

Policy Responses to Economic Crises Latvia, 2008-

Note: Policy background memos contain information from various sources on the political economy of a particular country and economic and social policy choices before, during, and after an economic crisis. The memos do NOT contain any original information or analyses, but rather summarize material from various sources. The material is at times quite raw – the text is often presented in bullet points and sources are often quoted verbatim. Thus, the background memos should primarily serve as an overview of 1) policy developments in a particular country, and 2) academic research on the subject.

1 Background

Economy

The Latvian economy expanded fast in the years leading up to the crisis – from 2000 to 2007, GDP growth was on average 9%, which is higher than in any other EU country at the time. Towards the end of the period, however, the economy became overheated – a real estate bubble formed and inflation went over 10%. Government expenditure rose considerably at the same time, contributing to the boom (IMF 2009a, 5)

Politics

Following the 2006 parliamentary elections, a four party government was formed, under the leadership of Aigars Kalvitis (People's Party, TP). In 2007, Kalvitis resigned as PM, and Ivars Godmanis took over, with the same four parties forming the new government (Ikstens 2008).

2 Crisis

Latvia was hard hit with the crisis. Although nearly 60 per cent of the banking system was owned by foreigners, the banking system came under increasing pressure in the fall of 2008, with the largest domestically owned bank, Parex, requiring considerable support from the authorities. When it became clear that the government could not continue to support the bank, it sought support from the IMF. As with the other Baltic states, external devaluation was not considered feasible (IMF 2009a, 7–8).

3 Policy Response and Politics

November 2008

Fiscal → 2009 Budget passed. The personal income tax rate reduced from 25% to 23% and the basic tax allowance increased (NOTE: this might have been in the December revised budget) (European

Policy Responses to Economic Crises Latvia, 2008-

Commission 2010, 39).

Politics → Latvian authorities requested technical and financial support from the IMF, due to the financial crisis. The IMF program foresaw an improvement of the structural primary balance by 14 percentage points between 2009 and 2010, which is one of the largest consolidation episodes recorded among comparable countries (IMF 2009a, 29).

December 2008

Fiscal → Parliament revises budget from last month, with 7 percent of GDP in measures to reduce the mounting deficit. Roughly a third comes from increasing revenues (e.g. the standard VAT was increased from 5% to 10%, various goods moved from reduced to standard VAT rate, excise duties increased), with two thirds coming from cuts in expenditures (e.g. reducing government wages and a 25 percent across the board cut in government expenditures) (IMF 2009a, 15).

Employment → Minimum wage increased from €228 to €265 (Zasova 2011, 13).

March 2009

Politics → The four party coalition government of the People's Party (TP), First Party of Latvia (LPP), Union of Greens and Farmers (ZZS) and For Fatherland and Freedom (LNNK) fell in February/March, a couple of months prior to upcoming municipal and European elections. The coalition breakup was largely considered to be due to extensive budgetary cuts and the poor condition of the economy. The incoming coalition was formed by three parties from the outgoing coalition (TP, ZSS, and LNNK), in addition to two additional parties – New Era (JL) and Civic Union (PS). LPP had held the position of PM in the earlier coalition, with JL taking over the position in the new coalition (Ikstens 2010).

June 2009

Fiscal → Another supplementary budget passed, with a focus on expenditure cuts. Revenue increases (about 0.5% of GDP) include higher dividends from state-owned companies and higher excise taxes. Spending cuts (about 3% of GDP) focused on across the board expenditure reductions. The authorities stated that they were allocating extra funding (1.5% of GDP) to protect and expand social safety nets,

Policy Responses to Economic Crises Latvia, 2008-

e.g. by increasing the guaranteed minimum income and implementing active labor market policies (IMF 2009b, 5). The basic tax allowance for the personal income tax reduced (European Commission 2010, 39).

Unemployment → Duration of unemployment benefits increased to 9 months, a minimum floor for benefits introduced, and eligibility criteria relaxed. A public works program established that provided employment for 24,000 unemployed without unemployment benefits (Purfield and Rosenberg 2010, 25).

December 2009

Fiscal → 2010 budget passed, with 4.2% of GDP of new measures (IMF 2010, 4). Revenues increases account for about half of the measures, and include an increase in the personal income tax from 23% to 26%, scrapping of a reduced income tax rate for self-employed persons, elimination of tax exemptions and a new capital gains tax (IMF 2010, 4; European Commission 2010, 218). Expenditure cuts focused on general public sector reform (IMF 2010, 4).

Family → Maternity and paternity benefits reduced for high income recipients (IMF 2010, 11).

March 2010

Politics → Increasing tension between TP and JL culminates in TP leaving the government coalition (Ikstens 2011, 1037).

October 2010

Politics → Parliamentary elections were held, with the party of the incumbent chief executive (JL) being returned to office (JL formed an electoral alliance, “Unity”, with PS and the Society for Different Politics, SCP). Even though the economy figured heavily in the campaign, ethnic tensions put their mark on the election. After the election, Unity formed a government with ZSS, with TP and LNNK moving from government status to the opposition (Bloom 2011).

December 2010

Policy Responses to Economic Crises Latvia, 2008-

Fiscal → 2011 budget passed, with several measures (1.8% of GDP in revenue increases, 0.8% of GDP in spending cuts) (IMF 2011, 4–5). On the revenue side, the standard VAT rate was increased from 21% to 22%, the reduced rate from 10% to 12%, and electricity was moved from the reduced to the standard rate. Furthermore, employee's social security contributions was increased from 9% to 11%, which increases the overall rate to 35.09% (European Commission 2011, 212).

Employment → Minimum wage increased, from €256 to €285 (Zasova 2011, 12).

April 2011

Fiscal → Supplementary budget passed.

September 2011

Politics → The Latvian (parliamentary elected) president, in an unprecedented move, dissolved parliament (later ratified in a referendum) less than a year after the previous parliamentary elections, which lead to a new election in September. This move came in the lead up to the end of his term as president and faced with the prospect of not being reelected by the parliament, Zatlers (the president) is considered to have called an extra election in retaliation. Zatlers himself formed a party (ZRP), which ended up as the second biggest party, with the incumbent Unity coming in third (losing a third of its vote share). A new coalition government was formed by Unity (which held the PM position), ZRP, the National Union, and independents (Ikstens 2012, 177).

Spring 2012 (?)

Taxation → Standard VAT rate lowered from 22% to 21% from July 2012 onward (European Commission 2013, 106).

Autumn 2012

Taxation → A plan to lower personal income taxes from 25% to 20% put into motion, with the first step (to 24%) taking effect in January 2013 (European Commission 2013, 106).

Autumn 2013

Fiscal → 2014 budget passed. Several changes meant to “unfreeze” the level of benefits – small

**Policy Responses to Economic Crises
Latvia, 2008-**

pensions index and minimum wages increased (IMF 2014, 10). The rate of social contributions reduced from 35.09% to 34.09% from Jan 2014 onward (European Commission 2014, 108).

January 2014

Monetary → Latvia adopted the Euro.

**Policy Responses to Economic Crises
Latvia, 2008-**

References

- Bloom, Stephen. 2011. "The 2010 Latvian Parliamentary Elections." *Electoral Studies*, Special Symposium: Electoral Forecasting Symposium, 30 (2): 379–83. doi:10.1016/j.electstud.2011.03.003.
- European Commission. 2010. *Taxation Trends in the European Union - — Data for the EU Member States, Iceland and Norway*. Luxembourg: Publications Office of the European Union.
- . 2011. *Taxation Trends in the European Union - — Data for the EU Member States, Iceland and Norway*. Luxembourg: Publications Office of the European Union.
- . 2013. *Taxation Trends in the European Union - — Data for the EU Member States, Iceland and Norway*. Luxembourg: Publications Office of the European Union.
- . 2014. *Taxation Trends in the European Union - — Data for the EU Member States, Iceland and Norway*. Luxembourg: Publications Office of the European Union.
- Ikstens, Jānis. 2008. "Latvia." *European Journal of Political Research* 47 (7-8): 1039–47. doi:10.1111/j.1475-6765.2008.00799.x.
- . 2010. "Latvia." *European Journal of Political Research* 49 (7-8): 1049–57. doi:10.1111/j.1475-6765.2010.01961.x.
- . 2011. "Latvia." *European Journal of Political Research* 50 (7-8): 1035–44. doi:10.1111/j.1475-6765.2011.02030.x.
- . 2012. "Latvia." *European Journal of Political Research Political Data Yearbook* 51 (1): 175–86. doi:10.1111/j.2047-8852.2012.00020.x.
- IMF. 2009a. *Republic of Latvia: Request for Stand-By Arrangement*. Country Report No. 09/3. Washington, D.C.: IMF.
- . 2009b. *Republic of Latvia: Letter of Intent and Technical Memorandum of Understanding*.
- . 2010. *Latvia: Letter of Intent and Technical Memorandum of Understanding*.
- . 2011. *Latvia: Letter of Intent and Technical Memorandum of Understanding*.
- . 2014. *Republic of Latvia: Staff Report for the 2014 Article Iv Consultation*.
- Purfield, Catriona, and Christoph B. Rosenberg. 2010. *Adjustment under a Currency Peg: Estonia, Latvia and Lithuania during the Global Financial Crisis 2008-09*. International Monetary Fund. <https://www.google.com/books?hl=en&lr=&id=IRTFFbn-x4YC&oi=fnd&pg=PA3&dq=Adjustment+Under+a+Currency+Peg:+Estonia,+Latvia+and+Lithuania+During+the+Global+Financial+Crisis+2008%E2%80%932009,&ots=hsIFOW00Mn&sig=oRVmxQAV7HCG1lISu9MBaegRz8M>.
- Zasova, Anna. 2011. "Labour Market Institutions: An Obstacle or Support to Latvian Labour Market." *Baltic Journal of Economics*, no. 1: 05–24.