, employment, tax administration, introduction of e-government, etc. In 2005 and 2006, improvements were made in operation of the Register of Enterprises and a new Insolvency Law was developed.

Priority in the field of competition protection is combating the gravest violations of the Competition Law – conclusion of prohibited agreements and abuse of dominant position. In order to implement this, amendments to the Competition Law have been made and regulations of the Cabinet of Ministers have been approved, envisaging the so-called Tolerance Programme in application of fine. Public funding is granted for measures to ensure efficient implementation of transposed directives, performing adequate market surveillance, which would create favourable business environment and fair

competition and reduce consumer risks of traumas and getting hurt in accidents, using unsafe goods or services.

In order to improve access of SME to funding, more attention is paid to granting funds for business development in early stage (measures for access to seed capital, opportunities to obtain loans on preferential terms) and access to finance in the form of risk capital as well as to co-funding for development projects of entrepreneurs in the territories requiring special assistance. Financial support for enterprises and innovation from the structural funds in the amount of EUR 480 million is planned in the next financial perspective period.

In order to improve access to loans on preferential terms, the Mortgage and Land Bank of Latvia (MLBL) implements support programmes financed by the state and EU, granting high-risk loans to viable and perspective projects of SME and business beginners, which are not financed by commercial banks due to insufficient collateral and other risks of the project. MLBL also implements other support programmes, among them training and consultation programme for business beginners and housing warranty programme. Crediting Programme for Beginners was started at MLBL in March 2006 and is co-financed from the state and EU Structural Funds resources.

Access of SME to credit resources is also promoted by the Latvian Guarantee Agency (LGA) that is a state-support institution. In order to improve the loan guarantee system, the procedure for consideration of applications has been optimised, speeding up consideration of guarantee applications by LGA. In 2005 the European Commission approved the state support programme for development of venture capital “Support to Venture Capital of Small and Medium-Sized Commercial Companies”. In the framework of this programme, in April 2006 LGA established 3 venture capital funds co-financed from the state budget and European structural funds, which might start making investment in the 4th quarter of 2006 already. These funds will invest in small and medium-sized commercial companies with high growth potential and value added, making investment in own capital of companies or granting it in the form of financial instruments related to own capital. As a result, the attracted additional financing is used for expansion of the current operation or for development of new products or technologies.

For the planning period of 2007-2013, such support programmes are envisaged as loan and leasing guarantees, export guarantees, heightened-risk loans, fund of venture capital funds, and business angels network.

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

The Programme pays special attention to quality improvement and development of international transport corridors, including both *Via Baltica* and East-West road corridors and the East-West railway corridor as well as development and rise of competitiveness of the port infrastructure.

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

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

Latvia particularly supports the decision of the Spring European Council meeting regarding the energy policy. It is important to improve security of energy supply and diversify energy sources, thereby reducing dependence of EU member states from one energy supplier. Latvia fully supports the idea to develop a common EU energy policy and use a co-ordinated approach in relations with third countries as

well as establish a crisis management system. Latvia is particularly interested in integration of the Baltic States' energy market into the single EU energy market. At present, the energy market of the Baltic States is isolated from the EU energy market. Co-operation projects with the neighbouring countries are being developed or implemented in order to decrease the energetic isolation from other EU member states.

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

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

Although **employment** in Latvia has increased in the last years, which was affected by the economic growth, the employment rate still lags behind the EU average and the unemployment rate is among the highest in EU.

The main problems in Latvian labour market 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.

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 a goal to reach employment rate of 65% in 2008 (61% for women and 48% for older people) and 67% (62% and 50%) respectively in 2010 (see Figure 6.4).

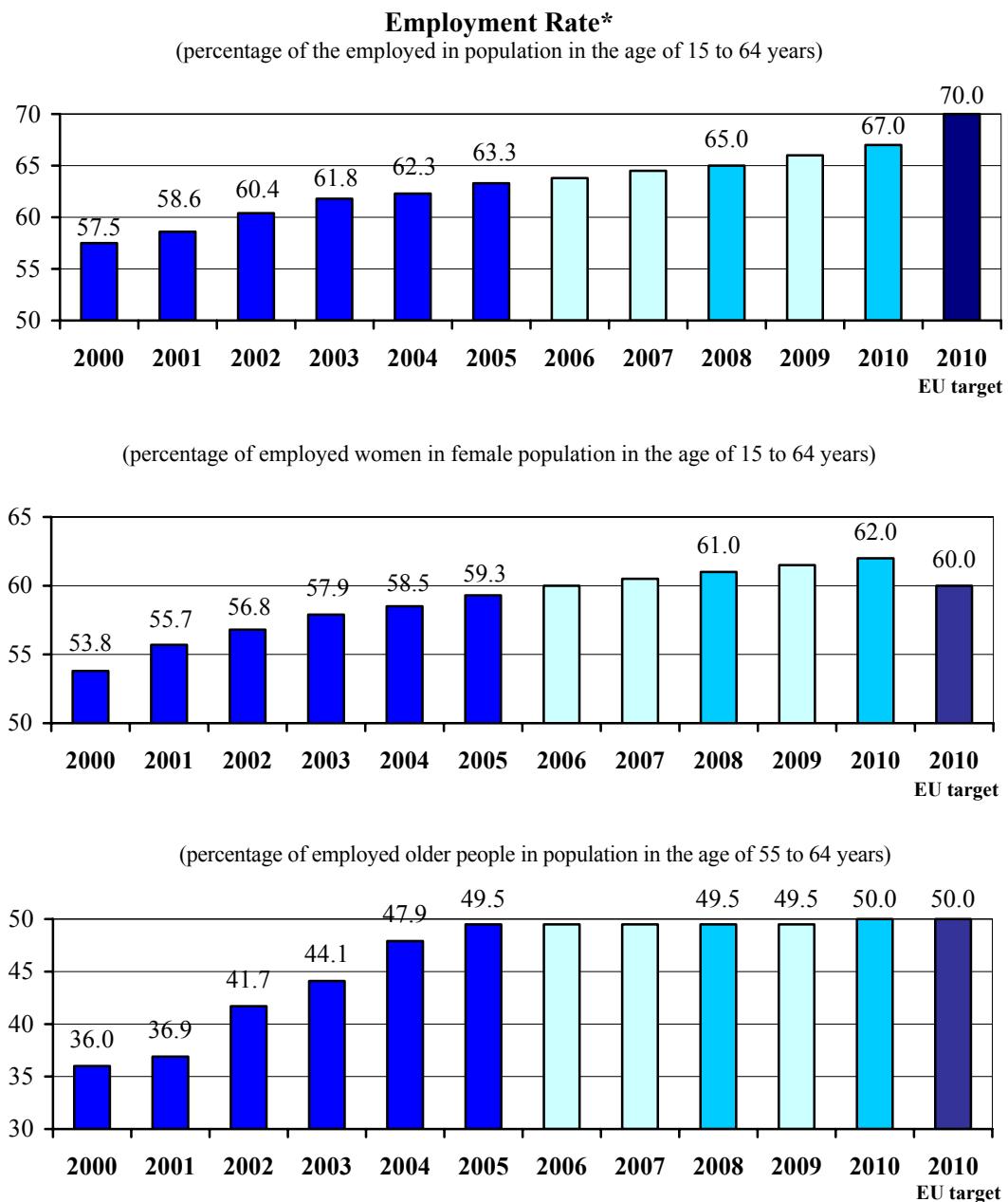
The rapid economic development in Latvia observed in the last years positively affects the situation in the labour market. During the last five years (2001-2005) the employment rate has increased by 5.8 percentage points.

Employment rate in 2005 was by 1 percentage point higher than in the previous year and reached 63.3%. It lags behind the target for 2010 set in the Programme by 4.7 percentage points. Male employment grows faster, increasing by 1.2 percentage points in 2005 and reaching 67.6% that is almost at the target level for 2010 set in the Programme (68%). It has to be noted that female employment rate in Latvia (59.3% in 2005) is higher than the EU average (56.3% in 2005).

Employment rate of older people has increased in 2005. It amounted to 49.5% in 2005 (age group of 55-64 years), which is by 1.6 percentage points higher than in the preceding year and exceeds the target for 2008 set in the Programme and slightly lags behind the target level set for 2010. However, it must be noted that employment rate of older people has substantially increased among women (from 41.9% in 2004 to 45.3% in 2005), but has slightly decreased among men (from 55.8% to 55.2%). It can be mostly explained by the different retirement age for women and men. At present, the retirement age is 62 years for men and 61 year for women. It is determined that also the female retirement age has to reach 62 years in 2008, and this age is being annually increased by 6 months. That is why the female employment rate in this age group is increasing.

Unemployment indicators have improved accordingly. Unemployment decreased especially fast in 2005 to 8.9% (10.4% in 2004). The share of long-term unemployed persons has decreased. Long-term unemployment rate amounted to 4.1% in 2005 and lagged behind the target level set for 2010 only by 0.1 percentage points.

Figure 6.4



\* 2000-2005 – fact, 2006-2010 – forecasts and targets

Unemployment of youth has substantially decreased from 18.1% in 2004 to 13.6% in 2005 (in the age group of 15-24 years). The number of employed young people has increased, but the number of economically active young people has gone down, because more and more young people continue their education.

Difference between youth unemployment and the average unemployment rate in the country has also decreased substantially. Youth unemployment rate in 2004 was by 7.7 percentage points higher than the average unemployment in the country, while in 2005 it was by mere 4.7 percentage points higher. This difference is among the lowest in EU member states.

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

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

In 2005, with ESF support in the framework of the national programme “Support to implementation of active employment measures”, SEA carried out 3 projects: the unemployed (among them long-term unemployed, the unemployed returning to the labour market after childcare leave, disabled unemployed and the unemployed after serving their sentence in detention facilities) were involved in training, retraining and skills-raising courses for the unemployed. More than one-third of them got work in 2005 after the training.

Support to development of business activity in territories requiring special assistance is provided both in the framework of national financing (Regional Fund) and by the use of EU financial resources (European Regional Development Fund), encouraging economic activities in these territories, creating new workplaces and maintaining the existing ones.

The grant scheme “Support to Investment in Development of Enterprises in Territories Requiring Special Assistance” is implemented from January 1, 2004 to December 31, 2006, while the national programme “Development of Entrepreneurship in Territories Requiring Special Assistance” was implemented from 1998 to the spring of 2004 and the national programme “Income Tax Allowances” is implemented from 1998 to the end of 2006.

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

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

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

As from January 1, 2006, both the minimum monthly wage was increased from LVL 80 to LVL 90 and the monthly minimum not subjected to personal income tax was raised from LVL 26 to LVL 32. It is foreseen to raise the minimum wage also in 2007.

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

Market economy, setting new requirements for professional skills, develops faster than the supply of adequate professional and higher education programmes. Therefore a mismatch between the labour market demand and the current education supply arises in several professions. Distribution of students by thematic fields of studies does not correspond to the needs of the national economy and labour market changes. Co-operation between educational establishments and employers is insufficient.

The life-long learning system that would increase opportunity of population to adapt to conditions of the changing labour market has not been established in Latvia. There is a shortage of professional orientation services at the basic stage of education, adaptation of the first-year students in professional education institutions is incomplete and the awareness of the opportunities for education and further education is insufficient. Number of those students, who do not complete their studies or do not obtain professional qualification is relatively high.

Professional skills and further education opportunities of teachers are insufficient, and teachers as well as academic staff become old. The number of new teachers and academic persons with a scientific degree decreases. The low wages of teachers do not encourage involvement of young teachers into education. Preparedness of medium-generation teachers in bilingual education is insufficient.

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

- to strengthen co-operation between public administration 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.

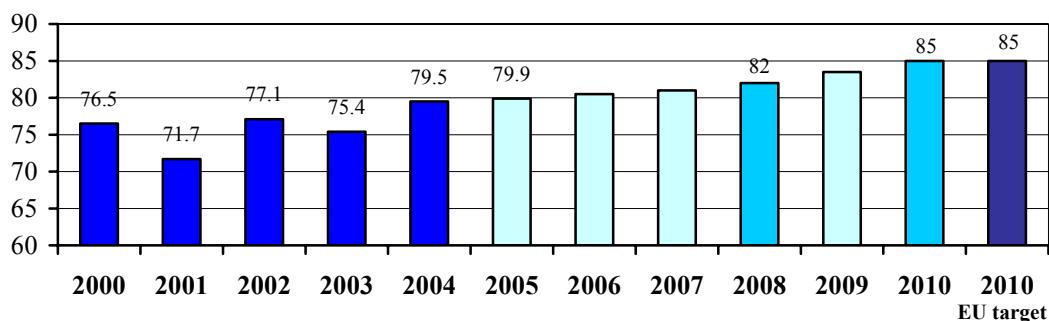
The Programme sets a goal to raise the education level of young people, which is quantitatively defined for 2010 – the share of young people (20-24 years) with at least a secondary education should reach 85% (see Figure 6.5). This indicator corresponds to the target indicator set by EU for 2010.

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

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

Figure 6.5

**Education Level Reached by Young People\***  
(share of young people (20-24 years old) with at least a secondary education in per cent of all young people (20-24 years old))



\* 2000-2004 – fact, 2005-2010 – forecasts and targets

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

Lifelong learning system that would provide opportunity for population to adapt to the conditions of the changing labour market is being created. Lifelong learning strategy has been developed (Lifelong Learning Policy Guidelines for 2007-2013) and will be reviewed by the government soon.

**Utilisation of structural funds** of the European Union facilitates achieving the targets set in the Lisbon Strategy in Latvia. Approximately 67% of financial resources from structural funds in 2004-2006 planning period have been channelled for implementation of the Lisbon Strategy's priorities. Priorities of Latvia for work in the next seven years are also clear, namely, raising competitiveness and development of a knowledge-based national economy. The government has identified three main priorities for further development of the country in the period of 2007-2013, namely, educated and

creative person, technological excellence and flexibility of enterprises, development of science and research (National Development Plan of Latvia for 2007-2013).

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

### **6.1.2. Ensuring Implementation of the Programme**

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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;
- the Advisory Working Group of the Lisbon Strategy, in order to ensure development of the National Lisbon Programme of Latvia and its implementation at the inter-institutional level. The Working Group is chaired by the State Secretary of the Ministry of Economics. Senior officials of the ministries linked to the Lisbon process are included in the Working Group.

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

Social dialogue is important for achieving the goals of the National Lisbon Programme of Latvia for 2005-2008. That is why the Programme foresees several measures for the improvement of the social dialogue both at the state level and at 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 labour market and gender equality policy in 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 Latvian Association of Local and Regional Governments are being built in order to ensure development of employment partnership and social dialogue at the local and regional government level.

Since September 2005, the Programme was presented and discussed:

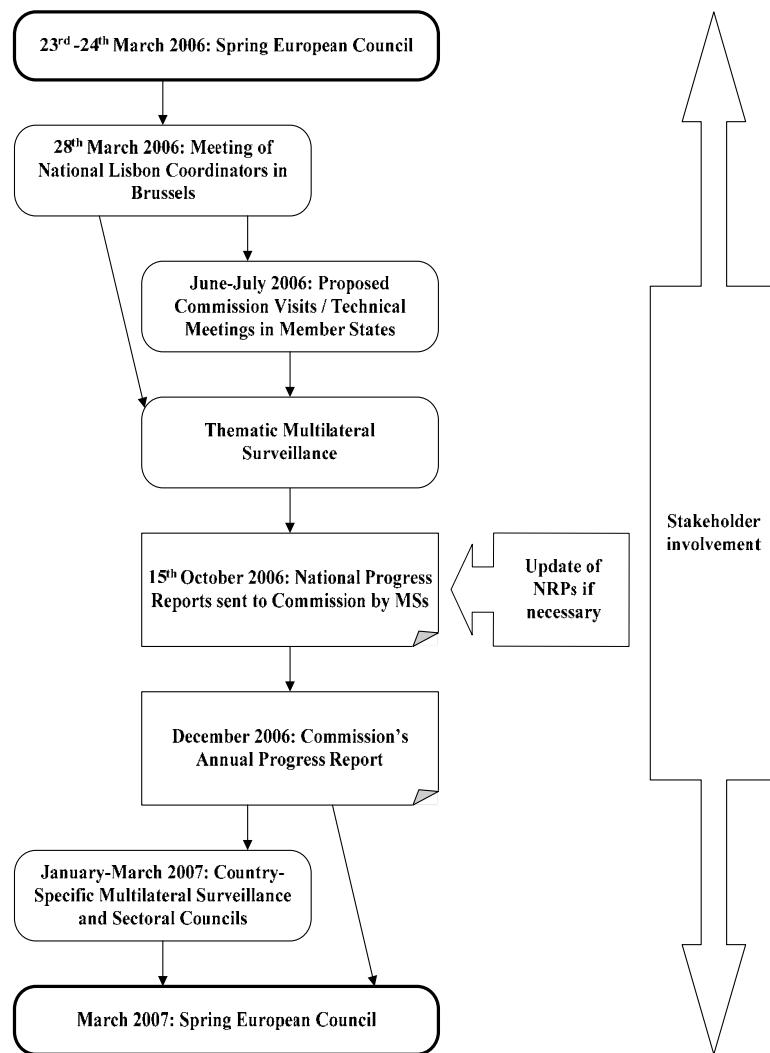
- at the European Affairs Commission of the Saeima;
- at the Sub-commission on Latvia's Future Development of the Education, Culture and Science Commission of the Saeima;
- at the National Economy Council;
- at the Latvian Council of the Small and Medium-Sized Enterprises and Crafts;
- at the Free Trade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

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

The European Commission, on the basis of the European Council decisions, has developed a schedule for implementation of national reform programmes (see Figure 6.6).

Figure 6.6

### Roadmap for Implementation of the Growth and Jobs Agenda in 2006/2007<sup>1</sup>



It is envisaged that the progress in implementation of national reform programmes will be assessed every year in autumn, including implementation of the National Lisbon Programme of Latvia for 2005-2008.

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

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

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

The goals regarding the planned use by Latvia of the support from the Structural Funds are set out under the Development Plan or the Single Programming Document (SPD). The Single Programming Document for the Structural Funds Objective 1 programme 2004-2006 for Latvia was approved by June 17, 2004 decision of the European Commission C(2004)2121 (see Box 6.1).

<sup>1</sup> Source: Annex III of the European Commission's Staff Working Paper "Working together for growth and jobs. Further steps in implementing the revised Lisbon Strategy": <http://register.consilium.europa.eu/pdf/en/06/st09/st09484.en06.pdf>

**Box 6.1****Priorities of the Development Plan**

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

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

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

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

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

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

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

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

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

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

Sub-priority 4.2 – promotion of sustainable development of fisheries, which includes the following measures:

- 4.2.1. balancing fishing intensity;
- 4.2.2. fleet renewal and modernisation of fishing vessels;
- 4.2.3. improvement of processing and marketing of fishery and aquaculture products, development of fishing port facilities and aquaculture;
- 4.2.4. development of coastal fishery, socio-economic measures, promotion of conquering new market outlets and support to producer organisations.

Priority 5 – technical assistance (EUR 22 million).

Total funds accessible to Latvia in the Structural Funds framework to which the beneficiaries will be able to apply are made up of financing from the EU Structural Funds and co-financing from the state budget of the Republic of Latvia and budgets of local governments. In almost all cases the financing amount from the EU Structural Funds is 75%, while 25% is financed from the state budget and budgets of local governments. In particular cases (projects of intermediary bodies in implementation of the EU Structural Funds) the percentage is 50% and 50% respectively. In order to apply for aid from the Structural Funds, the beneficiary will additionally have to provide its own co-financing.

Total financing accessible to Latvia in the framework of Structural Funds programmes in 2004-2006 amounts to EUR 845 million (EUR 625 million from the EU Structural Funds and EUR 220 million from the state budget of the Republic of Latvia) (see Figure 6.7).

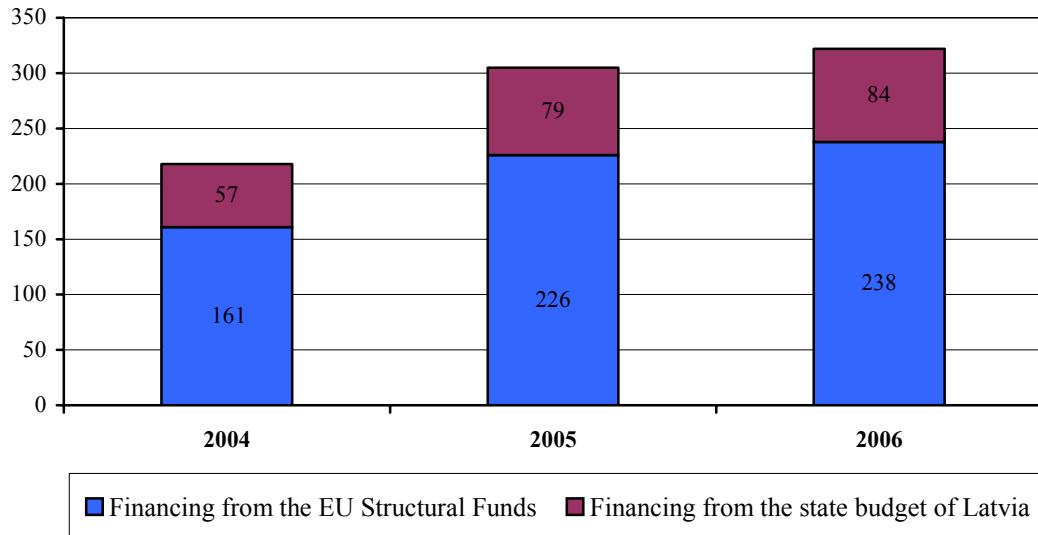
Financing of EUR 625 million from the EU Structural Funds is made up of resources from the following funds:

- European Regional Development Fund (EUR 369 million);
- European Social Fund (EUR 139 million);
- Guidance Section of the European Agricultural Guidance and Guarantee Fund (EUR 93 million);
- Financial Instrument for Fisheries Guidance (EUR 24 million).

Figure 6.7

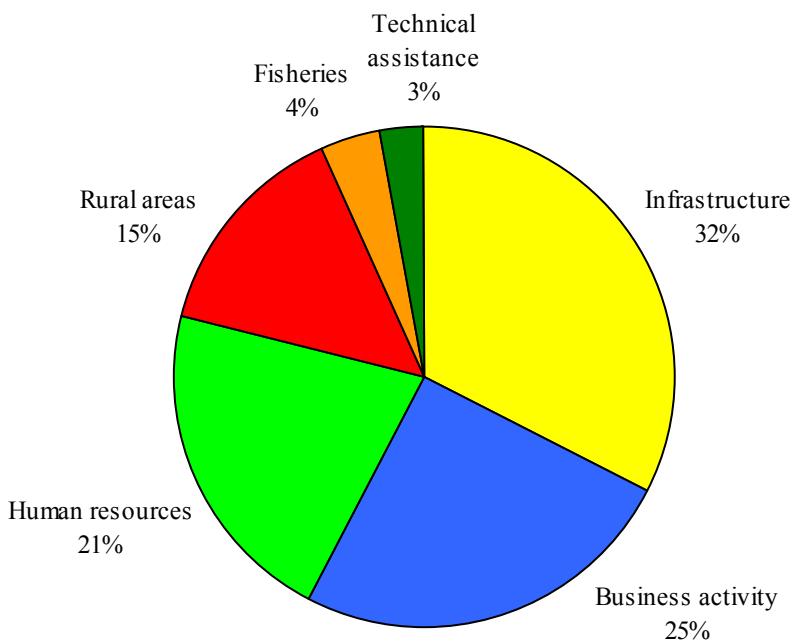
**Financing from Structural Funds to which Latvia has Access**

(million EUR)



Breakdown of support from the Structural Funds by sectors shows that the biggest part of financing (32.6%) is envisaged for infrastructure projects and projects for promotion of business development (25%) (see Figure 6.8).

Figure 6.8

**Breakdown of Support from the Structural Funds by Sectors for 2004–2006**

The informative report of the Ministry of Finance<sup>1</sup> on implementation process of activities of the Single Programming Document indicates that absorption of EU financial resources proceeds successfully in Latvia.

<sup>1</sup> Informative report “On absorption of the European Union financial resources (Structural Funds and Cohesion Fund)” of the Ministry of Finance, November 8, 2006.

As of September 30, 2006, projects for 80.67% of the total available financing from the Structural funds have been co-ordinated in Structural Funds Steering committees (see Table 6.1), including projects for 92.16% of the available financing approved in the framework of the European Social Fund (ESF) and (ELVGF) projects for 98.35% of the available financing approved in the framework of the Guidance Section of the European Agricultural Guidance and Guarantee Fund (EAGGF).

28.84% of the total available SF financing was paid to beneficiaries, including 62.78% of the available SF financing paid in EAGGF projects and 54.14% of this financing paid in Financial Instrument for Fisheries Guidance (FIFG) projects. Financing paid in ERDF and ESF projects corresponds to 18.89% and 21.58% respectively of the respective total resources granted from SF.

14.53% of the granted resources have been refunded in the state budget revenues from the European Commission (progress by 0.25 percentage points in comparison with the previous quarter).

As of September 30, 2006 – 45.99% of the planned SF financing in the amount of LVL 178.36 million in the state budget for 2006 was used. In the breakdown by funds, it was 37.20% ERDF, 64.79% ESF, 47.34% EAGGF and 84.31% FIFG respectively of SF resources planned in the state budget.

Table 6.1

### Progress in Absorption of the Structural Funds as of September 30, 2006

	SF financing million LVL	Projects approved in SF Steering committees		Paid to beneficiaries of SF financing		Payments received from the European Commission	
		million LVL	% of financing	million LVL	% of financing	million LVL	% of financing
<b>ERDF</b>	268.50	195.26	72.35	36.70	18.89	19.89	7.41
<b>ESF</b>	88.42	81.49	92.16	17.58	21.58	4.89	5.53
<b>EAGGF</b>	64.55	63.48	98.35	39.85	62.78	32.85	50.89
<b>FIFG</b>	17.10	14.55	85.10	7.88	54.14	6.10	35.67
<b>Total</b>	<b>438.57</b>	<b>353.78</b>	<b>80.67</b>	<b>102.01</b>	<b>28.84</b>	<b>63.73</b>	<b>14.53</b>

As of October 1, 2006, agreements have been concluded in the amount of 97% of the total financing approved by ERDF Steering committee. Taking into account that amendments to granting ERDF financing were approved by ERDF Steering committee on September 21, 2006, the process of concluding agreements and making amendments to the existing ones for absorption of the remaining financing approved by ERDF Steering committee continues. As tenders for project applications come to an end, conclusion of agreements with beneficiaries is ensured in the framework of grant schemes and open tenders, which means that indicators of the number of concluded agreements and their amount in the framework of absorption of ERDF resources continue growing.

The ERDF financing still not absorbed, i.e., the ERDF resources that are not approved by ERDF Steering committee and for which agreements with beneficiaries are not concluded, includes the financing foreseen for:

- open project application tenders that are announced and are in the assessment stage. Assessment of applications draws to a close in several activities of the announced open project application tenders, hence agreements for this part of ERDF financing may be concluded during the 4th quarter of 2006;
- grant tenders announced by grant scheme managers (Latvian Investment and Development Agency, State Regional Development Agency, Social Service Board) and being in the assessment stage. Several announced project application tenders draw to a close also in these activities, hence agreements for this part of ERDF financing may be concluded during the 4th quarter of 2006;
- financing technical aid activities of institutions involved in administration of SF in 2008.

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

**Box 6.2****Measures and priorities provided by the Development Plan and which are under the management of the Ministry of Economics**

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

Activities of Measure 1 “Environmental and tourism infrastructure development” under Priority 1 “Promotion of balanced development”:

- development of heat supply systems;
- improvement of heat supply system by lowering the content of sulphur in heating fuel;
- creation of tourism products and improvement of tourism infrastructure as well as preservation of cultural heritage and expansion of its economic potential;

Measures under Priority 2 “Promotion of business activity and innovations”:

- support to development of innovations;
- development of business infrastructure;
- strengthening the measures to support the small and medium-sized business activity;
- access to financing for small and medium-sized enterprises;

Activities of Measure 1 “Promotion of employment” under Priority 3 “Development of human resources and promotion of employment”:

- enhancing improvement of the retraining of employees;
- providing required training and consultations for launching a business.

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 will be allocated through state support programmes in accordance with provisions of the Law on Control of Aid for Commercial Activity.

As of May 30, 2006, all activities falling under responsibility of the Ministry of Economics have been approved.

On August 24, 2006 the Steering committee of the European Regional Development Fund (ERDF) co-ordinated the list of 9 projects to be supported in ERDF tender “Efficient use of cultural and historical heritage in tourism” in the framework of the SPD Activity 1.1.5. 112 project applications received within the tender exceeded 5 times the available ERDF financing in the amount of LVL 6.5 million. 85 of these applications after their administrative assessment were submitted for further assessment to the commission established by the Ministry of Economics, where also the Ministry of Culture, Ministry of Environment and Ministry of Regional Development and Local Government are represented.

After assessment of projects according to quality and specific assessment criteria on the available financing, it is possible to support nine projects with the highest evaluation. Most of the projects are publicly well-known tourism objects, e.g., Rundāle Palace, Cēsis Castle and Bauska Castle.

On November 21, 2006 the tender of open projects under responsibility of the Ministry of Economics, announced by the Central Finance and Contract Agency (CFC) in the framework of the SPD Sub-Activity 1.1.4.2 “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 final consumer side”, was concluded. 29 projects with the total financing of LVL 7.34 million have been approved. 87 projects in total were submitted for the open tender.

As from August 12, 2004 the Latvian Investment and Development Agency (hereinafter LIDA) has announced a tender of project applications for receiving co-financing from the EU Structural Funds in the framework of the state support programmes under responsibility of the Ministry of Economics. As on December 1, 2006, acceptance of projects is suspended in the framework of all programmes due to the lack of financing.

As on December 1, 2006, 1202 projects have been submitted to LIDA, of which the largest part (330 projects) make an infrastructure grant scheme “Improvement of commercial activity in line with requirements of international standards” (82 projects by March 17, 2006 and 248 projects after March 20, 2006) and 363 projects make a grant scheme “Consultation services”. The total required financing comprises LVL 161.84 million, the total amount of contracts concluded for receiving support equals to LVL 85.67 million and the amount of paid projects comprises LVL 29.64 million (see Table 6.2).

As on September 30, 2006 the most active businessmen were in Riga and Riga district (703 projects submitted for LVL 62.6 million). As for other regions: 88 projects for LVL 20.25 million were submitted from Zemgale, 127 projects for LVL 27.54 million were submitted from Vidzeme, 111 projects for LVL 26.58 million were submitted from Kurzeme and 88 projects for LVL 17.74 million were submitted from Latgale.

In order to level out differences between EU member states, Latvia after accession to the EU has access to resources from the **Cohesion Fund**, which replaces the ISPA funds that were available for Latvia before the accession. Support from the Cohesion Fund is available to those EU member states, where GDP per capita is below 90% of the EU average. The main goals of the Cohesion Fund are to provide support to environmental protection measures and improvement of transport infrastructure.

Similarly as with the Structural Funds, resources from the Cohesion Fund are only granted as a co-financing for measures supported financially by the member state. The EU co-financing from this fund has been set at 80-85%. Furthermore, the contribution from the EU may even reach up to 90% of the total project costs if financing is received from the Structural Funds as well. The total project costs have to reach at least LVL 7 million (EUR 10 million).

Table 6.2

**Projects Submitted to LIDA for Receiving the Structural Funds Financing  
by Types of Grant Schemes as of September 30, 2006**  
(million LVL)

Grant scheme	Amount planned in SSP 2004-2006	Accepted project applications		Concluded agreements		Paid agreements	
		Number	Amount of support planned by applicant	Number	Amount of support	Number	Amount of support
Support to infrastructure development: connection and reconstruction (by March 17, 2006)	3.72	30	5.81	22	3.69	10	0.93
Support to infrastructure development: connection and reconstruction (after March 20, 2006)	1.50	8	1.86	2	0.38	0	0
Improvement of commercial activity according to requirements of international standards (by March 17, 2006)	37.69	82	40.15	73	35.15	59	26.14
Improvement of commercial activity according to requirements of international standards (after March 20, 2006)	63.00	248	89.28	111	38.05	0	0
Support to shared infrastructure development (by March 17, 2006)	1.75	8	2.82	6	1.75	3	0.18
Support to shared infrastructure development (after March 20, 2006)	3.50	12	5.58	2	0.31	0	0
Support to development of new products and technologies	5.89	88	7.56	26	2.22	7	0.59
Consultation services	3.00	363	3.37	201	1.83	153	1.39
Participation of commercial companies in international exhibitions, fairs and trade missions (by July 10, 2006)	0.15	36	0.22	23	0.14	18	0.08
Participation of commercial companies in international exhibitions, fairs and trade missions (after July 10, 2006)	1.10	103	1.69	27	0.35	1	0.01
Support for training, re-training and further education of the employed (by March 24, 2006)	0.64	49	0.77	39	0.63	23	0.28
Support for training, re-training and further education of the employed (after March 27, 2006)	2.00	175	2.73	89	1.17	6	0.04
<b>Total</b>		<b>1202</b>	<b>161.84</b>	<b>621</b>	<b>85.67</b>	<b>280</b>	<b>29.64</b>

Utilisation of resources from the Cohesion Fund is set out under the Reference Framework Document co-ordinated with the European Commission in December 2003. In contrast to the Single Programming Document that only sets out priority areas of support, the Reference Framework Document defines specific projects, to which the financing will be granted. The Cohesion Fund has broader range of financing as compared to ISPA:

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

The total financing from the Cohesion Fund available for Latvia in the period of 2000–2006 amounts to EUR 710 million, of which EUR 310 million comprise the financing for projects under

implementation at present (former ISPA projects), EUR 230 million are earmarked for the Cohesion Fund project applications of 2004, EUR 170 million comprise the financing for the Cohesion Fund project applications to be submitted in 2005 and 2006.

44 projects for EUR 706.1 million have been approved by the European Commission (EC) by September 30, 2006. Two projects are submitted to the EC for approval, and proposals for amendments to financial memorandum/EC decision are submitted for four projects in the Ministry of Finance. After approval of these project applications and proposals for amendments to financial memorandum/EC decision, Latvia would have fully absorbed Cohesion Fund resources available to it.

EUR 245.7 million (35.2% of the approved Cohesion Fund financing for Latvia in this programming period) were received from the EC, while EUR 186.4 million (26.7% of the financing) were paid to executors in the framework of the concluded contracts (see Table 6.3).

Table 6.3

### **Progress in Absorption of the Cohesion Fund as of September 30, 2006**

	<b>Cohesion Fund financing million LVL</b>	<b>Projects approved by the European Commission</b>		<b>Paid to beneficiaries of Cohesion Fund financing</b>		<b>Payments received from the European Commission</b>	
		<b>million LVL</b>	<b>% of available financing</b>	<b>million LVL</b>	<b>% of approved projects</b>	<b>million LVL</b>	<b>% of approved projects</b>
Ministry of Environment		340.66	47.93	66.00	19.38	91.86	26.96
Ministry of Transport and Communications		353.93	49.80	119.86	33.87	152.69	43.14
Ministry of Finance		3.67	0.52	0.55	15.12	1.13	30.90
<b>Total</b>	<b>710.77</b>	<b>698.26</b>	<b>98.24</b>	<b>186.41</b>	<b>26.70</b>	<b>245.68</b>	<b>35.19</b>

Implementation of Cohesion Fund projects takes place steadily. Part of projects is completed, but the start of several projects has been delayed for two years. Implementation of some Cohesion Fund projects is foreseen until 2008-2009 in accordance with EC decisions or financial memoranda. The main problem in implementation of projects in the environmental and transport sectors is still created by considerable rise of prices in the construction sector, which has increased costs of a majority of projects that were planned and started in the previous years. This substantial rise of prices is explained by rapid increase in prices of both fuel and construction materials as well as by increased labour costs determined by the total increase of demand in the construction sector.

#### **Next planning period of 2007–2013**

Application for funding from the all abovementioned financial sources is possible in the period of 2004-2006. This multi-annual budget-planning period (also called financial perspective), lasting from 2000 till 2006 for the old EU member states, expires in 2006 and so the plans for EU expenditures, legislation and other documents determining the use of EU financial resources are no longer applicable for distribution and absorption of the new funding after the end of 2006. The period of financial perspective usually lasts five to seven years. At present, planning of EU expenditures and preparation of documents for the next period of 2007-2013 takes place.

In order to start efficient absorption of resources from the Structural Funds and the Cohesion Fund as from January 2007, it is offered to carry out the programming at 3 levels in accordance with the draft general regulation of the Structural Funds and the Cohesion Fund (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 of member states (hereinafter OP)).

The National Strategic Reference Framework Document for the period of 2007-2013 (hereinafter NSRFD) is the main Structural Funds and Cohesion Fund planning document at the level of Latvia, which ensures the linkage of the cohesion policy with national priorities and substantiates the choice of these priorities as well as determines the funds absorption strategy and the management framework and ensures co-ordination between OP and other financial instruments.

NSRFD is developed in accordance with the strategic goals and priorities set in the National Development Plan<sup>1</sup> of Latvia.

The general management framework and planning documents of the Structural Funds and the Cohesion Fund are being developed, mutually co-ordinating them with institutions involved in management of EU funds and consulting with partners (social partners, representatives of the regions, NGO) about a wording acceptable for all parties. During preparation of NSRFD at the end of 2005, a public discussion was also held, in the framework of which every inhabitant of Latvia could express his vision of this document.

The Ministry of Finance is appointed the institution responsible for implementation of NSRFD. In order to ensure supervision of preparation of NSRFD and OP co-financed from the EU Structural Funds and the Cohesion Fund for the planning period of 2007-2013, it was decided to organise a broad forum of partners or a committee for provisional supervision of OP of the EU Structural Funds and the Cohesion Fund.

NSRFD stresses that the most important task of the period of 2007-2013 (to be fulfilled with the help of the Structural Funds and the Cohesion Fund) is to create the necessary preconditions and directly achieve changes that would ensure formation of knowledge-intensive economy in the country. Hence the main emphasis in the use of Structural Funds and Cohesion Fund investments in the period of 2007-2013 in Latvia has to be put on those measures that develop knowledge as the main resource of growth and create favourable conditions of life for human being as the holder of this resource.

In order to reach this goal, investments from the Structural Funds and the Cohesion Fund are being 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.

Balanced development of territory, macroeconomic stability, equal opportunities, sustainable development, and information society are determined as horizontal priorities.

In order to achieve these goals, it is planned to manage investments from the Structural Funds and the Cohesion Fund, using three operational programmes:

- "Human Resources and Employment", OP of the European Social Fund;
- "Enterprise and Innovation", OP of the European Regional Development Fund;
- "Infrastructure and Services", OP of the European Regional Development Fund and the Cohesion Fund.

On August 15, 2006 the Cabinet of Ministers approved two of the three operational programmes of the EU funds (European Regional Development Fund, European Social Fund and Cohesion Fund) for 2007-2013, namely, "Enterprise and Innovation" and "Infrastructure and Services".

OP "Enterprise and Innovation" (financed from ERDF) with the total financing of EUR 743 730 950 envisages support to science and innovation (allocating 60.2% of the OP financing) and to promotion of entrepreneurship (allocating 36.4% of the OP financing). 3.4% of the OP financing will be allocated to administration of the OP.

The financially most voluminous OP is the OP "Infrastructure and Services" financed from ERDF and the Cohesion Fund, which envisages to allocate 48.6% of its total financing in the amount of EUR 2 800 251 123 to large-scale infrastructure projects, e.g., repairs and construction of the main state roads, improvement of railway and water management, and energy activities. It is envisaged to channel 31.1% of the financing in the framework of this programme to small-scale infrastructure projects, namely, improvement of the 1st class roads and municipal streets, water management projects, heat insulation of housing, projects of tourism and cultural environment. 18.3% of the financing is allocated to the support of education and social infrastructure, while 2% of the financing is allocated to management of the operational programme.

On August 28, 2006 the Cabinet of Ministers approved the EU funds operational programme "Human Resources and Employment" for 2007-2013.

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<sup>1</sup> National Development Plan is the main national medium-term planning document for 2007-2013 and was approved by the Cabinet of Ministers on July 4, 2006.

OP “Human Resources and Employment” with ESF financing in the amount of EUR 457 017 922 envisages to channel 55.9% of the total financing to the support of education and science, 34.3% of the financing to carrying out measures of employment and social inclusion, 5.8% of the financing to strengthening the administrative capacity or building the capacity of institutions involved in administration of EU funds, and 4% of the financing to implementation of the OP or the so-called technical assistance.

In November 2006 the European Commission accepted all EU funds planning documents for 2007-2013 developed by Latvia.

Latvia as the first among the EU member states has got a positive EC opinion about the EU Structural Funds and Cohesion Fund planning documents of 2007-2013, namely, the operational programmes “Human Resources and Employment”, “Enterprise and Innovation” and “Infrastructure and Services”. It allows the EC to start evaluation of operational programmes in order to take decision afterwards on their approval.

On April 18, 2006 the Cabinet of Ministers approved the breakdown of the EU Structural Funds and Cohesion Fund allotment between thematic axes and measures of the draft National Strategic Reference Framework Document for the period of 2007-2013 (Tables 6.4-6.6).

Table 6.4

#### Structural Funds

Thematic axis of NSRFD, title	Measure	Allotment, EUR	% of SF
<b>1 – development and efficient use of human resources</b>		<b>1 052 920 133</b>	<b>39.88</b>
	<b>Education</b>	<b>510 691 419</b>	<b>19.34</b>
	incl. education ERDF	255 345 709	9.67
	incl. education ESF	205 345 710	7.78
	incl. support to science ESF	50 000 000	1.89
	<b>Administrative capacity</b>	<b>26 410 000</b>	<b>1.00</b>
	<b>Technical assistance</b>	<b>101 429 712</b>	<b>3.84</b>
	incl. technical assistance ERDF	83 148 955	3.15
	incl. technical assistance ESF	18 280 717	0.69
	<b>Health</b>	<b>247 272 580</b>	<b>9.37</b>
	incl. health ERDF	207 272 580	7.86
	incl. health ESF	40 000 000	1.51
	<b>Employment</b>	<b>167 116 422</b>	<b>6.33</b>
	incl. employment ERDF	50 134 927	1.90
	incl. reconciliation of work and family life	33 545 711	1.27
	incl. employment ESF	116 981 495	4.43
<b>2 – increase of competitiveness and progress towards knowledge-intensive economy</b>		<b>718 192 000</b>	<b>27.19</b>
	Science, research and development	238 072 000	9.02
	Innovation	209 211 000	7.92
	Promotion of competitiveness	129 760 000	4.91
	Financial measures	141 150 000	5.34
<b>3 – improvements of public services and infrastructure as a precondition to balanced development of the country and its territory</b>		<b>869 887 867</b>	<b>32.93</b>
	Tourism	42 373 529	1.60
	Socio-economic impact of cultural environment	42 373 529	1.60
	Environment	243 693 781	9.23
	Energy efficiency of housing	29 968 597	1.13
	Transport and infrastructure	307 114 430	11.63
	Information society and infrastructure and services of information and communications	204 364 001	7.74
	<b>TOTAL:</b>	<b>2 641 000 000</b>	<b>100.00</b>

Table 6.5  
Cohesion Fund

Thematic axis of NSRFD, title	Measure	Allotment, EUR	% of CF
<b>3 – improvements of public services and infrastructure as a precondition to balanced development of the country and its territory</b>		<b>1 360 000 000</b>	<b>100.00</b>
	<b>Transport</b>	<b>619 000 000</b>	<b>45.51</b>
	<b>Environment</b>	<b>519 000 000</b>	<b>38.16</b>
	<b>Sustainable development</b>	<b>209 800 000</b>	<b>15.43</b>
	incl. sustainable transport	122 400 000	9.00
	incl. energy efficiency and renewable energy resources	87 400 000	6.43
	<b>Technical assistance</b>	<b>12 200 000</b>	<b>0.90</b>
	<b>TOTAL:</b>	<b>1 360 000 000</b>	<b>100.00</b>

Table 6.6

#### Breakdown of Financing by Funds

Fund	Allotment, EUR	% of SF and CF
<b>ERDF</b>	<b>2 183 982 078</b>	<b>54.59</b>
<b>ESF</b>	<b>457 017 922</b>	<b>11.42</b>
<b>CF</b>	<b>1 360 000 000</b>	<b>33.99</b>
<b>TOTAL:</b>	<b>4 001 000 000</b>	<b>100.00</b>

### 6.2.2. Foreign Trade Policy

The Treaty establishing the European Community prescribes that a common trade policy is implemented within the EU. In accordance with it, the European Commission (in the framework of the Article 133 Committee of the EU Council) agrees with member states on implementation of this policy both in bilateral and multilateral framework.

Taking into account the rapid changes in the global economy and increasing competition from developing countries, revision of EU trade policy is necessary, stressing that an open internal market and improvement of EU access to markets of third countries (outside the European Union) underlies improvement of competitiveness of EU entrepreneurs in the world. Thus, a new draft strategy of EU external competitiveness has currently been developed in the EU in order to ensure stable economic growth and creation of new workplaces in Europe and thereby ensure rise of welfare level of population, by using trade policy instruments as well as opportunities of facilitated access to markets of goods and services, created by international trade liberalisation.

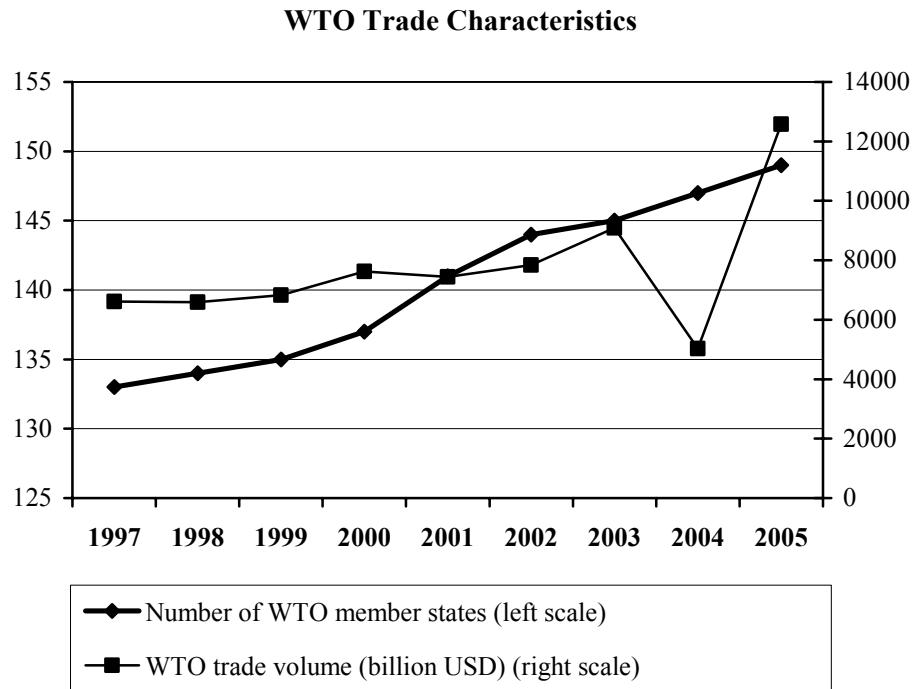
EU supports strengthening of multilateral trading system, because existence of unified and efficient rules provides a foundation for coordinated international trade based on internationally recognised legal norms and their application. In parallel, the EU establishes and constantly maintains a network of bilateral relations in the framework of various preferential, regional and free trade agreements.

#### **Multilateral relations**

The World Trade Organisation (WTO) is the sole international organisation that ensures development and implementation of multilateral rules of trade. Its main task is to provide non-discriminatory and predictable trade flows in the global space. Dynamics of WTO trade volumes and number of member states are shown in Figure 6.9.

In order to increase gains from international trade, in 2001 the WTO member states started a regular round of multilateral trade liberalisation (so-called WTO Doha Development Agenda (DDA)), which is closely linked with increased economic integration in the world and opportunities created by the latest scientific achievements and technology development and promotes development of various newly emerged trade opportunities as well as rapid economic growth of developing countries.

Figure 6.9



Source: "World Trade Report", WTO (reports of 1998-2006).

Development and reduction of poverty in the world and ambitious lift of trade restrictions are set as the target of this round. Successful integration of developing countries into international trading system by ensuring balanced redistribution of gains from global trade is set as the principal task for reduction of poverty. In the framework of DDA, WTO member states have agreed on granting preferences to the least developed countries, i.e., they will not have to undertake new commitments of trade liberalisation.

On December 13-18, 2005 the WTO 6th Ministerial Conference took place in Hong Kong, where trade ministers of WTO member states agreed to reach a comprehensive agreement in the main areas of negotiations, among them access to market of industrial goods and agricultural products, in order to reduce tariffs and subsidies for agricultural products and ensure freer access to market for industrial goods. At the same time continuing negotiations in other fields as well, among them trade of services, promotion of trade and regarding the assistance to trade, the goal to conclude DDA talks in the 1st half of 2007 was set.

However, as WTO member states could not come to agreement on the most sensitive issues, the member states in the framework of the WTO General Council in July 2006 took decision to suspend DDA negotiations indefinitely. The main problems in the process of multilateral trade liberalisation are the different approaches of WTO member states regarding reduction of the US internal state support to agriculture, lessening EU restrictions to accessibility of agricultural products market and diminishing restrictions of developing countries to accessibility of industrial goods market.

Although all WTO member states, being aware of gains from an ambitious result of the DDA negotiations round, constantly express wish to resume talks, they still fail to do it. However, in order to achieve the previously set goals and conclude the DDA round in the planned time, they have to agree on resumption of talks and intensive schedule of further work as soon as possible.

According to calculations by the World Bank, the total gain from liberalisation of multilateral trade may reach 290 to 520 billion USD in the next 10 years, which will be mostly constituted by gains from profits of companies and from increased purchasing power of consumers. It is forecasted that up to 70% of them will be gained by developing countries, and two-thirds of the gains will be received by consumers and companies operating in the agricultural sector.

From liberalisation of the multilateral trading system, Latvia will get freer access to markets of goods and services of third countries due to reduction of tariffs and equalisation of high tariffs and to more transparent setting of non-tariff barriers that are limiting import (rules of origin, import licensing procedures, investment restrictions, determination of customs value of goods, etc.). Freer access to markets of other countries will encourage expansion of export markets of Latvia and further growth of economy of the country.

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

Since May 1, 2004, trade relations of Latvia with third countries are regulated by agreements concluded by the EU.

EU has concluded several agreements prescribing conditions of free trade with third countries:

- European Economic Area agreements with Norway, Liechtenstein and Iceland;
- Europe agreements with Bulgaria and Romania;
- FTA with Faeroe Islands, Switzerland and Mexico;
- Association Agreements with Chile, Mediterranean countries (Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestinian Authority, Syria and Tunisia) and several overseas countries and territories;
- Customs unions with Turkey and Andorra;
- Stabilisation and Association Agreements with Macedonia and Croatia;
- Trade, Development and Co-operation Agreement with South Africa.

EU also works to expand economic co-operation with Russia, Ukraine, US, China, etc.

EU member states, including Latvia, support entry of **Russia (Russian Federation, RF)** in the WTO as soon as possible, but results of negotiations are more important than the speed of the entry. Russia still has not solved several issues, e.g., the ones concerning sanitary and phytosanitary measures, technical barriers to trade, rail tariffs, agriculture, etc.

The EU-Russia economic co-operation is regulated by the Partnership and Co-operation Agreement (PCA) that is due to expire on November 30, 2007. Development of a new framework agreement between the EU and Russian Federation is under way.

During the 17th EU-Russia summit on May 25, 2006 the parties agreed to keep the PCA in force after 2007, if the new agreement does not come into force by that time. Next meeting of the highest-level representatives took place in the framework of the EU-Russia summit in Helsinki on November 24, 2006. Key issues were creation of the four common spaces, co-operation in energy sphere, and environmental protection issues. The previously planned announcement on resumption of EU-Russia negotiations on new co-operation agreement as from 2007 did not take place during the summit, because EU member states could not agree on the document of the Commission's mandate for talks with Russia. Work for development of the mandate will continue within the EU.

Entry of **Ukraine** in the WTO is significant for Latvia as it is expected that it will deepen the commercial and economic co-operation between the EU and Ukraine. Latvia has special economic interests in conclusion of the EU Free Trade Agreement with Ukraine, taking into account that such agreement with Ukraine existed before Latvia's accession to the EU and encouraged development of transit and international trade.

Latvia is especially interested in considerable reduction of bureaucratic requirements and elimination of other non-tariff barriers to access the Ukrainian market.

In December 2005 Ukraine acquired market economy status in anti-dumping probes of the European Community. Latvia was one of the most energetic supporters of granting this status to Ukraine and appreciates persistence of Ukraine and its success in carrying out the reforms.

Relations between the EU and Ukraine are currently determined by a Partnership and Co-operation Agreement (PCA) that will expire in 2008 and will be replaced by an Enhanced Agreement. Development of mandate for talks with Ukraine on conclusion of the Enhanced Agreement is already taking place.

Economic co-operation between the EU and **US** takes place in the framework of the Transatlantic Economic Initiative. In order to deepen transatlantic economic relations, the EU-US initiative to enhance economic integration and growth was accepted at the EU-US summit on June 20, 2005. The initiative envisages to promote co-operation between high-level regulators, build more open and competitive financial markets, encourage investment for long-term development, co-operate in protection of intellectual property (including third countries), support and spur innovation and technological development, enhance security of trade not limiting the trade flow and applying visa-free regime to all EU member states, carry out negotiations in aviation sphere on conclusion of a new contract, strengthen co-operation in the sector of services, and ensure bilateral access to public procurement markets.

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

Economic dialogue between the EU and **China** is based on the EU-China Trade and Economic Co-operation Agreement concluded in 1985. Joint Committee for Trade is set up in the framework of this agreement. Talks on conclusion of a closer economic and political co-operation agreement are expected to start in January 2007.

China joined the WTO in 2001. In order to support economic and trade reforms of China and its integration in the world trading system, the five-year EU-China Co-operation Programme has been set up. It was launched in 2004 and is the biggest WTO programme of this kind in China. The programme consists of 6 components: Customs and import/export regulatory system; Agriculture and Agro-food; Technical barriers to trade; Services; Legislative and legal aspects; Enforcement of Intellectual property rights.

#### **Economic relations with third countries: economic co-operation agreements of Latvia**

In order to continue and activate bilateral economic co-operation after accession to the EU, Latvia has concluded bilateral economic co-operation agreements with **China, Belarus, Ukraine, Kazakhstan, Azerbaijan and Georgia**.

These agreements are the most important umbrella agreements that regulate bilateral economic co-operation and comprise co-operation in industry, tourism, transport, pharmaceuticals, agriculture, financial services, communications, professional training, investment policy, technologies and innovation and other spheres, thereby promoting development of economic co-operation.

The Ministry of Economics holds negotiations on bilateral economic co-operation agreement with **Uzbekistan**, and work for conclusion of economic co-operation agreements with **Armenia** and **India** is under way.

Economic co-operation agreements concluded between Latvia and third countries envisage establishment of Intergovernmental Commission and/or Joint Committee, which in turn ensure supervision of validity of these agreements and opportunities of analysis as well as improve further co-operation.

The 1st meeting of the **Latvia-Azerbaijan** Intergovernmental Commission is planned in January 2007. The 1st meeting of the **Latvia-Ukraine** Intergovernmental Commission, the 6th/3rd meeting of **Latvia-China** Joint Committee and the 2nd meeting of the **Latvia-Belarus** Intergovernmental Commission as well as the 1st meeting of the **Latvia-Georgia** Intergovernmental Commission are planned in 2007.

On October 26-27, 2006 the 2nd meeting of the **Latvia-Belarus** Intergovernmental Commission was held and the protocol of the meeting was signed, where co-operation opportunities in such areas as trade, transport, science, intellectual property protection, wood-processing, etc. are formulated. In the framework of the Commission's meeting on October 26, 2006, the Negotiation Protocol on Development of Co-operation in Accreditation, Conformity Assessment, Metrology and Public Construction Supervision was signed between the Belarussian State Standard and the State Agency "Latvian National Accreditation Bureau", and Amendments (2007-2008) to the Action Programme of the Intergovernmental Agreement on Co-operation in Tourism were signed between the Ministry of Economics of the Republic of Latvia and the Ministry of Sports and Tourism of Belarus.

Meeting between the Minister of Economics of the Republic of Latvia and the Minister of Economic Development and Trade of the **Russian Federation** took place in Moscow on October 13, 2006. Agreement between the government of the Republic of Latvia and the government of the Russian Federation on economic co-operation and agreement between both governments on establishment of intergovernmental commission in economic, scientific and technological, humanitarian and cultural co-operation spheres were signed during this meeting. The Latvian party works actively to organise the 1st meeting of this commission in 2007 and discuss those issues that up to now are not solved with Russia bilaterally at the level of ministries.

#### **Box 6.3**

##### **The new legal framework of EU-Russia and EU-Ukraine economic relations**

The **EU-Russia** economic co-operation is currently regulated by a Partnership and Co-operation Agreement (PCA) that will expire on November 30, 2007. Active development of a new EU-Russia framework agreement is taking place.

It is expected that the new co-operation document will constitute the legal base for relations between the EU and Russia and will comprise all spheres of co-operation, including those not included in the current PCA.

The agreement will to a great extent contain the structure and issues of the roadmaps for the Four Common Spaces (the 1st – Common Economic Space; the 2nd – Common Space of Freedom, Security and Justice; the 3rd – Common Space on External Security; the 4th – Common Space on Research, Education, Culture) and will envisage opportunities for conclusion of separate sectoral agreements.

**Box 6.3 continued**

Creation of the Four Common Spaces of the EU and Russia, including establishment of the Common European Economic Space (CEES), is especially substantial in order to promote and diversify trade between the EU and Russia, provide new opportunities for economic integration and convergence, and encourage access to market and development of infrastructure.

In the trade aspects, the aim of the agreement is to achieve gradual integration of economies of the EU and Russia, preventing barriers to investment and trade as well as carrying out convergence of regulators and approximation of legal norms and promotion of trade. Provisions of the agreement will be developed on the basis of provisions of the existing Partnership and Co-operation Agreement and of the Action Plan for the Common Economic Space.

After entry of Russia in the WTO, the EU and Russia may start negotiations on conclusion of deepened and ambitious Free Trade Agreement (FTA). Special interests of Latvia in the framework of the Free Trade Agreement are: considerable reduction of non-tariff trade barriers, national regime for public procurement, improvement of investment climate, incl. liberalisation of land market, annulment of export restrictions, standstill clause preventing introduction of new trade restrictions, efficient procedure for settlement of disputes, considerable liberalisation of the market of services (incl. transport), promotion of trade, co-operation in customs sphere, protection of investment and free movement of capital.

**EU-Ukraine** relations are currently determined by a PCA that will expire in 2008. This agreement will be replaced by an Enhanced Agreement. In comparison with the PCA, the Enhanced Agreement may contain several new elements, e.g., section on deepened space of free trade, expanded section on the rule of law, freedom and safety, as well as develop further the already existing economic and political co-operation.

The agreement's section on trade and related issues will concern co-operation in spheres of technical regulations, standards, conformity assessment procedures, sanitary and phytosanitary measures, trade promotion, customs, trade of services, intellectual property rights and public procurement. The agreement will determine transparency of regulations. The co-operation will be directed to development of Ukrainian sanitary and phytosanitary regulations and infrastructure and their gradual harmonisation with EU standards, building capacity of Ukrainian customs administration and other border institutions, and promoting compatibility of EU and Ukrainian transit systems. It is expected that the agreement will contain a protocol about mutual assistance in customs matters.

Latvia is especially interested to eliminate the current trade barriers and restrictions and conclude a free trade agreement with Ukraine in order to ensure conditions for export of Latvian goods as favourable as possible. The widest possible co-operation between the EU and Ukraine is important for Latvia. Latvia is interested in provision of technical regulations with regard to industrial goods, standards, sanitary and phytosanitary measures, freedom of trade in services and commercial activity, trade promotion and customs operation reforms, regulation of public procurement, conditions of competition policy as well as other measures in the agreement. It is important that the new agreement would provide for wide co-operation in spheres of transport, logistics and energy. The process of negotiations is expected after entry of Ukraine in the WTO.

**Steel**

Steel is the most widespread raw material in the world due to its diverse applications, processing capacity and strategic value. Steel sector takes a special place in international trade. In 2005 steel production in the world increased by 6% in comparison with 2004, and Asian countries were the most active producers of steel.

Steel production volumes in the EU decreased by 3.5% in 2005, but this did not make an essential impact on exports that continued growing and reached 31.7 million tons in 2005, which was by 6% more than in 2004.

Supply of steel from third countries has also increased, but its prices do not compete aggressively with EU prices.

EU and Latvia as EU member state apply provisions of double control system with quantitative restrictions to import of several steel products from Russia, Kazakhstan and Ukraine, and adequate agreements on steel trade are concluded with these countries. Negotiations on extension of the agreements to 2007 are being held. Provisions of the current agreements will be maintained. Amounts of quotas will be increased in view of the development and accession of new member states (Bulgaria and Romania) to the EU. The agreements will lapse automatically, when Russia, Kazakhstan and Ukraine will enter the WTO. It is expected that WTO entry procedures with Russia and Ukraine will be completed in 2007.

The mentioned countries are the most important ones ensuring steel import in Latvia, hence extension of the agreements provides to entrepreneurs the guarantees of supply of raw materials, predictable development, continuity and growth of the traditional trade flow.

Double control system without quantitative restrictions is applied to imports of particular steel products from Moldova and Macedonia. In view of the accession of Romania to the EU in 2007, the abovementioned system will be no more applied to this country.

Prior surveillance system is applied to imports of several steel products from all third countries.

**Textiles**

The textile sector is characterised by intensive use of labour force, high number of employees and considerable place in international trade. During the last years the role of several third countries (such as China, India and Pakistan) in textile trade has grown particularly. In the European Union, trade policy

issues related to development of this sector are considered by working groups of the Article 133 Committee/Textile of the EU Council of Ministers.

Since January 1, 2005 no quantitative restrictions are applied between WTO member states. Statistical data show that trade liberalisation in the textile sector has not made a negative impact on the Latvian textile industry sector, entrepreneurs are able to produce competitive goods and find sale markets.

EU and Latvia as EU member state apply the double control system with quantitative restrictions to import of textile products from those countries that are not WTO members (Belarus, Montenegro, North Korea), while the double control supervision system without quantitative restrictions is applied to import of textiles originated in Uzbekistan.

In accordance with the agreement on textile trade until 2008, concluded between the EU and China on June 10, 2005, import restrictions are prescribed for 10 categories of goods of Chinese origin.

High-level working group of the EC was set up in February 2004 (including representatives of the government and industry), which developed the EU action plan for promotion of development and competitiveness of the sector and defined the following principal lines of action: research and development, education, access to market of third countries, structural funds, deepened regional integration with Mediterranean countries, protection of intellectual property, and strengthening the dialogue between China and the EU. Revision of results of the abovementioned action plan is planned in the 2nd half of 2007.

### **Trade defence instruments**

Trade defence instruments (hereinafter TDI) are a constituent part of the common trade policy of the European Community. EU member states represent their interests regarding TDI in advisory committees of the European Commission, namely, the Anti-dumping and Anti-subsidy Committee and the Safeguard Committee. Interests of Latvia in these advisory committees are represented by the Ministry of Economics.

135 anti-dumping and 12 anti-subsidy measures against various goods in the European Community were in force as on October 1, 2006. At present, the European Commission examines 86 cases.

The following trade defence cases are the most essential for Latvia from the standpoint of producer and consumer interests:

- anti-dumping proceeding concerning imports of potassium chloride originating in Belarus and Russia;
- anti-dumping proceeding concerning imports of ammonium nitrate originating in Russia and Ukraine;
- anti-dumping proceeding concerning imports of particular leather-topped footwear originating in China and Vietnam;
- anti-dumping proceeding concerning imports of, among other things, silicon manganese originating in Ukraine.

Only through co-operation and active participation in proceedings carried out by the Commission<sup>1</sup>, it is possible to achieve efficient protection of own interests. Hence the interested parties in Latvia (producers, importers, exporters and consumers) have to submit substantiated information and opinion on the particular trade defence case to the Commission and the Ministry of Economics. This will be taken into account not only by working out the national position of Latvia but also by practically defending state interests in TDI proceedings carried out by the European Commission.

If a third country applies TDI and this affects interests of Latvian companies in the markets of the respective countries, Latvia tries to solve the emerged problem both at the level of bilateral relations and at the EU level. The most essential case, where a Latvian company incurs losses in a market of a third country is the anti-dumping measures against imports of steel bars from Latvia, which are in force in the US.

In order to raise competitiveness and lessen protectionism trends in application of TDI, in autumn 2006 the EU Commission launched discussion on use of TDI of the Community in conditions of global economy. Latvia as a small and open economy tends towards a more liberal model of foreign trade. The traditional Latvian trade partners that face trade defence proceedings most often are Belarus, Russia, China, Ukraine, etc. If anti-dumping measures were not introduced against these countries concerning imports of particular goods (leather footwear (China, Vietnam), potassium chloride (Russia, Belarus), ammonium nitrate (Belarus, Russia, Ukraine), steel bars and pipes (Ukraine, Croatia, Romania), etc.), Latvia could import many goods and raw materials without additional anti-dumping fee and hence could acquire cheaper resources.

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<sup>1</sup> Information on TDI procedures carried out by the Commission is available on the EC website [http://ec.europa.eu/comm/trade/issues/respectrules/anti\\_dumping/stats.htm](http://ec.europa.eu/comm/trade/issues/respectrules/anti_dumping/stats.htm)

### 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 included 28 countries (EU member states plus European Economic Area countries Norway, Iceland and Liechtenstein) with more than 450 million consumers. The European Union policy is aimed at development of the single internal market, where free movement of the factors of production (goods, services, persons and capital) is ensured in order to promote sustainable and stable development of EU economy and prosperity of EU population.

In Latvia, the process of implementation of the principles of the free movement of goods and services and the right of establishment, which are set out in Articles 28-30 and Articles 43-55 of the Treaty establishing the European Community, is supervised and co-ordinated by the Ministry of Economics, by constantly identifying the norms that may potentially or actually hinder implementation of the freedoms behind the EU internal market, *inter alia* by assessing normative acts still being in a draft stage.

In the framework of the procedure established for notifying draft technical regulations (Directives 98/34/EC and 98/48/EC), which prescribes obligation of EU member states to submit draft technical regulations to the European Commission and other EU member states and European Economic Area countries (Norway, Iceland and Liechtenstein) for further assessment in order to preventively assess and avert inclusion of such requirements into national law, which have the potential to create barriers to the free movement of goods as well as the freedom to provide information society services, Latvia in the first 10 months of 2006 submitted to the European Commission 9 draft regulations of the Cabinet of Ministers. Detailed opinion of the European Commission that the draft regulations have the potential to create barriers to the free movement of goods in the EU internal market was received in one case.

As from May 1, 2004 until November 1, 2006 Latvia has informed the European Commission about 38 draft technical regulations and received comments of the European Commission in 12 cases and its detailed opinions in 8 cases. In most cases the European Commission's detailed opinions pertained to the fact that draft normative acts did not include the principle of mutual recognition, which prescribes that products legally manufactured or put into the market in one EU member state or Turkey or legally manufactured in one of the European Free Trade Association country, which is a contractor of the European Economic Area Treaty, should be allowed free access to the Latvian market by national authorities. The European Commission also repeatedly indicated that requirements set out in draft technical regulations raise doubts about their necessity and compliance with the principle of proportionality. As from January 1, 2007 Bulgaria and Romania will engage in information exchange system on draft technical regulations. Hereby the concerned public institutions, non-governmental organisations and entrepreneurs will be able to provide their comments on the draft technical regulations prepared in these countries.

As from the 2nd half of 2005 Latvia has considerably improved the statistics of implementation of **internal market directives**. As on June 1, 2006 – 98.5% of internal market directives were transposed into national legislation, which fully ensures reaching the Lisbon goal to transpose at least 98.5% directives or to allow the deficit of transposition of directives in the amount of 1.5%. Since Latvia's accession to the European Union on May 1, 2004, eight violation procedures have been brought against Latvia for inadequate application of internal market legislation acts (*Internal Market Scoreboard* No. 15, July 2006).

In order to encourage business activity and innovation, one of the priorities of Latvia in the European Union is to promote the **free movement of services**. Among initiatives of EU legal acts, the draft directive of the European Parliament and the Council related to services in the internal market is the most substantial for Latvia. This draft directive was supported by overwhelming majority vote of the European Parliament in the second reading on November 15, 2006. The draft directive is aimed at creation of the legal regulation required to promote implementation of the right of establishment and free movement of services within the EU internal market. After its adoption, the member states will have to implement it in 3 years. Although several elements (e.g., country of origin principle, norms on prevention of administrative obstacles in the field of posting of workers) were crossed out from the initial draft directive with a view to reach a compromise acceptable to all 25 member states, the directive will make a positive contribution in the context of facilitating the provision of cross-border services as well as improvement of business environment, especially in the field of removal of administrative barriers. The compromise reached between EU member states on the draft directive envisages such measures for prevention of administrative obstacles as creation of single contact points ("one-stop shops"), provides opportunities for administrative procedures to be carried out electronically, unified requirements for issuance of licences, as well as foresees obligation to the EU

member states to submit information about the existing restrictions in provision of services, etc. to the European Commission that will further assess validity of the restrictions and indicate the necessary improvements.

In 2006 inhabitants and entrepreneurs were informed on their rights in the EU market and about the SOLVIT network that quickly and efficiently fights against violations of these rights by public bodies. This informing has resulted in increased number of complaints at Latvian SOLVIT centre. In 2004 Latvian SOLVIT centre sent 4 cases to centres of other member states and received 5 cases to be solved. The number of sent and received cases increased to 9 cases and 12 cases respectively in 2005 and to 13 cases and 13 cases respectively in 2006 (by November 20).

As a solution found by SOLVIT network (unlike a court decision) is not binding for the public body that violates EU normative acts, the proportion of successfully solved cases is an essential indicator. For instance, in 2004 a successful solution was achieved in mere half the cases, in 2005 this indicator grew to 67% and reached 79% in 2006, which indicates ever-growing professionalism of employees of the SOLVIT centre and authority of Latvian SOLVIT centre among public institutions.

Due to the campaign launched by the SOLVIT centre among inhabitants (not entrepreneurs), their awareness has increased, which is indicated by the proportion of complaints by inhabitants reaching 56% of the number of all complaints (previously two-third of complaints were made by companies).

Inhabitants mostly complain about border control, visas, state fees related to entry and stay in Latvia and other EU member states, and raising different requirements for students of Latvia and other EU member states. The main subject in complaints by companies is violations of free movement of goods (e.g., disregard of the CE conformity marking) and inclusion of discriminatory conditions in public procurement tenders (e.g., complaint of Swedish company about unequal treatment in waste management sphere at the Rīga municipality).

## 6.3. Sector-Specific Development Policies

### 6.3.1. Industrial Policy

One of the main goals of the national economy development in Latvia is to create an efficient and competitive industry that would ensure high and stable growth. Industrial policy in Latvia is being shaped in accordance with the policy development directions of the European Union, at the same time identifying and solving issues that are urgent for local industrial enterprises in co-operation with organisations that represent industrial enterprises. Industrial policy is closely connected with innovation, business activity, education and other policies. The most substantial documents formulating industrial policy in Latvia are as follows:

- Single Strategy of National Economy (approved by the Cabinet of Ministers on August 17, 2004);
- National Lisbon Programme of Latvia for 2005-2008 (approved by the Cabinet of Ministers on October 19, 2005);
- Long-term Economic Strategy of Latvia (accepted by the Cabinet of Ministers on July 17, 2001);
- Industrial Development Guidelines of Latvia for 2004-2013 (accepted by the Cabinet of Ministers on February 24, 2004).

National Lisbon Programme of Latvia for 2005-2008 was developed in 2005 (see Chapter 6.1), which defines the measures to create preconditions for development of knowledge-based economy in Latvia. The most important priorities in the field of industry are orientation to high value-added production and increase of the share of high technologies in the export structure as well as the rise of productivity level. Development and implementation of the programme for promotion of enterprise clusters as well as solution of sector-specific issues, which is based on conduction of studies about development prospects of individual industrial sectors, are set as measures to be taken in the field of industrial policy in the framework of the National Lisbon Programme.

Development of the Competitiveness and Innovation Framework Programme (2007-2013) has been started in 2006, which includes measures for promotion of development of innovation, commercial activity, small and medium-sized enterprises and industry. The Programme is developed in order to achieve bigger co-ordination of the economic policy of Latvia in this strategically important policy direction, which up to now was included in the framework of the National Innovation Programme for 2003-2006, Programme on Development of Small and Medium-Sized Enterprises of Latvia in 2004-2006 and Industrial Development Guidelines of Latvia. The time period for implementation of the Programme allows to successfully

co-ordinate it with the measures included in the National Development Plan of Latvia and with the structural funds utilisation opportunities offered by the EU Financial Perspective for 2007-2013.

The study "Prospects and possible restructuring of manufacturing sectors by 2020" commissioned by the Ministry of Economics was started in 2006. The common goal of this study is to forecast development of manufacturing industry as well as problems and potential improvements in manufacturing industry by 2020. Main emphasis in the study is put on analysis of statistics and creation of the regression model thereby providing a base for numerical sectoral forecasts as well as on exchange of discussions and opinions with representatives of industries. In the framework of the study, 14 most important manufacturing sectors in Latvia are being analysed and discussions with representatives of industries are taking place. It is planned to complete the study in February 2007.

After completion of the study, the Ministry of Economics plans to continue the started discussion with representatives of the most important manufacturing industries, holding an annual expert forum that would include forming and maintaining a common vision on issues essential for development of industries in medium-term and long-term.

Co-operation between Nordic and Baltic Sea countries in the sphere of innovation and industrial policy continues in 2006. Initiatives of co-operation between Northern European and Baltic Sea region countries in the field of innovation and industrial policy were continued by the inter-state co-operation project BSR InnoNet officially started in September 2006. This project or the innovation network of the Baltic Sea region will be financed from the 6th Framework Programme of the European Union and is oriented on co-operation in the field of creation of the cluster policy, promotion of contacts, exchange of information and co-operation between clusters, training, as well as analytical study and analysis of clusters in the region. The Nordic Innovation Centre is the institution co-ordinating the project. Latvian Investment and Development Agency as a project partner represents Latvia, involving also representatives of other public institutions and the private sector into various activities of the project. First meeting of participants of the project was held on September 28-29, 2006 in Rīga, and activities of the project will be implemented until 2009.

### 6.3.2. Energy Policy

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Main directions of the energy policy are promotion of competition, raising the level of energetic independence, increasing the security of energy supply, encouraging the use of renewable and local energy resources, diversification of usable energy resources and environmental protection.

The Ministry of Economics in co-operation with representatives of energy companies, scientists, economists and representatives of associations has drafted the policy-planning document "Guidelines for Development of Energy Sector for 2007-2016" approved by the Cabinet of Ministers 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.

**Electricity supply** is dominated by state JSC "Latvenergo" that generates more than 90% of all electricity generated in Latvia and ensures import of electricity, its distribution and supply to consumers. As from September 1, 2005 all functions of electricity transmission system operator are performed by JSC "Augstsprieguma tīkls" fully owned by SJSC "Latvenergo". By July 1, 2007 all functions of electricity distribution system operator have to be taken over by JSC "Latvenergo Sadales tīkls" fully owned by SJSC "Latvenergo". In addition, more than 100 small power plants and 15 licensed electricity distribution and sale companies operate.

Latvia, as EU member state, has to ensure compliance with the unified requirements set in EU legal acts (see Box 6.4). In the electricity supply sector it means that the electricity market in Latvia must be opened gradually and operate in accordance with provisions of Directive 2003/54/EC of June 26, 2003 concerning common rules for the internal market in electricity.

On July 23, 2004 the Cabinet of Ministers accepted the draft policy-planning document "Guidelines for Creation of Preconditions for Electricity Market in Latvia" prepared by the Ministry of Economics. It defines the basic principles for the model of opening the electricity market in Latvia, necessary preconditions for the market opening, market participants and their basic functions, duties and rights, and principles of perspective structure and regulation of the sector. It also formulates the problems that currently hinder opening the Latvian electricity market and implementation of electricity users' rights of choice. The draft guidelines have been prepared, taking into account Directive 2003/54/EC of the European Parliament and of the Council concerning common rules for the internal market in electricity. In

order to create legal environment for efficiently functioning and competitive electricity market, based on the guidelines, the Saeima passed the Electricity Market Law on May 5, 2005.

The most important precondition for creation of market relations in the electricity supply sector is the changes in the sector's structure, hence separating elements of a natural monopoly (transmission and distribution services) from competing elements (generation and trade). Creation of the sector's organisational structure correspondent to market conditions takes place in accordance with requirements of the new wording of Article 20.1 of the Energy Law and requirements of the Electricity Market Law.

Creation of mechanisms for market operation in the electricity sector is necessary, which constitutes one of the government's priorities. This will be accomplished through approval by the government of legal acts that ensure equal rights for all electricity users in Latvia to freely choose their electricity supplier and be qualitatively and securely supplied with energy in the necessary amount for lowest possible prices.

At present, JSC "Latvijas Gāze" is the only merchant in the **natural gas market** in Latvia. In compliance with licences issued by the Public Utilities Commission, "Latvijas Gāze" carries out transmission, distribution, storage and sale of natural gas. Approximately 70 companies compete in supply of liquefied gas.

Amendments to the Energy Law made on May 26, 2005 envisage main conditions for opening the natural gas market and were developed, taking into account Directive 2003/55/EC of the European Parliament and of the Council concerning common rules for the internal market in natural gas. The law includes issues concerning operation of systems, duties and rights of market participants, and competition opportunities in the natural gas market. The Saeima has passed a special law prescribing that these amendments will come into force on January 1, 2010.

By choosing a regulated procedure of access, member states carry out the necessary measures to confer rights of accessing the system to natural gas companies and qualified users inside or outside the area, which contains an interconnected system, on the basis of published tariffs and other conditions and obligations that are to be complied with, when the system is used.

#### **Box 6.4**

##### **Harmonisation of normative acts with EU directives**

The key fields in harmonisation of legal acts with EU legislation are oil and oil product reserves, security of supply, energy efficiency, and continued introduction of market principles in the energy sector:

- **security of supply and creation of oil product reserves.** The Concept of the State Oil Product Reserve was approved on June 27, 2006. On June 27, 2006 the Cabinet of Ministers accepted its Regulation No. 541 "Procedure for the Establishment and Storage of Petroleum Product Reserve", which regulates the procedure for oil product reserves to be established by merchants;
- **electricity sector.** On May 5, 2005 the Saeima passed the Electricity Market Law (in force as from June 8, 2005) with the aim to create preconditions for operation of efficiently functioning electricity market, so that electricity would be supplied to all electricity users safely, qualitatively and for justified prices, ensure all electricity users' rights to choose electricity merchant freely and promote electricity generation by use of renewable energy resources. On March 17, 2005 the Saeima passed the Law "Amendments to the Energy Law" (in force as from April 15, 2005), by which the previous electricity sector regulation was excluded from the law and Article 20<sup>1</sup> of the Energy Law was expressed in a new wording according to the market requirements. On June 13, 2006 the Cabinet of Ministers accepted the "Regulations on the Special Connection to Electricity Transmission System" that define procedure for establishment of special connection to electricity transmission system or increasing the capacity of a current connection. On April 25, 2006 the Cabinet of Ministers adopted Regulation No. 322 "Regulations on Annual Assessment Report of Transmission Operator" that determines the procedure, by which a transmission system operator develops and submits the assessment report to the Ministry of Economics and the Public Utilities Commission, as well as requirements regarding the content of the assessment report. Cabinet of Ministers Regulation No. 695 "Regulations on Permits for Increase of Electricity Generation Capacities or Introduction of New Generation Facilities" are in force as from August 29, 2006, which sets the requirements to be fulfilled so that electricity producer would get a permit for increase of electricity generation capacities or introduction of new generation facilities. On November 6, 2006 the Cabinet of Ministers adopted Regulation No. 921 "Regulations on Electricity Production from Cogeneration" that sets the criteria by which cogeneration power stations are qualified to get rights to sell the produced electricity within compulsory procurement;
- **gas sector.** On May 26, 2005 the Saeima passed the Law "Amendments to the Energy Law" (in force as from June 29, 2005) that determines principles for operation of the natural gas market. The aim of the law is to create conditions for competition in the natural gas market in Latvia and harmonise regulatory normative acts with requirements of EU legislation. Transitional provisions of the law prescribe that time and procedure for coming into force of the legal norms, which regulate principles for operation of the natural gas market, are determined by a special law. On June 20, 2006 the Cabinet of Ministers accepted the regulation "Regulations on Annual Assessment Report of Natural Gas Transmission Operator" that determines the procedure, by which a natural gas transmission system operator develops and submits the assessment report to the Ministry of Economics and the Public Utilities Commission, as well as requirements regarding the content of the assessment report.

##### **Investment in the energy sector**

State support in the energy sector is only given to projects linked to adjustment of heat supply systems.

In the framework of utilisation of EU Structural Funds (see Chapter 6.2.1), support to public and non-governmental sector is envisaged. The priorities for the use of the Structural Funds are listed in the

Development Plan, 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 for public sector institutions in modernisation of heat supply systems according to environmental requirements and improvement of energy efficiency of heat supply systems both in production and distribution and for the end consumers. In the framework of EU Structural Funds for 2004-2006, LVL 14.96 million will be allocated for the mentioned projects. It is planned to allocate approximately EUR 116 million in the energy sector from the Cohesion Fund in the next Structural Funds utilisation period of 2007-2013. This amount will be distributed to measures for increase of efficiency of district heating systems and for development of cogeneration plants that use biomass.

87 projects are submitted and assessed for financing from EU Structural Funds – European Regional Development Fund (ERDF). The projects prescribe modernisation of heat supply systems according to environmental requirements and improvement of energy efficiency both in production and distribution and for the end consumers.

Supporting reconstruction of district heating systems, construction of heat sub-distribution units and other heat regulation equipment and reduction of heat losses in buildings, the Cabinet of Ministers Regulation No. 433 "Distribution of the Appropriation Envisaged in the Ministry of Economics Programme 29.00.00 "Energy Policy" within the Framework of the State Heat Supply Sector Programme" of June 12, 2006 was issued in 2006, which envisages support to 61 projects for the total amount of LVL 7 million.

### **6.3.3. Construction Policy**

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The goal of the state policy in construction is creation of conditions to meet the demand of the national economy for environmentally friendly, healthy, energy-saving and resources-saving, aesthetic and modern buildings.

By planning the development of construction in the Republic of Latvia, the Cabinet of Ministers has accepted the following political documents:

- the Concept for State Strategy in Construction on November 5, 1996
- the Concept for Strategy on Terms for Converting the Former USSR Technical Norms of Construction and on Financing on September 28, 1999, and
- the National Programme on Construction on August 30, 2002.

*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 the 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 the National Programme on Construction* for the period until 2012 is updated every year. All ministries, Latvian Association of Local and Regional Governments, and non-governmental organisations of the construction sector involve in this process, giving and evaluating proposals on activities before their inclusion into the plan.

In 2006, the *Action Plan for Implementation of the National Programme on Construction* was supplemented with drafts of new normative acts for creation of the Construction Information System and introduction of environment accessibility requirements into construction, measures for alignment of business environment, promotion of fair competition in construction procurement, rise of competitiveness of local construction companies, and improvement of skills of construction specialists.

Construction volumes in our country increase consistently and have more than doubled in the last 10 years. Growth of construction volumes is promoted by increasing growth of economic development, availability of resources, including availability of credit resources and investment for development of new production facilities, use of progressive technologies and new materials, as well as improvement of normative base, simplification of procedures by reduction of administrative obstacles, and support to business activity.

In order to improve business environment in construction, amendments to the *Construction Law* were made in 2006, specifying issues of harmonisation and public discussion of construction objects,

obligating local government to inform society about received construction proposals, and specifying the action of building inspector and local government in cases of unwarranted construction.

In accordance with Article 10 of the *Construction Law* and Cabinet of Ministers Regulation No. 453 of June 28, 2005 “*Regulation on Registration of Construction Businesses*”, licensing of legal persons for business activity in construction is replaced with the Register of Construction Businesses, simplifying the procedure and reducing to a minimum the number of documents to be applied and hence economising time of entrepreneurs. In the transition period from July 1, 2005 to June 30, 2006, both the licensed companies and the ones registered in the Register of Construction Businesses were authorised to carry out business activity in construction. As from July 1, 2006, only the registered construction businesses are endowed with such rights.

As of December 1, 2006 the register contains information on 4060 construction businesses, staff employed by company, persons with rights of permanent practice in accordance with Article 8 of the *Construction Law*, data characterising company operation, information on violations in construction and on violations of rules of the register. Register of Construction Businesses is publicly available with the exception of the data, the availability of which is limited in accordance with normative acts regarding business secret and data protection.

Conformity assessment of specialists in various spheres of construction, granting a certificate of construction practice or architectural practice in the respective sphere, is carried out by 8 building specialist certification centres of non-governmental professional organisations (Latvian Association of Civil Engineers, Association of Heat, Gas and Water Technology Engineers of Latvia, Latvian Shipping Association, Certification Centre of Hydroamelioration Construction Specialists of the Latvian Land Reclamation Specialists Society, Latvian Railwaymen Society, Latvian Association of Energy Construction, Latvian Electricians' Society), which are accredited by the Latvian National Accreditation Bureau (LATAK; see Chapter 6.12.2), and by the Latvian Architects Society.

The joint register of certified specialists, which is maintained by the Ministry of Economics, contains information on 7306 practice certificates, of which 6407 are construction practice certificates in various fields of construction and 899 are architectural practice certificates.

Improvement of Latvian construction norms and the National Standardisation System for construction continues, new draft normative acts are prepared, harmonising requirements of the current normative acts with EU positions, and adaptation of EU standards takes place. 340 standards and their changes were adapted in 2006, of which 20 with a translation.

Construction is a complicated process full of risks, therefore big attention is paid to improvement of the normative base so that safety of buildings and people is guaranteed along with simplification of procedures. In parallel to reduction of administrative obstacles, amendments to the Code of Administrative Violations specify and raise penalties for non-observance of the requirements of laws and other normative acts in construction. Compulsory insurance of civil liability is introduced in construction. Regulations of the Cabinet of Ministers “*On Compulsory Insurance of Civil Liability of Holders of Hydraulic Structures of Hydroelectric Power Stations*”, “*Procedure for Issuance and Annulment of Safety Certificates of Hydraulic Structures of Hydroelectric Power Stations*”, LBN 229-06 “*Hydraulic Structures of Hydroelectric Power Stations*”, “*Methodology for Setting Operational Protective Zones along Water-pipe and Sewerage Systems*”, and “*Regulations of Construction Information System*” were issued in 2006.

Draft regulations of the Cabinet of Ministers on amendments to the Cabinet of Ministers Regulation No. 112 of April 1, 1997 “*General Construction Regulations*”, LBN 211-98 “*Multi-Storey Apartment Houses*”, “*Regulations on the Latvian Building Norm LBN 261-06 Construction of Internal Wiring of Buildings*”, “*Regulations on European Technical Approval*” and “*Procedure for Public Discussion of Construction*” are in the process of harmonisation.

A unified Construction Information System is developed with the aim to ensure accumulation of construction information and electronic exchange of information between construction management and control institutions and participants of construction.

Although the sector develops rapidly and total volumes of construction increase year by year, the territorial distribution of investment and construction activities in the country is still very uneven (it is the highest in Rīga city, Rīga district, Ventspils and Liepāja), level of corruption possibility in local governments is comparatively high, development rates of scientific potential in the sector are insufficient, and the growing demand for skilled specialists in construction is still not fully met.

The rapid growth of construction not always keeps pace with adequately dynamic increase of quality. Conclusions made by the State Construction Inspection and non-governmental professional organisations indicate that insufficient attention is paid to the quality of construction designs, and as a result also the quality of buildings not always matches up to the desired level.

Deficit of construction specialists is caused both by the fact that the optimal number of students in construction specialities at higher education institutions was not completed in a long time period and by the outflow of specialists to foreign countries in search of higher wages.

Non-governmental organisations that unite specialists in different spheres of the sector have a good knowledge of the labour force situation, its skills and demand for it in the market and try to respond timely by organising the training of employees as well as propose training of students in the desirable specialities taking into account the special technological and EU requirements.

Transposition of the new EU norms is one of especially work-consuming tasks. In order to implement them, it is essential not only to adapt the respective normative acts, but also to ensure that their requirements are taken into account in the learning process and the construction practice. In order to fulfil this, the Ministry of Economics worked out the project "Introduction of Eurocode Standards in Design of Building Structures" that was approved for receipt of funding from the Transition Programme financed by the European Union. Implementation of the project is carried out according to the twinning principle between the Ministry of Economics of the Republic of Latvia as aid beneficiary and the German Federal Ministry of Transport, Construction and Urban Affairs as aid provider. 12 months until June 2007 are envisaged for implementation of the project. The second stage in implementation of the project concludes in December 2006. This stage is a voluminous cycle of seminars, where German experts (24 diplomaed engineers and professors in total) gave lectures on all parts of Eurocode and their application and introduction into national legal acts as well as consultations on complete introduction of Eurocode subjects in the respective Latvian education programmes were held. Teaching staff and students of Latvian education institutions as well as practicing engineers took part in the seminars.

Careful and economic use of natural resources is especially important in all national economy sectors in the context of sustainable development of the country, hence special attention is paid to issues of environment, ecology and energy efficiency. They are also important in the construction sector, as both the production and transport of construction products and the building operations and further maintenance and management of building create consumption of raw materials and energy, pollution of air and water, noise, waste, and changes of microclimate and environment, which results in substantial reduction of natural resources.

As construction volumes grow, development of production facilities of building materials and related issues have become topical. Commission for assessment of the grant scheme "Improvement of business activity in accordance with requirements of standards" has supported 163 project applications with the total value of LVL 58 million, of which 33 projects (20%) with the total value of LVL 12.7 million (22%) are directly related to the construction sector, but development of construction will be also promoted by many other projects.

Division of functions of the organisational structure of the sector is inefficient. Fragmentation and overlapping of construction management functions or their duplication in public institutions, insufficiency of real control, uncertainty of vision and tasks of the future are mentioned as one of the main problems for a long time.

General supervision and co-ordination of construction in the country is carried out by the Ministry of Economics, while supervision of particular areas is under competence of other ministries. The competence of the Ministry of Transport and Communications includes road construction (Road Directorate of Latvia), railways, ports and telecommunications, while territorial planning is within the scope of competence of the Ministry of Regional Development and Local Government. Ministry of Welfare, Ministry of Justice, Ministry of the Interior, Ministry of Environment, Ministry of Health and Ministry of Agriculture determine particular requirements for buildings or their construction. State Inspection for Heritage Protection that is subordinate to the Ministry of Culture sets requirements for reconstruction and restoration of cultural monuments.

Direct supervision of construction in their administrative territories is carried out by 553 local governments (7 cities, 53 towns, 35 amalgamated local governments (novads), 432 rural municipalities) that have established their construction boards for this purpose or have delegated their supervision powers to other construction boards. 156 construction boards (boards of cities, towns, districts, amalgamated local governments, rural municipalities or united boards) operate in Latvia.

Latvia is a member state of the European Union for more than two years already and this has strongly affected the construction sphere as well, but the political documents in the construction sector were developed at the end of 1990s.

There is no single methodology in assessment of public procurement in construction, development of tender statutes, implementation and supervision of procurement in the guarantee period. As considerable budgetary resources are channelled to construction, optimisation of procurement system in construction would reduce possibility of corruption, increase transparency of the process and ensure professional conduction of public procurement in the central and local government sector.

Development of the construction sector is still hindered by interpretation of the requirements of normative acts by institutions involved in preparation of construction, frequent changes of normative acts regulating construction, shortage of territorial planning and building rules, and the lack of transparency of processes in local governments, which creates suspicions on possible corruption. At present, information included in registers or information systems of 12 various ministries and institutions is used in preparation of construction documents.

Capacity of state supervision institutions of the construction product conformity assessment system is insufficient. Such new type of conformity assessment technical regulations still unused in Latvia as European Technical Approval is introduced in circulation of construction products, and each member state has to authorise a specific body for its issuance. A full-fledged institution, which would be responsible for issuance of European Technical Approvals (ETA) in Latvia and for analysis of documents prepared by ETA issuance bodies of other EU member states as regards their compliance with Latvian national interests is not established.

**Declaration of the Intended Activities of the Cabinet of Ministers headed by the Prime Minister Mr. Aigars Kalvītis** sets the goals: "We will ensure development and implementation of a single construction policy, inter alia, eliminating the fragmentation and functional overlapping of involved institutions and by creating a co-ordinated and integrated construction management and control system.

We will modernise the Latvian system of construction standards by laying down minimum requirements for functionality of buildings, and will improve the National building standardisation and supervision system.

We will reduce administrative obstacles in construction and simultaneously improve quality control in construction and observation of environmental requirements, and will eliminate bureaucratic obstacles to performing repair works of buildings and to destruction of illegally constructed buildings.

We will provide construction branch players with access to building standards and local government construction regulations.

We will promote construction that is safe to the public, friendly to environment and human health and also energy-efficient, and will improve the system of normative acts in construction."

Considering these goals, the main action priorities in construction during the next years are:

- development of a new political document – construction guidelines;
- optimisation of the institutional structure of construction;
- improvement of construction control system.

As immediate tasks important for development of the sector, one should also point:

- improvement of the supervision of construction products market;
- promotion of development of scientific disciplines related to construction;
- development of production of domestic building materials;
- improvement of educational system for training of highly skilled construction specialists.

Action Plan of the Ministry of Economics includes also other measures for development of the construction sector along with the mentioned priority tasks:

- introduction of construction information system, which will improve co-operation of central and local government institutions and construction control as well as will provide the society with opportunity to follow construction processes in the country. Access to the system will allow control services to get current information about construction and fulfil control functions in fire-fighting, cultural heritage protection, environmental protection, employment, tax administration and other spheres more efficiently. Introduction of construction information system will reduce time for harmonisation of construction documentation, exchange of information between central and local

- government institutions will allow to diminish the illegal employment and will promote payment of taxes. Thereby, creation of a single construction information system in the country will improve not only operation of central and local government bodies supervising construction, but also co-operation with other institutions involved in construction process. Through implementation of the system, the society will get a convenient and operative mechanism to follow processes in the construction sector and will get an opportunity for public control of construction, which will reduce launch of illegal construction and will diminish possibility of corruption;
- amendments to the Cabinet of Ministers Regulation No. 112 of April 1, 1997 “*General Construction Regulations*” and to the Cabinet of Ministers Regulation No. 299 of April 13, 2004 “*Regulations for Commissioning of Buildings*”, simplifying the procedures of starting the construction and commissioning of buildings;
  - development of necessary standards to meet LBN 229-06 “*Hydraulic Structures of Hydroelectric Power Stations*”;
  - adaptation of CEN and Eurocode standards;
  - organisation of training for introduction of Eurocode standards in designing of the building structures in the framework of Twinning project of Transition Facilities programme;
  - working out National Annexes to Eurocode standards;
  - preparation of proposals for market surveillance institutions in regard to surveillance of construction products market, etc.

To increase awareness of construction participants and the public, seminars on topicalities of the sector in areas of normative regulation, construction products, designing, technologies, quality, labour protection and other areas are planned in addition to the current information on the Ministry of Economics website and monthly information days.

Also social partners are involved in formation and implementation of the construction policy: Latvian Architects Society, Latvian Association of Civil Engineers, Latvian Construction Contractors Association, Latvian Building Inspectors and Supervisors Association, Association of Heat, Gas and Water Technology Engineers of Latvia, Latvian Building Materials Producers’ Association, Latvian Window and Door Manufacturers’ Association, Latvian Building Materials Traders’ Association, Latvian Builders’ Trade Union, Technical Experts Association, Latvian Association of Local and Regional Governments, Association of Road Builders of Latvia, Latvian Land Reclamation Specialists Society, Latvian Shipping Association, Latvian Railwaymen Society, Latvian Geotechnical Union, Latvian Association of Energy Construction, Latvia’s Electricians’ Brotherhood, Latvian Electricians’ Society, Latvian Consulting Engineers’ Association, as well as Society of People with Disabilities and their Friends “Apeirons”.

#### **6.3.4. Tourism Policy**

For determination and implementation of state tourism development policy, a complex base of tourism policy planning documents is being created in Latvia.

In order to ensure achievement of objectives set in the Guidelines of Tourism Development Policy of Latvia for 2004-2008 (Cabinet of Ministers Instruction No. 559 of August 11, 2004 and Cabinet of Ministers Instruction No. 253 of April 21, 2005), the Tourism Development Programme of Latvia for 2006-2008 was developed (approved by the Cabinet of Ministers Instruction No. 505 on July 5, 2006) (hereinafter – Programme). The Programme is a medium-term policy-planning document developed for three years and including horizontal activities of tourism development (Box 6.5).

##### **Box 6.5**

###### **Goals and subgoals of the Tourism Development Programme of Latvia**

The main goal of the Programme is to ensure annual increase of the value-added of the tourism sector by 10-15% and growth of the proportion of the tourism sector in GDP by 20% annually (at current prices) in 2006-2008.

Subgoals of the Programme are as follows:

- promote recognition of Latvia as a tourist destination, increasing the market share of Latvian tourism in tourism markets of Latvia and achieving repeated return of travellers (tourists) to Latvia;
- encourage development of commercial activity of tourism, achieving balanced development of tourism infrastructure, tourism services and tourism products, which would correspond to tourism demand;
- foster development of co-operation in the field of tourism, attaining improved capacity of public bodies in the tourism sector as well as local governments and non-governmental organisations.

Specific activities of tourism development are determined through development of the annual action plan of tourism development. Action Plan of Latvian Tourism Development for 2006 was approved by the Cabinet of Ministers Regulation No. 425 on June 6, 2006. It includes horizontal activities for tourism development, which are implemented by the Ministry of Economics, Latvian Tourism Development Agency and other public institutions in co-operation with local governments, the private sector and non-governmental organisations.

In 2006, LVL 1.8 million were allocated to the state budget programme "Implementation of the Tourism Policy". In accordance with the set priorities, these finances are directed to improvement of tourism infrastructure, promoting development of new tourism products and services and strengthening positions of Latvia as a tourist destination.

Two projects for establishment of tourism information system were implemented in 2006. As a result of implementation of the PHARE project "Promoting establishment of a unified informative system of tourism in Latvia – informative stands in objects of natural, cultural and historical tourism", 195 stands were put up in various objects of tourism. In the framework of the PHARE project "Promoting establishment of a unified informative system of tourism in Latvia – establishment of a network of informative stands on Latvian roads", 92 stands were put up on the main roads of Latvia. The aim of the projects is to ensure available, comprehensible and reliable tourism information of the respective region. The function of the stands is to improve regional tourism services and the publicly available information on cultural and historical objects and promote the image of recognisable and reliable tourism products. The main target audience of the project is both the local and foreign tourists that travel on Latvian roads. Providers of tourism services as well as owners and managers of cultural and historical objects will also make gains from it.

In order to ensure access to tourism information for increasingly wider range of interested people, several new languages (Polish, Finnish, Swedish, Spanish and Italian) were added to the official Latvia tourism portal [www.latviatourism.lv](http://www.latviatourism.lv) in the 2nd half of 2006. The portal can be viewed in 12 languages in total. Formation of a new concept and structure of the portal has been started. In the tourism season, the Free Accommodation System was available on the portal, which provided travellers with opportunity to find free accommodation.

Notwithstanding the positive development of tourism in Latvia, main places of tourist concentration in our country still are in Rīga and its neighbourhood. Latvia could attract much more tourists also in regions if a unified national-level set of tourism products, which would include high-level services not only in Rīga, would be purposefully directed in the market, using modern information technologies. Development of new tourism products would create preconditions for additional investment in tourism infrastructure, which would promote competitiveness of Latvia regarding other EU tourism destinations. Supply of tourism products in all country, including different forms of tourism objects (e.g., thematic/atraction parks, active recreation areas for families with children, older people, persons with special needs, ethnographic villages, objects of industrial and military heritage, etc.), is not balanced in Latvia. The current supply of tourism products is one-sided and hence negatively affects the increase of tourist flow in the country in total, concentrating it in separate regions.

In order to popularise new tourism products in Latvian regions and promote development of products of local tourism and co-operation between providers of tourism service and potential travellers, the Latvian Tourism Development Agency (hereinafter Agency) held the "Latvian Travel Marathon" from March 18, 2006 to November 18, 2006. In the framework of this project, interested people had an opportunity to visit and acquaint themselves with more than 30 various objects of tourism in all Latvian regions. This project helped the Agency and the Latvian Tourism Information Bureau in Riga to promote development and recognisability of tourism products among Latvian population and foreign travellers.

In order to popularise Latvian tourism opportunities in domestic and international markets, the Agency has updated and reprinted more than 30 various informative materials of tourism – booklets, brochures, maps and practical information leaflets in 10 languages in 2006. The informative materials are foreseen both for tourists and for professionals. During 2006 the Agency has implemented marketing activities both in highly prioritary target markets and in the prioritary ones. Latvian tourism opportunities were advertised in 16 international tourism fairs, and 39 visits of foreign journalists were organised. Due to additional funding, strengthened purposeful marketing activities will be implemented in target markets at the end of this year.

Latvia has continued co-operation at international level (taking part in the work of the UN World Tourism Organisation and its Regional Commission for Europe as well as the European Travel

Commission), in the EU framework (participating in the work of the Tourism Advisory Committee and the Tourism Sustainability Group of the European Commission) and in the Baltic Sea region (taking part 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”), as well as in implementation of intergovernmental and interagency agreements. Annual convention of the European Union of Tourist Officers (EUTO) and the international tourism conference (September 23-30, 2007) are planned in Latvia in 2007.

#### **Box 6.6**

##### **Trends of Latvian tourism development**

In the period from 2000, a stable increase in the incoming tourism has taken place by 15% on average annually, which indicates a successful development of the sector on the whole and gives hope to achieve even better results in the future. However, notwithstanding this positive trend, the number of those travellers staying more than 24 hours in Latvia has not increased (they make merely about 30% of all travellers) and the indicators of tourism balance of payments are still negative (expenses of Latvian residents during their trips abroad exceed expenses of foreign travellers in Latvia).

Growth of the tourism sector in 2006 was mostly promoted by the following factors:

- Latvia's accession to the European Union;
- measures of Latvian tourism marketing implemented in target markets of tourism;
- appearance of supply of low-cost airline services;
- growing popularity of short holidays in Europe;
- development of urban and business tourism;
- establishment of medium-price and low-price hotels.

Comparing tourism development in other EU member states after accession to the EU, one can forecast growth of tourism in the following years in Latvia as well, hence the activities promoting tourism development have to maintain growth in the sector on the whole and ensure continuous development of tourism infrastructure, tourism products and services and their quality as well as strengthening Latvia as a tourist destination and growth of its competitiveness both in the EU internal market and in the international tourism market.

The rapid development of tourism has brought to the forefront the issue of quality of the provided tourism services, number of skilled specialists and level of professional knowledge in the tourism sector. Nonconformity of the supply of tourist guide services with the rapidly growing demand has reduced competition in this sector and negatively affected the quality of provided services. Assessing the tourist guide quality assurance measures implemented in other EU member states and their harmonisation with normative acts in the EU space, the Ministry of Economics has envisaged to prepare the appropriate base of normative acts in order to introduce the requirement for professional skills certificate as from January 1, 2008. A substantial problem is also constituted by the abuse of tourist confidence, which is related to various fraud cases in short term, but may undermine the positive image of the state and result in introduction of various sanctions in long term, which would reduce the tourist flow to Latvia. Such situation would be a big step backwards and an invaluable loss both for the tourism sector and for Latvia on the whole. Solving this problem, one has to achieve that tourists orient themselves in their rights in Latvia as well as in services and have an opportunity to get help in case of necessity.

Taking into account the rapid growth of the number of tourists, the demand for labour force in the tourism sector has increased. In order to attract skilled labour force, Latvian tourism service providers have to compete with tourism service providers in the EU member states. The offered opportunities to work in the EU member states, including in one of the most active sectors (tourism), have roused interest of many tourism sector specialists from Latvia (especially the young ones), therefore tourism service providers in Latvia face shortage of skilled labour.

Mutual co-operation of European countries for promotion of tourism development in the future is especially important. Advancement of tourism policy to sustainable development of tourism, including not only the economic aspect of tourism, but also environmental protection, preservation of cultural heritage and development of innovative tourism products is also important for European tourism development in perspective.

Evaluating the current situation and the potential of tourism resources, the following main priorities may be set for the further period:

- development of tourism infrastructure;
- promoting development of new innovative inter-season tourism products and services;
- raising quality of tourism services;
- strengthening competitiveness of Latvia as a tourist destination.

## 6.4. Business Environment

Business environment in Latvia is being constantly improved through development of the legal framework, harmonising it with EU requirements and monitoring the effects of administrative procedures on business activity. Considerable reforms and improvements have been achieved in registration of enterprises, taxation policy, customs legislation and procedures and border crossing, construction, real estate development and other areas.

Reforms for improvement of business environment are estimated positively in various surveys, for example, in the survey “***Doing Business in 2007: How to reform***” ([www.doingbusiness.org](http://www.doingbusiness.org)) conducted by the World Bank Group, business environment of Latvia takes the 24th place among 175 countries, which is by 2 positions higher in comparison with the previous year (in “*Doing Business in 2006*”, Latvia took the 26th place among 155 countries). Achievements in the spheres of taxation, licensing and liquidation of enterprises allowed getting the higher place. Latvia also has a high place in the topic “Enforcing Contracts”, where Latvia takes the 11th position, and starting a business is also made simpler. In the topic “Registering Property” Latvia has climbed by 7 positions, but still only takes the 82nd place. The indicator in the topic “Employing Workers” is the lowest due to a complicated situation in dismissing workers. Latvia is placed among 15 countries, where reforms favourable to business activity proceed most rapidly.

***Action Plan for Improvement of Business Environment*** worked out annually since 1999 is among efficient mechanisms for improvement of business environment in Latvia. The *Action Plan* is an inter-ministry policy planning document setting out directions of activity for implementation of business environment policy as well as tasks, measures to be carried out, responsible institutions, indicators for assessment of how the tasks have been accomplished and their accomplishment terms. Problems included in the *Action Plan* and their solutions are identified through close co-operation with organisations representing entrepreneurs (Council of the Small and Medium-Sized Enterprises and Crafts, National Economy Council, Foreign Investors Council in Latvia) as well as through assessment of problems identified in business environment surveys. The *Action Plan* covers amendments to legal acts, revision and simplification of procedures, improvement of co-ordination between various bodies, preparation and publication of information, as well as training employees of public institutions.

Directions and tasks of the *Action Plan* cover such spheres as taxation policy and tax administration, improvement of legal environment for business activity, reduction of the number of procedures and the required time, and improvement of access to information.

The latest *Action Plan* for 2006 includes 23 measures. With its help it is planned to find solutions to such issues as reduction of time for settlement of issues with the SRS, reform of the tax penalty system, development of e-government services, improvement of regulation of real estate transactions, and simplification of construction procedures. On August 15, 2006 the Ministry of Economics submitted to the Cabinet of Ministers the informative report on the process of fulfilment of the plan in respect of measures whose fulfilment term was June 1, 2006. The deadline of June 1, 2006 was for 9 measures, of which 6 are completely fulfilled and 3 are partly fulfilled.

Simultaneously with efforts to eliminate administrative obstacles, meetings with higher government officials are held annually in co-operation with the **Foreign Investors Council in Latvia (FICIL)**. Prime Minister, Minister of Economics, Minister of Foreign Affairs, Minister of Finance and other government officials take part in the high-level meetings. They meet with leaders of bigger international investor companies and other higher officials that represent various spheres and countries. Since the 2nd High-Level Meeting, recommendations of FICIL are included in the *Action Plan*. The 10th high-level meeting of Latvian government and FICIL took place on June 21-22, 2006. The most important issues discussed were:

- Potential improvements of taxation policy and tax administration;
- Issues of transport infrastructure;
- Issues of development of real estate market;
- Development of Latvian economy and business environment;
- Co-operation between Latvian government and investors: progress of previous years and further co-operation;
- In search of excellence: development strategies of Latvia.

In August-December 2005 the Ministry of Economics and the Latvian Investment and Development Agency (LIDA) in co-operation with the market and sociological research centre SKDS and the World Bank's Foreign Investment Advisory Service (FIAS) conducted their regular (already the 4th) **survey to assess measures for improvement of business environment**. The survey consists of three main elements: business survey, self-appraisal of the influence on business environment exerted by national and local government institutions, and report of policy recommendations. SKDS conducted the business survey by using methodology jointly improved by the World Bank/FIAS, Central Statistical Bureau, LIDA and SKDS. 701 company managers in Latvian cities and regions were interviewed in the survey.

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 entrepreneurs' daily business activities in phases of start-up, choice of location and operation.

The survey allows to compare development trends of business environment and to identify spheres where new reform programmes are required as well as to measure effectiveness of various activities for improvement of business environment. The survey helps both to develop measures of assistance to small and medium-sized enterprises and find out the opinion of entrepreneurs about operation of state and local government bodies.

**Panel of private sector experts and representatives of entrepreneur associations** is established for independent supervision of the survey and determination of entrepreneur priorities. Representatives of non-governmental organisations (National Economy Council, Council of the Small and Medium-Sized Enterprises and Crafts, Foreign Investors Council in Latvia, Employers' Confederation of Latvia, Latvian Chamber of Commerce and Industry, Latvian Association of Certified Auditors, Foundation for Representation of Taxpayers' Rights and Interests, Association of Mechanical Engineering and Metalworking Industries of Latvia, Latvian Association of Business Consultants, Logistics and Customs Brokers Association, Latvian Real Estate Association) as well as independent experts are represented in the expert panel.

The survey indicates that business environment has improved in comparison with results of previous surveys in all parameters, except the *inflation* indicator that has deteriorated in comparison with 2003. Indicators of *constancy of laws and predictability of changes, tax rates, competition with shadow economy, corruption in the public sector, personal and property safety* have improved by 10% on average in comparison with 2003.

In order to encourage discussion of entrepreneurs and public bodies about the problems that are faced by entrepreneurs daily and to jointly seek solutions, the **conference "Initiative "Better Regulation": for Raising Competitiveness of Business Environment in Latvia and Europe"** (see Box 6.7) was organised on June 30, 2006.

Recommendations of the conference as well as other proposals of entrepreneurs will be included in the *Action Plan for Improvement of Business Environment* for 2007.

On August 14, 2006 the Cabinet of Ministers reviewed the informative report on proposals for ensuring **flexicurity in labour regulation**. Pursuant to instruction of the Cabinet of Ministers, several amendments to normative acts have to be made – on seasonal work, work where young people are employed, work where contracts of indefinite duration are not concluded, work permits for foreigners, etc. Draft instruction prescribes continuing discussions on improvement of the system of leaves for studies as well as on introduction of a unified system of residence/work permits. It is planned to improve the legal base for establishment and operation of private employment agencies and temporary employment agencies.

On November 21, 2006 the Cabinet of Ministers approved Regulation No. 941 that amends the procedure for issuance of sick leave certificates. The regulation prescribes that in case when incapacity for work lasts 45 days and the attending physician or physician assistant has not consulted with other specialist physicians in this period, the attending physician or physician assistant is obliged to send the patient to a specialist physician who, in 30 days, has to assess if the patient must interrupt or continue the sick leave. In the case, when incapacity lasts six months, the attending physician or physician assistant is obliged to send the patient to the Health and Working Capacity Medical Expert Commission (HWCMEC) that decides on determination of disability for the person, making appropriate note in the sick leave certificate.

In October 2006 the government adopted the **Draft Concept on Development of the State Joint Stock Company “Latvijas Hipotēku un zemes banka”** (Mortgage and Land Bank of Latvia, MLBL) for 2007-2013 (Order of the Cabinet of Ministers No. 841 of November 1, 2006). In accordance with the version of the concept approved by the government, MLBL will be made as a development bank and will be kept as a state property in order to ensure retaining of the experience gathered through administration and implementation of various state support programmes carried out up to now.

#### **Box 6.7**

##### **Conference “Initiative “Better Regulation”: for Raising Competitiveness of Business Environment in Latvia and Europe” of June 30, 2006**

The goals of the conference:

- deepen awareness of the society and specialists in respect of importance of "better regulation" in improvement of business environment in Latvia and the European Union;
- assess achievements and problems of Latvia so far in improvement of regulation quality;
- outline the vision and priority reform tasks of Latvia in improvement of regulation.

Parallel round-table discussions were organised within the conference, where employees of public administration institutions, entrepreneurs and employees of organisations representing entrepreneurs discussed opportunities to improve the system, abolish unsubstantiated requirements, etc. Round-table discussions were held on the following subjects:

###### *1) Taxation policy and tax administration*

Subjects: policy of tax penalties, customs policy, selectivity of VAT norms, electronic declaration, required improvements in tax administration, etc.

Main recommendations: it is necessary to introduce the principle of fairness in the system of imposition of penalties; process of information exchange between the SRS and a businessman is pretty often formal and hence also incomprehensible; SRS would pay more attention to consulting of entrepreneurs;

###### *2) Territorial planning, real estate development and related construction procedures*

Subjects: territorial planning, process of construction harmonisation, co-operation of institutions, role of local governments, technical standards, etc.

Main recommendations: it is necessary to complete working-out of development plans and territorial planning in local governments and adopt these binding rules by strongly set term as well as ensure public access to planning and construction rules in the local government and on the internet; create an information system that would contain all decisions on planning and construction and ensure transparency of all process; revise the procedure of preparation of inventarisation plans. The function of inventory maker should be also delegated to the private business; construction issues have to be advanced along with planning development issues therefore a single public administration body (not several ones as now) should be responsible;

###### *3) Lobbying in Riga and Brussels: Role of entrepreneurs in prevention of administrative obstacles, capacity of entrepreneur associations, instruments of lobbying, dialogue between entrepreneurs and the government*

Subjects: how to improve involvement of entrepreneurs in improvement of business environment and development of policy planning and normative acts; forms of state-entrepreneur dialogue, etc.

Main recommendations: associations should solve not only issues of legislative changes, but also involve in adoption of important political decisions. One may conclude that co-operation even between various public bodies and entrepreneurs do not work.

Too short time for comments and harmonisations is given to assessment of Latvian national positions. Incomplete information is also sent to the associations. There is no feedback between public institutions and entrepreneurs – no information what comments have been taken into account and what is the final wording after the initial opinion of entrepreneurs about some national position. At present, only 34% of national positions are harmonised with the non-governmental sector. It should be determined that it is required not only to consult with entrepreneurs, but also take into account their comments, recommendations and initiatives;

###### *4) Labour legislation and labour relations*

Subjects: promoting flexibility of labour relations, regulation of dismissal, payment of disability, leaves for studies, optimal trial period, etc.

Main recommendations: it is necessary to facilitate work of young people in order to give an opportunity to employ young people more flexibly, employment of disabled people (maintaining allowance in case if the disabled person works), and more flexible return to work of young mothers. Trial period – employer should be given the rights to choose a shorter period, but 6 months should be set as the maximum period by the law. Labour courts are to be established, which would provide an opportunity to settle labour disputes more efficiently and faster. Necessity of payroll tax books has to be assessed. Obligation of employer to cover costs related to payment of leaves for studies has to be excluded, covering them from the state budget.

## **6.5. Research and Innovation**

National innovation system of Latvia is poorly developed at present and considerably lags behind the average level of EU member states. Although a growth of the number of companies active in the sphere of innovation has been observed, especially in the sector of services, results of the Central

Statistical Bureau's survey for 2005 show that merely 17.5% on average of all companies in Latvia are innovative while in EU member states this indicator is 45% on average.

In 2005, the total financing for research and development in Latvia increased by 0.15% and constituted 0.57% of GDP (1.93% of GDP in EU member states on average in 2003). Financing by the private sector increased by 0.08% in 2005 in comparison with the previous year and made 0.23% of GDP in 2005. National Lisbon Programme of Latvia for 2005-2008 (see Chapter 6.1) sets the target that the total expenditure on research and development in Latvia has to constitute 1.5% of GDP in 2010. In order to reach this goal, the Law on Scientific Activity prescribes annual increase of financing for scientific activity from the state budget by at least 0.15% of GDP or it is planned to increase the state budget financing for scientific activity and innovations by LVL 10-15 million on average every year.

National Lisbon Programme of Latvia for 2005-2008 sets knowledge and innovation among priorities. In order to foster research and development, the following priority tasks are set in the framework of this programme:

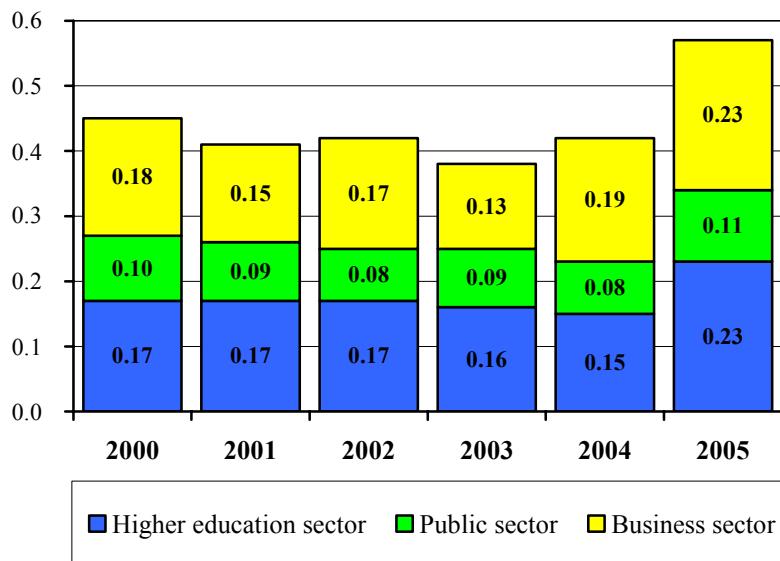
- Ensure substantial growth of public investment in research and development to achieve that the mechanism for granting finances would ensure the attraction of private investment as much as possible;
- Strengthen the role of universities in the development of higher education and science;
- Consolidate the intellectual potential of science and develop applied research in the area of innovative technologies, create preconditions for scientific research in those fields, which have adequate potential and development prospects;
- Promote competitiveness of Latvian science at international level.

Priority directions to increase national innovation capacity are as follows:

- To create favourable institutional environment for innovative activity;
- To promote co-operation of science, education and the private sector;
- To support transfer of knowledge and technologies;
- To encourage development of new products and technologies, including promotion of entrepreneurs' awareness of the intellectual property and its protection.

Figure 6.10

#### Expenditures on Research and Development in Latvia in 2000-2005 (% of GDP)



Source: CSB

In order to fulfil tasks set in the mentioned programme, the planned activities for promotion of industrial research and for development of new products and their introduction into market were continued and several new activities were launched in 2006.

For financing of the fundamental and applied research in 2006-2009, the following priority scientific directions were approved by the Cabinet of Ministers Instruction No. 412 of June 6, 2006: biomedicine and pharmacy, power industry, informatics, Lettonics (Latvian studies), material sciences, forestry and wood science, medical science, environmental science and agrobiotechnology.

In order to increase financing for fundamental research in the priority directions set by the Cabinet of Ministers, in 2006 the Ministry of Education and Science granted funds to the following four state research programmes in addition to five state research programmes already started in 2005:

- “Innovative technologies for production of high-value safe and healthy foodstuffs from genetically, physiologically and biochemically diverse plant and animal raw material”. The programme is led by the Latvia University of Agriculture;
- “Research and development of modern methods and technologies in power industry: for environmentally friendly forms of renewable energy, security of energy supply and efficient use of energy”. The programme is led by the Institute of Physical Energetics;
- “Scientific research of main pathologies endangering survival and life quality of Latvian inhabitants did by the way of multidisciplinary research consortium”. The programme is led by the Pauls Stradiņš Clinical University Hospital;
- “Influence of climate change on water environment of Latvia”. The programme is led by the University of Latvia.

As from 2006, commercial companies have an opportunity to get support for implementation of projects in the framework of EUREKA Programme. EUREKA Programme is EU programme for fostering commercial activities and international co-operation of scientific institutions in order to promote development of high technologies, new competitive products and services. Commercial companies may receive up to LVL 91 000 for implementation of collaborative research project, and the aid intensity may constitute 75% of costs for realization conduction of industrial research costs and 50% of costs for planning work. The aid is granted in accordance with the Cabinet of Ministers Regulation No. 479 “Regulations for Provision of State Aid to Projects in the Framework of EUREKA Programme” of June 13, 2006.

Latvian Investment and Development Agency (LIDA) continued implementing the state aid programme “Support to Development of New Products and Technologies” in 2006. In its framework, entrepreneurs had access to support for development of new products or processes in the form of non-repayable grant up to 45% of the eligible project costs. It is planned to continue the mentioned programme in 2007-2013, attracting finances from the European Structural Funds.

As from June 1, 2006 the Technology Agency is established, which is integrated in LIDA as the Knowledge and Innovation System Department. Its main tasks are: to increase commercial return of knowledge created in the Republic of Latvia, promote development of new technological companies, encourage application of knowledge in business and improve the state support to innovative development (see Box 6.8).

#### **Box 6.8**

##### **Knowledge and Innovation System Department in Latvian Investment and Development Agency**

In order to promote innovation policy and technology transfer and encourage entrepreneurship with high value added, technology agencies have been established in several EU member states (e.g., VINNOVA in Sweden, TEKES in Finland, etc.). In Latvia, like in Ireland and Estonia, the technology agency is integrated in the Latvian Investment and Development Agency, where the Knowledge and Innovation System Department “ZINIS” is established as from June 1, 2006. Its main task is to ensure constant analysis of the national innovation system, preparation of proposals for its improvement and efficient implementation of measures of the national innovation programme. “ZINIS” ensures implementation of the National Lisbon Programme of Latvia for 2005-2008 and the National Development Plan for 2007-2013 in the framework of its competence as well as development of new National Innovation Programme.

Under assignment of the Ministry of Economics, “ZINIS” develops proposals and implements policy in the following areas:

- innovation;
- development of science and research;
- transfer and commercialisation of knowledge and technologies;
- creation and development of new technologically innovative companies;
- attraction of investment to technological and/or innovative companies.

The main goal of “ZINIS” activity is to promote development of knowledge-based economy:

- creating institutional environment favourable for innovative activity;
- improving co-operation of science, education and the private sector;
- supporting transfer of knowledge and technologies;
- supporting development of new products and technologies;
- promoting efficient use of human resources.

In 2006, “ZINIS” activity was mostly focussed on development of new state support programmes related to innovation. Most of the started activities are directly oriented to raising society’s awareness of innovation and its essence as well as to stimulation of business spirit in Latvian population.

In order to promote transfer of technologies and knowledge, in 2006 the Ministry of Economics continued supporting operation of technology transfer contact points at the University of Latvia, Rīga Technical University, Latvia University of Agriculture, Rēzekne Higher Education Institution and Ventspils University College. The goal of technology transfer contact points is to encourage co-operation of scientists and entrepreneurs and ensure efficient introduction of research results of state research institutions into production. LVL 240 000 were granted for implementation of the projects in 2006. In the framework of technology transfer contact points, 34 commercialisation offers were prepared, at least 10 co-operation agreements with entrepreneurs were initiated and 15 patent applications were prepared in 2006.

In order to encourage co-operation of science, education and the private sector, the Ministry of Economics organised an open tender for projects in June-July 2006, aimed at provision of support to research and development infrastructure improvement projects promoting co-operation of commercial companies and scientific institutes. State scientific institutes as well as higher educational establishments and scientific institutes founded by Latvian Academy of Sciences could submit projects for the tender.

25 project applications for the tender were received in the total amount of LVL 6 131 085, which exceeded the available funding almost 3 times. The projects were assessed by eight different quality criteria and financing was granted to projects with higher assessment. The following 9 projects qualified for financing:

- “Establishment of a regional technology competence centre in Ventspils” of Ventspils University College;
- “First phase of Recombinant Biotechnology Centre” of the Biomedical Research and Study Centre;
- “Renovation of the scientific equipment park of Latvian Institute of Organic Synthesis” of the state agency Latvian Institute of Organic Synthesis;
- “Establishment of a laboratory for material testing and verification of industrial processes at Rēzekne Higher Education Institution” of Rēzekne Higher Education Institution;
- “Establishment of a laboratory of material radioactivity and hygiene” of Latvia University of Agriculture;
- “Development of applied research infrastructure in the energy and electrical engineering sector” of Rīga Technical University;
- “Centre for prototyping of innovative biomaterials and prospective ceramic materials” of Rīga Technical University;
- “Co-operation with commercial companies for introduction of modern information technologies in construction planning and operation management” of the University of Latvia;
- “Establishment of laboratorial research complex for the use of RFID technologies and development of embedded systems” of Vidzeme University College.

The Ministry of Economics plans to support projects of research and new products development, which are jointly implemented by commercial companies and research institutes, also in the future in order to promote rise of competitiveness. It is planned, through attraction of financing from the European structural funds, to implement the competence centres programme from 2007 until 2013. In its framework, joint industrial research projects of companies and scientists and research infrastructure development projects will be supported. It is planned to attract at least EUR 30 million from the European Regional Development Fund for the implementation of this measure.

## 6.6. Information Society

Information society is a social development phase based on free mutual exchange of information and developing a knowledge-based economy. Information society consists of the technological base (infrastructure, software), range of information services available to the society, and the level of individual skills and knowledge. As a result of development of information and telecommunications technologies, information and knowledge are more and more widely used in the work and labour relations, education and everyday life.

With Latvia's accession to the EU, the European Union initiatives with regard to building the information society (see Box 6.9) became binding for Latvia.

**Box 6.9****European Union initiatives in building the information society**

In December 1999 the European Union launched the initiative “*eEurope – an Information Society for All*”. In June 2000 the initiative was harmonised with Lisbon Strategy objectives and the *eEurope 2002 Action Plan* was worked out. The main three goals of this action plan were:

- cheaper, faster, secure Internet;
- investing in people and skills;
- stimulate use of the Internet.

As a result of implementation of the action plan in EU member states, in 2002 more than 90% of schools and companies had Internet connection and more than half of all population used Internet on a regular basis. However, the majority of individual users used dial-up access that is an Internet connection with small speed. Therefore, the main goal in the *eEurope 2005 Action Plan* is a wide distribution of broadband data transfer in networks, which by 2010 should embrace at least 50% of all networks.

To boost development of digital economy, on June 1, 2005 the European Commission launched a new initiative “*i2010: European Information Society 2010*”, which is a strategy for the next 5 years. Its goal is to foster growth and jobs in the information society and media industries. 3 policy priorities are outlined in the initiative:

- to create an open and competitive single market for information society and media services within the EU;
- to increase EU investment in research on information and communication technologies by 80%;
- to promote an inclusive European information society.

On April 25, 2006 the European Commission communicated the action plan “*i2010. eGovernment Action Plan: Accelerating eGovernment in Europe for the Benefit of All*” that corresponds to the initiative “*i2010*” and is focussed on such important eGovernment goals for the period by 2010 as inclusion of all EU population in use of information, provision of access to a wide range of informative services, creation of an electronic public procurement system, achieving conclusion of 50% of transactions electronically and ensuring availability of all information about all public procurement, etc.

**Declaration of the Intended Activities of the Cabinet of Ministers headed by the Prime Minister Mr. Aigars Kalvītis** emphasizes the tasks for ensuring publicly accessible information services: increasing the role of traditional and electronic libraries and the information network that connects them for receiving information; construction of the Latvian National Library and its development as the central point and co-ordinator of the network of libraries; creation of a Single State Archive Information System; and improvement of the National Ordering System for public broadcasters.

In order to ensure access to information, the following tasks for development of ICT infrastructure and services have been set: ensuring that all people and entities in every part of Latvia have the possibility to receive electronic communications services, including broadband Internet services; development of publicly available Internet access points; implementation of the terrestrial digital television broadcasting; efficient use of limited national resources (radio frequency spectrum, numeration); creation of a single national emergency medical and crisis situation management structure; and increasing the range of electronic mail services.

In order to promote development of eGovernment and eServices, the following activities are envisaged: capacity building of public administration and expansion of the range of e-services and availability of information; development of various channels for delivery of state and local government services (Internet, telephones and cell phones, radio and TV broadcasts); development of ICT infrastructure and services at the national and local government level by extensive use of external services; provision of a complete processing cycle of electronic documents in all national, local and judicial authorities; improvement of data quality in the national and local government information systems, their security, integration and linkage; introduction of uniform identification cards of Latvia's residents; formation of a common geospatial information infrastructure; improvement of the state electronic procurement system; improvement of the procedures and systems for collection and processing of statistical data; establishment of an e-election system; enhancement of general IT-related skills among Latvia's residents.

Building the information society is set as a priority in the National Lisbon Programme of Latvia for 2005-2008 (see Chapter 6.1). The main planned activities for promotion of ICT and building the information society are the following:

- to encourage widespread use of ICT in public services, SMEs and households (see Box 6.10);
- 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.

**Box 6.10****Computer and Internet usage in Latvia**

According to the data of the CSB survey “Computer and Internet Usage in Households”, 41% of all households (households, where at least one person in the age of 16-74 years lives) had computers and 42% of households had Internet connection in 2006. 60% of inhabitants had ever used a computer and 56% of inhabitants had ever used Internet. 49% of inhabitants (inhabitants in the age of 16-74 years) used computer on a regular basis and 46% of inhabitants used Internet on a regular basis. 23% of all households had broadband Internet connection.

At the beginning of 2006, 59% of all companies had computers, 46% of companies had Internet connection, and 15% of companies had their own Internet website. 28% of all employees of companies used computer on a regular basis, while Internet was used regularly by 22% of employees.

At the beginning of 2005-2006 academic year, the number of computers per 100 full-time students at higher education institutions and colleges was 10.7 (7.5 at professional education institutions and 6.2 at comprehensive schools). 100% of higher education institutions and colleges, 87.4% of professional education institutions and 95% of comprehensive schools had Internet connection.

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 of its usage;
- to support creation of online services and innovative, knowledge-intensive and environmentally friendly products.

Lines of long-term action for development of information society are:

- to expand the access infrastructure and promote ICT accessibility;
- to develop knowledge and skills of users;
- to develop services and content;
- to develop ICT usage in commercial companies and in innovation;
- to develop ICT science and research;
- to promote creation of export-capable ICT products and services.

Financing from EU structural funds and resources from the state and local government budgets will be used for implementation of the development programme.

*Action Strategy of the Secretariat of the Special Tasks Minister for eGovernment Affairs for 2007-2009* was approved by the Cabinet of Ministers Instruction No. 954 of December 13, 2006. The strategy comprises lines of action and spheres of competence of the secretariat. Measures and the funding planned for them are formulated in accordance with the principle of development of budget programmes. In the framework of budget programmes, the following new policy initiatives are set in priority sequence:

- management of projects of the operational programme measure “Infrastructure and Services of Information and Communication Technologies for 2007-2013”;
- increasing the number of the secretariat’s employees and harmonisation of the pay for work;
- improvement of human resources of ERDF technical assistance;
- introduction of a safe electronic signature in Latvia;
- management of maintenance of centralised state information systems;
- management of other projects financed by the EU;
- conducting studies on e-services, state information systems, etc.;
- improvement of human resources of electronic procurement agency;
- establishment of contact points of the national e-access network and maintenance of National Contact Points of the *eContent plus* programme of the European Commission.

In order to implement the new policy initiatives, the Secretariat of the Special Tasks Minister for eGovernment Affairs plans to develop the following policy documents and normative acts in 2007 and 2008:

- amendments to the e-Government Development Programme for 2005-2009;

- guidelines of public private partnership (basic positions/concept) in the sphere of ICT infrastructure and services;
- concept on planning and development of architecture of the State Information Systems;
- concept “National Interoperability Framework for eGovernment”;
- guidelines of development policy of e-services in public administration and their delivery channels (concept/action plan);
- amendments to the Law on State Information Systems;
- changes in normative acts in order to ensure creation and accessibility of the catalogue of public services;
- to introduce the term of public service and prescribe the procedure for provision of public services;
- the Cabinet of Ministers Regulation “Procedure for Provision of Public Services in Public Administration Institutions”;
- normative acts regulating maintenance of state information systems;
- normative acts regarding standardisation of interfaces and data exchange in the framework of the State Integrated Information System;
- to improve the status of electronic documents and the base of normative acts regulating their circulation;
- the Cabinet of Ministers regulations on provision of e-services, the standard of the description of services;
- the Cabinet of Ministers Regulation “Procedure by which the Information at Disposal of Institution is Made Public and Handed Over to Repeated Use”;
- the Cabinet of Ministers Regulation “Procedure by which Exclusive Rights are Granted and Information on Granting Such Rights is Made Public”;
- the Cabinet of Ministers Regulation “Procedure by which Institutions Place Information on the Internet”;
- the Cabinet of Ministers Regulation “Procedure for the Use of Integrated State Information Systems”;
- concept of development of e-services and the normative acts that regulate development, working out and provision of e-services;
- strategies (basic positions) of Latvia’s e-inclusion and e-access and the Action Programme (plan);
- policy planning document and action plan in the area of the security of information society;
- concept of operation of customer service centres;
- strategy for development of repeated use of the public sector information.

On May 26, 2006 the Electronic Procurement State Agency started its operation. The agency took over functions of system maintenance and ensuring of procurement as well as computers, software and accumulated data from the Procurement Supervision Bureau and made first centralised procurements.

Conference “Information and Communication Technologies for Inclusive Society” took place in Rīga on June 11-13, 2006. Ministerial Declaration was signed during the conference, which is a joint political agreement of 34 countries to implement e-inclusion goals: to solve the needs of aged employees and other aged people, reduce the geographic digital divide, improve access to electronic services and promote the ICT usability, improve ICT usage skills and competence of the population, and encourage cultural diversity and development of inclusive electronic government. The first meeting of the e-inclusion subgroup of the EU initiative “i2010 – a European Information Society for Growth and Employment” also took place during the conference.

In September 2006 the state JSC “Latvijas Pasts” introduced the service of e-signature. At the end of 2006 the Secretariat of the Special Assignments Minister for Electronic Government Affairs organised procurement of 50 000 smart cards that are bearers of electronic signature. The smart cards will be distributed to employees of public institutions.

The Cabinet of Ministers Instruction No. 789 of October 11, 2006 supported the 1<sup>st</sup> version of the concept “On Development of the Terrestrial Digital Television Broadcasting in Latvia”, charging the Ministry of Transport and Communications with development of the procedure by which the broadcasting in digital format of programmes made by electronic mass media is introduced.

The programme “*Information and Communication Technologies for Education Quality*” for 2007-2013 was approved by the Cabinet of Ministers Instruction No. 812 of October 20, 2006.

The strategic goal of the programme is to promote formation of educated and creative personality by raising knowledge, abilities and skills of educatees in the use of information and communication technologies. The programme has the following sub-goals:

- to achieve high-quality acquirement of information literacy and computer literacy;
- to use ICT in the learning process widely by developing electronic teaching materials, improving the content of educational programme for improvement of education quality and attraction, creating and using various services to raise education quality;
- to increase ICT knowledge and skills of teachers and education employees by raising the qualification level and work efficiency of teachers/lecturers;
- to establish an efficient information system of education by ensuring availability of electronic teaching materials and raising efficiency of management of education system;
- to create corresponding to its tasks, cost-efficient, safe and reliable ICT infrastructure in all stages and forms of education institutions and education administration bodies.

In order to achieve the goal and sub-goals of the programme, the following lines of action are set:

- formation of electronic teaching resources;
- establishment of education information system;
- raising ICT competence of the teaching staff;
- modernisation and maintenance of ICT infrastructure of education system.

The required financing for implementation of the programme amounts to LVL 130.1 million, the envisaged sources of financing are the EU structural funds, state and local government budgets, and the private capital.

## 6.7. Small and Medium-Sized Enterprises

Small and medium-sized enterprises (SME) comprise a major part of national economy and play a significant role in GDP growth and employment in Latvia like elsewhere in Europe (see Box 6.11).

### Box 6.11

#### **Number of small and medium-sized enterprises in Latvia**

According to provisional data, in the 1st half of 2006 there were 55 621 economically active businessmen and commercial companies in Latvia (excluding agricultural and fishing farms and self-employed persons, which perform economic activity), of which more than 99% fell in the category of SME. The distribution of economically active SME in Latvia according to their size is similar to the one in EU member states: micro enterprises – 76%, small enterprises – 20%, medium-sized enterprises – 4%. 69.9% of private sector employees are employed in SME, which create 63.2% of GDP.

Important indicator characterising economic activity is the number of economically active businessmen and commercial companies per 1000 inhabitants. This indicator in Latvia has constantly grown in the last 5 years from 17 in 2001 to 24 in 2006.

It is of the same importance to accentuate the number of performers of individual piecework (self-employed persons), which amounted to 36 344 in 2004 (16 per 1000 inhabitants), and the number of agricultural and fishing farms, which equalled to 13 850 in 2004 (6 per 1000 inhabitants). In view of the fact that there is no single methodological practice among EU member states for calculation of such indicator characterising economic activity as the number of enterprises per 1000 inhabitants, it is difficult to conduct objective comparative analysis of this indicator. The current practice of responsible EU institutions shows that calculation of the number of enterprises per 1000 inhabitants includes not only businessmen and commercial companies, but also performers of individual piece-work, agricultural and fishing farms, etc. Accordingly applying an analogous practice, Latvia had 44 performers of economic activity per 1000 inhabitants in 2004, 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. Lursoft data show that 10 221 newly founded enterprises were registered in 2004, while 11 009 newly founded enterprises were registered in 2005, which is by 8% more than in 2004, and 12 497 newly founded enterprises were registered in 11 months of 2006, which is by 21% more than in the respective period of the previous year (9895). This on the whole may indicate efficiency of measures taken to ensure improvement of business environment and promotion of business development.

However, it is important not to forget that constant natural growth is inevitable in any free market conditions under certain objective positive circumstances as in the case of Latvia, where favourable conditions for equable growth of the number of newly founded enterprises are already ensured with accession to the EU and substantially increased opportunities of local enterprises. Nevertheless, promoting establishment of newly founded enterprises does not suffice to ensure sustainable development. In order to ensure rise of competitiveness, these newly founded enterprises have to be viable. Statistical data show that the total number of enterprises increases by approximately half of the growth of the number of newly founded enterprises, hence indirectly indicating problems in regard to their viability.

Assistance to SME in Latvia is regulated by the Law on Control of Aid for Commercial Activity, which is in force as from January 1, 2003.

**Box 6.12****Definition of SME**

The **Law on Control of Aid for Commercial Activity** lays down the definition of small and medium-sized enterprises (according to the European Commission Regulation No. 70/2001 and amendments to the European Commission Regulation No. 364/2004, and according to the European Commission Recommendation No. 361 of May 6, 2003):

Medium-sized enterprises:

- number of employees from 50 to 249;
- annual turnover does not exceed EUR 50 million;
- total balance sheet value is under EUR 43 million.

Small enterprises:

- number of employees from 10 to 49;
- annual turnover does not exceed EUR 10 million;
- total balance sheet value is under EUR 10 million.

Micro enterprises:

- number of employees from 1 to 9;
- annual turnover does not exceed EUR 2 million;
- total balance sheet value is under EUR 2 million.

The main problems hindering development of SME in Latvia are the following:

1. Business environment. Competitiveness of the SME sector cannot develop without favourable environment to business activity, and this is greatly determined by competitiveness of the state tax policy, efficiency of the capital market, infrastructure, educational system and state aid, as well as alignment and stability of business legislation. Results of business surveys and discussions of meetings and conferences of non-governmental organisations representing SME interests allow to come to a conclusion that many of these factors in Latvia are unfavourable to business development;

2. Availability of finances. Although opportunities to receive external financing have recently increased to a considerable extent, access to current and capital financing is a significant obstacle to rise of business activity and competitiveness of small and medium-sized enterprises and among business beginners. Guarantee and investment funds are still insufficiently developed. Problems in the field of availability of external financing are more pronounced outside Riga, and the problem of availability of finances has an explicit territorial dimension;

3. Human resources. SME often face problems in the choice of personnel: insufficient business management skills, knowledge on management and business and technical knowledge, to be able to develop business plans of high quality and value; insufficient level of knowledge about financial and money flow management; and poor culture of business organisation while working in the global economy. Shortage of highly skilled labour force is observed in most national economy sectors;

4. Competitiveness of SME. Latvian enterprises, working with EU directives on quality, lack information about product standards and new production methods, and also this is a topical issue. Product quality assessment instruments are not available in Latvia;

5. Regional differences. In the last 10 years, negative trends are observed in the socio-economic development of Latvia, namely, rapid development of Latvian economic centres and stagnation or even regress in development of the rest of the territory at the same time. This has created increased differences between cities and rural areas as well as between the central part and periphery of the country. Integrated development of rural areas, including development of non-agricultural business activity, is a necessary precondition for balanced development of the country;

6. Administrative capacity of public and non-governmental organisations for development and implementation of SME policy and for absorption of the EU Structural Funds is insufficient at present. The main reasons for that are: insufficient opportunities of financing from the state budget, lack and high changeability of human resources, insufficient competence and qualification of policy developers and implementers, as well as lack of training of the current and potential specialists.

On January 27, 2004 the Cabinet of Ministers approved the **Basic Guidelines of the SME Development Policy 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 activity, spur initiative of entrepreneurs and lessen the total risk, prevent obstacles to business activity, and foster stability and efficiency of the financial system and capital market, in order to improve competitiveness of enterprises in the market.

The *Basic Guidelines* foresee implementation of policy based on the best practices of companies of the developed countries in accordance with the activities outlined in the European Charter for Small Enterprises, at the same time also taking into account the specifics of SME development problems in Latvia.

For implementation of the *Basic Guidelines*, the Cabinet of Ministers approved the **Programme on Development of Small and Medium-Sized Enterprises of Latvia in 2004-2006** (hereinafter Programme) on May 25, 2004, in order to facilitate achievement of SME development policy goals. 2006 is the last year for implementation of the Programme, so the Ministry of Economics in co-operation with bodies responsible for implementation of measures of the Programme has prepared and submitted to the Cabinet of Ministers two informative reports on measures implemented by the reference year of Programme's operation (see Box 6.13).

#### **Box 6.13**

##### **Programme on Development of Small and Medium-Sized Enterprises of Latvia in 2004-2006**

The main measures implemented in the framework of the Programme in accordance with the main actions of the Programme are:

###### **for creation of favourable environment for business activity, especially in relation to SME:**

- the Council of the Small and Medium-Sized Enterprises and Crafts (hereinafter CSMEC) was established in 2004, which consists of representatives delegated by 27 organisations. CSMEC meetings have been held on a regular basis since 2004. Key issues were reviewed and proposals for amendments to legal acts and changes in SME development and tax policy and regarding the key issues affecting SME interests were given at these meetings;
- in order to eliminate administrative obstacles to business development, annual Action Plan for Improvement of Business Environment was prepared in co-operation with organisations representing entrepreneurs and submitted to the Cabinet of Ministers every year;
- in order to encourage more active involvement of entrepreneurs in solving issues of business environment improvement, the Ministry of Economics in co-operation with the Latvian Investment and Development Agency (LIDA) held the conference "Better Regulation Initiative to raise competitiveness of business environment in Latvia and Europe" on June 30, 2006;

###### **for promotion of availability of finances for development of small and medium-sized business:**

- in order to improve accessibility of preferential loans, the Mortgage and Land Bank of Latvia has granted loans for development of small and medium-sized enterprises in the framework of the first phase (2000-2009) and second phase (2003-2012) of the Programme of Crediting Latvian SME Development;
- in the framework of the national programme "Development of the Loan Guarantee System" from the beginning of 2005 to the 1st half of 2006, the Latvian Guarantee Agency issued guarantees to 28 enterprises for the total amount of LVL 1 366 857, which enabled entrepreneurs to attract investment in the form of credit resources for the total amount of LVL 3 029 584;
- in the framework of the state support programme "Support to the Risk Capital of Small and Medium-Sized Commercial Companies", 3 risk capital funds co-financed by the state (LLC "Zaļās gaismas investīcijas", JSC "Eko Investors" and LLC "TechVentures Fondu Vadības Kompanija") have been established;

###### **for development of human resources and new business initiative:**

- the Ministry of Economics and LIDA have organised seminars for entrepreneurs in relation to information and consultations on absorption of the EU Structural Funds (inter alia, about technical issues of drawing up of project applications). Support was provided to entrepreneurs of Latgale in preparation of project applications for submission;
- conferences for promotion of activities related to business were organised, namely, "Latvian Entrepreneur – EU Entrepreneur", the 2nd conference of Latvian entrepreneurs "State Support to Entrepreneurship", "Days of Knowledge for Entrepreneurs", and the International Quality Management Conference. Seminars were organised, namely, entrepreneur motivation seminars, seminars on application of EU legislation requirements in Latvian enterprises, business forums on opportunities of application of EU funds for inservice training of employees and improvement of technology processes in enterprises (about 150 participants), as well as regional seminars on financial instrument and topicalities in the state support programmes for availability of finances;
- in order to ensure receipt of information to entrepreneurs according to the *one-stop-shop principle*, LIDA has rendered consultations to entrepreneurs on a regular basis, providing information and references, distributing their business offers, searching information about co-operation partners, EU legislation requirements, national legislation, opportunities of joint projects, etc.;

###### **promotion of competitiveness of small enterprises:**

- LIDA has organised business forums and meetings with directors of Latvian foreign economic representative offices for entrepreneurs, provided consultations and organised seminars on finding (searching) of potential co-operation partners, export opportunities, fields of operation of foreign companies in Latvia, participation in international exhibitions and contact exchanges, development of branch catalogues, customs procedures, restrictions and quotas;
- informative materials about start of business and related issues were published. Portal of business beginners and entrepreneurs ([www.mazaibizness.lv](http://www.mazaibizness.lv)) was created;
- for promotion of export, the portal of entrepreneurs [www.exim.lv](http://www.exim.lv) was created, where business offers and information about exhibitions and activities are placed;
- for promotion of competitiveness of SME, provision of support to participation of commercial companies in international exhibitions, fairs and trade missions, promotion of development of new products, technologies, design, etc., attraction of infrastructure (co)financing support to SME, attraction of co-financing from EU Structural Funds has provided Latvian entrepreneurs with opportunity to submit their projects to the following state support programmes administered by LIDA for 2004-2006:
  - support to consultations and participation of commercial companies in international exhibitions, fairs and trade missions;
  - support to development of new products and technologies;
  - support to modernisation of business infrastructure;
  - support to raising qualification of employees, their retraining and further education.

More information on state support programmes and guidelines and methodological instructions for receipt of support is available on the website of the Latvian Investment and Development Agency [www.liaa.gov.lv](http://www.liaa.gov.lv).

SME support policy is set in Chapter 2.2.4 of the **National Lisbon Programme of Latvia for 2005-2008**, defining the main directions of governmental policy to promote SME development, which are:

- promotion of availability of finance, including funds for development of an idea (seed capital);

- ensuring informative and consultative support;
- raising competitiveness through support to introduction of new technologies and modernisation of production.

The Mortgage and Land Bank of Latvia (MLBL) plays an important role in the SME support system. Since 2000 MLBL helps to introduce and implement the “Programme of Crediting Latvian SME Development”. The insofar implementation of the programme has substantially promoted accessibility of capital to SME and has encouraged more active involvement of commercial banks in offering loans to SME. On November 26, 2002 the Cabinet of Ministers approved the Programme of Crediting Latvian SME Development (second phase) for the next three years, foreseeing state guarantees in the amount of LVL 20 million to MLBL in order to enable the bank to borrow the necessary resources for crediting SME in the financial market. On January 21, 2004 MLBL started crediting in the framework of the Programme of Crediting Latvian SME Development (second phase). Funding projects of specific SME (business beginners, rapidly growing SME, SME in regions requiring special assistance and female SME) supported in the framework of EU programmes is continued in the framework of the Programme of Crediting Latvian SME Development (second phase). By October 1, 2006 in the framework of the Programme of Crediting Latvian SME Development (first phase), MLBL has granted 998 loans for the total amount of EUR 48.5 million, which promoted creation of approximately 2800 new jobs. In the framework of the second phase of the SME crediting programme, MLBL has granted 978 loans for the total amount of LVL 50.2 million, hence promoting creation of 3070 new jobs and establishment of 160 new enterprises.

At the beginning of 2005, a separate structural unit, the Administration of Support Programmes ALTUM, was established in the framework of MLBL operation for consolidation and growth of business support functions. ALTUM implements support programmes financed by the state and the EU, granting high-risk loans to viable and perspective projects of SME and business beginners, which are not financed by commercial banks due to insufficient collateral and other risks of the project. ALTUM also implements other support programmes, among them the programme of training and consultations for business beginners and the housing guarantee programme. Crediting Programme for Beginners, which is co-financed from resources of the state and EU Structural Funds, was started in March 2006. So far, LVL 5 million from the state budget have been granted for implementation of the programme. Loans for the total amount of LVL 4.4 million have been granted in the framework of the programme by October 1, 2006. Special assistance loans in the framework of special programmes have been granted to 528 SME for the total amount of approximately LVL 24.1 million by October 1, 2006. Most of special assistance loans were granted to SME in the regions requiring special assistance (approximately LVL 10.4 million), business beginners (about LVL 4.8 million), female enterprises (approximately LVL 3.7 million) and rapidly growing SME (about LVL 5.2 million).

The Latvian Guarantee Agency (LGA) is a state-supported institution with a goal to support development of business activities of small and medium-sized enterprises (commercial companies) registered in Latvia, by issuing:

- loan guarantees that solve the problem of insufficient collateral to get loan from a commercial bank;
- financial leasing guarantees in industrial leasing transactions.

In 2006 the Latvian Guarantee Agency took part in 57 informative seminars (1700 participants in total) in order to inform both entrepreneurs and credit structures about guarantee products and procedure for receiving them. In December 2006, LGA made substantial additions to the current guarantee regulations as well as developed new guarantee products (leasing guarantees and current assets guarantees). In the period from January 2006 to December 2006, LGA issued 29 loan guarantees for the total amount of LVL 2 012 715, which enabled entrepreneurs to attract investment in the form of credit resources for the total amount of LVL 5 073 710.

In 2005 the European Commission (EC) approved the State Support Programme (SSP) for development of risk capital, which was worked out by the Ministry of Economics. In 2005 LGA announced a tender for selection of risk capital fund management companies in the framework of the SSP *Support to Risk Capital of Small and Medium-Sized Commercial Companies*. 8 applications for establishment of risk capital fund management companies were received, which several times exceeds the number of funds to be established (three funds), 3 winners of the tender were chosen and contracts were concluded with them, and 3 risk capital funds co-financed by the state were established, namely, LLC “Zaļās gaismas investīcijas”, JSC “Eko Investors”, and LLC “TechVentures Fondu Vadības Kompānija”.

Taking into account that 2006 is the last year for implementation of the Programme on Development of Small and Medium-Sized Enterprises of Latvia in 2004-2006 and of the National Programme of

Innovation 2003-2006, and in accordance with the EC practice to review the entrepreneurial, innovation and industrial development policy planning together, the Ministry of Economics is currently working out a new **Programme for Promotion of Business Competitiveness and Innovation in 2007-2013**.

The programme will comprise setups and action policy of business competitiveness promotion, innovative activity and industrial development, describing the vision of competitiveness promotion as well as development of innovation and industry for the next 7 years, will give description of the main goals and evaluation of potential factors of influence as well as the amounts of resources and measures necessary for implementation of the programme.

EU member states approved the **European Charter for Small Enterprises** at the European Council meeting in Feira on June 19-20, 2000. This is one of the most important political documents of the EU for achievement of the Lisbon goals. It recognises the great role of small enterprises in development of competitiveness, innovation and employment spheres, and they also constitute the driving force for social and local integration in Europe and the base of national economy growth. Latvia joined the Charter on April 23, 2002 by signing the Maribor Declaration in Slovenia together with other EU candidate countries, thereby pledging to work in accordance with 10 lines of action of the Charter (see Box 6.14).

#### **Box 6.14**

##### **European Charter for Small Enterprises**

Ten lines of action of the Charter:

1. education and training for entrepreneurship;
2. cheaper and faster establishment of enterprises;
3. more efficient legislation and regulation;
4. availability of training;
5. improving Internet access;
6. gaining more out of the Single Market;
7. taxation and financial matters;
8. strengthening the technological capacity of small enterprises;
9. making use of successful e-business models and developing top-class small business support;
10. developing stronger, more effective representation of the interests of small enterprises at the EU and national level.

In April 2005 the European Commission came forward with a legislative initiative, by which the **Competitiveness and Innovation Framework Programme (2007-2013)** would be established. The programme was officially adopted by the Transport, Telecommunications and Energy Council of Ministers on October 12, 2006. It is intended as a continuation of the **Multiannual Programme for Enterprise and Entrepreneurship, in Particular for Small and Medium-Sized Enterprises (2001-2006)** and would be organised in the framework of the next EU financial perspective (2007-2013).

#### **Box 6.15**

##### **Competitiveness and Innovation Framework Programme (2007-2013)**

The programme has 3 separate subprogrammes or pillars:

- the Entrepreneurship and Innovation Programme;
- the ICT Policy Support Programme;
- the Intelligent Energy – Europe programme.

In the framework of the **first pillar**, the following financial instruments will be developed:

- the High Growth and Innovative SME Facility (GIF) – actually, the development of risk capital, dividing it into GIF 1 (seed and startup stage of SME) and GIF 2 (SME expansion stage investments);
- the SME Guarantee Facility;
- the Capacity Building Scheme – is designed to improve the capacity of institutions investing in innovative SME.

The **second pillar** is established in order to support the information and communication policy and achieve more investment in this sector. It is envisaged to ensure the support by:

- developing a single European information space and strengthening information products and services of the Internal Market;
- stimulating innovation and its implementation and investment in information and communication technologies;
- developing an inclusive information society and effective services interesting for society, as well as improving the quality of life.

In the framework of the **third pillar**, the Intelligent Energy – Europe programme for 2003-2006 will be continued and expanded. It was established by merging the following 4 programmes:

- SAVE programme; in its framework, norms and standards for rise of efficiency of heat insulation of buildings were developed;
- in the framework of ALTENER programme, projects for more efficient use of renewable energy resources in heat supply and electricity generation were implemented;
- in STEER programme, projects related to the rise of energy efficiency in transport and to the promotion of the use of renewable energy resources (among them biofuel) in transport were implemented;
- COOPENER programme envisaged to develop energy policy and market conditions.

## 6.8. Competition Policy

The Competition Council (hereinafter CC), which is a state institution under the Ministry of Economics of the Republic of Latvia, is responsible for implementation of competition policy and carries out supervision of the abuse of dominant position, unfair competition and prohibited agreements by market participants as well as exercises control over merger of market participants in accordance with norms of the Competition Law and supervises conformity of advertising with requirements of the Advertising Law. Tasks, rights and duties of the CC are also determined by the European Council Regulation No. 1/2003 "On the Implementation of the Rules on Competition Laid Down in Articles 81 and 82 of the Treaty", the Cabinet of Ministers Regulation No. 849 "Statute of the Competition Council" of October 12, 2004 and other normative acts.

On August 29, 2006 the Cabinet of Ministers approved the action strategy of the CC for 2007-2009, which 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.

### **Protection of competition**

Protection of competition comprises competition protection measures, especially regarding the gravest violations of the Competition Law (prohibited agreements and abuse of dominant position). Medium-term priorities are:

- Improvement of the system for determination of the markets to be supervised prioritarily;
- Strengthening the proactive role of the CC in determination of the gravest violations of the Competition Law;
- Improvement of investigation methods;
- Optimisation of terms for investigation of cases;
- Improvement of the legal base;
- Improvement of methods of analysis and supervision so that, at the end of the planning period, it would be possible to apply a supervision approach based on assessment of effect versus form for at least a part of market sectors.

As the norms included in the currently valid wording of the Competition Law do not fully ensure implementation of efficient competition policy, draft amendments to the Competition Law were developed at the beginning of 2006. The mentioned amendments will provide that:

- Rights of the Competition Council and the executive directorate in carrying out the investigation activities prescribed by the law will be specified and more clearly defined;
- The law will include the definition of substantial influence, applying it to the retail trade sector, and the prohibition to abuse it. The notion of substantial influence will apply to such market participants whose net turnover in the previous closed financial year in the particular market was at least LVL 70 million or their market share was at least 25% but who are not in a dominant position.
- Henceforth, market participants will be obliged to submit a notification of merger to the CC if their combined market share will reach 35%;
- Procedure by which the CC may allow the agreements mentioned in Item 1 of Article 11 and the rights of the CC in application of Article 18 of the law will be specified;
- Opportunity that a case of EU competition law violation may be examined, applying norms of the Competition Law, will be provided.

In 10 months of 2006 the CC adopted 85 decisions, which is by 20% more than in 2005 on the whole (68 decisions). 23 decisions pertained to establishment of violation, among them 16 decisions on establishment of violation and imposition of fine. At present, 49 cases in various violation groups are under examination and 9 cases are in proceedings.

Final decisions adopted by the CC in 2006 may be broken down by violation groups as follows:

**1. Abuse of dominant position** – 11 decisions (5 decisions in 2005), of which 4 on establishment of violation.

In September of this year the CC adopted decision on establishment of violation and imposition of the legal obligation and a fine to the supplier of medical oxygen LLC “AGA” that has violated Article 13 of the Competition Law (see Box 6.16).

#### Box 6.16

##### **The Competition Council establishes violations in the medical oxygen gas market**

The Competition Council has established an abuse of dominant position in activities of LLC “AGA” through setting unfounded prices of medical oxygen and, in separate cases, setting different prices of identical product for different customers. Fine in the amount of LVL 117 128.64 and the legal obligation were imposed to the company for the violation. LLC “AGA” acquires medical gases from related companies and sells them in liquefied and compressed form in cylinders of different volumes to medical establishments of Latvia. Information acquired by the CC indicates that the market share of LLC “AGA” in the total market of medical oxygen considerably exceeds 40% and that LLC “AGA” has acquired a monopoly position in the market of compressed medical oxygen gas filled in cylinders. As the company is in a dominant position in the particular market, it has to comply with several conditions mentioned in the Competition Law so that its activities would not distort competition to a disadvantage of other market participants and consumers.

In the process of examination the CC concluded that, after Latvia’s accession to the EU, requirements to production and distribution of medical oxygen gas have not changed. Misleading its customers on requirements of Latvian public bodies and the EU, LLC “AGA” unjustifiably raised the price of compressed medical oxygen gas filled in 40-litre cylinders almost four times. The CC acknowledged that this rise of prices has to be assessed as unfair and hence LLC “AGA” has abused its dominant position in the particular market. The CC also established that LLC “AGA” has applied discriminatorily different prices of one medical oxygen cylinder unit to medical establishments. After the rise of prices in 2004, difference in prices of compressed medical gas supplied by LLC “AGA” to different medical establishments even reached up to 281% (see the full text of the CC decision: [www.kp.gov.lv/?object\\_id=752&module=news](http://www.kp.gov.lv/?object_id=752&module=news)).

## **2. Prohibited agreements – 10 decisions (7 decisions in 2005), of which 5 on establishment of violation.**

In 2006, fines in the total amount of LVL 344 568 were imposed to the companies involved in prohibited agreements, and these fines have to be transferred into the state budget. In October 2006, the CC adopted two decisions on prohibited agreements in procurement tenders. In both cases, companies had exchanged information on prices, harmonised tender estimates and mutually agreed on the winner of the tender beforehand. One of the latest adopted CC decisions on established violation, as regards harmonisation of information beforehand by companies participating in the tender announced by JSC “Latvenergo”, concerns activities of LLC “El Plūsma” and LLC “Energorements Rīga” (see Box 6.17).

#### Box 6.17

##### **The Competition Council establishes prohibited agreement in activities of applicants of the “Latvenergo” tender**

The Competition Council has established that a prohibited agreement has taken place in 2005 in actions of LLC “El Plūsma” and LLC “Energorements Rīga”, which were taking part in the open tender announced by JSC “Latvenergo”. The violation manifested as a concerted action of companies, in the framework of which an exchange of information regarding prices took place and participation in the “Latvenergo” tender “On replacement of pipes of the fire watermain of CHP-2 production unit of Riga Thermal Power Station” was harmonised. The competition supervision body imposed fines to companies for the established violation: LVL 133 812 to LLC “Energorements Rīga” and LVL 7591 to LLC “El Plūsma”.

The CC addressed JSC “Latvenergo”, asking to assess potential violations in actions of LLC “El Plūsma” and LLC “Energorements Rīga”. The organiser of the tender told that both companies have submitted applications with identical tender sums although an arithmetical mistake in the estimate of LLC “El Plūsma” was found, which would result in non-coincidence of the tender sums.

The CC indicates that, irrespective of information exchange being done by an employee of the tender applicant (legal person) or by another person entrusted by the tender applicant to prepare the tender offer, the tender applicant is responsible for this. Information acquired in the case indicates that the goal of the agreement of market participants was to create competition conditions not corresponding with normal conditions of the particular market; in normal conditions, every applicant signs his offer and submits to the tender in writing as well as ensures that the information included in the offer is not available until its opening.

The CC acknowledged that actions of the companies have resulted in hindrance, restriction and distortion of competition (see the full text of the CC decision: [www.kp.gov.lv/?object\\_id=772&module=news](http://www.kp.gov.lv/?object_id=772&module=news)).

One of the goals of the Competition Council in application of punishment is to deter violator and other market participants from committing violation. This goal is also achievable in cases where market participant admits violation and voluntarily co-operates with the CC. Normative acts envisage an option to apply reduction or exemption from punitive sanctions to market participant who has involved in prohibited agreement with other market participants. Such option is envisaged by the “*leniency programme*” – discharging from fines or fines’ reduction of participant of horizontal cartel agreement, due to different levels of his co-operation with the Competition Council – provided by the Competition

Law and Cabinet of Ministers Regulation No. 862 “Procedure for Calculation of Fine for Violations referred to in Article 11, Paragraph one and Article 13 of the Competition Law” of October 19, 2004.

**3. Merger of companies** – 28 decisions (17 decisions in 2005), of which 4 on establishment of violation due to non-submission of notification prior to merger and 1 on termination of examination of case.

In 2006 the CC adopted 22 decisions in total, giving permission to merge for market participants, as well as 1 decision that allows market participants to merge, prescribing special rules. In the 2nd half of 2006 the CC, receiving applications of market participants, in most cases decided to allow merger of market participants in such markets as retail trade of fuel, retail trade of medicines, sale and maintenance of vehicles, and food products.

**4. Unfair competition** – 15 decisions (23 decisions in 2005), of which 3 on establishment of violation.

In the 2nd half of 2006, unfair competition cases examined by the CC comprised such markets as alcohol, food supplements and sale of cosmetics, provision of express mail and employment services. Information mainly included in applications of market participants indicated such manifestations of unfair competition as imitation of likeness and packaging of goods, distribution of false information, illicit acquisition of commercial secret and even exerting influence by threat.

**5. Potential violations of the Advertising Law** – 21 decisions (16 decisions in 2005), of which 7 on establishment of violation.

Competence of the CC includes supervision of those advertising messages and publicity measures that are directly or indirectly turned against competitor, i.e., the advertisement contains reference to competitor, comparison with competitor or goods offered by him is used, superiority over product offered by competitor is directly demonstrated, property of competitor is included without his permission, and imitation is used. In July of this year the CC adopted decision on violation of Article 8 of the Advertising Law in advertisement distributed by investment management JSC “Parex Asset Management”, imposing a legal obligation to the company and starting record-keeping in the administrative violation case (see Box 6.18).

#### Box 6.18

##### **The Competition Council established deception in advertisement of IMJSC “Parex Asset Management”**

The Competition Council has established that the message “Parex pension plans are most profitable in long term! Increase by 26% since launching operation” included in the advertisement distributed by investment management JSC “Parex Asset Management” with the slogan “Replace your pension with a bigger one!” is misleading in accordance with norms of the Advertising Law. The CC imposed obligation to distribute public retraction of the advertisement and imposed fine in the amount of LVL 3000 to the company.

It was established that the advertising message “Parex pension plans are most profitable in long term!” depends on several essential conditions which are concealed. Not receiving information on such conditions, consumers may be misled. The advertisement also does not make it clear that the highlighted numerical indicator of 26% only concerns one of pension plans.

The Competition Council acknowledged that, in case where a generalised advertising message is not based on affirmative evidence, receivers of such message may be misled and the advertisement may affect their economic action. Such advertisement may also be harmful to competitors who offer more profitable pension plans.

In its decision, the CC also established that the main advertising message “Parex pension plans are most profitable in long term! Increase by 26% since launching operation” does not provide information about time when operation of the pension plans advertised by Parex was started.

The CC acknowledged that the advertisement must contain clear information about the period when profitability of the pension plans was achieved, as the mentioned term is an essential information from the standpoint of the target audience of the advertisement. Not providing such information has to be considered an incorrect and inaccurate way of advertisement presentation, besides, it may mislead consumer about the time period when the advertised numerical indicator was achieved and hence about the true advantage of the offered services (see the full text of the CC decision: [www.kp.gov.lv/?object\\_id=739&module=news](http://www.kp.gov.lv/?object_id=739&module=news)).

#### **Promotion of competition**

This direction of activity includes supervision of market sectors and formation of competition culture in the society. Medium-term priorities are:

- improve methods of market determination and market analysis;
- create a data acquisition and accumulation system;
- develop the system for implementation of measures of the so-called *competition advocacy*<sup>1</sup>;
- improve the procedure by which the Competition Council gives conclusions on legal acts developed by public administration institutions.

<sup>1</sup> Competition advocacy includes two principal elements – development and submission of recommendations to the government and public administration bodies; informing the society on gains from competition.

One of ways for getting deepened report on competition situation in various sectors is *conduction of market studies*. Action strategy of the CC envisages recruitment of experts for conduction of sectoral studies on a regular basis in order to determine and prevent potential risks to efficient protection of competition. The CC has concluded agreements with experts on conduction of six voluminous economic studies in such sectors as markets for production of meat and meat products, milk and dairy products, corn and corn products, construction market, market for production of non-metallic mineral products, market for production of fish and fish products, and market of transport and communications. Results of the studies will be available at the beginning of December 2006.

In March-November 2006 the CC in co-operation with the Federal Ministry of Economics and Technologies of Germany implemented activities of the Twinning Light Project "Strengthening the Administrative Capacity of the Competition Council for Enforcement of Competition Legislation Implementation and Competition Advocacy Measures" of the EU Transition Facility programme. In the framework of the project, training programme was organised for representatives of Latvian public administration bodies, consumers, entrepreneurs and non-governmental organisations with a goal to promote development of competition advocacy measures in Latvia and strengthen the feedback of the CC with entrepreneurs and society.

The CC currently continues market surveillance in 10 different markets with a goal to determine the concentration level or whether competition problems exist in the particular market or at some separate trade levels. E.g., the CC has completed supervision of dairy product market (see Box 6.20) as well as continues work at supervision of cement market (see Box 6.19).

#### **Box 6.19**

##### **Competition trends in cement market**

In the 2nd half of 2006, the Competition Council continued supervision of cement market. Cement market is characterised by structure with a pronounced market leader, namely, local producer LLC "Cemex" whose supply constitutes about two-third of the volume of all supply in the market in Latvia. Proportion of imported cement makes approximately one-third of all supply volume in Latvia. LLC "Cemex" and foreign cement importers provide cement both to retail shops and to companies that use cement in production of concrete and concrete products. The market is characterised by non-existence of supply from Western producers, which is explicable by high cement transportation costs that strongly increase price of cement of Western producers. Characteristic feature of competition situation in cement market is that demand exceeds supply. Hence competition between suppliers of cement in cement market is insufficient.

Cement market is also characterised by dependence on import suppliers because the local producer only covers 60-70% of demand. If the level of cement prices in neighbouring countries exceeds the price level in Latvia, it becomes economically more advantageous for cement suppliers to sell cement in these countries. Fast increase of cement production volumes in short-term period is impossible, besides, growth of demand for cement is anticipated. Therefore the balance of demand and supply as well as dependence on the imported cement will continue until 2008 when it is planned to complete reconstruction of the Brocēni Cement Factory. In view of the plans of LLC "Cemex" to develop the direction of concrete production in Latvia, i.e., development of vertically integrated production, increased market power of the local producer is anticipated. Market structure with a pronounced market leader, especially in conditions where cement deficit is observed, creates a high risk of the abuse of market power.

#### **Box 6.20**

##### **Competition trends in milk and dairy product market**

At the beginning of 2006, the Competition Council carried out supervision of milk (2% and 2.5%, 1 litre) and curds (0.5% and 0.6%, 200 g) market for the period of 2004-2005. In the framework of supervision of the particular products market, analysis was conducted at three levels (production, processing and retail trade) with the main stress on processing and retail trade. During the mentioned period in the milk purchase market, an unchanged market structure was observed, which contains more than 40 processing enterprises. Total market share of three processing enterprises (JSC "Rīgas piena kombināts", JSC "Valmieras piens" and JSC "Tukuma piens"), calculated by milk purchase volumes in 2004 and 2005, amounted to 44%. The CC acknowledges that milk processing market should not be considered a concentrated one, and the concentration process was not observed in the supervision period. Fluctuations of milk purchase prices in the mentioned period showed a trend of growth by 15-20% on average annually. Through market surveillance, the CC concluded that milk purchase volumes are not related to changes in milk purchase prices because increase of milk purchase volume along with decrease of prices or vice versa is not observed. At the processing level it was established that, selling one particular dairy product to different retail companies during one period, sale prices of processing companies for these retail traders are different. Retail companies set the increase of price, using individual price-setting principles. Average increase of price for the particular milk in retail trade was established at 25% with a trend to fluctuate in the range of 1-100%, while average increase of price for curds in retail trade was 30% with a trend to fluctuate in the range of 25-36%.

The CC concludes that unequal proportion of market power exists between milk processors and two biggest traders. Notwithstanding that the added value of milk processors and costs in the processing process are bigger than in the process of milk resale in retail trade, the profit gained by supermarkets per unit of the respective product is substantially higher. In this market surveillance, the CC has not established signs of prohibited agreement or parallel actions in price-setting (see the publication version of the study on the CC website: [www.kp.gov.lv/?object\\_id=762&module=news](http://www.kp.gov.lv/?object_id=762&module=news)).

### **Strengthening role of the Competition Council**

In order to strengthen the role of the Competition Council in development and implementation of EU legal acts and in international organisations and networks, the following medium-term priorities are set:

- to take part in development of normative acts at the EU level and ensure timely transposition of requirements in the legal system of Latvia;
- to actively participate in discussion of documents and in preparation and process of meetings;
- to develop a system how to take over the best practice of the EU and world competition institutions in operation of the Competition Council.

In many member states, including Latvia, the set legal norms regulating the activities of members of liberal professions (lawyers, notaries, architects, accountants, etc.) and the developed professional self-regulation norms are not substantiated by interests of an individual or society to receive high-quality service. On this account, the European Commission has initiated measures for promotion of competition in the field of liberal professions. **Competition must not be restricted, distorted and hindered by the regulation** of the forms and quality of services provided by representatives of liberal professions. Violation of the norms of competition law may manifest when representatives of liberal professions implement a self-regulation mechanism restricting competition, and such actions are classified as prohibited agreements in the sense of Article 11 of the Competition Law or Article 81 of the Treaty Establishing the European Community. At present, the CC has initiated proceedings in two violation cases.

Legal norms existing in the country may contain requirements that are contrary to competition law. In this context, the CC has also actively involved in assessment of the Notariate Law and normative acts subordinate to it, pointing that the legal regulation, which is included in the law and Cabinet of Ministers Regulation “On Payment Rates of Certified Notaries Public” and actually fixes a set price of service provided by notaries, contradicts the Competition Law and Article 81 of the Treaty Establishing the European Community.

In the sector of compulsory civil liability insurance for land vehicle owners (OCTA), the CC has given opinions on compliance of law regulating this sector with Articles 81 and 82 of the Treaty Establishing the European Community and Articles 11 and 13 of the Competition Law. In the framework of market surveillance, the CC has established that the Methodology for Technical Appraisal of Vehicles developed and approved by the Motor Insurers’ Bureau of Latvia (hereinafter MIBL) uniting all OCTA companies includes several norms that create preconditions for violations of competition law. In this context, active co-operation with the MIBL and the Ministry of Finance is taking place for prevention of the current situation and creation of appropriate legal base, which would not allow such situation in the future.

The Competition Council has planned to implement the *initiative of the new competition law policy* for 2007-2008, which is necessary due to the fact that successful implementation of competition policy is unattainable without society’s understanding of legal aspects of competition aspects and its advocacy. Activities anticipated in the framework of the new policy will leave a quantitative and qualitative impact on fulfilment of those activity indicators, which concern the direction of competition promotion activity, as well as improve fulfilment of competition protection measures. The CC, through participation in various working groups, co-operates with the European Commission and competition bodies of other EU member states in development of various legal acts.

## **6.9. Regulation of Public Utilities**

According to the Law “On Regulators of Public Utilities”, a two-tier regulation system of public utilities is established in Latvia and the sectors regulated at the state level are separated from the sectors regulated at the local government level.

The Public Utilities Commission (hereinafter Commission) regulates public utilities at the state level, while the local government regulators regulate local providers of services in the respective municipal territories and supervise sectors of municipal waste management (with the exception of municipal waste processing), water supply, sewage, and heat supply (except combined heat and power). It has to be noted that the Commission does not supervise the local government regulators and is not authorised to influence their operation.

The Commission is a multi-sector regulator performing regulation functions in the sectors of energy, electronic communications, postal services and railway transport. The task of the Commission is to ensure to all users the opportunity to receive uninterrupted and safe services for economically reasonable prices and to ensure to businesses providing public utilities the possibility to develop with profitability according to the economic situation. An important part of the Commission's work is promotion of competition in the regulated sectors. The Commission adopts its decisions independently and is not subject to decisions of the government or other state institutions. Members of the Commission's Board are appointed by the Saeima and only a court may declare decisions taken by the Commission substantively unlawful and repeal them. Activities of the Commission are financed from the duty paid by businesses on the basis of the annual net turnover of regulated public utilities.

Functions of the Commission include regulation of regulated sectors and businesses, protecting interests of users and fostering development of public utility providers, setting tariff calculation methodologies, approving tariffs, issuing licenses and registering general authorisations, promoting competition in regulated sectors, carrying out extra-judicial settlement of disputes, supervising compliance of the provided utilities with license conditions and specified quality requirements.

On January 4, 2006 the concept on the establishment of an efficient public utilities regulation model, which is best suitable for the situation in Latvia, was accepted by the Cabinet of Ministers. In order to reach this goal, a unified system for regulation of public utilities will be established in Latvia. The concept envisages that, in order to ensure uniform consideration of issues related to public utilities regulation in the country, decisions will be taken by the Board of the Public Utilities Commission, while the required obtaining and assessment of information, preparation of decisions and control over their implementation will be ensured by an executive body which will include regional structural units of the regulator. Elaboration and confirmation of the draft amendments to the Law "On Regulators of Public Utilities" was taking place during 2006.

### **The situation and policies in the regulated sectors**

#### ***Energy sector***

In the energy sector (see Chapter 6.3.2), electricity supply and gas supply are regulated by the state. The dominant role in the electricity supply is played by the JSC "Latvenergo" that generates approximately 88% of the electricity generated in Latvia and ensures import of electricity, its transmission, distribution and delivery to users. Electricity is also generated by about 150 small hydropower stations with the total capacity of 25 MW and 14 wind power stations with the total capacity of 25.2 MW. Among 36 independent cogeneration plants, there are three biogas power stations with the total capacity of 7.77 MW and wood cogeneration plants in Krāslava, Riga and Sarkaņi (Madona district) with the total output of 2.15 MW. Along with the JSC "Latvenergo", 10 licensed businesses carry out distribution or sale of electricity. Supply of natural gas in Latvia is ensured by vertically integrated JSC "Latvijas Gāze", while about 50 companies compete in the supply of liquefied gas.

Since July 1, 2004 all electricity users, except households, have the opportunity to choose alternative suppliers of electricity. However, practically no user has changed his supplier of electricity.

On October 17, 2006 the Commission received electricity sales end tariff proposal (differentiated tariffs) of the JSC "Latvenergo", envisaging rise of electricity tariffs as from January 1, 2007. These draft tariffs were rejected by the Commission on October 25, 2006. JSC "Latvenergo" submitted new tariff proposal on October 26, 2006. The increase in tariffs is based on the rise of prices of natural gas and imported electricity as well as tariff changes for network services.

In view of the lack of competition in natural gas supply, regulation of all consumer tariffs is reasonable also in the future. The regulation process ensures higher stability of tariffs, balancing interests of supplier and users as much as possible.

On October 11, 2006 the JSC "Latvijas Gāze" submitted to the Commission the natural gas tariff proposal for 2007. The Commission rejected the proposal on October 25, 2006 because all required documents substantiating the increase in purchase price for natural gas (natural gas supply agreements) were not submitted.

#### ***Electronic communications and post***

The biggest market participants in the sector of electronic communications are the fixed network operator LLC "Lattelecom" and mobile communication operators LLC "LMT" and LLC "Tele2". A total of 448 companies are registered in the sector of electronic communications.

The Commission has completed market analysis in all electronic communication markets that were planned to be analysed in 2006: Access to the public telephone network at a fixed location for residential customers; Access to the public telephone network at a fixed location for non-residential customers; Publicly available local and/or national telephone services provided at a fixed location for residential customers; Publicly available international telephone services provided at a fixed location for residential customers; Publicly available local and/or national telephone services provided at a fixed location for non-residential customers; Publicly available international telephone services provided at a fixed location for non-residential customers; The minimum set of leased lines; Call Origination on the Fixed Public Telephone Network; Call Termination on the Fixed Public Telephone Network; Transit Services in the Fixed Public Telephone Network; Wholesale unbundled access (including shared access) to metallic loops and sub-loops for the purpose of providing broadband and voice services; Wholesale broadband access; Wholesale terminating segments of leased lines; Wholesale trunk segments of leased lines; Access and call origination on public mobile telephone networks; Voice call termination on individual mobile networks.

The Commission has received the opinion of the European Commission (EC) on the submitted market analysis in the fixed public networks and mobile public networks. Electronic communications markets analysis will be continued in 2007.

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.

As from January 1, 2006, in accordance with the Postal Law, the state JSC "Latvijas Pasts" has monopoly rights to accept, send and distribute both domestic and international mail correspondence weighing no more than 50 grams within the country borders. New tariffs for general postal services, including separately determined tariffs for domestic priority (class A) mail for the first time, came into force as from January 1, 2006. Introduction of class A domestic mail and setting its tariffs provides to postal service users the opportunity to choose mail items of different quality for different tariffs.

In 2006 the Commission took part in development of a new Postal Law that will determine unified regulation for all participants of the postal services market.

#### **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 SJSC "Latvijas Dzelzceļš".

On April 12, 2006 the Commission set the fee for the use of public usage railway infrastructure for transportation during the 2006/2007 period of train traffic timetable. There were two main reasons to raise the fee. Firstly, the increased costs of railway infrastructure maintenance. Secondly, the volume of transportation has decreased but infrastructure costs are attributed to the actual transportation.

## **6.10. Export Promotion Policy**

The objective of the export promotion policy is to actively promote international competitiveness of Latvian companies and foster entry into new markets and consolidation in the current ones. **Latvian Export Promotion Programme for 2005-2009 (LEPP)** is being implemented to achieve this objective.

The Export Promotion Council chaired by the Minister of Economics supervises implementation of LEPP. The Council is made up of representatives of public institutions and industry associations as well as social partners.

In order to provide assistance to Latvian companies in export promotion in accordance with LEPP lines of action, several measures have been implemented in the framework of the LEPP action plan for 2006 in the four main lines of action:

- Development of institutional base for export promotion;
- Promotion of international competitiveness of Latvian companies and development of export capability;
- Support in export marketing and in the entry into new markets;
- Financial instruments for export promotion.

In the framework of LEPP, the Ministry of Economics has worked out the *Law on Guaranteeing Export Credits* adopted by the Saeima on June 22, 2006. In addition to the law, two draft regulations of the Cabinet of Ministers have been developed, which determine the procedure for issuance of export credit guarantees and exchange of information with the European Commission and other EU member states. The aim of export credit guarantees is to provide state support to exporters, reducing the current risks in transactions with foreign buyers, and promote export of goods and services of Latvian origin outside the European Union.

The link to the **Development Concept of Foreign Economic Representative Offices of Latvia** is essential for LEPP. Implementation of the Concept substantially contributes to strengthened competitiveness of Latvian entrepreneurs in the global market.

10 foreign economic representative offices of Latvia – in Germany, United Kingdom, Sweden, France, Russia, Kazakhstan, Netherlands, Norway, Denmark and USA – have been opened in the period since 2002 and are operating abroad.

Taking into account that economic interests of Latvia are represented in Europe, it is also necessary to enter into new markets that are interesting for entrepreneurs and geographically distant. Therefore a foreign economic representative office of Latvia was opened in 2006 in the USA that is an important economic partner of Latvia in the sphere of foreign trade and attraction of investment.

Foreign economic representative offices of Latvia constitute one of the most efficient instruments for export promotion and attraction of foreign investment, so it is essential to ensure expansion and development of the network of these offices. In accordance with LEPP, it is planned to open 2 new foreign economic representative offices of Latvia abroad every year.

Representative offices operate in three main directions: identification and channelling of the potential investment and export projects, provision of services for Latvian companies, and distribution of information to foreign companies on the economic situation and business environment of Latvia.

The Ministry of Economics and the LIDA organise forums for Latvian entrepreneurs twice a year. Within the framework of these forums, Latvian entrepreneurs are acquainted with the foreign markets where representative offices operate, and bilateral meetings of companies with leaders of representative offices are organised in order to discuss interests of companies and their business opportunities. In December 2006, such activity took place outside Riga for the first time, namely, in Liepāja, in order to address and make direct links with entrepreneurs of Kurzeme region. Broader insight into export opportunities of companies of various sectors in those foreign markets where foreign economic representative offices of Latvia are opened were given to entrepreneurs during the forum. Entrepreneurs also got information about services offered by the LIDA and met leaders of representative offices.

**External marketing** is one of the main export promotion instruments. The Ministry of Economics carries out several external marketing measures in co-operation with the 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. Visits to Austria, Israel, Russia (Vologda, Pskov), Moldova, Finland, Japan, Slovakia, United Kingdom, Denmark and Canada took place in 2006. More than 250 company representatives in total have participated in these visits.

In nine months of 2006, 48 Latvian entrepreneurs have participated in the stands organised by the LIDA at 4 international exhibitions in Sweden (construction), Norway (wood processing, structures of horizontal logs), United Kingdom (machine building, metal working) and Barntrup, Germany (furniture), and representatives of 24 companies and institutions supported by the Ministry of Economics and the LIDA took part at the leading exhibition of machine building and metal working sector “Hannover Messe 2006” with two national stands. Contact exchanges of companies and seminars on the potential of Latvian sectors were additionally organised in the framework of several exhibitions.

Several trade missions abroad of Latvian companies were organised in 2006. In their framework, an individual business programme was prepared for each entrepreneur.

Customer Service Department of the LIDA was established in 2006, where Latvian companies can get consultations in one place on issues involving foreign trade, selection of business partners, external marketing activities proposed by the LIDA, state support programmes, and other issues.

As Latvian companies are interested in information about external markets also in electronic form, the LIDA has formed several electronic bulletins in 2006, compiling information on topicalities in foreign markets. Profiles of 19 countries (Israel, Austria, USA, Moldova, Japan, Finland, etc.) were prepared and placed on the LIDA website in the section “Foreign Markets”.

In 2006 several studies of foreign markets were completed and, in accordance with LEPP, a broad and comprehensive programme of seminars for Latvian companies was carried out about issues of specific export conditions for product groups of individual sectors in target markets, promotion of business competitiveness in the EU and other topical subjects such as business opportunities in the EU single market, EU legislation, funding opportunities in the EU, etc.

A cycle of export skills seminars for export beginners was developed and carried out. The cycle contains three seminars (the 1st subject “Are you ready for export? Export strategy”, the 2nd subject “Marketing. Advertising”, and the 3rd subject “Logistics”). In the framework of the seminars, both theoretical knowledge and practical examples were given to entrepreneurs, and successful well-known Latvian companies shared their experience. Representatives of 173 companies in total attended these seminars.

In order to provide to Latvian entrepreneurs those services they are most interested in, the LIDA has developed a new co-operation model between a company, LIDA project manager and employee of representative office, considering that the Latvian company is a primary LIDA customer but offers and requests of foreign companies are subordinate to it.

#### **Box 6.21**

##### **Competition “Export Award of the Year 2005”**

The competition “**Export Award of the Year**” founded in the framework of Latvian Export Promotion Programme for Latvian commercial companies’ achievements in export was organised the second 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 product and service exports, 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 product/service export.

61 applications from 40 Latvian commercial companies for participation in the competition were submitted this year, representing the principal export sectors – wood processing and furniture industry, metal processing and machine building, light industry, food processing and confectionery, as well as chemical and pharmaceutical industry.

Winners of the 1st place in the competition are: in the 1st category “*Product/service with the most rapid increase in export volume*”: **LLC Primekss** (floors of rooms, monolithic concrete roof coverings); in the 2nd category “*New export product/service*”: **JSC Rīgas Vagonbūves Rūpnīca** (diesel train DR1B, model 63-555); in the 3rd category “*Most innovative export solution of product/service*”: **LLC Zieglera Mašīnbūve** (mowing machines, swathers, spreaders, oilseed rape cutters).

The jury commission also decided to confer special awards of the Ministry of Economics for development of marketing materials in every category, which were received by **JSC LEMIS BALTIC** (densitometer LPG Di), **LLC Baltic Supplying Group** (metal containers) and **LLC MedPro Inc** (thiopentalum-natrium).

## **6.11. Protection of Consumer Rights and Market Surveillance**

The system of consumer rights protection in Latvia gradually strengthens and develops 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 the institutional capacity building to ensure adequate market surveillance and supervision of the observance of consumer rights.

In the 2nd half of 2006, important documents of consumer rights protection policy were developed in order to promote efficient market surveillance and protect consumers against risks that could arise from use of goods and services non-compliant with requirements as well as encourage efficient introduction and supervision of consumer protection law. Normative legal base has also been improved in order to ensure as quick and high-quality as possible review of consumer complaints on goods and services non-compliant with contract provisions as well as ensure information exchange and co-operation between national bodies thereby providing higher level of consumer protection and fostering consumer confidence in institutions of consumer rights protection.

#### **Policy planning and development of the normative base**

On November 6, 2006 the Cabinet of Ministers approved the **Operation and Development Strategy of the Consumer Rights Protection Centre for 2007-2009**. The Strategy is a medium-term planning document based on functions and tasks of the Consumer Rights Protection Centre, which are defined in the Consumer Rights Protection Law and other normative acts. The Strategy is directed to

efficient introduction and supervision of legal acts of consumer protection, which is one of the main goals in EU consumer policy, hence also promoting a fair competition and favourable business environment.

The supreme goal of operation of the Consumer Rights Protection Centre is to implement protection of consumer rights and interests in order to provide to inhabitants an opportunity to live healthily and safely and be convinced about safety of goods and services, give an opportunity to efficiently fulfil their consumer rights and ensure participation and awareness of the society about consumer rights and interests.

In order to achieve the supreme goal of operation of the Consumer Rights Protection Centre, the Strategy sets 5 sub-goals:

- ensure consumer protection against unsafe goods and services, carrying out adequate and efficient market surveillance;
- provide favourable business environment and fair competition by protecting economic interests of consumers as well as prevent cross-border violations in EU context;
- raise the level of consumer awareness by giving them an opportunity to use advantages provided by the EU Internal Market and preventing risks to consumer health and life;
- ensure consumer rights to reimbursement and efficient review of individual consumer complaints;
- improve control and ensure metrological supervision of measuring instruments and control of pre-packed goods.

The Ministry of Economics has worked out the **draft Guidelines of Market Surveillance**, which determines basic principles of market surveillance as well as development goals and priorities in carrying out market surveillance for the next 5 years.

Efficient market surveillance plays an essential role both in consumer rights protection and in ensuring equal and fair competition, as it includes supervision and verification of the compliance of goods and services placed in the market as well as ensures taking appropriate actions in case of necessity if it has been established that the commodity or service does not comply with requirements. Latvia as EU member state has to provide that the market surveillance system complies with requirements of the European single market and that only goods and services, which are safe and comply with set essential requirements, are available in Latvian market.

The supreme goal of the market surveillance policy is to protect consumers against risks and hazards for their life and health and economic interests by an efficiently functioning market surveillance system and successful fulfilment of tasks of the involved parties (economic agents, consumers and public bodies).

3 main lines of action are formulated in the draft guidelines:

- improvement of requirements of the normative acts regulating market surveillance and strengthening the planning of operation of market surveillance bodies by establishment of a result-oriented supervision system;
- carrying out efficient and purposeful market surveillance by improving the business environment and promoting fair competition;
- informing consumers and economic agents by raising the level of awareness about responsibility and role in the market.

Through implementation of the guidelines, a modern, sustainable, well-co-ordinated and result- oriented market surveillance system will be created, which is provided with adequate resources, and supervision actions will be based on risk assessment in accordance with annual provisions of the market surveillance institution programme by conducting visual inspections, testing of goods and extended examination of a market for particular goods or services. In order to implement the guidelines, it is planned to work out the Consumer Rights Protection and Market Surveillance Programme for 2008-2010, operation and development strategies for market surveillance institutions, as well as annual market surveillance programmes of market surveillance institutions.

On August 1, 2006, Cabinet of Ministers Regulation No. 631 “Procedure by which a Consumer Claim on Product or Service Non-compliant with Contract Terms is Notified and Reviewed” was approved, which replaces Cabinet of Ministers Regulation No. 154 of March 23, 2004 “Procedure by which a Consumer Claim on Product or Service Non-compliant with Contract Terms is Notified and Expertise of the Product or Service is Organised”, making the requirements currently in force clearer and more understandable for consumers and entrepreneurs. The regulation is worked out in order to specify particular issues related to notification and review of a consumer claim and set stronger requirements for experts and expert conclusions. The regulation also defines exceptions for notification

of expertise on a service, the result of whose provision is immaterialised (tourism services, financial services, etc.), and the annex “Example of Claim Notification” is added to it.

On November 21, 2006, the Cabinet of Ministers approved the Regulation “Essential Requirements for Lighters and Procedure of their Supervision”. The regulation is worked out so that the requirements for lighters set in the European Commission (EC) 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 would be binding for Latvian producers and importers as well. The regulation is developed on the basis of Article 7, Part 1 of the Law “On Conformity Assessment” and has the aim to set essential requirements for lighters and procedure of their supervision as well as define the Consumer Rights Protection Centre as the responsible institution that will carry out surveillance of the lighter market. The regulation will come into force on March 11, 2007.

The work for transposition of 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”) continued in 2006. The aim of the Directive is to determine high consumer protection against unfair commercial practices of businessmen. The Directive sets rules on misleading and aggressive commercial practices, and its annex lists such commercial practices which are in all circumstances considered misleading. EU member states have to transpose this directive by June 12, 2007. Latvia plans to develop draft Fair Trade Practice Law and amendments to related normative acts by March 1, 2007, while approval of normative acts is planned by June 2007.

The Ministry of Economics continues active work at the new draft consumer credit agreements directive in the Working Party on Consumer Protection and Information of the EU Council of Ministers. The aim of the directive is to harmonise particular aspects of member states’ normative and administrative acts regarding the consumption credit. The field of operation of the directive will concern credit agreements. The draft directive sets clearer and stronger demands that are more adequate to the current situation in the financial services market in respect of information to be provided to consumer before conclusion of a credit agreement as well as information to be indicated in the consumer credit agreement. Latvia supports and positively evaluates the developed draft directive on the whole, has actively involved in discussions and work of the Council’s working party and has successfully protected its own interests as regards problem issues urgent for Latvia.

### **Supervision of consumer rights**

The Consumer Rights Protection Centre (hereinafter CRPC) under supervision of the Ministry of Economics is the main co-ordinating institution that supervises observance of the normative acts of consumer rights 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 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 [www.pateretaja-celvedis.lv](http://www.pateretaja-celvedis.lv) of non-governmental organisations of consumer protection. These websites contain information on the consumer rights protection legislation in force, various goods and services, and opportunities to protect legitimate rights of a consumer. In accordance with the new Cabinet of Ministers Regulation No. 631 “Procedure for Submission and Review of Consumer Claims Concerning Goods or Services Non-compliant with Agreement Terms”, the CRPC created and placed on the website a database of examiners (where 11 examiners are registered) in August, however, a bigger diversity for examination of various goods and services would be desirable.

In 9 months of 2006, CRPC:

- carried out 2143 inspection visits to trade and service companies (sites),
- provided 294 consultations to entrepreneurs,
- provided 19057 consultations to consumers,
- reviewed 846 cases of administrative offences in the area of consumer rights protection,
- reviewed 906 applications and complaints of consumers.

430 of the received complaints were settled in favour of consumers, while 227 complaints proved to be unfounded. In 9 months of 2006 the number of consumer complaints has increased by 25.6% in comparison with the same period in 2005 (721 complaints in 9 months of 2005).

As a result of the review of applications, consumers got refunds of money paid for goods or services that do not comply with agreement terms, and the total amount of refunded money comprised LVL 72760.63. In their applications, consumers have presented claims about:

- non-observance of the principle of legal equality of contracting parties – 24 times,
- provision of incomplete information – 29 times,
- incorrectly set payment for purchase and weight or measure – 19 times,
- violations of review of claims – 284 times,
- non-issuance of documents attesting to the transaction, and other offences – 114 times,
- services that do not comply with agreement terms – 261 times,
- goods that do not comply with agreement terms – 477 times.

Consumer applications mostly include complaints about footwear, electric appliances, mobile phones, textiles, while recently an increasing number of complaints pertain to crediting services and such construction services as window and door framing, reconstruction and repair work. This may be explained by increased economic activity of the population, saturated and increasing real estate market as well as the big demand for construction services; as a result, construction services are expensive and often do not comply with quality requirements.

In 9 months of this year, the CRPC assessed 4627 advertisements and established 139 violations as well as received 58 complaints. The number of complaints about misleading advertisements related to various health improvement preparation and food supplements has increased in 2006.

In order to settle consumer complaints more efficiently as well as arrange and provide protection of consumer interests in various spheres, the CRPC has co-operated with several business associations. CRPC has co-operated with the Leasing and Factoring Committee of the Association of Latvian Commercial Banks, working out the Code of Good Practice of Leasing and Factoring Companies. Meetings with representatives of Latvian Real Estate Developers Association as well as with Association of Latvian Travel Agents (ALTA) were organised in order to discuss the assessed agreements and ensure observance of consumer rights in them.

CRPC continues co-operation with other central and local government bodies as well. Employees of the CRPC have participated in working groups organised by the state agency “Housing Agency”, where “Example of Agreement for Management and Administration of Newly-Built Housing and Rules for Use and Management of Apartment House and Underground Parking Lot” was developed. Agreement with the management of the State Agency of Health Statistics and Medical Technologies on exchange of information regarding traumas got by inhabitants through use of unsafe goods has been achieved.

In April 2006, draft statute of the Consumer Advisory Council was elaborated and an advisory council was established with the main goal to promote development of consumer protection policy and increase of the consumer rights protection level, ensuring and encouraging dialogue and exchange of information in the field of consumer rights protection between public institutions, associations and foundations of consumer rights protection and entrepreneurs.

### **Supervision of agreements**

In 9 months of 2006, 38 decisions on unfair and unequal terms of agreement have been issued, by which CRPC has instructed the addressee of administrative act to cease fulfilling unfair terms of agreements concluded with consumers or to alter draft agreements offered to consumers.

In June 2006, conformity of approximately 20 websites with norms of the Law on Information Society Services and the Cabinet of Ministers Regulation “On Requirements of Distance Agreements” was assessed and appeals to prevent violations of normative acts established by CRPC were sent.

In July 2006, the CRPC started implementing the project for supervision of the “Regulations on Complex Tourism Services” issued by the Cabinet of Ministers; in its framework, 20 inspection visits were carried out and 21 agreements and service programmes were assessed. Non-issuance of agreements or travel programme, non-inclusion of safety guarantees and other violations are among the most essential violations. No violations were established in mere two of the inspected agencies. By the end of 2006, CRPC will review the respective administrative process cases and will work to achieve changes in the offered agreements.

CRPC has also participated in solution of problems that are related to inclusion of arbitration clause in agreements with consumer; several dozen decisions were taken in 2006, where exclusion of the

arbitration clause is demanded. The Department of Administrative Cases of the Supreme Court has also admitted (in the decision of March 7, 2006 in the case No. SKA-59) that the arbitration clause that only envisages settlement of disputes through arbitration court in agreement concluded with consumer has been acknowledged by judicature as an unfair term of agreement.

#### **Box 6.22**

##### **International co-operation of CRPC**

In 2006, the CRPC participates in the project “Best Practice techniques, Enhancement of market surveillance of Consumer Product Safety within the framework of the GPSD” financed by the European Commission and organised by PROSAFE. In the framework of the project, 24 countries have aggregated information about national legislation of market surveillance, its strategy, processes, procedures and publications. Manual on good practice of market surveillance in the EU will be made as a result of the project.

##### **Co-operation of Baltic states**

On June 16, 2005, mutual project in the field of children’s product safety was organised between **market surveillance and consumer rights protection bodies of Baltic states** in the framework of concluded co-operation agreement. 3 child bicycles were tested in Latvia during 2006, and the test results showed that none of them complied with the set requirements and were to be considered unsafe as they create risk of injury and risk of poisoning. Trade of these goods was stopped and the chain of distribution and placing in the market was explored. As a result, administrative cases were initiated and administrative penalties were imposed for trade of such goods, goods were recalled from consumers, 99 hazardous goods were destroyed and 251 hazardous goods were removed out of Latvia and brought to the importer.

In May 2006, a co-operation agreement was concluded between Latvian CRPC, Lithuanian Consumer Council and Estonian Consumer Protection Council about co-operation in introduction of EU Regulation on administrative co-operation between consumer rights protection institutions. It is envisaged to co-operate in the framework of this agreement in order to prevent various violations of terms of EU directives more efficiently, especially regarding economic interests of consumers.

##### **Co-operation network of Baltic Sea region**

In 2006, Latvia as one of **Baltic Sea region co-operation countries** participated actively in network meetings on market protection issues and got involved in a joint project on safety of goods. 5 transformer toys were chosen and sent to a German laboratory for safety tests. Trade of the goods was halted because, as a result of tests, they were acknowledged non-compliant with requirements of normative acts. Administrative cases on trade of non-compliant goods were initiated.

CRPC continues its work in the ICPEN (an international co-operation network where consumer rights protection and fair trade supervision bodies work, encouraging international co-operation in prevention of unfair and misleading marketing activities). In February 2006, CRPC took part in the Internet Sweep day organised by the network. During this day, systematic search of Internet websites was conducted in all participant countries of the network, supervising observance of consumer rights. On websites searched in Latvia, not all normative acts of consumer rights protection were observed for the greater part.

#### **Cross-border trade**

Considering that the number of Latvian inhabitants going abroad and the number of tourists visiting Riga have rapidly increased in the recent time, the cross-border consumer protection becomes increasingly topical. The European Consumer Centre of Latvia (ECC Latvia), which was established at CRPC with a financial support from the European Commission, has received 74 complaints and provided 456 consultations in 9 months of 2006, and 18 of the received complaints pertained to air services. It has to be noted that such complaints are complicated and, frequently, are difficult to solve. There is a trend of growing popularity of e-commerce in the population, and ECC Latvia has also received eight complaints on Internet shopping. ECC Latvia also continues updating information on the website [www.ecclatvia.lv](http://www.ecclatvia.lv), so that consumers received more and more high-quality information on cross-border purchases and helped to implement their rights.

#### **Market surveillance**

In order to ensure that only safe goods complying with certain requirements are available in Latvian market, effective market surveillance (MS) is necessary.

In order to make CRPC more effective and systemise MS, a new action concept was started in 2006, which prescribes that MS activities are being implemented on the basis of projects. In 9 months of 2006, several projects were implemented in priority directions set by CRPC – toys, price tags, and ballast of fluorescent lamps.

During the toy market surveillance project, CRPC conducted 76 inspection visits to toy production and trade places, and no violations were established during mere seven of these visits. The following violations were established most frequently during the inspection visits:

- no warnings in the state language are added about risks related to use of commodity, e.g., warning that the commodity may only be used by people above certain age or under supervision by adults;
- usage instructions or warnings are not added;

- one cannot produce documents certifying conformity, commodities are unmarked or insubstantially marked with conformity marking CE;
- producer or importer is unidentifiable, hence the responsible person is unidentifiable.

Seven airlines at Riga International Airport were inspected in respect of implementation of requirements of Regulation No. 261/2004 (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, regarding specification of information at check-in that passengers have certain rights in the event of cancellation or delay of flights. Requirements of the Regulation were not observed in flight registration places of any airline.

## 6.12. Quality Assurance

### 6.12.1. Quality Structural Policy

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The main task in the area of quality assurance is to promote observance of requirements of normative acts in the regulated and non-regulated sphere as well as improve the legislative base, hence ensuring compliance of products placed in the market and the provided services with national and EU requirements and encouraging increased competitiveness of entrepreneurs and reduction of obstacles to inter-state trade.

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 the Cabinet of Ministers Regulations deriving from these laws.

The main directions of the policy are:

- Improvement of the conformity assessment infrastructure (including testing and calibration laboratories, inspection and certification institutions, environmental verifiers) in accordance with the needs of Latvian national economy in order to protect consumers and environment from low-quality products and services, promote growth of competitiveness of entrepreneurs and reliability of products and services provided by Latvian entrepreneurs;
- Improvement of the informative and consultative base in order to inform inhabitants of Latvia on the recent national requirements and requirements of EU normative acts;
- Participation of national institutions of accreditation, standardisation and metrology in international organisations, ensuring their international recognition and compliance of the Latvian quality assurance system with international requirements;
- Maintenance and international comparison of the national base of standards in order to ensure the necessary traceability of measurements and protect the society from inaccurately conducted measurements;
- Encouraging introduction of quality management system, environmental and other voluntary quality systems in enterprises in order to ensure manufacturing of higher-quality products and provision of higher-quality services as well as competitiveness of Latvian companies in international markets;
- Improvement of market surveillance system in order to provide equal conditions for all market participants and protect consumers from actions performed within unfair competition of entrepreneurs.

In order to improve the legislative, informative and consultative base as well as the infrastructure of the conformity assessment system, it is planned to carry out the following activities in 2007:

- to improve the Latvian conformity assessment system, at the same time making the necessary changes in normative acts;
- to inform the society about topicalities in the field of quality assurance on a regular basis in order to raise society’s awareness of quality assurance issues;
- to organise the annual National Accreditation Conference in co-operation with the state agency “Latvian National Accreditation Bureau” in order to promote confidence in accredited institutions of conformity assessment;
- to organise the annual international quality conference and the Latvian Quality Award 2006 in co-operation with the Latvian Association for Quality in order to popularise the quality assurance as a way for raising the business competitiveness.

**Box 6.23****Measures of quality structural policy in 2006 and 2007**

In order to foster development of Latvian national economy, the following activities were carried out in 2006:

- transition to notification of conformity assessment institutions accredited in the regulated sphere to the European Commission and other EU member states in the electronic form, using the "Nando-input" database. Thus it will be possible to notify and receive information about changes in the list of conformity assessment institutions notified on the basis of the New Approach directives more operatively;
- regulations of the measuring instruments subject to the state metrological control have been drafted in accordance with requirements of the Law "On Uniformity of Measurements" and the Law "On Conformity Assessment" in order to harmonise the national legislation with requirements of EU legal acts;
- meetings of Latvian national accreditation, standardisation and metrology councils have been organised;
- the informative report about solutions corresponding to EU law in regard to transposition of lapsed standards included in EU legal acts and transposition of standards developed by ASTM and other standardisation organisations, which are impossible to translate into Latvian at present, has been worked out;
- publication of Latvian conformity assessment institutions in "Latvijas Vēstnesis" (official newspaper) and their notification to the European Commission and EU member states as well as publication of EU conformity assessment institutions in "Latvijas Vēstnesis" in accordance with requirements of the Law "On Conformity Assessment" have been ensured;
- supervision of measuring instruments offered in the regulated sphere in the market in accordance with requirements set in normative acts has been ensured;
- participation of national accreditation, standardisation and metrology institutions in working groups and conferences of international organisations has been ensured in order to shape unified conformity assessment policy throughout the EU, *inter alia* protecting interests of Latvia.

Success of organisations in the market of free competition greatly depends on successful management of company. Management systems and voluntary standardisation and certification is an instrument for promotion of competitiveness. In Western economy, quality management has been a fundamental driving force and motivation basis of entrepreneurship for the last 40 years. Quality is an argument necessary to convince consumers about excellence of products and services of the company. Quality is a guarantee that consumers will return again and again. High-quality entrepreneurship is based on reputation for excellence. For a company that has decided to keep up with the rapid rhythm of life and survive in conditions of market competition, one alternative to improve quality of its work is to create a management system oriented on quality and development and improve it continuously.

In conditions of modern economy, raising awareness of entrepreneurs and society about quality assurance issues and introduction of quality systems in companies is voluntary, hence the measures deriving from state policy in the field of quality assurance are mainly conducive with an implicit influence on competitiveness of entrepreneurs and oriented on improvement of the hitherto operation.

Latvian entrepreneurs and society on the whole has little awareness of what added value is provided by quality assurance (standardisation, conformity assessment, quality management systems, methods, methodologies, etc.) in promotion of competitiveness and economic growth on the whole. Quality management is perceived as an isolated and separate sphere. Such lack of awareness does not allow entrepreneurs to evaluate and practically use competitiveness promotion instruments that are popular in the world and bring results (self-appraisal of company, quality management systems, etc.). Society lacks information on expedience and potential of quality assurance. This seriously hinders integration of the economic environment of the country in the common European space.

A comparatively small number of companies in Latvia know about the Excellence Model, and even smaller number of companies use self-appraisal for improvement of their operation. This is confirmed by the Quality Award competition organised by the Latvian Association for Quality (LAQ). Analysis of company applications for this competition shows that 10 companies on average apply every year.

Other progressive quality management methodologies, such as Six Sigma, Lean Manufacturing, transformation, use of statistical analysis methods for analysis and improvement of operation are appraised even lower.

Six Sigma methodology was used by no Latvian company up to 2005, only few of them used Lean Manufacturing, and only some companies used statistical analysis methods for analysis and improvement of operation. These factors directly affect competitiveness of Latvian companies both in the local market and in foreign ones.

In view of the fact that the number of certified companies is one of the most assessed and most available indicators in the world, analysis of the database of companies certified in Latvia was carried out. Certification of companies in accordance with ISO 9001:2000 quality management system standard, ISO 14001 environmental management system standard, HACCP (Hazard Analysis and Critical control points) food safety standard, and

OHSAS (Occupational Health and Safety Management System) labour environment and safety standard keeps growing. This is one of the indicators that clearly demonstrate the situation in the area of quality assurance in the country. Certification trends in Latvia were analysed in order to forecast further trends in development of management systems and successfully find the factors affecting these trends.

By the end of 2005, 747 certificates have been issued in Latvia, which certify conformity with some of the international management system standards – ISO9001, ISO14001, OHSAS18001 or HACCP DS3027.

Opportunities offered by European funds both for introduction of quality management systems and for training of employees are not very actively used at present. Merely some dozens of companies have used the opportunity to introduce quality management systems through use of the funds. This is explicable by the fact that companies are insufficiently motivated to invest resources in introduction of quality management systems and by insufficient information.

### **6.12.2. Standardisation, Metrology, Accreditation**

**Standardisation.** The limited liability company “Latvijas standarts” (LVS) is the national standardisation institution in Latvia and operates according to provisions of the Standardisation Law.

The main functions of LVS are as follows:

- set up the national set of standards by organising development of Latvian national standards and adaptation of international and regional standards at the status of national standards;
- issue Latvian national standards, maintain the informative base of standardisation documents and distribute information of standardisation;
- participate in work of international and regional organisations of standardisation and ensure regular co-operation with EU institutions.

Since 2004, LVS is a full-fledged member of the European Committee for Standardisation (CEN) and 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).

#### **Box 6.24**

##### **Activities of standardisation organisations in 2006**

In 2006, LVS held the following internationally important standardisation work activities – meetings of CEN TC:

- CEN/TC 286 “Liquefied petroleum gas equipment and accessories”;
- CEN/TC 165 “Waste water engineering”;
- CEN/TC 176 “Heat meters”;
- CEN/BT/TF 180 “Services of real estate agents”;
- CEN/TC 252 “Child use and care articles”;
- CEN/TC 256 SC 1 „Railway applications”.

At meetings of the committees, issues on drafting new sectoral standards were examined, reports on work performed since the previous meetings were given, and participants had an opportunity to get information on topicalities in the respective sectors. These organisationally labour-consuming activities were held in co-operation with the respective standardisation technical committees of LVS, concerned sectoral ministries and professional associations.

In November 2006, members of the CEN Technical Board (CEN/BT) from national standardisation organisations of Scandinavian and Baltic states met at LVS. CEN/BT manages standard development programmes and encourages their fulfilment. Representatives from Norway, Sweden, Finland, Denmark, Estonia and Latvia as well as the Standardisation Director of CEN took place at the meeting. Agenda of the meeting contained issues on:

- situation in national standardisation organisations;
- national identifiers on European standards;
- references to national standards in EU directives;
- desirable transformation of the internet site of CEN, making it easier to use;
- stages of formal vote and poll in European standard voting procedures.

Among the examined issues of the agenda, the issue on direct references to national standards in EU directives is especially important; Latvian legislation prescribes compulsory translation of these standards into Latvian language. In order to foster solution of this problem, it was decided to include the issue into agenda of the next CEN/BT meeting in December of this year.

This year, the co-operation activity of national standardisation organisations of the Baltic states – the annual Baltic Standards Forum (BSF) – was organised by Lithuanian Standards Board (LST). Agenda of the plenary session of the meeting contained reports on work done by national standardisation organisations since the previous BSF in 2005, and topical issues of standardisation work were also discussed.

Wider information about LVS, Latvian national standards and technical committees of standardisation is available on the website <http://www.lvs.lv>.

In order to develop national standards and adapt international and regional standards at the status of Latvian standard, 42 technical committees of standardisation have been set up and operate in various national economy sectors with wide participation of those organisations of producers, users, consumer interest protection, certification, testing, accreditation, control and supervision, which are interested in establishment of certain standards. New working group of standardisation LVS/DG 03 "Precious metals – their application in jewellery and related products" was founded in June 2006.

20 744 standardisation documents were registered by LVS by November 1, 2006, of which 18 437 standards at the status of Latvian national standard, among them 17 390 EU standards were adapted. 1422 European standards and 59 international standards were adapted in 10 months of 2006.

Since the beginning of 2006, standardisation information services have been provided to 6546 legal and physical persons. Automatic information notification system provides a free service to customers, namely, the "Monthly Report on Standards Registered at the Status of Latvian Standard and on Abolished Latvian Standards" in the areas indicated by the customer.

2006 is also important because LVS joined those national standardisation organisations of CEN, which undertake to hold meetings of CEN Technical Committees (CEN TC) (see Box 6.24).

**Metrology.** In accordance with amendments to the Law "On Uniformity of Measurements" and the Cabinet of Ministers Instruction No. 573 of August 1, 2006, a new state agency Latvian National Metrology Centre was established as from August 1, 2006; its main tasks are maintenance of National standards, reproduction of measurement units and calibration of measuring instruments.

In 2 months of operation, the action plan for 2006 was developed and the following activities were carried out:

- in the field of electric measurements:
  - calibration method in measurements of resistance values was improved, carrying out drift measurements of D.C. measuring bridge UMIS-2M of electric resistance standard;
  - equipment of uninterrupted power supply was installed for time standard;
- in the field of geometric measurements:
  - participation at the annual 18<sup>th</sup> conference of EUROMET Technical Committee Length section and the following seminar on topical issues of length measurements;
  - participation in EUROMET Key comparison projects was evaluated and the evaluation "executive" received for measuring tapes (L-S14 project 677) and for length measures (L-K2 project 602);
  - calibration of seven measuring instruments for a part of geometric measurements was carried out in accordance with schedule;
- in the field of mass measurements:
  - participation in international inter-laboratory comparison project "Intercomparison of balances" No. VM1-2006 "Metrosert" in Tartu, Estonia;
  - analysis and addition to inter-laboratory comparison project EUROMET 832 "Calibration of 50 kg mass standards";
  - intercomparison of national mass standards before calibration in DFM institution (in Denmark), at the same time carrying out a proficiency test (in testing of standard counterweights of 1 mg to 1 kg);
  - preparation of equipment and selection of appropriate method, preparing for inter-laboratory comparison project organised by MIKES (Finland) (in calibration of 500 kg standard counterweights).

**State metrological supervision.** In accordance with amendments to the Law "On Uniformity of Measurements", as from August 1, 2006 the metrological supervision in the country is carried out by the Consumer Rights Protection Centre (CRPC) in order to ensure accuracy and credibility of measurements in the areas that affect human life and health, environmental health and safety as well as consumer rights protection.

CRPC controls and supervises compliance with requirements set in normative acts of measuring instruments offered in the market in the regulated sphere as well as performs state metrological supervision of measuring instruments handed over for use and metrological control of pre-packed goods in line with the Law "On Uniformity of Measurements". Ensuring that the actual content of a package of "e"-marked pre-packed goods produced in Latvia conforms to requirements of the respective EU directives and related national legal acts requires periodic and efficient control in enterprises producing

pre-packed goods. CRPC officials are authorised to draw up reports regarding administrative violations and impose administrative penalties for non-observance of metrological requirements.

In 9 months of 2006, the State Metrological Inspection has carried out inspections in 1274 enterprises, subjecting 23.6 thousand measuring instruments to the state metrological supervision. Control of pre-packed goods was performed in 52 enterprises.

CRPC constantly co-operates with metrological supervision institutions of other countries and takes part in working groups WG4 "Legal Metrology", WG5 "Metrological Supervision" and WG8 "Implementation of Measuring Instruments Directive 2004/22/EC" of the European Co-operation in Legal Metrology (WELMEC).

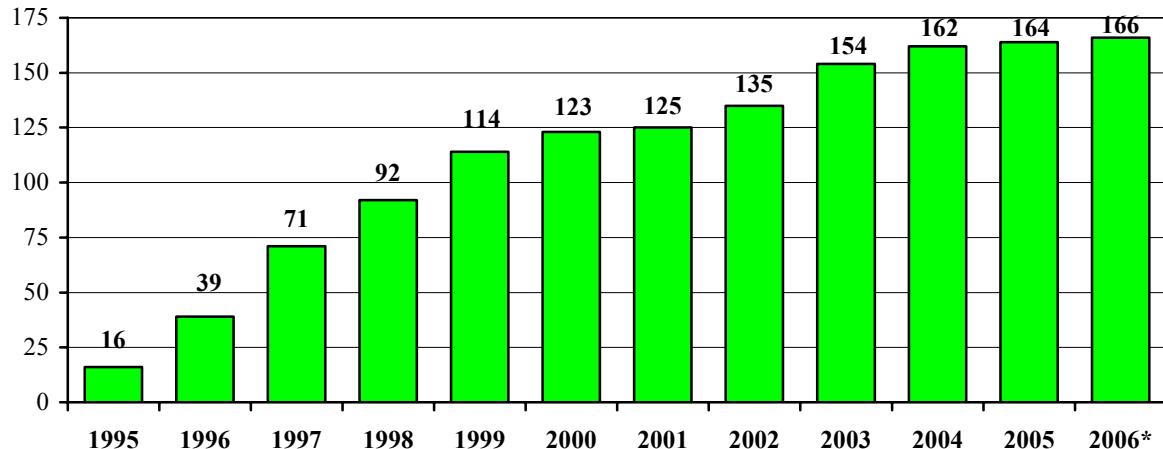
**Accreditation.** The state agency Latvian National Accreditation Bureau (hereinafter LATAK) is a public administration institution under supervision of the Ministry of Economics of the Republic of Latvia, which ensures operation of the national accreditation system.

The Cabinet of Ministers has approved the statute of LATAK, prescribing the following functions of the agency:

- to evaluate, accredit and supervise testing and calibration laboratories and certification and inspection institutions in conformity with the prescribed requirements of Latvian national standards and normative acts as well as European or international standards;
- to organise and co-ordinate inter-laboratory comparative testing in compliance with Latvian, EU and international requirements;
- to represent Latvia at international accreditation organisations;
- to maintain and update the informative base of accredited institutions.

Figure 6.11

#### Development Dynamics of the National Accreditation System



\* as of November 1, 2006

166 accredited laboratories and certification and inspection institutions are supervised by LATAK as on November 1, 2006. Increase in the number of accredited institutions is small in recent years because optimisation of the work of testing laboratories has been carried out in the country and, as a result of reorganisation, the legal status of several institutions has changed.

LATAK provides accreditation services in Ukraine where 2 institutions are supervised by the agency.

Fulfilling functions of methodical management of assessors, LATAK has organised 7 training seminars for LATAK assessors and experts, co-ordinated 2 inter-laboratory comparative testing programmes and organised 14 bilateral proficiency tests.

In 2006 LATAK participated in several committees: the European Co-operation for Accreditation (EA) Laboratory Committee, session of Multilateral Recognition Agreement (MLA) committee, EA Committee on Laboratory Medicine, EA Inspection – Certification Committee (EA IC/CC), EUROMET-EUROCHEM Technical Committee, and the working session for establishment of the Centre for Intercomparison (CFI).

Wider information about LATAK, accreditation procedures and accredited institutions is available on the website <http://www.latak.gov.lv>.

## 6.13. Privatisation

On September 1, 2005, the Law on Completion of the State and Local Government Property Privatisation and Use of Privatisation Certificates (hereinafter Privatisation Completion Law) came into force. This law prescribes how to complete the privatisation process and land reforms and ensure completion of the use of privatisation certificates.

The Privatisation Completion Law determines:

- 1) the term of August 31, 2006 by which every legal or physical person may propose to bring any state or local government property to privatisation;
- 2) the procedure how the privatisation proposal submitted by the person is reviewed and decision is adopted to bring the state or local government property to privatisation;
- 3) that privatisation may be denied and the property maintained in possession of the state or local government if the property is necessary for implementation of public administration functions or commercial activity of the central or local government;
- 4) that the Cabinet of Ministers or a local government may take decisions on bringing the state or local government property to privatisation by February 28, 2007;
- 5) that the state joint stock companies "Latvenergo", "Latvijas pasts", "Starptautiskā līdosta "Rīga""", "Latvijas dzelzceļš", "Latvijas gaisa satiksme" and "Latvijas valsts meži" will not be privatised or alienated;
- 6) the terms by which the persons willing to redeem land allocated for permanent use have to submit land redemption application (August 31, 2006) or by which the land boundary plan or confirmation of the land redemption payment done in privatisation certificates before conclusion of the land redemption contract has to be submitted to the State Land Service (September 1, 2008);
- 7) that privatisation certificates do not have an expiry term but may be only used in the framework of privatisation process;
- 8) the procedure of ending the issuance of privatisation certificates. The final term of April 28, 2006 is set for persons, by which they can submit application for privatisation certificates.

In order to ensure successful and open progress of privatisation completion processes, the Cabinet of Ministers has set the procedure of how the institutions conducting privatisation and land reform have to establish publicly available registers of privatisation proposals and land redemption.

After completion of privatisation process and land reform, it will be possible to sell a central or local government property in compliance with the Law on Alienation of State and Municipal Property and the Law "On the State and Local Government Capital Shares and Capital Companies", which include the market-regulated condition to sell to the person offering the highest price and using Latvian national currency lat as a means of payment. Selling a state or local government property, the general pre-emption rights of a person prescribed by the Civil Law have to be observed.

### **Privatisation of state property**

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".

Decision to bring state-owned property unit (including capital shares) or vacant land plot to privatisation is taken by the Cabinet of Ministers, while the decision to bring built-up land plot (on which there are buildings owned by other person) to privatisation is taken by the Privatisation Agency. The decision is taken on the basis of privatisation proposal submitted by any physical or legal person.

595 proposals for privatisation of real estate, 57 proposals for privatisation of state capital shares and 3973 proposals for privatisation of land plots have been received and registered by the Privatisation Agency from September 1, 2005 (when the Privatisation Completion Law came into force) till August 31, 2006.

A physical or legal person eligible to acquire a movable or immovable property in Latvia can be the subject in privatisation of state-owned property (real estate, capital shares, land). Payments for the property units have to be done in lats (LVL) and/or privatisation certificates.

From April 17, 1994 till October 1, 2006, privatisation rules have been approved in the statutory procedure for 2202 state property units (except land). 94 companies were transformed to public joint stock companies, putting 439.14 million shares into public circulation. The total sale price for state property units (except land) sold for lats and privatisation certificates was LVL 1.75 billion, including LVL 1.262 billion for privatisation certificates. New owners took over obligations of privatised state

companies (enterprises) for more than LVL 185.1 million. The amount of the specified investments was LVL 130.1 million, while the amount of investments actually invested reached LVL 253.8 million.

Privatisation Agency carries out privatisation of state-owned lands since 1997. 3769 state-owned land plots with the total area of 5804.4 hectares were privatised (purchase agreements signed) by October 1, 2006. Total sale price for the privatised state lands reached LVL 118.38 million, including LVL 22.83 million in cash and LVL 95.55 million in property compensation certificates.

#### **Privatisation of local government property**

Decision concerning real estate owned by a local government is taken by the council of the local government (city, amalgamated local government, rural municipality). The decision is taken on the basis of a privatisation proposal submitted by any physical or legal person.

A physical or legal person eligible to acquire a movable or immovable property in Latvia can be the subject in privatisation of local government property (real estate, capital shares, land). Payments for the property units have to be done in lats 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, amalgamated local government).

Compliance of privatisation projects, rules and announcements approved by a local government with provisions of the Law "On Privatisation of Property Units Owned by the State and Local Governments" and the Privatisation Completion Law is ensured by the Ministry of Economics.

From February 17, 1994 till October 1, 2006 the Ministry of Economics has reviewed and accepted for information 2977 privatisation projects for the total relative price of LVL 94.7 million (including payments in certificates for the nominal value of LVL 56.2 million).

From January 1, 1997 till October 1, 2006 the Ministry of Economics has reviewed and accepted privatisation rules in respect of 1549 built-up and vacant local government lands with the total value of LVL 18.8 million (of which LVL 12.5 million have to be paid in property compensation certificates).

Pursuant to Item 7 of Article 5 of the Privatisation Completion Law, after August 31, 2006, local governments shall quarterly submit data to the Ministry of Economics, regarding the received privatisation proposals for municipal property units and built-up and vacant land plots, decisions on bringing these property units and land plots to privatisation, the sale price and the amount of privatisation certificates to be used for payment.

#### **Privatisation of apartment houses**

Privatisation of apartment houses in Latvia was started in 1995. By September 30, 2006 the Central Apartment Houses Privatisation Commission (renamed as the state agency "Mājokļu aģentūra" (Housing Agency) as from January 1, 2004) and apartment privatisation commissions of the respective local governments have prepared and put up for privatisation in the procedure laid down in the Law "On Privatisation of State and Local Government Apartment Houses" 28 603 state and local government apartment houses with 493 927 apartments or 99.25% of the total number of apartments (497 655). 194 149 apartments have been handed over to private owners by a resolution preceding privatisation of the apartment house.

There are 418 156 state and local government apartments privatised (purchase agreements signed or handed over to private owners preceding privatisation of the apartment house) in Latvia by September 30, 2006, making up 84.03% of the total number of apartments. Apartment owners so far have taken over management of 8847 apartment houses, including 5417 local government apartment houses and 3430 state-owned apartment houses, where more than 50% of apartment properties have been privatised.

Owners of privatised apartments can decide themselves on the most acceptable form for management and maintenance of their apartment house: either organise a co-operative society of apartment owners (CSAO) or sign an authorisation agreement for management of the house. As a result of this process, 337 CSAOs have been founded in Latvia, among them 229 in seven biggest cities and 108 in districts of Latvia. The biggest number of CSAOs has been founded in cities of Riga and Ventspils and in Kuldīga and Valmiera districts. Authorisation agreements for house management have been signed for 2666 apartment houses.

#### **Land reform**

State land reform includes restoration of property rights, privatisation of state and local government land properties and allocation of free land cognisable to the state for permanent use, and redemption of the allocated land. Land redemption and privatisation of land plots is being carried out in relation to the rural and urban land reform that is under way in the country. The reform of the rural and

urban land cognisable to the state is close to completion. According to data of the information system of the Real Estate State Cadastre, 954 000 land units are registered in the country, of which approximately 632 000 or 66.3% are recorded in the Land Register.

Allocation of urban land for use to apartment house owners or orchard users who received the land for laying out an orchard with building rights is over and urban land commissions have reviewed conclusions concerning rights to acquire ownership of land for payment but, in accordance with the conclusions made, conclusion of purchase agreements is continuing in compliance with the Cabinet of Ministers Regulation No. 171 "On Calculation of Compensation for Former Landowners or their Heirs and on Setting Fee for Urban Land Given into Ownership" of May 6, 1997. SJSC "Latvijas Hipotēku un zemes banka" (Mortgage and Land Bank of Latvia) has signed a total of 69 223 agreements (1353 agreements in three quarters of 2006).

Allocation of free (unclaimed) rural land cognisable to the state for permanent use, i.e. until June 1, 2006, and submission of redemption claims to the State Land Service for redemption of rural land allocated for permanent use, i.e. until August 31, 2006, have been finished. After submission of a redemption claim, the State Land Service verifies the claimant's rights to acquire ownership of land. If the claimant is entitled to redeem land, the State Land Service includes this land redemption claim into the Rural Land Redemption Register. By September 1, 2008, claimants included in this register have to submit a land border plan registered in the information system of the Real Estate State Cadastre or, in the procedure set by the Cabinet of Ministers, a confirmation of land redemption payment in privatisation certificates before conclusion of land redemption agreement to the respective regional bureau of the State Land Service.

The State Land Service has received a total of 53 700 claims for more than 86 000 land units with the total area of more than 346 000 hectares. Review of the submitted claims is completed and decision on the rights to redeem land was adopted for 75 000 land units or 87% of the claimed land units with the total area of more than 299 000 hectares. Denial of land redemption was adopted for 1370 land units or 1.6% of the claimed land units with the total area of 8400 hectares. Until review of land redemption claim and adoption of decision and receipt of lacking documents, adoption of decisions is postponed for 8970 land units or 10.4% of the claimed land units with the total area of 36 000 hectares. Transfer of ownership of rural land for pay and conclusion of land purchase agreements with the SJSC "Latvijas Hipotēku un zemes banka" are continued. SJSC "Latvijas Hipotēku un zemes banka" has signed a total of 273 400 agreements (6155 in three quarters of 2006) for sale of 1.550 million hectares of land (32 562 hectares in three quarters of 2006).

Pursuant to Article 16 of the Law "On Completion of Land Reform in Rural Areas", submission of claims for restoration of property rights of former owners or their heirs for the free (unclaimed) state land to the Central Land Commission is continued. According to data of the information system of the Real Estate State Cadastre, 3600 land units with the total area of 5900 hectares were registered as free (unclaimed) state land as of November 2006. It must be noted that buildings exist on 1900 land units with the total area of 2500 hectares.

### **Privatisation certificates**

Privatisation certificate is a state-issued dematerialised security that can be used only once as means of payment for the state or local government property to be privatised.

Privatisation certificates are issued and used according to the Law "On Privatisation Certificates". By October 1, 2006 a total amount of 103.9 million certificates have been issued to 2.45 million people for the time they had lived in Latvia, including 793.7 thousand certificates granted to 41.2 thousand politically repressed persons. 7.96 million property compensation certificates have been issued to 116.5 thousand former owners or their heirs, including 691.7 thousand certificates for property appropriated for state needs at the privatised specialised state agricultural enterprises, 4869 thousand for land in rural areas, 959.5 thousand for house ownership, 809.5 thousand for urban land, 460.8 thousand for companies and other property units, 89.8 thousand for property taken away from politically repressed persons, and 83.5 thousand for property alienated in illegal manner.

In three quarters of 2006, a total of 101.7 thousand property compensation certificates have been granted to 1.8 thousand former owners or their heirs.

By October 1, 2006, in accordance with the limitation period set in Item 5 of Article 27 of the Law on Completion of the State and Local Government Property Privatisation and Use of Privatisation Certificates, 55.8 thousand persons lost their rights to transfer certificates to the account.

According to the Law "On Privatisation of Land in Rural Areas", 11 073 decisions have been made by October 1, 2006 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 8412 persons, cancelling 0.62 million property compensation certificates.

Cash compensations in the total amount of LVL 4.39 million were paid to 25.3 thousand politically repressed persons as payment for privatisation certificates by October 1, 2006.

104.10 million certificates or 93.1% of the total number of issued certificates have been used for privatisation of state and local government property units by October 1, 2006 (see Table 6.7).

As on October 1, 2006 a total amount of 2.49 million certificates or 2.2% of the total number of issued certificates, including 0.22 million compensation certificates, were on accounts of 409 thousand physical persons.

As on October 1, 2006, accounts of legal persons held 3.14 million privatisation certificates or 2.77% of the total number of issued certificates, including 0.05 million property compensation certificates.

Table 6.7

#### Use of Privatisation Certificates (by October 1, 2006)

Type of property	Number	Number of privatisation certificates (million)	incl. property compensation certificates (thousand)
Apartment houses	426 thousand privatised housing units	36.94	589.8
Companies and other properties	accurate data not available	7.14	109.6
Capital shares (stocks) including: in a public offering	accurate data not available 128.7 million shares	44.43 37.14	954.0 820.0
Land	280 thousand land plots	15.59	5355.4
<b>Total:</b>		<b>104.10</b>	<b>7008.8</b>
% of total certificates issued		93.1%	88.0%

In October 2006, holders of privatisation certificates could use services of 19 licensed intermediary capital companies for transactions in the market of privatisation certificates. Total monthly transactions with privatisation certificates (buying from physical persons and selling) carried out by intermediary capital companies in three quarters of 2006 fluctuated from 0.14 million certificates in April to 0.47 million certificates in August.

## 6.14. Public Private Partnership

Public private partnership (PPP) is a co-operation between a state or local government institution and a partner from the private sector whereby a public service or object is being transferred over to the private entrepreneur for a certain period of time and certain conditions on the basis of agreement in order to ensure public services and attract resources of the private sector. It is essential to note that the terminology used for characterisation of partnership processes is not standardised. European Community law currently provides no special definition of PPP and only gives a general explanation of PPP. The European Commission classifies PPPs<sup>1</sup> as:

- purely contractual PPPs (DBFO type contracts and concessions), if co-operation between the public institution and the private partner is based on a long-term contract;
- institutionalised PPPs (joint entities), if co-operation between the public institution and the private partner is carried out within a joint entity.

Frequently used PPP models are:

- joint contract of design, building, financing and operation or the DBFO type contract – the private partner designs, builds, finances and operates the object or provides service, receiving an annual payment of the public sector for duration of the contract. DBFO type projects may be with various modifications, e.g., BFO type projects (from Build-Finance-Operate) if the

<sup>1</sup> EC Green Paper on PPPs and Community Law on Public Contracts and Concessions, 30.04.2004

public sector has already developed the technical project and the private partner is only attracted to build, finance and operate the object. In the case of RFO type projects (from Renovate-Finance-Operate), the private partner renovates some existing object of the public sector, e.g., a school or kindergarten, finances 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 PPP project should ensure gains not only for the public partner but also for the private one who must be ready to undertake implementation of the project. From entrepreneur's standpoint, involvement in projects of such type means wider business opportunities and predictable 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 means to choose the most economically advantageous solution that not always is the solution with the lowest costs. Thereby, in the case of every new PPP project, it would be required to conduct financial and economic calculations and, within their framework, to determine which model of project implementation (i.e., traditional procurement or PPP) will give the biggest value for the invested finances. Similar approach is used in every EU member state that implements sound PPP policy. Thereby, assessment of project's VFM in public investment projects is very essential component of initial assessment of the project. Global practice proves that medium savings through implementation of investment project in PPP form makes up to 20%, besides, PPP projects are more frequently implemented within the planned budget and time;
- Risk management of PPP. In PPP projects, the public partner shares risk with the private partner who can better manage many substantial project risks;
- Observance of responsible budget discipline. In many cases, implementation of PPP project is linked with long-term obligations of the public person, which in turn is related to observance of fiscal discipline.

### **Institutions involved in the public private partnership process**

The Ministry of Economics is the leading public administration body that develops the PPP policy and co-ordinates its implementation. Main goals of the Ministry of Economics in PPP sphere are:

- elaborate proposals for improvement of the legal and methodological base of PPP;
- co-operate with Latvian, EU and other international and foreign bodies on PPP policy issues;
- identify potential PPP projects;
- co-ordinate activities of state, local government and private sector in the area of PPP.

Latvian Investment and Development Agency (LIDA) is responsible for implementation of PPP projects, working out proposals for promotion of PPP development and supporting development and implementation of respective projects as well as provision of informative, consultative, legal and other public services on this issue to state and local government bodies as well as natural and legal persons.

Along with the Ministry of Economics and LIDA, there are other institutions related to PPP, e.g., the Cabinet of Ministers, in pursuance of the Public Procurement Law, adopts decision on conclusion of PPP service agreements for up to 30 years; the Ministry of Finance (responsible for the influence of PPP projects on the state budget and debt); line ministries and local governments, which are implementers of PPP projects and have a substantial influence on opportunities for usage of PPP.

### **Most important normative acts regulating public private partnership**

- Concessions Law (in force as from February 16, 2000);

Taking into account that new directives of the European Parliament and of the Council have been adopted, namely, *Directive 2004/17/EC co-ordinating the procurement procedures on entities operating in the water, energy, transport and postal services sectors*, and *Directive 2004/18/EC on the co-ordination of procedures for the award of public works contracts, public supply contracts and public service contracts*, the Ministry of Economics has worked out new draft Concessions Law that envisages to create more favourable environment for attraction of private capital in order to ensure public infrastructure and services as well as

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<sup>1</sup> Value for money

- more transparent and equal procedure for the award of concessions. The draft law was approved by the Saeima in the 2<sup>nd</sup> reading;
- Public Procurement Law (in force as from May 1, 2006) prescribing that DBFO and other PPP agreements not regulated by the Concessions Law may be concluded for up to 30 years;
  - Cabinet of Ministers Regulation No. 700 “On the Procedure of Registration, Recording and Control of Concession Agreements” of August 10, 2004 (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) was approved by the Cabinet of Ministers on April 16, 2002. It envisaged to create the Concessions Division at the Ministry of Economics and expand the competence of LIDA by including PPP issues;
  - PPP Policy Framework Document 2005-2009, approved by the Cabinet of Ministers on March 23, 2005. They determine the basic principles and targets of PPP policy and indicators of their attainment;
  - Action Plan for Implementation of the PPP Policy Framework Document, for 2006-2009, approved by the Cabinet of Ministers on November 16, 2005. It sets the following lines of action for PPP promotion:
    - Co-ordinated activity of institutions and organisations involved in the PPP process (establishment of Advisory council of PPP, etc.);
    - Examination of PPP by sectors (to conduct analysis of national economy sectors from the standpoint of PPP);
    - Creation of instruments promoting the PPP process (development of methodology and standardised documentation);
    - Alignment of the legislative framework (development of the Concessions Law in compliance with requirements of EU directives);
    - Improvement of the knowledge and understanding of PPP (creation of a unified PPP website, organisation of informative seminars).

### **Implementation of the public private partnership policy**

Implementation of PPP mechanism in Latvia has been initiated by the Ministry of Economics (from September 2003) and LIDA (from the beginning of 2004) in two directions:

1. Activities related to the expansion of understanding of PPP , among them:
  - consulting the knowledge on PPP to a wider society;
  - development of methodical support;
2. Activities on PPP project level; – provision of advisory support to the owners of potential PPP projects, informing them about:
  - the applicable type of PPP transaction;
  - the applied conduction of procurement procedure;
  - financial and economic calculations and procedures for performing those;
  - the possible legal solutions of the project agreement;
  - other PPP issues.

Important role in PPP promotion is underlined by the programme “Promotion of Public Private Partnership” co-financed by the bilateral financial instrument of the Norwegian government. Main goal of the programme is to support state and local government institutions in their efforts to implement consistent and well-founded PPP approach to development of infrastructure and public services. The following activities will be supported in the framework of the programme:

- development of the technical and economic justification of PPP projects (VFM analysis);
- development of competition documents of PPP projects, among them drafting PPP agreement for projects that have VFM in case of PPP co-operation in accordance with the conducted survey.

Co-financing of the programme from the bilateral financial instrument of the Norwegian government is EUR 1.8 million. Two open tenders are planned in the framework of the programme – in the middle of 2007 (in the amount of EUR 0.8 million) and in the middle of 2008 (in the amount of EUR 1 million). Implementation of the projects has to be completed by April 30, 2011.

The most topical PPP projects to be implemented in Latvia are characterised in Box 6.25.

**Box 6.25****PPP projects in Latvia**

The following PPP projects are currently being implemented in Latvia:

- on July 11 of this year, the Cabinet of Ministers (Protocol No. 37, Paragraph 17) gave permission for Ogre municipality council to conclude service agreement on management of Art School in Ogre, Brīvības Street 11 with the winner of the procurement procedure for 15 years. On July 28 of this year, Ogre amalgamated municipality council concluded PPP agreement with LLC “JS&J Ūdensmeistars” on renovation and management of Ogre Art School;
- at present, LIDA has developed legal documentation (draft competition statute and draft agreement) for PPP pilot project “*Reconstruction of heat supply system in Jēkabpils*” (concession) and PPP pilot project “*Construction of new pre-school educational establishment in Cēsis*” (BFO), which will serve as a base for preparation of standardised procurement documentation for further PPP projects;
- on September 12 of this year, the Cabinet of Ministers (Protocol No. 47, Paragraph 34) reviewed and approved the draft Cabinet of Ministers instruction “Informative report on action plan for construction of new pre-school educational establishments” submitted by the Ministry of Economics. On the basis of this protocol, the Ministry of Economics in co-operation with the Ministry of Finance and Ministry of Regional Development and Local Government prepares report to the Cabinet of Ministers about options of financing construction of new pre-school educational establishments, determining whether usage of PPP for public administration in the certain situation is more useful than the use of public (traditional) procurement, as well as explores the normative acts that hinder implementation of PPP;
- Cabinet of Ministers Instruction No. 816 “On the Concept “Construction of a motorway in the segment Riga ringroad-Sēnīte of the main state road A2 on the E77 route”” of October 20 of this year approved the proposals submitted by the Ministry of Transport and Communications on the first construction of a motorway by usage of PPP model, transferring over design, construction, financing and operation to the private partner. Contractual relations between the Ministry of Transport and Communications and the private sector’s enterprise will include long-term obligations of the public sector in the form of annual payments after completion and commissioning of the object and will last 20 years. Calculated construction costs of the project are approximately LVL 100-110 million but implementation of the PPP agreement may affect the state budget deficit only in the amount of annual access payments after commissioning of the object, which would amount to approximately LVL 12 million annually;
- on December 27, 2005, the Cabinet of Ministers (Protocol No. 77, Paragraph 47) supported the PPP pilot project “Construction of administrative complex of Ventspils City and District Police Department” that will be implemented as a DBFO type project, and it is planned to conclude agreement for 20 years. In November of this year, an agreement on development of the required procurement documentation is concluded with a group of persons (LLC “Forburga”, LLC „Labo namu aģentūra”, LLC „Uzņēmuma vadības institūts” and LLC „Sorainen Law Offices”).
- Cabinet of Ministers Instruction No. 668 “On Concept for Establishment of the National Multifunctional Cyclotron Centre” of August 31, 2006 supported construction of a cyclotron with four irradiation channels, doing financial and economic calculations in order to choose optimal variant of PPP agreement. The Ministry of Environment in co-operation with the Ministry of Economics, Ministry of Education and Science and Ministry of Health, after financial and economic calculations, have to prepare conditions for award of concession and submit them to the Cabinet of Ministers by June 1, 2007.

## 6.15. Advisory Councils of the Ministry of Economics

### 6.15.1. National Economy Council

The National Economy Council of the Ministry of Economics (hereinafter NEC) was established in 1999 and operates as an advisory council of the Ministry of Economics.

Founders of the NEC are the Ministry of Economics, Free Trade Union Confederation of Latvia, Employers’ Confederation of Latvia, Latvian Association of Local and Regional Governments, Latvian Chamber of Commerce and Industry, and Industrial Confederation of Latvia.

NEC consists of the Minister of Economics and 21 experts designated by founders of the NEC, including representatives of entrepreneur organisations, University of Latvia, Riga Technical University, public bodies and other organisations. Representatives of the Council of the Small and Medium Sized Enterprises and Crafts of the Ministry of Economics (see Chapter 6.15.2) and of the Foreign Investors Council in Latvia participate in NEC meetings in the status of observers.

NEC meetings are held once per month on average. The meetings are led by the Chairman elected by the NEC Steering Committee (representatives of the NEC founders); the current Chairman is the Chairman of the Latvian Association of Local and Regional Governments Andris Jaunsleinis. NEC invites organisations representing national economy sectors to participate in the meetings as observers.

**Box 6.26****Proposals of the NEC for improvement of business environment**

NEC reviews and monitors settlement of issues and development of draft normative documents, national economy development concepts, state budget and other documents important for development of Latvian economy. NEC prepares proposals and adopts recommending decisions on these issues. NEC carries out a dialogue between entrepreneurs and the Ministry of Economics, Single Economic Strategy and Development Council, and other public institutions and non-governmental organisations.

NEC holds a view that it is necessary to encourage business activity in Latvia, creating favourable environment for business activity, lessening administrative obstacles, stimulating initiative of entrepreneurs, promoting availability of finances, improving business support services system and efficiency, at the same time promoting competitiveness of Latvian companies.

To ensure prosperity in the country, development of business activity is required. Competitiveness of countries and their opportunities to create new workplaces and capability to ensure well-being for their population is greatly determined by establishment of efficient business policy and ensuring business regulation processes (simpler business procedures, easier access to information, lower costs, more comprehensible official demands).

One of tasks of the state is to ensure balanced development of national economy sectors and promote balanced development of regions so that every inhabitant of Latvia irrespective of his residence or profession had all opportunities to fulfil his potential both as entrepreneur and as employee. To achieve this, the state has to implement a very well considered policy that would improve environment favourable to business activity, and this is greatly determined by how much considered the national taxation policy is, by efficiency of infrastructure, educational system and state support, and by how much aligned and stable the business legislation is.

In their daily work, participating organisations of the NEC have identified several provisions governing the corporate income tax and the personal income tax, seen as a hindrance to business development in Latvia and to increase of tax revenues. Experts of the NEC work actively with the Ministry of Finance working group dealing with assessment of the national taxation policy in order to reduce the tax burden on entrepreneurs and enhance business development in Latvia.

Balanced distribution of money through taxation system and efficient administration of taxes and customs are the most important preconditions so that the state could finance broad range of public needs and entrepreneurs would be motivated to honestly meet their legal commitments to the state by investing in business development, introduction of modern technologies and creation of new workplaces. Tax administration requires consistent and constant reforms with the goal to make this system competitive and friendlier to taxpayers.

It is necessary to introduce electronic tax declaration more broadly in Latvia, improving the communication regime between taxpayers and the State Revenue Service, and the State Revenue Service may also digitally prepare draft tax reports, sending them to taxpayers and creating opportunity to change them electronically by a set term.

Important contribution to Latvian national economy is made by small business entities – self-employed persons, individual pieceworkers, and sole proprietors. As self-employed persons mostly are not accountancy or tax specialists and their turnover is relatively small, the state may support this form of business by utmost reduction of the time spent for settlement of tax accounts and payment of various taxes.

Licences and permits enable the state to separately control and supervise business forms characterised by special risks and influence on public safety and health. Precise and clear normative base as well as good access to information on issuance of licences and permits improve entrepreneurs' compliance with requirements of regulating institutions, so it would be expedient for the state to maintain a complete list of licences and permits with all conditions, documents to be submitted, and conformity criteria. It would also be useful to update information on a regular basis about various licences and permits to be received by entrepreneurs in information portals available to entrepreneurs.

State support may be an important business stimulus in cases where asymmetry of demand and supply develops in the market. There is a shortage of easily accessible and cheap financing, deficit of adequately educated and trained workforce arises, or some new but perspective sector of the national economy requires incentive for initial development.

In order to improve efficiency of the support administration system, placing of easily perceptible information on TV, radio, press, internet, websites and preparation of printed material are required in order to explain for entrepreneurs the opportunities to get state support.

Specification of internal procedures of administration bodies and accelerated review of projects, more broadly implementing opportunities for electronic submission and processing of projects, are also required.

NEC has unambiguously expressed the opinion that successful absorption of the EU Structural Funds requires creation of procedures as simple as possible so that maximum number of projects submitted by small and medium-sized commercial companies of Latvia would be implemented.

Entrepreneurs are among the most important "users" of legal acts and most directly face the controlling influence of legislation in their daily work, so it would be necessary for the state to popularise work of business associations as partners in development of legal acts and help raise the capacity of business associations. At the same time it is necessary to improve the dialogue between Latvian entrepreneurs and the state and local governments. One solution may be to hold annual Latvian business forums where the government at the highest level would meet Latvian business organisations and hear out their proposals for improvement of business environment and legal acts.

It would be necessary for the government to pay special attention to the role of regulation policy in promotion and ensuring of national economy competitiveness because after accession to the European Union (hereinafter EU) on May 1, 2004 Latvia as a relatively small market is closely involved in the global market of capital, labour, commodities and services.

Taking into account that Latvia competes with other Baltic and Scandinavian states and other "transition economy" countries for attraction of foreign investment and location of production units of international companies, the way Latvian business environment depends on national policy priorities and strategy of reforms is an important factor.

Looking at the influence of Latvia's accession to the EU on various spheres of business activity, one has to conclude that there are only a few fields where the accession has facilitated entrepreneur work on the whole – transportation of goods across the country border has become easier; access to new sale markets within the EU and access to capital within the EU have also become easier.

**Box 6.26 continued**

In many fields, accession to the EU has complicated rather than facilitated the employer work, e.g., the burden of administrative procedures has become heavier; compliance with labour protection/safety requirements has become more complicated; observance of environmental requirements after Latvia's accession to the EU has become more difficult; competition from other EU countries has become heavier; observance of labour law after Latvia's accession to the EU has become more difficult, and receiving licences and permits has become more complicated.

It is necessary to improve administrative procedures in Latvia, because after accession to the EU an extremely big expenditure of time is required when entrepreneurs solve issues related to regulating requirements and administrative procedures of the state and local governments and acquire new administrative procedures related to application of EU legal acts as well as acquaint themselves with frequently voluminous EU legal acts to be applied directly.

NEC concludes that the business environment on the whole is favourable and the governmental policy of promotion and support to business activity has to be evaluated positively, which is indicated by the rapid development of Latvian economy in the recent years, growth of GDP and increase of economic activity in all sectors; however, it is necessary to improve this further because business activity must be a priority for every government and it constitutes the backbone and driving force of all national economy. Owing to business activity, state budgets get revenues to maintain the state machinery, pay retirement pensions, allowances, grants, ensure health and social care, and finance all activities necessary for all society.

In between the NEC meetings the recommending decisions of the NEC are taken by the NEC Steering Committee, which consists of five representatives of the NEC founders. Work of the NEC is organised by the Secretariat of the National Economy Council.

NEC co-operates with the Saeima, ministries and other public bodies in order to incorporate NEC's proposals necessary for improvement of business environment into normative acts prepared by the bodies.

In order to ensure professional representation of the interests of industries in effective dialogue with the Ministry of Economics, NEC and other business organisations and public bodies, the Ministry of Economics has set up a model of co-operation with industries.

The Ministry of Economics and the NEC have concluded a protocol of agreement on co-operation with the following councils of experts (CE) of industries: CE of Machine Building and Metal Processing Industry, CE of Chemical and Pharmaceutical Industry, CE of Light Industry, CE of Construction Materials Producers, CE of Timber Industry, CE of Food Industry, CE of Construction Industry, CE of Passenger Carrier Industry, CE of Business Education and Management Advisers, CE of Tourism, and CE of Printing and Publishing Industry.

On signing the protocol of agreement, the parties agreed to unite their resources for development of programmatic documents, take measures towards implementation of the economic development and business environment improvement programmes adopted as part of the governmental declaration, and that the councils of experts will assess draft legislative acts worked out by ministries and will issue their opinion thereof.

Co-operation partners believe that an important role in this dialogue is played by the ability of bodies representing the industries to define the pressing problematic issues that need to be addressed as well as by regular meetings joined by the NEC, the Minister of Economics and bodies representing the industries, with the aim to discuss implementation of the co-operation mechanism and the pressing issues.

NEC members and experts work in the following councils, boards, committees and working groups:

- Consultative Board for Development Co-operation Policy Issues at the Ministry of Foreign Affairs;
- Supervision Council of the Lisbon Strategy at the Ministry of Economics;
- Construction Council at the Ministry of Economics;
- Advisory Council on Latvian Tourism at the Ministry of Economics;
- Export Promotion Council at the Ministry of Economics;
- National Standardisation Council at the Ministry of Economics;
- European Union Structural Funds Supervision Committee at the Ministry of Finance;
- Working Group of the European Union Structural Funds Steering Committee at the Ministry of Finance;
- Working group for national taxation policy assessment at the Ministry of Finance;
- Information Society National Council of Special Assignments Minister for Electronic Government Affairs;
- Advisory Council of the Latvian Investment and Development Agency.

NEC members and experts also work in the Single Economic Strategy and Development Council chaired by the Prime Minister of the Republic of Latvia, which is a co-ordinating institution with an aim to ensure implementation of tasks for promotion and better co-ordination of economic development set in the Governmental Declaration on the planned activity of the Cabinet of Ministers, as well as

encourage introduction of principles of sustainable development and promote the process of sustainable development of the country and participation of society in this process.

In the 2<sup>nd</sup> half of 2006, three NEC meetings were held. The following most important issues were discussed at these meetings:

- System of professional education and opportunities to improve it;
- Amendments to the Competition Law;
- Productivity of labour and labour payment relations;
- Opportunities of social partners' participation in development of policy planning documents and directives of the European Commission;
- State budget for 2007;
- Public and private partnership in Latvia.

### **6.15.2. Council of the Small and Medium-Sized Enterprises and Crafts**

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The Council of the Small and Medium-Sized Enterprises and Crafts (hereinafter CSMEC) is an advisory institution of the Ministry of Economics.

CSMEC consists of representatives delegated by 27 non-governmental organisations representing small and medium-sized enterprises (SME) and businessmen (organisations of various sectors of economy and regional organisations of SME). The composition and statutes of the CSMEC were approved by Regulation No. 49 of February 16, 2004 of the Ministry of Economics.

The activity of the CSMEC has an aim to involve the non-governmental organisations of SME and the industry associations into development and implementation of favourable SME business environment policy as well as promote SME development and co-operation and competitiveness of Latvian businessmen in the European Union.

The key functions of the CSMEC are: to review and follow settlement of such issues (draft normative documents, national economy development concepts, state budget and other documents) that are important for development and implementation of favourable SME business environment policy and would promote SME development, as well as prepare proposals and make recommending decisions on these issues; to carry out dialogue between entrepreneurs, the Ministry of Economics, other public bodies and non-governmental organisations as well as international organisations, which affect operation and development of SME.

CSMEC meetings are held once per month on average. Work of the Council of the Small and Medium-Sized Enterprises and Crafts is led by the Chairman elected by the Council.

In between CSMEC meetings, the recommending decisions are taken by the CSMEC Steering Committee that consists of five CSMEC members nominated by participating organisations of the Council. The Business Environment Improvement Division of the Latvian Investment and Development Agency ensures work of the Council and performs functions of its secretariat.

In the 2<sup>nd</sup> half of 2006, seven meetings of the Council of the Small and Medium-Sized Enterprises and Crafts have taken place, where the following most important issues were reviewed:

- on Operational Programmes "Entrepreneurship and Innovation" and "Infrastructure and Services";
- on amendments to the Competition Law;
- on opportunities of small enterprises to participate in public procurement;
- on the planned state support to energy efficiency improvement, combined heat and power generation and thermal energy generation, as well as other opportunities to finance and support such measures;
- on opportunities to absorb financing from EU Structural Funds of the 2007-2013 planning period and other funds and on setting priorities for increase of competitiveness of business activity;
- on attraction of labour force in the Latvian market, etc.

The Council has continued the launched positive and efficient dialogue with institutions representing businessmen as well as with the Ministry of Economics and the public bodies responsible for improvement of Latvian business environment.

A positive trend to be noted is that, through co-operative efforts with the Ministry of Economics, businessmen are invited on a regular basis to assess SME development issues and the draft programming documents shaping SME development policy before their adoption by the government. Proposals for various legal acts and for action plan for improvement of business environment have been developed in

working groups and submitted to the responsible ministries. For example, the Council actively participated in searching solutions for issues related to improvement of taxation policy, preparation of businessmen's project applications and receiving financing from the EU Structural Funds, etc.

On initiative of the CSMEC, an internet portal [www.mazaisbizness.lv](http://www.mazaisbizness.lv) has been set up for small and medium-sized entrepreneurs, which serves as a manual and provides practical information for people willing to launch business activity as well as information necessary for small and medium-sized entrepreneurs about legislative acts and various legal and financial issues and latest developments.

Proposals have been made both for the action plan for improvement of business environment and for measures of promotion of SME development, for example:

- To hold annual "Businessmen's Knowledge Day" with the aim to provide for businessmen a comprehensive information on opportunities of further education and development of human resources in Latvia;
- To prepare manual for businessmen about the available state support and opportunities to attract finances;
- Conducting study about influence of administrative procedures on business activity – study of Latvian regions with the aim to advise what administrative obstacles hinder SME development;
- To hold seminars on opportunities of risk capital and about the influence of funds on business activity, etc.

During the year, comments and proposals for several draft legal acts have also been given, for example, "Regulations on Conditions of Providing Support to Small and Medium-Sized Commercial Companies and Industry Associations for Consultations and Participation at International Exhibitions and Trade Missions" and "Regulations on the Amount of the Entrepreneurship Risk State Fee and the Part of the Fee to be Transferred into the Employee Claims Guarantee Fund in 2007" as well as draft Law "Amendments to the Competition Law".

For more detailed acquaintance with business environment in Latvian regions, the CSMEC organises visiting sessions on a regular basis; during these sessions, meetings with local government leaders and specialists and businessmen of the respective regions are held, problems and needs of entrepreneurs are discovered and solutions to them are searched collectively.

In the visiting sessions, the main topics of discussion are business environment and development prospects in the respective region, municipal support to entrepreneurs, opportunities for entrepreneurs to use financing from the EU Structural Funds and hindering factors.

In order to strengthen the role of the CSMEC in improvement of business environment and ensure that the non-governmental sector is competently represented in absorption of the EU Structural Funds and support programmes, the CSMEC members and representatives of its participating organisations are delegated to take part in the following councils and committees:

- EU Structural Funds Supervision Committee at the Ministry of Finance;
- Working group of the EU Structural Funds Steering Committee at the Ministry of Finance;
- Information Society National Council;
- Export Promotion Council at the Ministry of Economics;
- Advisory Council of the Latvian Investment and Development Agency;
- Working group for national taxation policy assessment at the Ministry of Finance;
- Entrepreneurs/experts panel of the Latvian Investment and Development Agency;
- Commercial Activity Development Council of the Riga City Council, etc.

Representative of the Council in Brussels takes part in work of the European Economic and Social Affairs Committee, and comments and proposals on several draft opinions have been given.

Through participation in entrepreneur delegations outside Latvia, co-operation agreements between the Council and similar organisations of the Republic of Azerbaijan and the State of Israel were concluded and talks with representatives of the Republic of Moldova were started.

The Council of the Small and Medium-Sized Enterprises and Crafts plans to solve the following issues at meetings in the nearest future:

- on improvement of entrepreneurship support instruments;
- on improvement of the legal environment of entrepreneurship;
- on prevention of payment delays in commercial transactions in the country;
- on reduction of personal income tax, etc.

## 7. Recommendations

In order to ensure high growth rates also in the future, it is necessary to provide stable macroeconomic environment in Latvia and implement structural reforms for growth of productivity and economic activity and improvement of business environment, infrastructure, labour force and education.

**In our opinion, the most important and urgent objectives of the economic policy are as follows:**

in order to maintain stable macroeconomic environment and promote competition, it is necessary:

- **to create a balanced budget in the next years. It is necessary to consistently introduce the strategic planning in ministries and the medium-term budget planning**, thereby promoting purposeful, far-sighted, co-ordinated, transparent and result-oriented use of available resources and a link of strategic plans of ministries with the budget;
- **to develop a complex inflation restraining plan** that would also include measures for slow-down of consumption and mortgage crediting growth rates and stimulation of the entry of new market participants in those sectors where competition is insufficient;
- **to ensure efficient unified and independent system of public utilities regulation**, assessing the necessity of incorporation of the regulated sectors of local governments into the *Public Utilities Commission*. In order to avoid a rapid growth of inflation, not only specific criteria and methodology for review of prices have to be in place, which ensure compliance of tariffs with economically justified costs, but also a system must be developed, which would allow to forecast the potential impact of measures for raising all administratively regulated prices, among them prices of public utilities regulated at local government level, on the total inflation in certain time period;
- by transposing EU requirements on further opening of energy and electronic communication and postal markets, it is important to promote real competition and ensure that the implemented changes are in consumer interests. Availability and adequacy of energy have to be ensured by improving the energy supply infrastructure and widely implementing energy-efficiency measures in the consumer sector as well as increasing efficient use of renewable energy resources and generation of energy in the co-generation process. **The market liberalisation process has to be harmonised with application of flexible regulation principles and further improvement of commercial activity principles of energy companies;**
- **to strengthen supervision of competition and encourage development of competition to public benefit in all national economy sectors**, timely identifying the risk sectors where violations of competition law are possible, limiting administrative and other obstacles to competition. More active fight is needed against the heaviest violations of competition law, such as abuse of dominant position and cartel agreements, introducing more efficient investigation instruments and sanction policy. Along the *ex post* application of competition protection instruments, when market distortions are identified and investigation is under way in the framework of particular cases, it is necessary to focus more actively on the use of *ex ante* preventive measures in order to disallow a possibility of such distortions;
- **to assess normative acts already during their drafting** in order to identify and prevent unsubstantiated restrictions of competition by reducing a negative impact on competition, technical barriers to trade and discriminating conditions (legal and administrative barriers) in the area of free circulation of goods and services and business law;
- **to continue fight against corruption and money laundering and opportunities to operate in shadow economy**. Supervision of state support and procurement has to be improved, achieving high level of transparency for state support projects as well as following the changes in EU normative acts and implementing preconditions for electronisation of the procurement process. Opportunities to prevent money laundering, which are prescribed in normative acts, have to be used more efficiently. It is essential to ensure availability of information about implementation and legal control of public administration functions delegated to commercial companies. This should promote more efficient use of resources and lessen opportunities of corruption;

in order to create conditions favourable for functioning of business activity and promote functioning of the domestic market, it is necessary:

- **to ease the legislative burden on business activity** by promoting simplification, clarity, mutual harmonisation and transparency of the legislative process. *Action Plan for Improvement of Business Environment* has to be updated and implemented on a regular basis, including in it the recommendations of the *National Economy Council of the Ministry of Economics, Council of the Small and Medium-Sized Enterprises and Crafts, Foreign Investors Council in Latvia and Foreign Investment Advisory Service of the World Bank* and maintaining a constant dialogue with social partners;
- **to ensure implementation of the EU initiative on better regulation in Latvia**, determining the institution responsible for this initiative and developing the strategy of its implementation;
- to encourage development of local governments and ensure rise of their capacity. **The administrative territorial reform has to be completed before the local elections of 2009** in order to establish optimum administrative and organisational structure of local governments and promote their capacity; **special attention has to be paid to incentives for development of less developed regions**. Real levers and instruments have to be created in order to stimulate entrepreneurs to invest into depressive regions;
- in order to ensure high-quality efficient absorption of the Structural Funds and the Cohesion Fund, **the system for introduction of EU funds has to be improved** by simplifying procedures and institutional system for granting resources from EU funds and control of their utilisation;
- **to improve the energy supply safety and diversify energy sources**, hence reducing Latvia's dependence on a single supplier of energy. The main tasks at present are to liberalise the electricity market and develop interconnections between electric grids of the Baltic States and Nordic countries and electric grids of Central European countries. In order to ensure sustainable use of energy resources, **a substantial role is played by the support to energy efficiency raising measures, use of co-generation and renewable energy resources, and promotion of development of environmental technologies**;
- **to promote introduction of the public private partnership mechanism**, especially with regard to absorption of EU structural funds. For the *Concessions Law* to become really functional and for the central and local government officials and business people to understand and start using an entirely new instrument in provision of public services, allowing for considerable economy of the central or local government budget resources, the legal base must be improved, development of public private partnership (PPP) projects and evaluation of PPP resources have to be encouraged, consultations on risk analysis should be given, and recommendations have to be made for preparation and administration of public private partnership;
- **to provide efficient management of state-owned properties** by promoting expropriation of state-owned real estates and capital shares that are not needed for public administration functions, among other things, promoting privatisation of state-owned entities, improving and centralising the state-owned real estate management system. Legal improvement and consolidation must be made to the management of state-owned corporate enterprises and the mechanism for application of national interests in the state-controlled corporate and other enterprises;
- **to strengthen supervision of consumer rights** through continued improvement of supervision methods of normative acts, especially by creating an efficient market surveillance system and a mechanism for protection of collective interests of consumers as well as ensuring a successful review of consumer complaints. Special attention has to be focussed on safety of children's goods and safety of services as well as on supervision of observance of economic interests of consumers. **Informing and educating consumers and entrepreneurs has to be strengthened**, hence promoting prevention of consumer rights violations before they appear;
- **to promote observance of consumer rights in the cross-border context and prevention of cross-border violations**, ensuring implementation of the EU Regulation on co-operation between national authorities responsible for consumer protection as well as efficiently co-operating with consumer rights protection authorities of the Baltic States;

in order to promote creation of efficient and competitive sectoral structure, it is necessary:

- **to promote research and development (R&D) and innovation, especially in the private sector.** Measures have to be developed and carried out to foster co-operation between educational, research and national economy sectors, ensuring transfer of knowledge and technologies. National research programmes and principles for distribution of grants need to be improved. State aid must be provided to innovative enterprises and infrastructure for development of technology transfer contact points, business incubators and knowledge-intensive technology enterprises;
- **to enhance society's awareness about the essence of innovation and its necessity,** especially in Latvian regions;
- **to promote development of the information society more actively** by raising availability of internet and introducing the e-government. **It is necessary to develop the e-services more actively**, e.g., to introduce the electronic declaration of taxes, improving the communication regime between a taxpayer and the State Revenue Service;
- in order to improve access to financing for SME, **more attention has to be paid to allocation of finances for business development in early stage** (measures for availability of pre-seed and seed capital, opportunities to receive preferential loans) and access to finances in the form of risk capital as well as to co-funding for business development projects in areas requiring special assistance. **Informative and advisory support to SME and business beginners has to be ensured**;
- **to conduct analysis and forecasting of the labour market on a regular basis**, which will promote ensuring mutual correspondence of labour supply and labour demand and will provide the required information on introduction of the changes necessary for public administration institutions in training of the labour force;
- **to improve efficiency, capacity and quality of the educational and training system and its compliance with long-term labour market demands.** Co-operation between public administration bodies, educational establishments and employers in correction of educational system supply in accordance with labour market needs has to be strengthened, and cost efficiency in all stages and forms of education has to be raised. Implementing changes in the educational system, the principle of access to education must be observed in order to ensure it in the context of life-long learning;
- **to improve the motivation system for doctoral students** in order to restore the potential of science and research, and **raise the level of technological skills and knowledge of natural sciences on the whole** by improving the system of professional orientation and ensuring availability of professional orientation services for all population in the context of life-long learning;
- **to foster expansion into new export markets and consolidation in the current ones.** It is essential to provide the institutional base of export promotion and rise of its capacity, development of the network of foreign economic representative offices, access to financial instruments and support to companies in the export marketing. In order to strengthen the international competitiveness of Latvian companies, it is necessary to ensure that border-crossing procedures (tariff and non-tariff barriers) do not raise unjustifiably the costs of raw materials, inter-consumption goods and services for Latvian companies and to promote bigger market access for exporters in third countries, especially in rapidly growing markets (Russia, China, India);
- **to foster introduction of quality assurance systems.** Introduction of such quality management systems as environmental management systems, labour protection and safety management systems, food quality assurance systems and other quality management systems must be supported and fostered in order to promote upgrading of companies and hence the growth of competitiveness;
- **to improve conformity assessment system** by co-ordinating the standardisation policy at the national level, ensuring international traceability of conducted measurements and encouraging the use of adequate measuring instruments, as well as promoting accreditation of conformity assessment institutions in the regulated and non-regulated spheres. Applying these conformity assessment instruments, Latvian entrepreneurs and their products/services will have additional credibility also in other EU member states;

- **to improve the current state aid programmes** by making them an effective instrument to strengthen long-term competitiveness of Latvian entrepreneurs. The state aid granting system must be improved, focusing the state aid on the projects that will make the biggest contribution to national economy development in the future. Impact of the current state aid programmes on competitiveness of Latvia has to be assessed and state aid programme priorities for the next planning period must be defined, changes in aid granting conditions have to be done in order to channel resources to activities where state aid will be needed the most for strengthening of the long-term competitiveness of Latvian entrepreneurs;

promotion of employment requires:

- **to solve structural problems of employment** by supporting efforts to get adequate and higher skills in accordance with labour market requirements and facilitating the labour mobility, especially through improvement of transport infrastructure;
- **to facilitate work of young people** in order to provide an opportunity to employ young people more flexibly, **promote employment of young people with special needs** by retaining the benefit in case when the young person works, and foster **more flexible return of new mothers to work**. It is advisable to entitle the employer to opt for a shorter trial period but to determine the maximum trial period of 6 months by the law. It is desirable to establish labour courts, which would provide an opportunity to settle labour disputes more efficiently and faster. It is advisable not to obligate the employer to cover expenses related to leave for studies and examinations, as these expenses would be covered by state budget resources;
- **to reduce undeclared employment** by raising the minimum wage and increasing the non-taxable minimum in order to lessen the tax burden on people with low income, and raising administrative capacities of the State Labour Inspectorate, attracting additional personnel, improving control over observance of labour law norms, raising the level of society's awareness about labour law issues, strengthening the role of trade unions and employer associations in business activity, encouraging entrepreneurs to unite in business organisations in order to create a favourable environment for increased reputation of socially responsible business activity;
- **to revise the system of taxes and allowances so that the work would pay off**, increase the efficiency of social expenditures and raise the non-taxable minimum.

In order to achieve strategic goals of Latvia, **it is essential to continue improving co-ordination of economic policy in the country and continue the reform of public administration** by introducing, among other things, a uniform system of wages and strengthening the current public administration bodies.

**Consistently implemented economic policy will promote the convergence process and increased standard of living of the population. Successful development and economic growth of Latvia will depend not only on the work of public institutions but also on everyone's personal initiative everywhere in Latvia under the conditions of mutual understanding and dialogue within the society.**