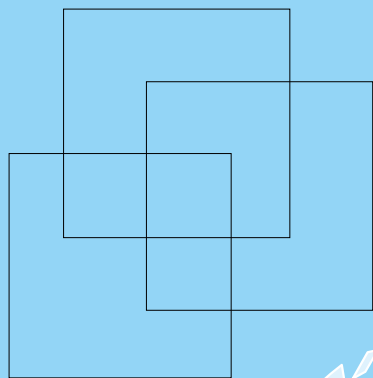




International
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Labour Market Measures in Latvia 2008–13: The Crisis and Beyond

Author
Anna Zasova



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Anna Zasova

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Introduction¹

Latvia was one of the world's hardest-hit economies during the Great Recession. In 2008–09, Latvian GDP contracted by almost 25 per cent, employment fell by about 20 per cent and the unemployment rate exceeded 21 per cent. The sectors that suffered most were construction, industry and trade, but essentially the recession affected all sectors of the economy and all population groups.

The crisis was preceded by one of the biggest booms in the EU: in the five years prior to the recession, GDP increased cumulatively by 50 per cent. The initial trigger of the recession was the end of the domestic demand boom, which began in the second half of 2007, and then in 2008 the slowdown was reinforced by deficient external financing and growth reduction in trading partners' economies. Adjustment to the crisis and subsequent economic recovery took place under a fixed exchange rate and constrained public finances, which limited the scope for policy response and made the ability of the Latvian product and labour market to respond flexibly, crucial to the adjustment.

Adjustment in labour costs took place mainly through cuts in employment and hours worked, while the adjustment in private sector wages was relatively minor. Latvian employment protection legislation does not excessively restrict job turnover (World Bank, 2004), as it acknowledges, for example, lack of demand as a sufficient basis for worker dismissal. The maximum duration of a temporary contract is effectively not restricted, provided there is a break of 60 days (30 days until 2015) between subsequent contracts. Trade union density is one of the lowest in the EU and the role of trade unions in the private sector is virtually non-existent. This, together with weak law enforcement, allowed for rapid adjustment, and existing empirical evidence on labour flows during the recession confirms that employment was rapidly adjusting through job separations and reduced hours, and it became more widespread to sign

fixed-term contracts during the crisis (Brauksa and Fadejeva, 2013).

The unemployment rate increased from below 6 per cent in 2007 to a peak of 21.3 per cent in 2010. The subsequent reduction in unemployment was far less rapid, which gives rise to the question as to whether the persistence in unemployment is demand- or supply-side driven. There is evidence (IMF, 2013; European Commission, 2014) suggesting that the natural rate of unemployment is quite high (above 10 per cent), which supports the supply-side arguments explaining the slow reduction in unemployment. However, this naturally high rate is hard to interpret given the flexible employment relations, weak trade unions and short duration of unemployment benefits (Blanchard et al., 2013). Moreover, the job vacancy rate remains extremely low and the existing vacancies are filled fairly quickly (Hazans, 2013b), which rather supports the demand-side explanations of unemployment persistency.

One of the important factors that constrained unemployment growth was emigration. The net emigration rate in 2009–10 more than doubled compared with the post-accession emigration wave of 2004–08 (Hazans, 2013a). Emigration is estimated to have reduced unemployment, as the share of previously unemployed individuals among emigrants with registered labour market experience increased from about 25 per cent in 2009 to almost 50 per cent in 2011.

Wage adjustment in the private sector was much less sizeable than wage reduction in the public sector, suggesting a weak spillover effect from public wage cuts into private sector wages. Analysis of micro-level administrative data on wages suggests that adjustment in labour costs in the private sector was mainly achieved by employing new workers at wages that were considerably below wages of incumbent employees, whereas wages of incumbents declined only marginally.

Despite there being no automatic built-in mechanisms that ensure more generous unemployment benefits in bad times, a number of reforms of unemployment benefits

1. Anna Zasova is a Research Fellow at Baltic International Centre for Economic Policy Studies, Latvia.

were implemented in response to the crisis. Reforms of unemployment benefit duration that were implemented after 2009 were generally aimed at increasing the generosity of the benefits; however, these reforms were implemented after a reduction in benefit duration for individuals with shorter employment histories that was introduced in 2008 and had been designed before the upsurge in unemployment. Moreover, the increase in unemployment benefit duration was accompanied by an introduction of a benefit ceiling, which was in place in 2010–14. As a result, on the whole, generosity of unemployment benefits in 2009–13 is estimated to have declined, compared with the pre-crisis 2007 system.

A number of major reforms were implemented to increase support of the poorest population groups through increased financing of means-tested benefits. First, the standard amount of the Guaranteed Minimum Income (GMI) benefit was increased by about 50 per cent. Second, the central government budget provided 50 per cent co-financing of means-tested benefits. As of 2013, however, the direction of the reforms was reversed: the standard GMI amount was reduced, and financing of the benefits became again the sole responsibility of local governments (which was the pre-crisis financing scheme). Existing evidence (World Bank, 2013b) suggests that even with the increased financing during the crisis, the coverage and adequacy of the GMI programme was not sufficient. While programme targeting was good, it did not provide adequate support to a sufficient number of individuals. It is estimated that the reduction in the poverty rate, ensured by means-tested benefits in Latvia, is one of the lowest in the EU. The fully decentralized system of benefit financing also raises concerns, as it can increase disparities between poor and rich local governments. In this light, the 2013 reform of provision of means-tested benefits is assessed negatively.

In circumstances of falling incomes and employment, a crucial role in mitigating adverse social consequences of the crisis was played by the subsidized public employment programme “Workplaces with Stipends”,

which was implemented in 2009–11 and in 2012–14 it was replaced by a similarly designed “Temporary Public Works Programme”. The programmes provided short-term paid (€142 per month in 2009–mid-2011 and €114 per month in mid-2011–14) non-commercial work in municipalities to unemployed persons who were not eligible for unemployment benefits. The programmes were very much in demand among the unemployed, and, according to the in-depth study carried out after completion of the first part of *Workplaces with Stipends*, the programme was effective in achieving its objectives (Azam et al., 2012). Despite there being no formal selection of the beneficiaries, labour-intensive work and relatively low remuneration ensured self-selection of those who are most in need and the programme was effective in targeting the poorest and most vulnerable population groups.

Another direction of the reforms implemented in response to the crisis was in the provision of training to unemployed and vulnerable employed individuals. Spending on training programmes in 2007–10 increased from about 0.05 to 0.25 per cent of GDP. One of the reasons for such an increase was of course the growing number of unemployed; however, it was also determined by introduction of new training programmes. A new system of training vouchers was introduced, which allowed beneficiaries to choose training providers themselves, as opposed to the previous arrangements whereby the State Employment Agency assigned both training programmes and training providers. The system of vouchers was a successful step, as it increases competition among training providers and simplifies administration of the training process (World Bank, 2013c). Results of an in-depth study on the effectiveness of various training programmes implemented during the crisis (Hazans and Dmitrijeva, 2013) suggest that occupational training programmes and informal education programmes have been effective and have improved labour market performance of programme beneficiaries, while training programmes provided by employers were least effective.

1.1 Employment trends

Latvia was one of the hardest-hit economies in the world during the Great Recession. In 2008–09, Latvia's GDP fell by almost one quarter in cumulative terms, bringing incomes to below the 2005 level. Employment losses were massive, reaching about 20 per cent (based on a labour force survey (LFS)). The fall took place over a very short period: in 2008, employment fell by about 5 per cent (end-2007 to end-2008) and in 2009 it fell by about 16 per cent (end-2008 to end-2009). This was followed by a gradual recovery, nevertheless, employment in the third quarter of 2014 remained 18 per cent below the third quarter of 2007.

The sector that saw the largest fall was construction, where the number of workers declined by more than 50 per cent during the crisis, and, despite the relatively small size of the sector (less than 10 per cent of the number of employed in 2007), this sector was a major contributor to the overall fall in employment. Trade, accommodation and restaurants, as well as industry, were also facing a major demand shock and employment cuts, while the contribution of public administration,

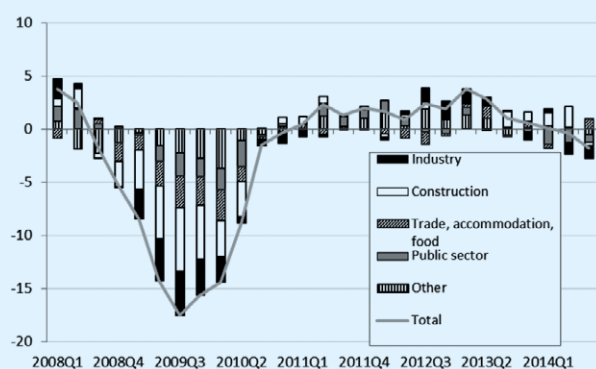
despite the implemented austerity measures, was relatively minor, especially in the initial phase of the recession (see figure 1.1, left-hand panel).

The decline in the number of jobs and in hours worked was even larger than the fall in the number of people in employment. The share of employed individuals who had more than one job declined from about 6 per cent in 2007 to 4.1 per cent in 2011. The share of individuals who worked less than 40 hours per week increased and the share of individuals who worked more than 40 hours per week declined notably, but the share of part-time employment increased from about 6 per cent to 10 per cent. Data from an enterprise survey, which reports the number of jobs in full-time equivalents, suggests that the fall in the number of jobs in the course of the crisis was about 30 per cent (figure 1.1, right-hand panel).

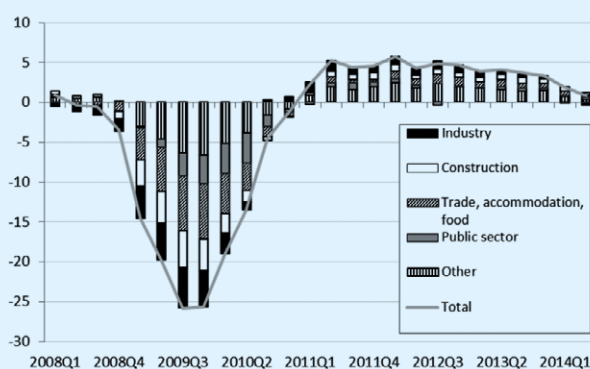
Generally, employment in Latvia has responded fairly strongly to the fall in demand (see figure 1.2). The overall fall in employment from peak to trough was as strong as the fall in value added (amounting to about 22 per cent). Normally, employers may be reluctant to cut employment in response to a reduction in demand,

Figure 1.1 Year-on-year change in the number of employed (per cent) and contributions from sectors in 2008–2014Q3

Number of employed (based on LFS)



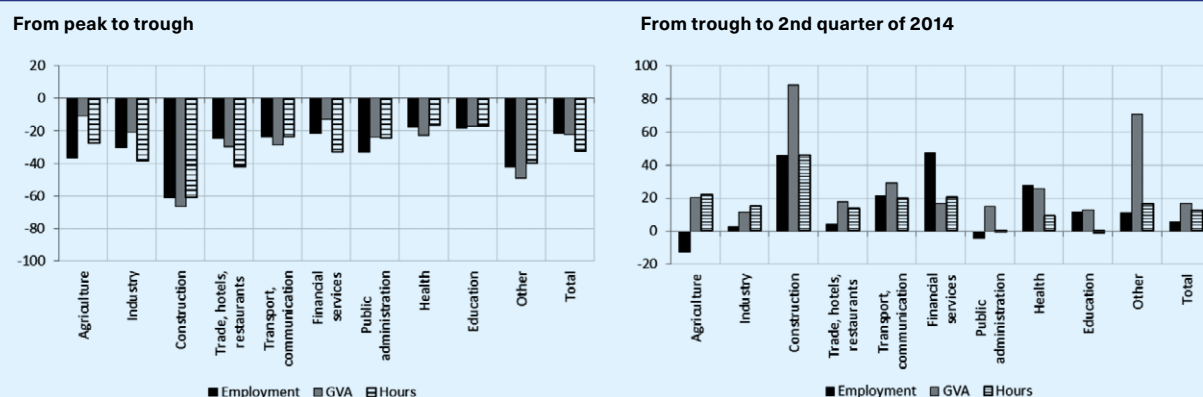
Number of jobs in full-time equivalents (based on enterprise survey)



Note: Classification of industries by NACE Rev.2. "Industry" includes mining and quarrying, electricity, gas, steam, air conditioning supply, water supply, sewerage, waste management and remediation services; "Construction" corresponds to construction industry by NACE Rev.2; "Trade, accommodation, food" includes wholesale and retail trade, repair of motor vehicles and motorcycles, accommodation and food service activities; "Public sector" includes public administration and defence, compulsory social security, education, human health and social work activities.

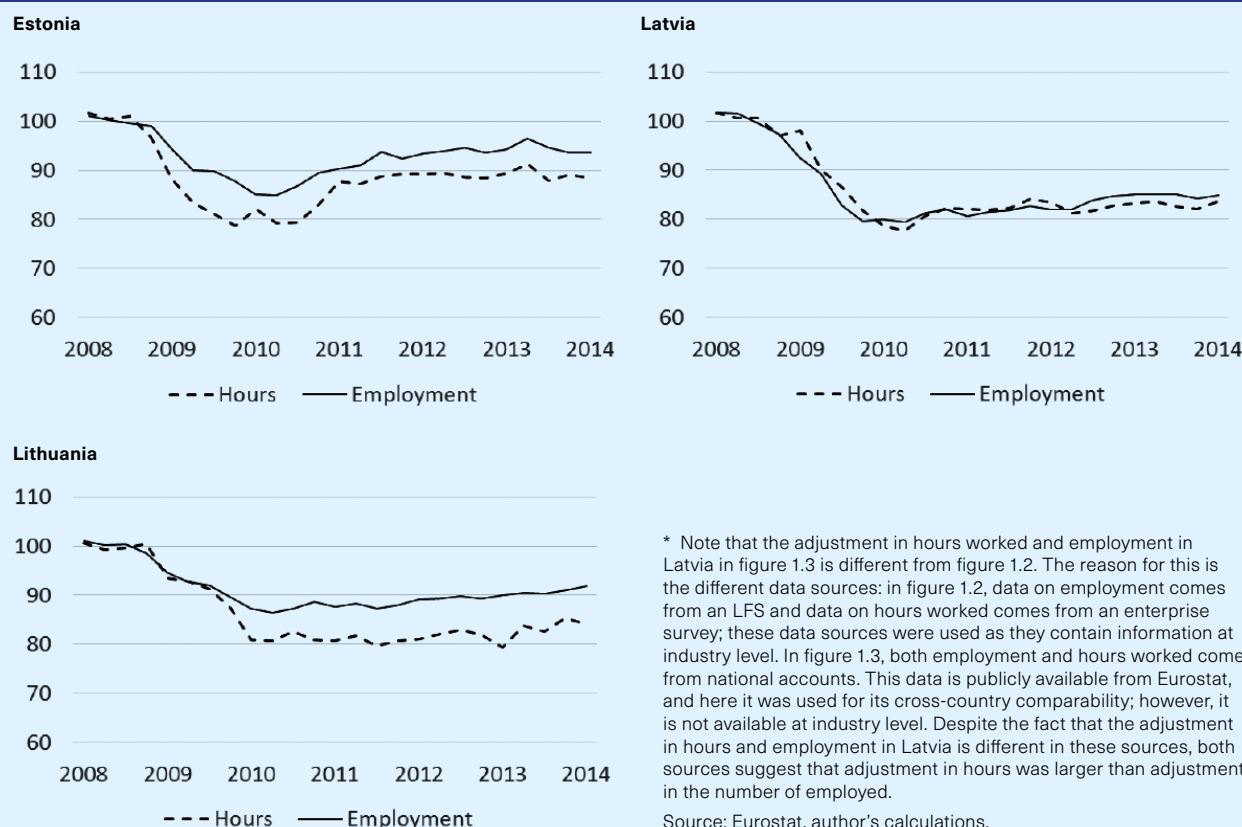
Source: Central Statistical Bureau of Latvia, author's calculations.

Figure 1.2 Percentage change in employment, gross value added (GVA) and hours worked from peak to trough and from trough to the 2nd quarter of 2014 (seasonally adjusted)



Note: Data on employment comes from LFS and refers to number of persons employed, data on hours worked comes from enterprise reports.
Source: Central Statistical Bureau of Latvia, author's calculations.

Figure 1.3 Employment and hours worked in Estonia, Latvia and Lithuania in 2008–2014Q1 (index 2008 = 100), seasonally adjusted*



because of recruitment costs that they are likely to incur when demand starts to recover. Arpaia and Curci (2010) compare employment reduction in the current recession with the responsiveness of employment to output in the previous periods in selected EU countries. They show that at the outset of the crisis (first half of 2008) employment response to changes in output in

Latvia was smaller than that estimated on historical data; however, starting from the second half of 2008, employment “overreacted” and the reduction was larger than could be expected.

The subsequent recovery in output was accompanied by less than proportional employment growth, in particular in industry and construction, as well as the trade,

hotel and restaurant sectors (see figure 1.2, right-hand panel). The percentage increase in hours worked was larger than the increase in the number of employed. Over the recession, hours worked first declined by more than employment and then increased more than employment, which is consistent with re-employment being costly and suggests that some of the adjustment took place by reducing the workload rather than laying-off workers. However, if contrasted with Estonia and Lithuania, which had an output contraction of comparable size and pace, the adjustment relied to a larger extent on adjustment in employment (see figure 1.3).

Employment figures in the private sector are potentially biased by changes in the share of undeclared work; however, existing estimates suggest that the share of undeclared employees during the crisis declined (Hazans, 2012; Putniņš and Sauka, 2014), which implies that employment statistics may even underestimate the true job losses. A possible reason for the reduction in undeclared employment is that employers facing a reduction in demand first of all dismiss workers without work contracts, as this does not involve any dismissal costs. Another possible explanation relates to the changes in the composition of employment, as the sectors that are known to be particularly problematic in terms of undeclared work – trade and construction (State Labour Inspectorate, 2014) – faced a disproportionately strong fall in demand during the recession.

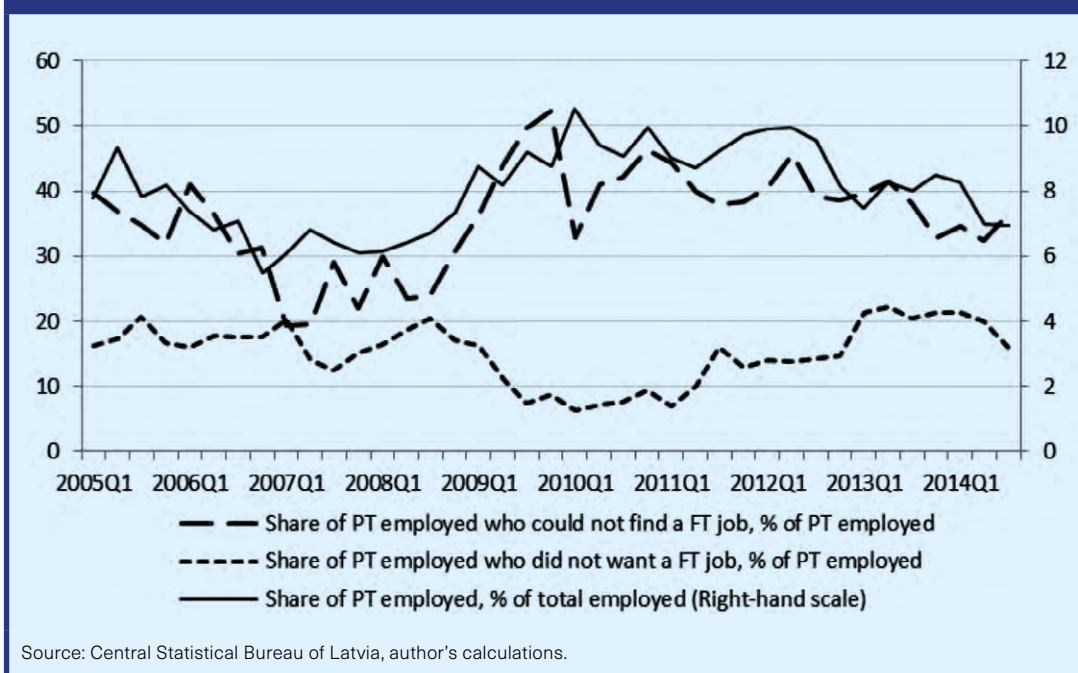
1.1.1 Part-time employment

Part-time employment in Latvia is generally much less widespread than in the EU-28 (the share of part-time employees in Latvia in 2013 was 8.1 vs. 20.2 per cent in the EU-28 (Eurostat, LFS data)). This difference mainly stems from low part-time employment among women (10.0 vs. 32.6 per cent). Low part-time employment among women is not a specific feature of the Latvian labour market, it is typical for all post-transition economies (e.g., the share of women working part-time in 2013 was 10.8 per cent in Lithuania and 14.3 per cent in Estonia).

It is not only the overall level, it is also the nature of part-time employment that is different in Latvia and the EU-28, and this difference is again to a large extent driven by women. While in the EU-28 the need to look after a child or incapacitated adult as the reason for being part-time employed was almost as widespread as the inability to find a full-time job (21.0 and 28.2 per cent of part-time employed, respectively), in Latvia the need to look after someone was far less important (2.9 and 38.0 per cent, respectively). The corresponding shares for women in the EU-28 were 26.8 and 25.6 per cent, but for Latvia, 4.4 and 38.1 per cent. This suggests that part-time employment in Latvia is to a larger extent caused by the shortage of full-time jobs.

In the course of the recession, the share of part-time employment increased from about 6 per cent to 10 per

Figure 1.4 Share of part-time employed and reasons for being employed part time in 2005–14, seasonally adjusted



cent, which was mainly driven by the growing number of people who could not find a full-time job (see figure 1.4), with the largest increase in the share of part-time employment being observed in industry and construction. After reaching a peak in early 2010, the share of part-time employment has been gradually declining, but as of mid-2014 it still remained above the pre-crisis level.

1.1.2 Gender and age composition of employment

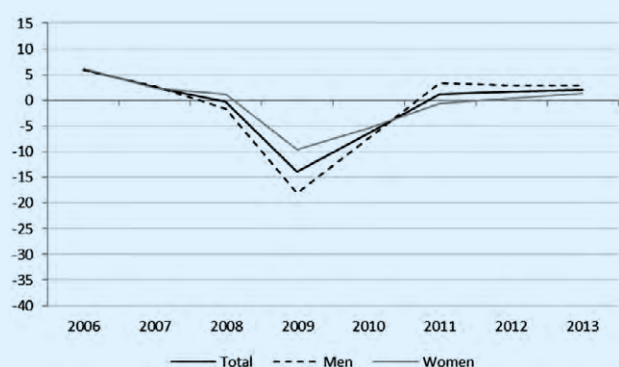
As in other countries, during the Great Recession male employment was more affected. But, after a sharper reduction, male employment started to recover earlier (see figure 1.5). The biggest contribution to the growth of male employment in 2011 came from male employment in construction and trade (while female employment was still declining in both 2011 and 2012). Generally, however, the share of men in employment

declined in the course of the crisis and is still below the pre-crisis level. The trends in youth employment were similar, to the extent that male employment fell stronger and started to recover earlier. Changes in employment by educational attainment (see figure 1.6) reflect employment changes by sectors: employment of individuals with lower educational attainment showed a greater decline, as the sectors with a relatively high share of low-skilled labour (construction, manufacturing and trade) faced the strongest decline in output.

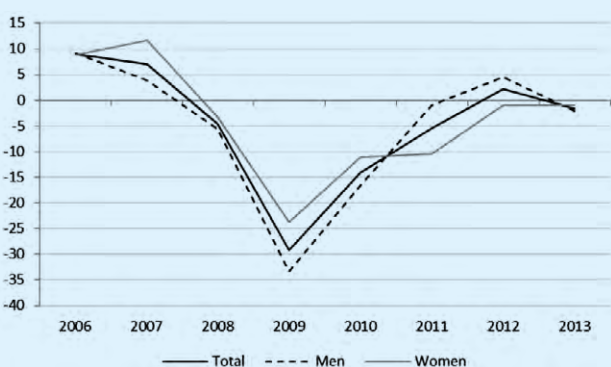
As in all EU countries, the share of young (aged 15–24) individuals in total employment declined in the last recession. In Latvia, the reduction was one of the strongest in the EU countries – the share of young individuals in total employment went from being above the EU-27 average in 2007 (10.9 per cent in Latvia vs. 9.4 per cent EU-27 average) to being below the EU-27 average (7.4 vs. 7.8 per cent) in 2013. The share of young

Figure 1.5 Percentage annual change in employment by gender in all age groups and in the age group 15–24

All age groups



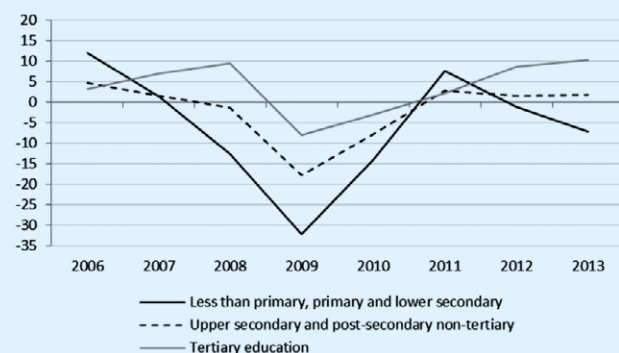
Age group 15–24



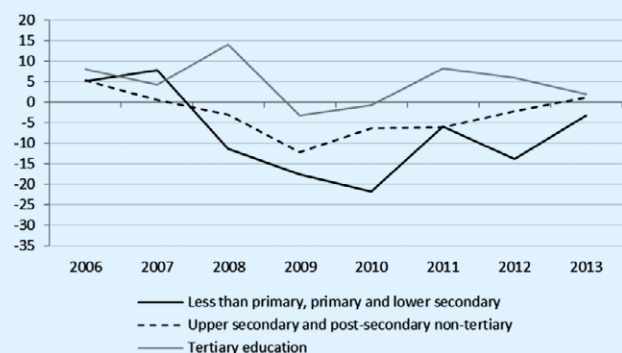
Source: Central Statistical Bureau of Latvia, author's calculations.

Figure 1.6 Percentage annual change in employment by gender and educational attainment in all age groups

Men



Women



Source: Eurostat, author's calculations.

Figure 1.7 Share of employees aged 15–24 and 55–74 in the total number of employees by industries in 2008 and 2013 (per cent)

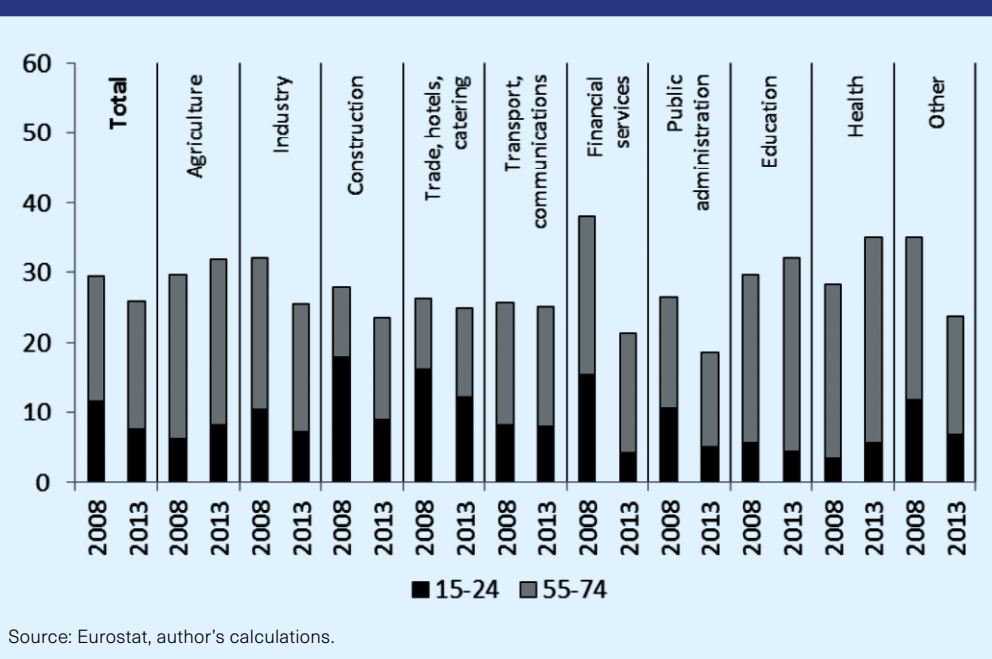
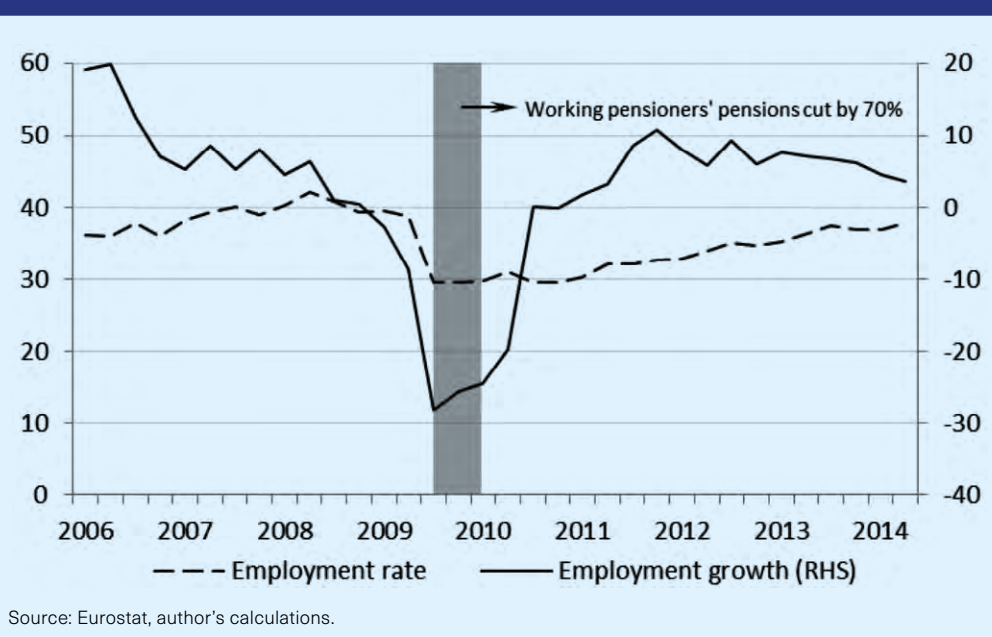


Figure 1.8 Year-on-year growth of employment and employment rate in the age group 55–74 (per cent)



individuals in total employment declined in all major sectors (see figure 1.7), in particular in industry, construction, financial services and public administration.

The share of older workers increased slightly in the course of the crisis (in particular, the largest increase was observed in construction and education); however, in absolute terms, employment of those in the age group 55–74 declined by over 10 per cent in the course of the

crisis. Apart from a general fall in demand for labour, a likely reason for the reduction in employment of older workers was a pension reform of 2009. As of July 1, 2009, working pensioners' pensions were cut by 70 per cent and non-working pensioners' pensions were cut by 10 per cent. The justification for these cuts provided by the government was to reduce spending on pensions; however, the immediate effect was a sharp fall in the employment rate among older workers (see figure 1.8).

The cut in pensions was not expected. Before the local government elections that were held in early June 2009, the government was committed to avoiding any reductions in pensions; however, just several days after the elections, the cut was announced. Then in December of that year, the Constitutional Court ruled the decision to cut pensions unconstitutional and stipulated that the amount should be restored to the previous level and the unpaid pensions should be paid back. However, the employment rate among the older workers remained low and increased very gradually in the post-crisis years.

1.2 Unemployment

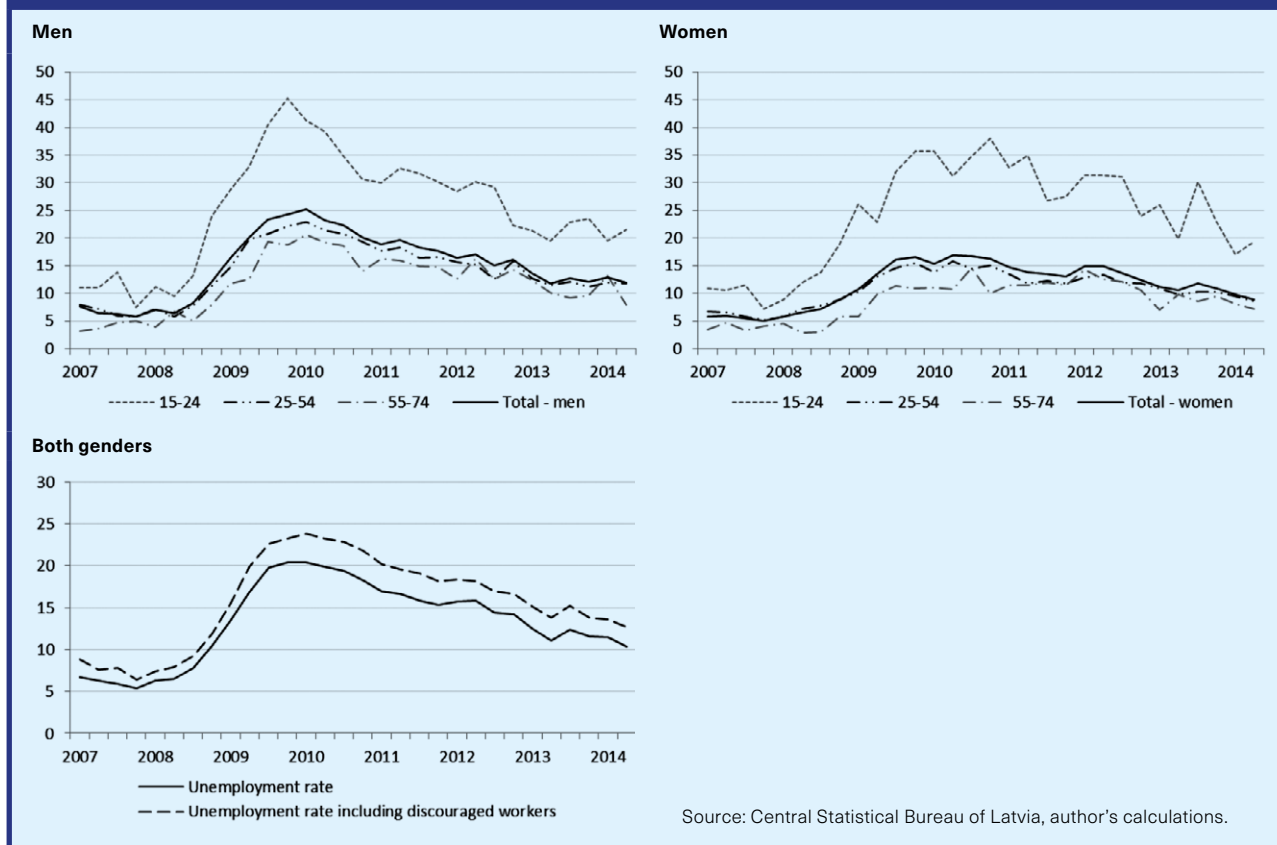
The unemployment rate started to grow in 2008 and by 2010 reached its peak of 20 per cent (almost 25 per cent, if discouraged workers are included). The increase in the unemployment rate was stronger for men in all wage groups; however, the reduction in male unemployment in the post-crisis period was also stronger and by 2014, male and female unemployment were both close to 10 per cent (see figure 1.9).

The gradual reduction in the unemployment rate in the post-crisis years was not accompanied by notable changes in participation rates. In the primary age

group, the participation rate for women even increased slightly, which is likely to reflect the so-called “added worker effect”. For men, the participation rate in the primary age group virtually did not change over the crisis. Participation rates among older men and women declined in 2008–11, with a particularly sharp drop in mid-2009, which is likely to reflect the cut in working pensioners’ pensions (see description above); however, after 2011 the participation rate among older persons was gradually increasing (see figure 1.10).

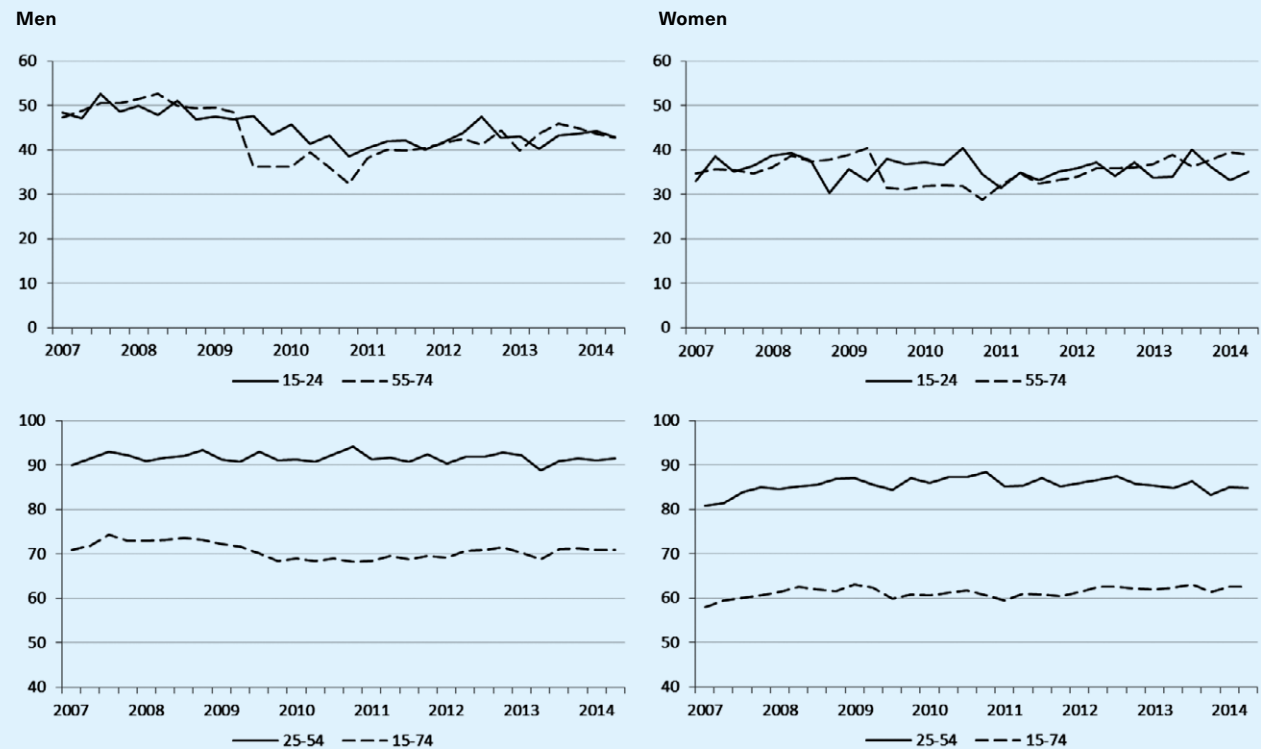
The sharp rise in unemployment in the early phase of the crisis and a sluggish reduction afterwards raises the question of whether the slow recovery in the labour market is a consequence of structural shifts in the labour market, or rather that it reflects the weak cyclical position of the economy. The first thing to notice is that, despite the economic recovery, the vacancy rate in the private sector in Latvia remained extremely low, both compared with the pre-crisis period and with other countries (see figure 1.11). Hazans (2013b) shows that the vacancy rate remained very low despite a significant rise in emigration, and also that 50 per cent of the available vacancies for permanent positions in 2009–12 were filled in less than one month, and there was no clear increase during this period. All in all, Hazans (2013b) argues that the

Figure 1.9 Unemployment rate by gender and age groups, seasonally adjusted (per cent)



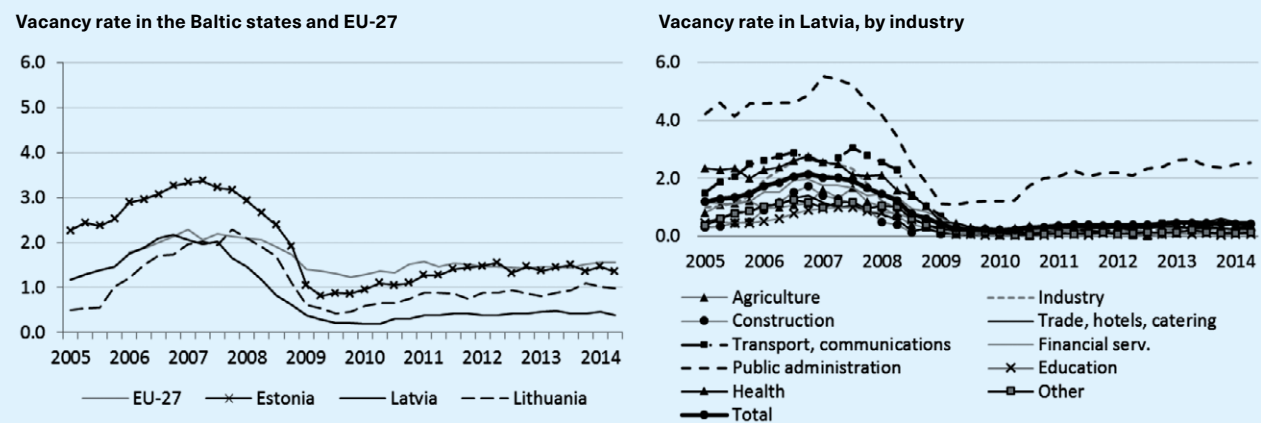
Source: Central Statistical Bureau of Latvia, author's calculations.

Figure 1.10 Participation rate by gender and age groups (per cent)



Source: Eurostat and author's calculations.

Figure 1.11 Vacancy rate in 2005–14, seasonally adjusted (per cent)



Source: Eurostat, Central Statistical Bureau of Latvia, author's calculations.

slow recovery of the labour market is rather a consequence of lack of demand in the labour market.

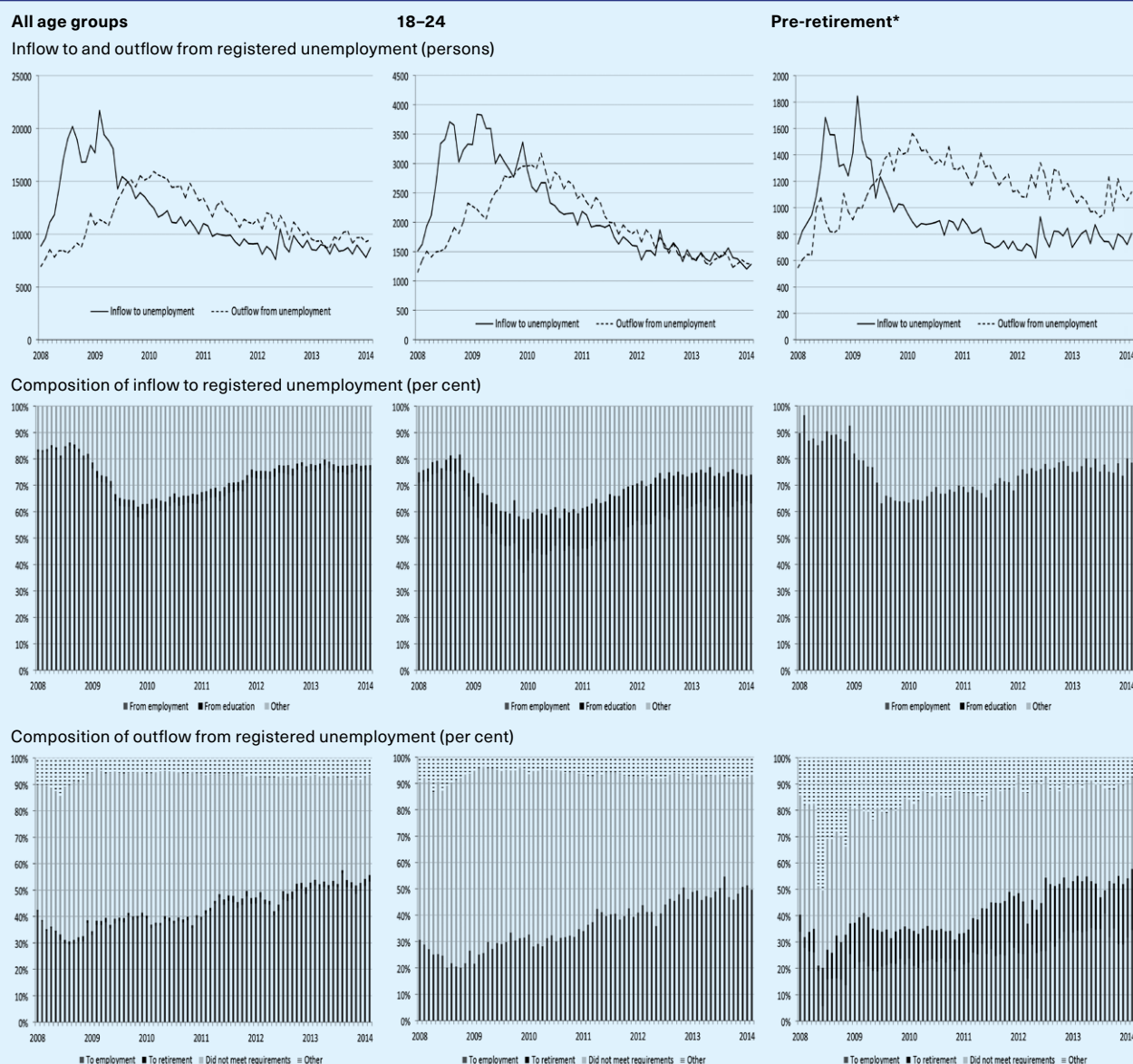
Similarly, Anosova et al. (2013) show that the increase in unemployment and its subsequent reduction can be attributed to cyclical factors, whereas the structural unemployment rate did not change during the crisis. The exact position of the structural rate of unemployment is hard to pin down, given the short and volatile series; however, as argued by Anosova et al. (2013), analysis

of vacancy rates and sectoral unemployment rates suggests that the persistency in unemployment cannot be explained by supply-side effects.

On the contrary, studies that employ time-series methods to estimate the structural rate of unemployment (NAIRU or NAWRU)² generally arrive at

2. NAIRU stands for Non-Accelerating Inflation Rate of Unemployment; NAWRU stands for Non-Accelerating Wage Inflation Rate of Unemployment.

Figure 1.12 Inflow to and outflow from registered unemployment, August 2008 to September 2014 (seasonally adjusted)



* This group consists of individuals who are 5 years below the retirement age. In the period August 2008 to December 2013 the retirement age for both men and women was 62 years. Since January 2014 it is 62 years and 3 months for both genders. Respectively, in 2014 the right panel of the graph depicts individuals in the age group 57 years and 3 months to 62 years and 2 months.

Source: Employment State Agency of Latvia, author's calculations

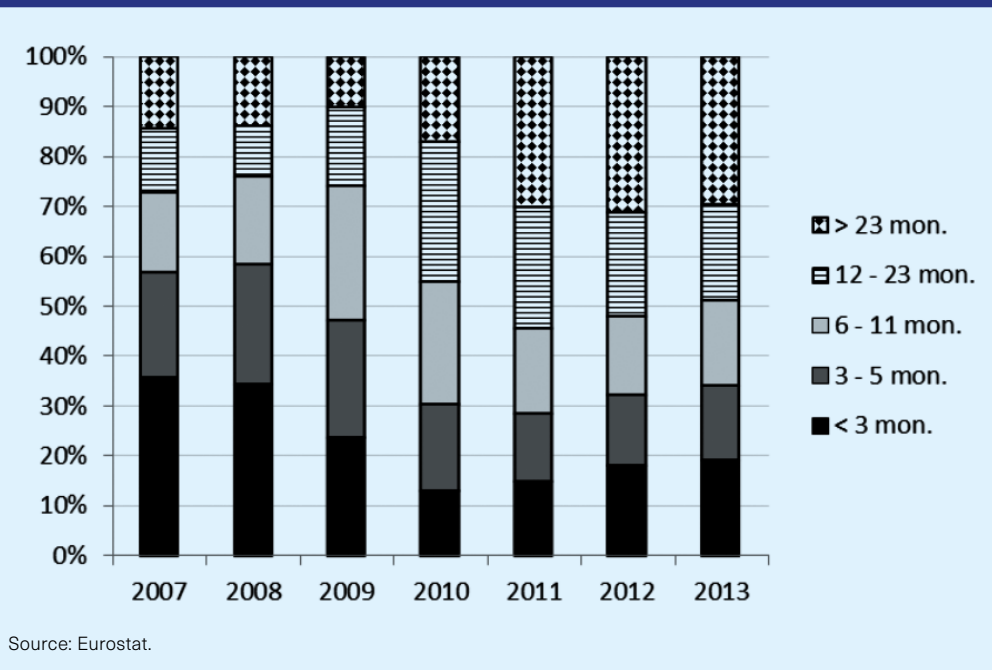
the conclusion that the rate of structural unemployment in Latvia is fairly high, being in excess of 10 per cent (IMF, 2013; European Commission, 2014), which implies that the rate of unemployment in 2013–14 was close to its natural rate. This high estimate of the natural rate, however, as noted by Blanchard et al. (2013), who estimate the natural rate to be around 10 per cent, is surprising, given the nature of employment relations in Latvia, which supposedly ensure a fairly high degree of market flexibility.

Figure 1.12 shows the decomposition of inflows to and outflows from registered unemployment. After a strong

increase in the inflow to unemployment in 2008–09, inflow was steadily declining and, as of 2010, outflow from unemployment exceeded inflow in all age groups. It is important to note that the increase took place on account of the increasing share of those who found a job, as the share of outflow to employment in all age groups in total outflow increased from about 30 per cent in early 2009 to around 50 per cent in 2014. The increase was even stronger among young individuals, but less pronounced among the older age group.

The share of the long-term unemployed (unemployed for 12 months and more) peaked at almost 55 per

Figure 1.13 Distribution of unemployed by duration of unemployment (percentage of total unemployed)



cent in 2011, but has been declining since then (see figure 1.13). It should be noted that generally the share of long-term unemployed among young individuals (aged 15–24) in Latvia is rather low compared with the EU average: thus the average share of young unemployed who were looking for a job for more than a year in Latvia in 2005–07 was 17.2 per cent (vs. 28.9 per cent in EU-27). In 2010, the share peaked at 33.1 per cent, but then it started to decline and in 2013 amounted to 29.4 per cent.

Latvia experienced a dramatic increase in labour emigration during the crisis. The stock of Latvian citizens in other EU countries increased by 47 per cent between 2008 and 2011, but the net emigration rate in 2009–10 more than doubled compared with the post-accession emigration wave of 2004–08 (Hazans, 2013a). The increase in emigration is estimated to have considerably reduced unemployment both directly (the share of registered unemployed among emigrants with registered labour market experience increased from slightly above 25 per cent in 2009 to almost 50 per cent in 2011 (Hazans, 2013a: Fig. 4.17)) and indirectly, as vacancies left by previously employed emigrants contributed to a reduction in unemployment.

Contractual arrangements and Employment Protection Legislation (EPL)

2

Latvian employment protection legislation (EPL) generally ensures a reasonably high degree of market flexibility and does not excessively restrict job turnover (World Bank, 2004). Labour law acknowledges lack of demand as sufficient justification for a dismissal and an employer can base the sequence of dismissal on the relative productivity of workers. Only if workers perform equally well should the employer take into account tenure, age, employees' household material conditions and other factors in deciding on the order of dismissal.

In cases of collective dismissal, an employer has to consult representatives of the employees to try to minimize the number of dismissed workers and minimize the adverse social impact of the dismissal. If dismissed workers are members of a trade union, the employer has to consult the representatives even in the case of an individual dismissal. In practice, however, this provision is not likely to put an excessive burden on Latvian employers, given that trade union density in Latvia is very low (around 13 per cent in 2012, according to data from Free Trade Union Confederation of Latvia). The notice period for individual dismissals depends on the reason for dismissal and ranges from 10 days or immediate (where the reason for dismissal is an illegal act, misbehaviour of the employee or other similar reasons) to one month.

Existing evidence from the literature suggests that, on the whole, the strictness of EPL in Latvia is not much different from that of other EU countries. Thus, using a unique hand-collected database, Lehmann and Muravyev (2012) document that the degree of protection ensured by EPL in Central and Eastern Europe (CEE) (including Latvia) corresponds approximately to that in the EU-15. Similarly, Eamets and Masso (2004) show that EPL in the Baltics, on the whole, ensures a labour market flexibility that is close to the EU average, though analysis of different types of contracts suggests that individual and collective dismissals are relatively heavily regulated, while temporary contracts ensure a weaker degree of protection. However, despite the relatively strict regulations, employers in the Baltics generally characterize the legal environment regulating

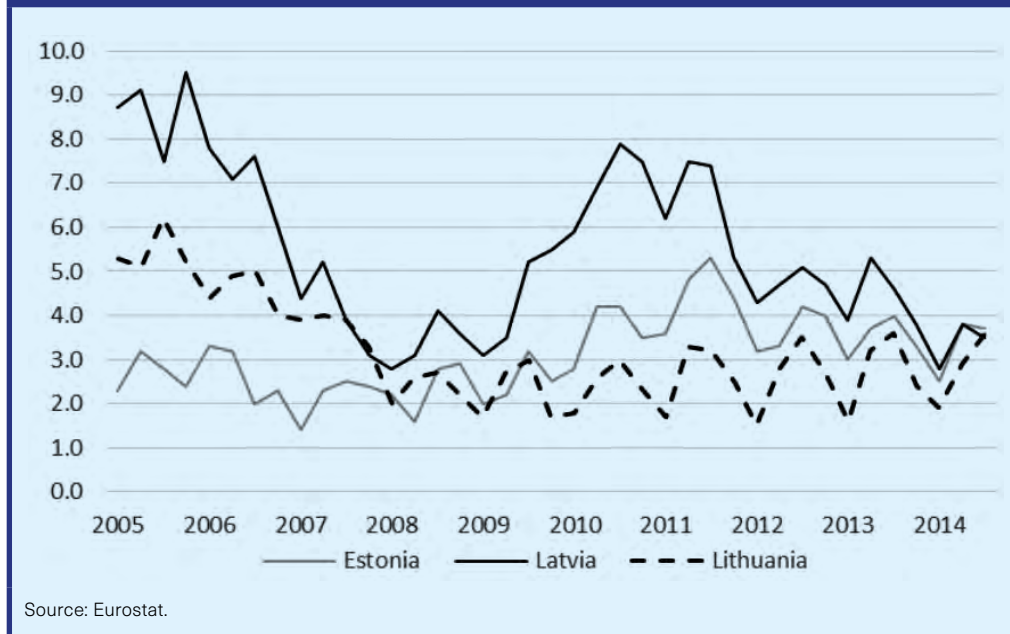
employment relations as being very flexible; Eamets and Masso (2004) show that in CEE, correlation between the OECD overall EPL strictness index and the World Competitiveness Yearbook labour legislation flexibility index (based on the business opinion survey) is rather low, which they interpret as a sign of relatively weak law enforcement. Zasova (2011) uses a similar approach and more recent data (data on the OECD EPL index from Muravyev (2010) and data on the Hiring and Firing Practices index (World Economic Forum, 2010)), and arrives at the same conclusion, showing that correlation between these indices in the EU-15 is higher than in the EU-12.

Changes in EPL in the crisis period were relatively minor. Labour Law amendments passed in March 2010 introduced a new cause for dismissal – namely, that an employee can be laid off if they are incapable of working for more than six months uninterruptedly or for more than one year with interruptions in a three-year period. Another change introduced in 2010 was that the minimum notification period in cases of collective dismissal was shortened from 60 to 45 days.³ Another change was introduced in July 2011. Before 2011, the Labour Law did not contain specific norms regulating Temporary Work Agencies (TWAs). The new norms allowed TWAs and did not impose any restrictions as to the types of work they can offer.

The most notable change came into force on 1 January 2015. Namely, from 2015, the maximum duration of a fixed-term contract increased from three years to five years. The maximum duration includes any contract extensions and new contracts between the same employer and employee. However, if there is a break between the contracts (until 2015, the minimum break stipulated by the Law was 30 days, but as of 2015, the minimum break is 60 days), a new fixed-term contract between the same parties is allowed, so effectively, there is no maximum duration for fixed term contracts.

3. In cases of collective dismissal, employers have to notify the State Employment Agency and the local government where the enterprise is located.

Figure 2.1 Temporary employees as a percentage of the total number of employees in the Baltic states, 2005–14



Nevertheless, temporary contracts in Latvia are less widespread, compared to other EU countries. Thus, in 2013, the share of employees on temporary contracts in Latvia was 4.4 per cent, compared with an average of 13.7 per cent in the EU-27. As in most EU countries, inability to find a permanent job is the most common reason for having a temporary contract (67.7 per cent of all temporary contracts in Latvia and 61.5 per cent in the EU on average in 2013). There is a rather large difference, however, in the share of those who had a temporary contract while being on a probation period: in Latvia, these temporary workers accounted for more than 14 per cent of all temporary contracts in 2013, while on average in the EU it was only 9 per cent. Thus, given that the maximum trial period is stipulated in the Law not to exceed three months, employers can opt for a fixed-term contract for the probation period.

The share of temporary contracts in Latvia increased strongly during the crisis (see figure 2.1): the share almost doubled and the increase was much sharper than that in neighbouring Estonia and Lithuania (in the latter, the share hardly increased at all). The rise in temporary employment was mainly driven by those who could not find a permanent job.

It is notable that it was not only the share of temporary employees that increased during the crisis; the absolute number of temporary employees also increased despite the severe reduction in overall employment. The most notable increase was observed in industries where the temporary employees are mainly concentrated: agriculture,

construction, and administrative and support service activities. Brauksa and Fadejeva (2013) use micro-level LFS data and also document an increased prevalence of temporary contracts during the crisis: they show that during the crisis the Latvian employers became more prone to signing temporary contracts and by 2010, 15 per cent of all newly signed contracts were fixed-term contracts.

There is no specific age profile of those who are working on fixed-term contracts or are employed with TWAs. In many OECD countries young workers are disproportionately represented in both of these categories of workers (OECD, 2014). In Latvia, the share of fixed-term contracts is relatively low both in the prime-age group and among the young. The share of workers employed with TWAs in Latvia is around 2 per cent, which is higher than in many OECD countries, but unlike the situation in many other countries, TWA employment in Latvia is not much more widespread among young workers.

All in all, labour market regulations in Latvia ensure a relatively high degree of market flexibility, which is in part due to weak law enforcement and low trade union density. This makes the labour market an effective shock absorption mechanism, as employers are not faced with excessive firing costs. Existing empirical evidence on labour flows during the recession confirms the flexible adjustment of the market: employment was rapidly adjusting through job separations and reduced hours, and it became more widespread to sign fixed-term contracts during the crisis (Brauksa and Fadejeva, 2013).

Unemployment benefits, social insurance and social assistance

3

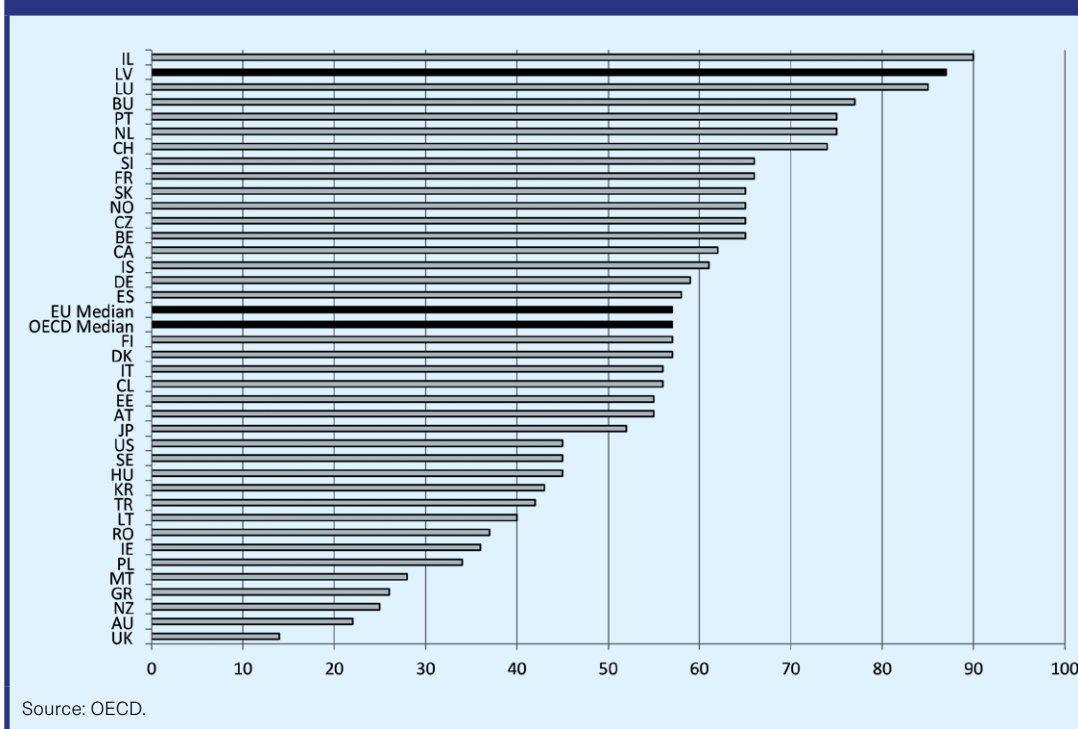
3.1 Unemployment insurance

The unemployment benefit in Latvia depends on previous earnings and is paid to an unemployed person conditional on their being registered with the State Employment Agency (SEA) and their active search for a job. There is a minimum contribution history that makes a person eligible for the benefit; it is relatively short (in the crisis years it changed from 9 to 12 months in the period preceding unemployment). The benefit is paid on an individual basis and is not means tested.

The replacement rate of the benefit is relatively high: according to OECD data, the net replacement rate (i.e., the share of previous earnings that is retained while unemployed, taking into account all major elements of national tax-benefit regimes) in Latvia in 2012 was one of the highest among OECD economies and selected non-OECD countries (see figure 3.1).

These replacement rates are simulated for 40-year-old single childless individuals who have worked continuously since the age of 18. For Latvia, it implies a higher replacement rate than for individuals with shorter employment histories: the initial amount of monthly unemployment benefit equals 65 per cent of the previous average gross monthly wage for individuals with a working history of more than 30 years, 60 per cent for individuals with a working history of 20–29 years, 55 per cent for individuals with a working history of 10–19 years and 50 per cent for individuals with a working history of 1–9 years. Moreover, the initial size of the benefit tapers off gradually with duration of unemployment and the maximum duration of the benefit is relatively short (9 months). Therefore, despite the relatively high initial replacement rate, the design of the benefit creates reasonably good job search incentives. There are no additional unemployment allowances that would substitute for the unemployment benefit once it expires.

Figure 3.1 Net replacement rate for a single childless person earning the full average wage in the initial phase of unemployment (per cent)



There are no automatic built-in mechanisms in the Latvian unemployment benefit system that would act to cushion the social consequences of the business cycle, i.e., there are no rules ensuring that duration or generosity of the benefits automatically adjusts to the economic cycle. However, in response to the crisis, in the period of a rapidly growing unemployment rate several major reforms were implemented to increase the support to those who lost their jobs. Some of these measures were announced as permanent, others were introduced initially as temporary and were specifically designed to mitigate the effects of the crisis.

First, the period over which an individual should make social contributions to be eligible for unemployment benefits was changed. Before the crisis, it was sufficient that a person made contributions for at least nine months in the 12-month period preceding unemployment. In 2008, the period was increased to 12 months in the preceding 18-month period, but from 1 July 2009, it was again shortened to nine months over the 12-month period, and this was made a permanent change, which was not explicitly related to the recession.

Second, the duration of the unemployment benefit was changed several times during the crisis. Before the crisis, in 2007, the duration was nine months, irrespective of the working history.⁴ In 2008, the duration was shortened for people with shorter working histories: it was made four months for people with a working history of 1–9 years and six months for people with a working history of 10–19 years.⁵ This reform was designed before the upsurge in unemployment, so this was not a crisis-induced change. In 2009, unemployment started to rapidly increase and as of 1 July 2009, the maximum duration of the benefit was again made nine months for all unemployed; however, in the last few months of unemployment, people with shorter working histories received benefits restricted to a maximum of 45 lats (LVL)⁶ per month (€64), which was considerably below

the average size of the benefit. This reform was specifically designed to alleviate the social consequences of the crisis and was announced as a temporary measure, expiring in 2011. However, in 2013, one year after the reformed system expired, the benefit duration was restored to the 2008 level (i.e., four, six or nine months, depending on the working history); the benefit duration was again raised for individuals with shorter working histories – it was made nine months for all unemployed, and this time it was not announced that it would expire after a certain period.

Falling budget revenues and growing social spending were putting an extraordinary pressure on the social budget, and in 2009 the government abolished the ceiling on income from which social contributions should be paid. Until 2009, there was a threshold above which income was not subject to social contributions (in 2008, it was LVL29,600 or €42,117 per year). This was announced as a temporary anti-crisis measure that would expire at the end of 2013. Removal of the ceiling on contributions effectively removed the ceiling on contributory benefits, which allowed unreasonably high benefits (see Springe, 2012). It was rather easy to manipulate the system, as the period over which the average wage was relevant to the size of the unemployment benefit was quite short before the crisis – six months. To restrict the possibility for manipulation, as of 2010, the period over which the average wage was calculated was increased from six to 12 months and, starting from November 2009, two months (the months in which the person received the highest and the lowest wage) were excluded from the period. This change was introduced permanently.

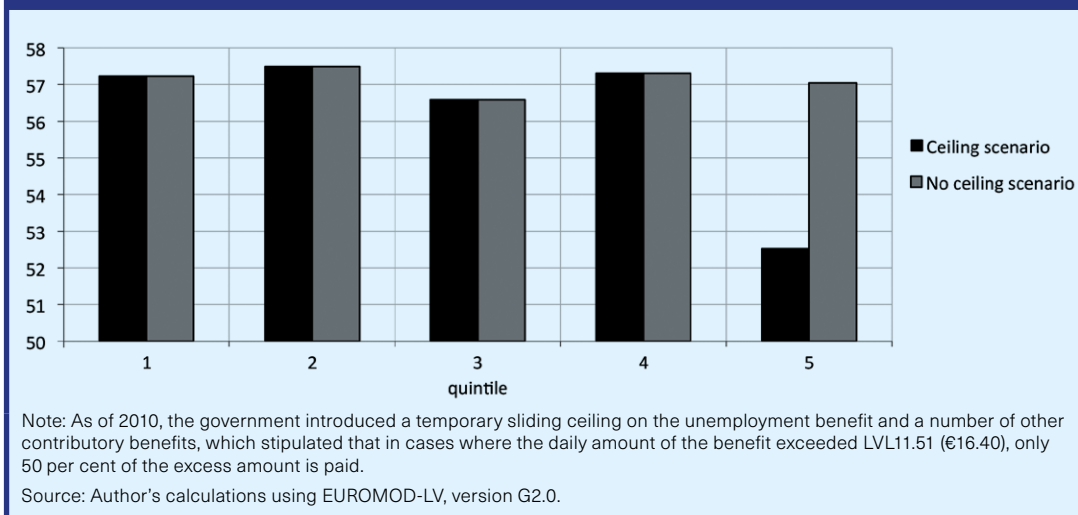
In 2010, the size of a number of contributory benefits, including the unemployment benefit, was directly restricted by the introduction of a sliding ceiling on the benefits. Namely, if the initial size of the benefit exceeded LVL11.51 (€16.40) per day, only 50 per cent of the benefit exceeding the threshold was paid out. The ceiling was introduced initially as a temporary measure and it was initially planned to be in place until 2012. However, due to continuing budgetary pressures, in the middle of 2011 it was decided to preserve the ceiling on unemployment benefits until the end of 2014. Imposition of the ceiling on the benefit is assessed positively; however, given that the ceiling is not a fixed amount and that the cap on social security contributions was removed, it still allowed very high benefits for high-wage earners and ensured low benefits for low-wage earners. As pointed out by the World Bank (2013a), “among countries with a purely earnings-related unemployment benefit, Latvia is the only country which has neither a benefit floor, nor a ceiling”.

4. The benefit tapered off with duration of unemployment: 100 per cent of the assigned benefit in the first three months of unemployment, 75 per cent of the assigned benefit in the 4th–6th months, 50 per cent in the 7th–9th months.

5. For individuals with a working history of nine years or less, the size of the benefit decreased to 75 per cent of the initially assigned benefit in the 3rd and 4th months of unemployment; for individuals with a working history of 10–19 years the benefit decreased to 75 per cent of the initial size in the 3rd and 4th months of unemployment and 50 per cent in the 5th and 6th months of unemployment; for individuals with a working history of 20 years or more the benefit decreased to 75 per cent in the 4th–6th months of unemployment, and to 50 per cent in the 7th–9th months of unemployment.

6. The lat was the Latvian national currency until January 2014, when Latvia joined the Eurozone. The lat was pegged to the euro at the exchange rate €1 = LVL0.7028.

Figure 3.2 Simulated unemployment benefit gross replacement rate in 2010 with and without the ceiling on unemployment benefit by quintiles of previous gross monthly wage of the unemployed (per cent)



Was the ceiling binding for many registered unemployed persons? Assuming that a person was employed full time throughout the period that is taken into account in benefit calculations, the monthly average gross wage that would ensure an unemployment benefit above the threshold introduced in 2010 was €505–€656,⁷ which was either below or about the size of the average monthly wage in 2009 (€655). According to estimations by the Ministry of Welfare made at the end of 2009, the ceiling was expected to affect on average 8,460 unemployed per month (Ministry of Welfare, 2009), which is approximately 14 per cent of the average monthly number of unemployed in 2010.

The statutory replacement rate of the unemployment benefit was not changed during the crisis. The replacement rate increases with working history, namely, the initial size of the benefit varies from 50 to 65 per cent of previous gross average monthly wage, and then gradually tapers off with duration of unemployment. However, the introduction of the ceiling in 2010 has effectively reduced the replacement rate for high-wage earners. To estimate the effect of the ceiling on actual unemployment benefit gross replacement rate faced by the unemployed, the microsimulation tax-benefit model EUROMOD⁸ (Sutherland and Figari, 2013) version G2.0 was used. One of the advantages of this approach is that the model is calibrated and the simulations are based on

representative population data, EU-SILC, which allows for inferences on the actual impact as opposed to the impact on hypothetical representative individuals.⁹

The estimated effect relates to gross replacement rate (GRR), which shows the share of previous gross income from employment that is preserved when the person loses income from employment, thus disregarding the effect of other components of a tax-benefit system. The impact is simulated for the initial phase of unemployment, i.e., it shows the impact on the maximum benefit that an individual can be eligible for; given that the benefit amount gradually declines with unemployment duration, but the ceiling does not depend on unemployment duration, the effect on the average benefit over the unemployment spell can be smaller.

Figure 3.2 shows simulated GRR in 2010 by quintiles of previous monthly earnings of the unemployed in the baseline scenario (“Ceiling scenario”) and in an alternative scenario assuming that no ceiling is imposed on the benefit (“No ceiling scenario”). In the alternative scenario, GRR in all quintiles of the previous earnings is very close to 57 per cent.¹⁰ Simulation results suggest that the introduction of the ceiling has affected the replacement rate in the top quintile, reducing it by approximately 5 percentage points.

7. The interval results from the fact that the replacement ratio for the unemployment benefit depends on the working history.

8. EUROMOD has been developed by the Institute for Social & Economic Research (ISER, University of Essex) in co-operation with national teams and is supported by PROGRESS funding from EC DG-EMPL.

9. Simulations are based on the EU-SILC 2010 Latvian database, which contains information about yearly incomes for 2009. Simulations for 2010 are done on uprated income data, whereby income components are uprated to 2010 using macro-level data on dynamics of respective income components (for details, see Zasova, Rastrigina and Vanags, 2013).

10. Note that the replacement rate reported in Figure 3.1 is higher, as it reflects the net replacement rate.

Figure 3.3 Ratio of the average unemployment benefit to the average gross monthly wage, January 2007 to September 2014 (per cent)



Figure 3.4 (Left) Share of registered unemployed receiving unemployment benefit (per cent). (Right) Ratio of unemployment benefit recipients to short-term unemployed (per cent) and share of previously non-employed individuals in total monthly inflow to registered unemployment (per cent)

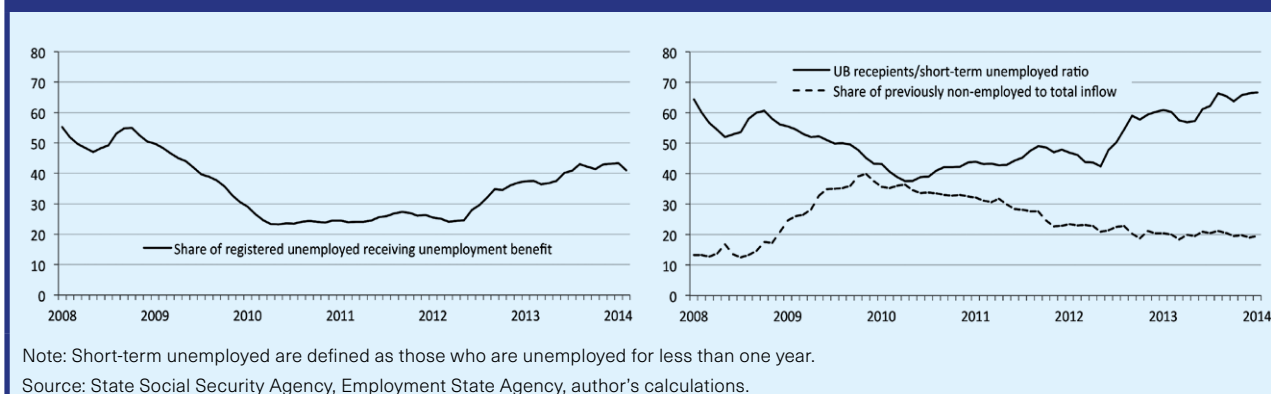
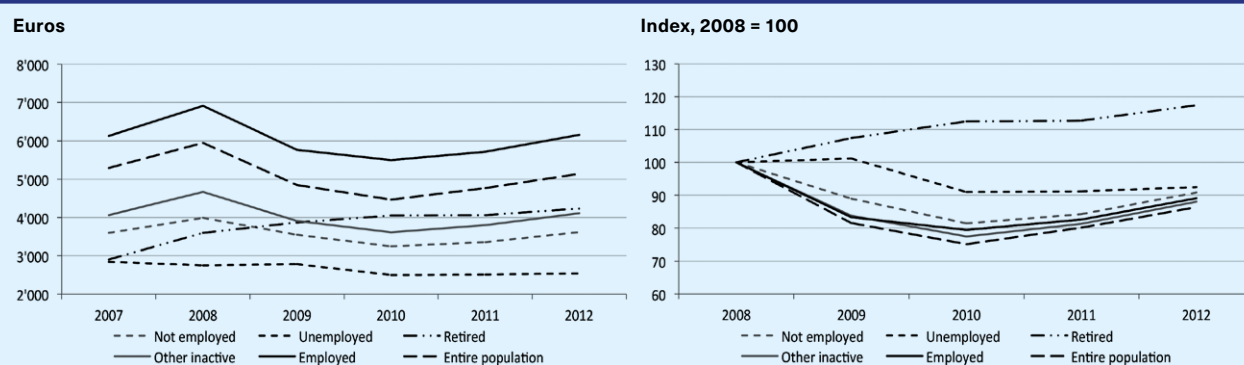


Figure 3.3 shows the ratio of the average unemployment benefit to the average gross monthly wage of currently employed workers. After an increase in the initial phase of the crisis, the ratio sharply declined in 2010. The ratio can be affected by several factors. First, it can be affected by the composition of the unemployed (e.g., if in the early phase of the recession the share of relatively well-paid individuals losing their jobs was higher than in the later periods, this would result in a falling ratio of the benefit to the average wage). Second, it is likely to be affected by the increase in the duration of the benefit in the second half of 2009, whereby in the last few months of unemployment individuals with a shorter working history received a fixed amount which was far below the average unemployment benefit. Third, a growing share of long-term unemployed could have led to a lower average benefit, as the benefit declines with duration of unemployment.

The share of benefit recipients in total registered unemployed declined gradually in 2009–10 from above 50 per cent to just over 20 per cent (see figure 3.4, left-hand panel). This again is partly attributable to the growing share of the long-term unemployed whose eligibility for the benefit expires; however, even if the share of benefit recipients is calculated against the number of short-term unemployed (i.e., unemployed for less than 1 year), it followed a similar trend until the beginning of 2011, despite the fact that there were no changes in maximum benefit duration in this period (see figure 3.4, right-hand panel). A possible explanation for this is the sharp increase in the inflow from non-employment to unemployment (which includes education, home activities, and other, presumably also informal, employment), thus increasing the share of unemployed individuals who are not eligible for unemployment benefits. As of 2013, however, the share

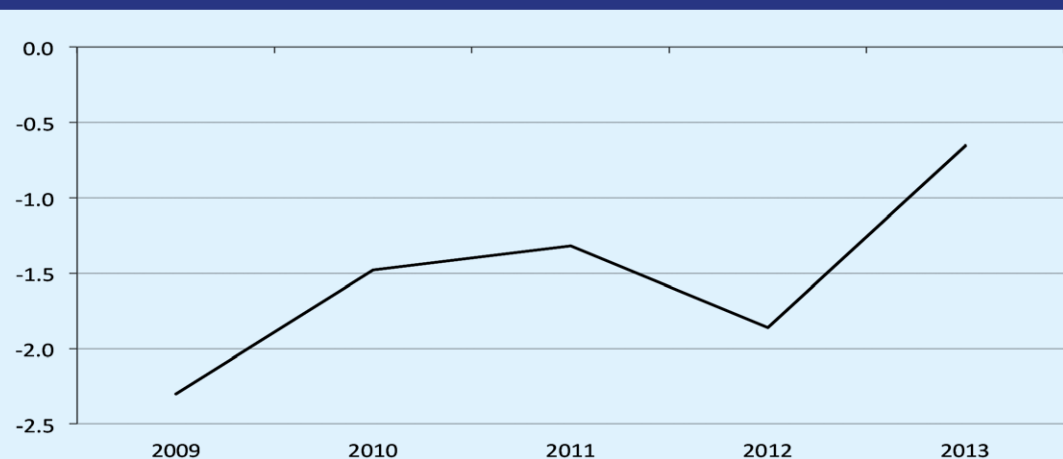
Figure 3.5 Median equalized net income by activity status



Notes: (1) Activity status is defined based on the information from EU-SILC where respondents are asked to report the number of months in the income reference year spent in each of the activity statuses; (2) years shown in the figure correspond to income reference period (not to the year of the interview).

Source: Eurostat (EU-SILC data), author's calculations.

Figure 3.6 Simulated change in median equalized disposable income of unemployed in 2009–13 caused by reforms of unemployment benefit system, baseline to the 2007 system (per cent)



Note: Baseline scenario in each of the depicted years reflects the tax-benefit systems that were actually in place in 2009–13. The baseline scenario is compared with the 2007 year system, in which all of the simulated tax-benefit system components are the same as in the baseline system, except for the unemployment benefit, which corresponds to the policy rules that were in place in 2007.

Source: Author's calculations using EUROMOD-LV, version G2.0.

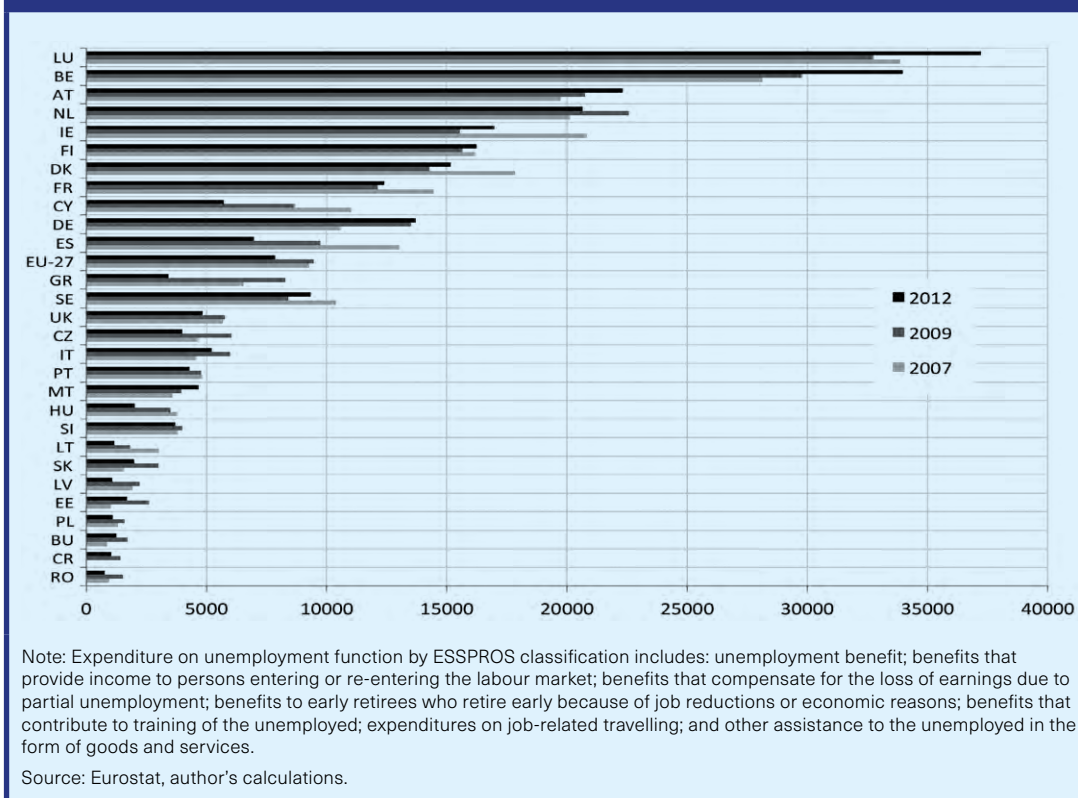
of unemployment benefit recipients increased sharply. This was due to a change in the maximum duration of unemployment benefits, which was raised to nine months for all unemployed persons (see description of the changes in duration of unemployment benefit above).

The median equalized net income of the unemployed declined by about 10 per cent in the course of the crisis (see figure 3.5, left-hand panel), which is about the same as the fall in income of the employed population; however, at the outset of the recession, income of the employed fell far more rapidly. But median income of the unemployed was the lowest of all categories

in figure 3.5, and the only one to have continuously decreased since 2007.

Figure 3.6 presents simulation results that compare median equalized income of unemployment benefit recipients in the baseline scenario (that reflects the unemployment benefit system in place in 2009–13) with an alternative scenario (that reflects the unemployment benefit system in place in 2007). Simulations are done assuming no changes in population structure: neither demographic, nor employment changes that took place over this period are modelled, and the simulated effect reflects a pure effect of reforms in the unemployment benefit system. Each year's system reflects the system that

Figure 3.7 Government expenditure on unemployment function (ESSPROS classification) per unemployed (LFS-based), purchasing power parity adjusted (euros per year)



was in place on 30 June of a particular year; therefore, for example, the reform that came into force on 1 July 2009 will affect simulation results for 2010, but not for 2009.

The results suggest that reforms of the unemployment benefit that were implemented in 2008–13 have, on the whole, reduced income of the unemployed vs. the system that was in place in 2007. The reduction was close to 2.5 per cent in 2009; in 2010 and 2011 the reduction was smaller, due to prolongation of the maximum duration of the benefit to nine months for all unemployed. Then in 2012, when benefit duration was again reduced for unemployed persons with shorter employment histories, the simulated reduction was again larger and was close to 2 per cent, but in 2013 the income difference sharply declined, as the benefit duration was again made nine months for all unemployed.

The massive increase in unemployment resulted in a sizeable increase in budget expenditures. According to Eurostat data, expenditures on measures related to unemployment (by ESSPROS classification, roughly corresponding to active and passive measures)¹¹ more

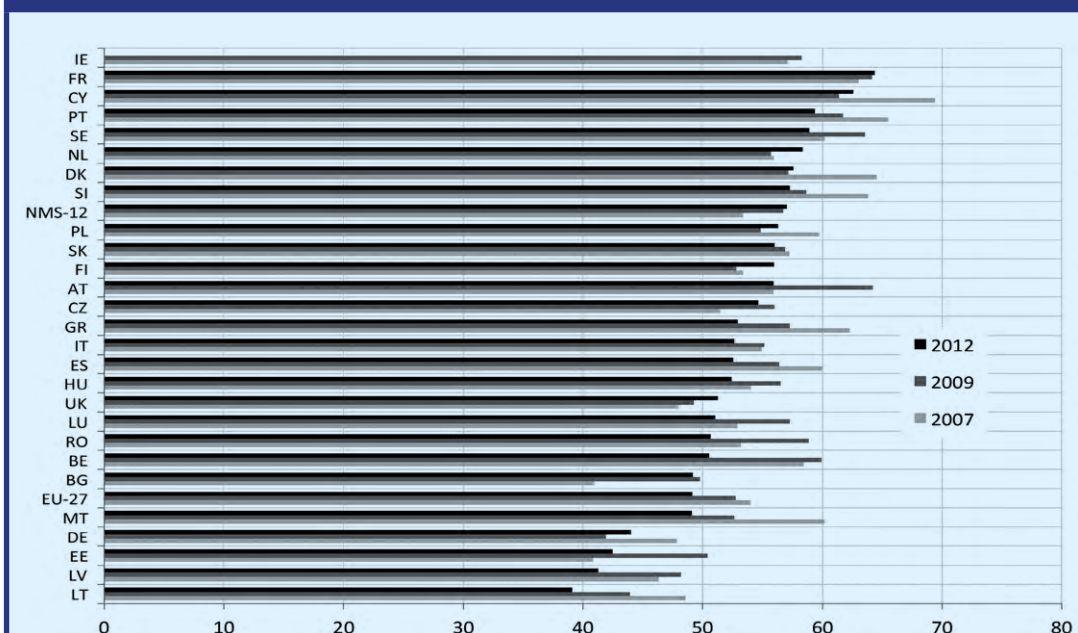
than tripled between 2007 and 2009, increasing from €87 million (0.4 per cent of GDP in 2007) to €294 million (1.6 per cent of GDP in 2009) and then gradually declined to €114 million by 2012 (0.5 per cent of GDP). The increase was mainly driven by expenditures on unemployment benefits, which constitute more than half of expenditures on unemployment by ESSPROS classification; however, other categories, such as active labour market policy measures, also increased notably. The expenditure per unemployed (LFS-based) in 2009 was about 20 per cent higher than it was in 2007; however, by 2012 it had declined and was just about 50 per cent of the 2007 level. Budget expenditure per unemployed person compared with other countries in Latvia have remained one of the lowest in the EU (see figure 3.7).

As a result, the income of the unemployed relative to median income in Latvia remains one of the lowest amongst EU countries, at around 40 per cent, about 10 percentage points lower than the EU-27 average (figure 3.8).

11. The main categories of expenditure on the unemployment function include expenditure on replacing income lost due to unemployment, expenditure on training or retraining of the unemployed, expenditure on compensation of travelling

expenditure of the unemployed if it is related to re-employment, expenditure on provision of goods and services to the unemployed, which includes placement services and job-search assistance (Eurostat, 2012).

Figure 3.8 Ratio of median equalized net income of unemployed to median equalized net income of employed population in EU countries in 2008 and 2012 (per cent)



Note: Data displayed in the figure refers to the year preceding the EU-SILC survey, which in most countries is the income reference year. For example, data on 2012 comes from the EU-SILC 2013 database (and in Eurostat online database the data refers to 2013); however, for most countries, including Latvia, it describes incomes in 2012.

Source: Eurostat (EU-SILC data), author's calculations

3.2 Anti-crisis temporary support schemes

Unemployment insurance is the only benefit available to the unemployed, therefore once the unemployment benefit expires, the unemployed individual is no longer eligible for any support designed specifically for unemployed individuals. To provide additional support to the unemployed during the recession, several temporary support schemes were implemented aimed at providing additional financial support and facilitating their re-integration into the labour market.

First, during September 2009–11, the government, in cooperation and with technical assistance from the World Bank, and financial support from the European Social Fund, ran a programme “Workplaces with Stipends”, which was specifically targeted at those unemployed not receiving unemployment benefits. The programme has become known as a “100-lat programme”,¹² as the participants in this programme were paid LVL100 (€142) per month for performing the simplest non-commercial tasks in municipalities that do not require specialized skills (cleaning, building simple infrastructure objects on the territory of municipalities, child care, etc.) (Ministry of Welfare, 2011a).

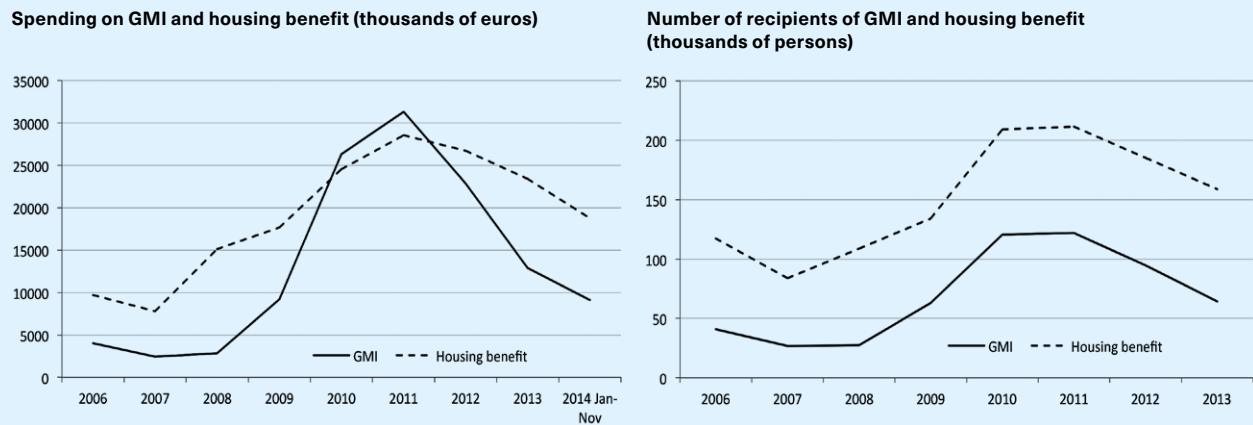
The jobs had to be newly created; the programme did not finance replacement of the existing workers with the unemployed. Candidate selection was done on a “first-come-first-served” basis. The stipends were not subject to either personal income tax or social tax (but all participants were insured against work-related accidents), monthly remuneration received within this programme amounted to just about three-quarters of the statutory net minimum wage,¹³ and as of July 2011, the stipend was reduced to LVL80 (€114) per month. Nevertheless, the programme was very much in demand among the unemployed individuals; the waiting list for jobs financed under this programme was about twice the number of available positions (Azam et al., 2012).

The programme has been evaluated as being effective in achieving its objectives. Overall, about 20,000 individuals participated in the programme per month, which is about 20 per cent of the registered unemployed not receiving unemployment benefits (IFC-GHK, 2012). According to in-depth evaluation carried out by the World Bank, the programme was effective in targeting the poorest and most vulnerable population groups: despite there being no formal selection of the

12. “Simlatnieku programma” in Latvian.

13. Assuming no allowances for dependents are applicable; dependents would affect the size of the net minimum wage, as minimum wage is subject to personal income tax.

Figure 3.9 Spending and number of recipients of means-tested social assistance benefits



Source: Ministry of Welfare, annual reports on social services and social assistance in municipalities.

beneficiaries, labour-intensive work and relatively low remuneration ensured self-selection of those who were most in need (Azam et al., 2012).

In 2012, the “Workplaces with Stipends” programme was replaced by a similarly designed “Temporary Public Works Programme”, which was also co-financed from the national budget and the Social European Fund. The new programme was implemented until the end of 2014. During this period, more than 82,000 unemployed persons benefited from the programme, mostly in the eastern part of the country, where the unemployment rate is the highest (NRA, 2014).

3.3 Social assistance

The unemployed who are not eligible for the unemployment insurance benefit, or who do receive the benefit but their household income per member still falls below a certain threshold, can be eligible for means-tested social assistance benefits – Guaranteed Minimum Income (GMI) benefit and housing benefit. The benefits are provided by municipalities, and despite there being general rules with respect to the provision of the benefits (e.g. there is a minimum GMI level), municipalities have some autonomy in the provision of the benefits.

To be eligible for GMI, a household has to be classified as being “in need”, which requires income per household member in the previous three months to be lower than a certain threshold. Until 2010, the threshold was 50 per cent of the minimum wage (€114 in 2008, €128 in 2009 and 2010), but as of 2011 the threshold was made a fixed amount of €128. Other eligibility requirements include absence of deposits, financial assets and

property from which the household can earn income. Eligibility for housing benefits is determined by municipalities and therefore differs between them.

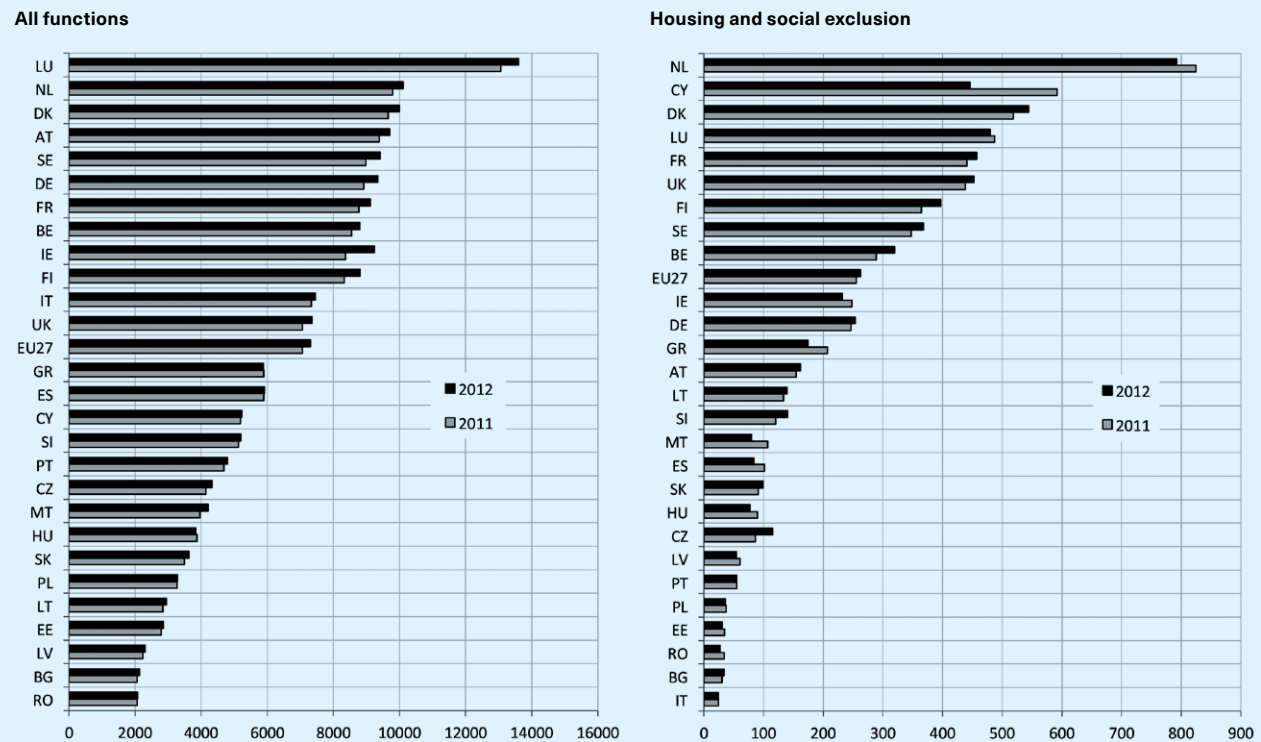
There were several major reforms implemented during the crisis aimed at increasing the support of the poorest population groups. As part of the Social Safety Net Strategy, which the government adopted in 2009 and which was elaborated in cooperation with the World Bank and the IMF, the minimum standard¹⁴ amount of GMI was raised by almost 50 per cent.¹⁵ Another major reform concerned the financing scheme: before the crisis, GMI and housing benefits were fully financed from the local governments’ budgets, but in the crisis period, the central government budget provided 50 per cent co-financing of the social assistance benefits. Another major reform was related to eligibility for GMI: in 2010 the condition stating that a person having taken out or been given loans cannot be eligible for the benefit, was abolished.

Spending on social assistance benefits increased considerably during the crisis (see figure 3.9): expenditure on GMI in 2011 was 13 times as high as in 2007, and expenditure on housing benefits was four times as high. The number of recipients of GMI increased by a factor of 5, and the number of recipients of the housing benefit increased by a factor of 3.

14. The standard GMI amount refers to all people who comply with income test conditions. Apart from the standard GMI amount, municipalities can set a higher GMI for certain population groups such as children or older people.

15. The minimum standard amount of the GMI benefit was raised from LVL27 (€38) per month per household member in 2007 and 2009, to LVL37 (€53) in 2009 and LVL40 (€57) in 2010–12.

Figure 3.10 Expenditure on social protection benefits in EU countries (purchasing power standards per head)



Source: Eurostat.

Despite the increase, however, spending on social assistance programmes in Latvia remained remarkably low compared with other EU countries (see figure 3.10). Even in 2011, when expenditure on GMI and the housing benefit was the highest, Latvia ranked at the bottom among EU countries in terms of spending on social protection benefits.

Compared with other EU countries, means-tested benefits, which are targeted everywhere at the poorest population groups, play a very minor role in reducing poverty (see figure 3.11). Although the reduction in poverty risk ensured by means-tested benefits increased slightly in 2010 and 2011, it still remained the second lowest in the EU, with a weaker role being observed only in Estonia. This suggests that there is likely to be a considerable scope for increasing generosity of the means-tested benefits.

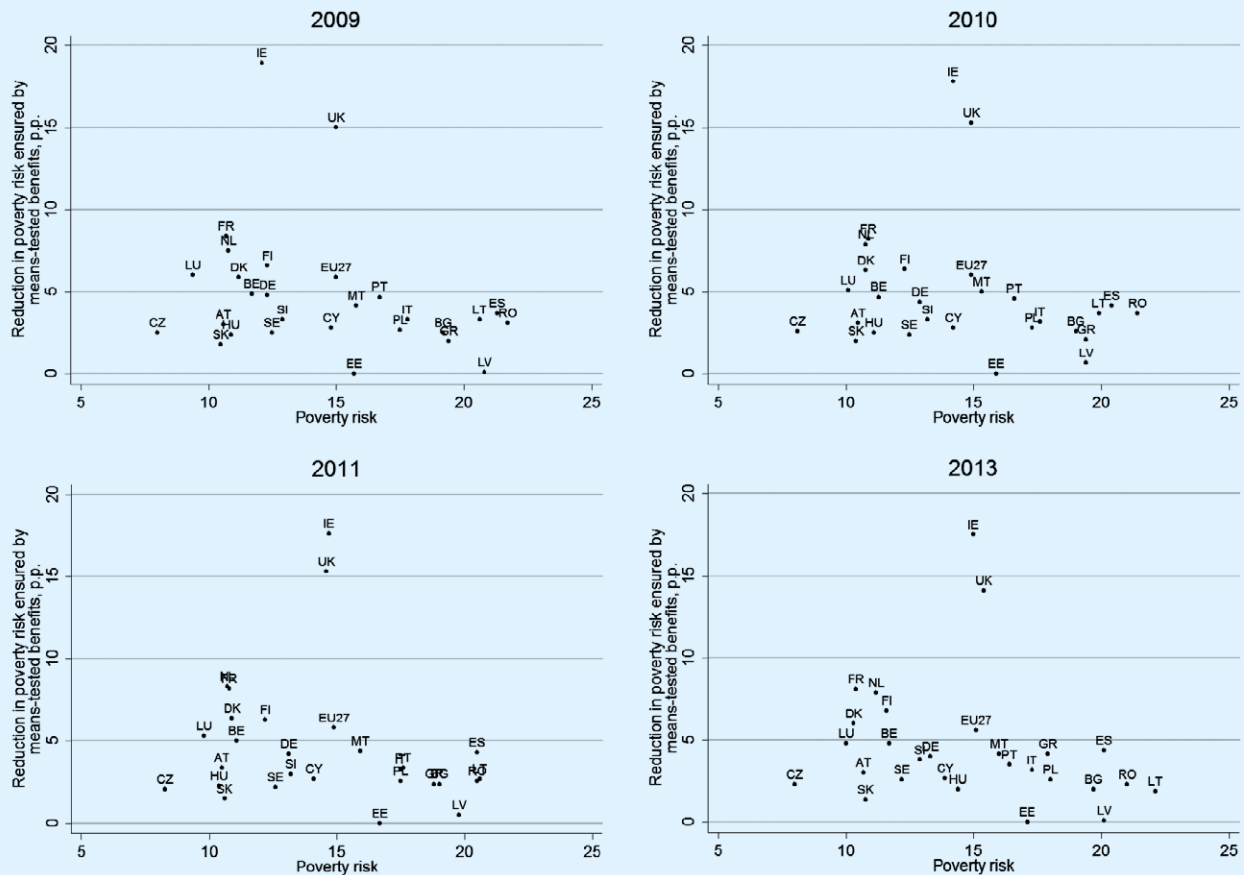
In 2013, the direction of GMI and housing benefit reforms was reversed: the GMI benefit was cut and the central government's 50 per cent co-financing of the benefits ceased.

The minimum standard GMI level that municipalities have to ensure was cut by 12.5 per cent (from LVL40 to LVL35 (€57 to €50) per month). The government's motivation for the reduction was an improvement in

work incentives for low-skilled workers; however, as acknowledged by the Ministry of Welfare, the proposal for this reform had not been preceded by any in-depth analysis (Ministry of Welfare, 2012). Another measure was to add children to the group of individuals for which municipalities can set a higher GMI level (LVL90 or €128 per month), though at the same time an obligatory higher GMI for children (LVL45 or €64) that was already in place was abolished. Thus effectively the maximum possible GMI for children increased in 2013, but it became optional for municipalities to pay a higher GMI to children. For example, Riga, the biggest municipality, left GMI levels for all population groups unchanged: it kept paying LVL40 (€57) to standard GMI allowance recipients (through a supplementary benefit to the reduced standard GMI allowance), kept GMI allowance for children at LVL45 (€64) and GMI allowance for pensioners at LVL90 (€128).

As pointed out in the World Bank study that became available just several months after the reform (World Bank, 2013b), the coverage and adequacy of the GMI programme is not sufficient. Targeting of the programme is good, but the programme covers only a few of the poor and the amount of the benefit is not sufficient to serve as an adequate safeguard against poverty for many of the recipients. In this light, the

Figure 3.11 Poverty risk (per cent) vs. reduction in poverty risk (percentage points, p.p.) ensured by means-tested benefits in EU-27 in 2009, 2010, 2011 and 2013



Source: EUROMOD statistics.

implemented benefit cut is assessed to “further undermine the coverage of the program and adequacy of the minimum income support”. Another concern raised by the World Bank (2013b, 2010) is the fully decentralized financing of GMI and housing benefits, as this can create bad incentives for the provision of the benefits and increase disparities in assistance provision between rich and poor municipalities.

A major problem with the design of the means-tested benefits is that recipients of the benefits are faced with a 100 per cent marginal tax rate: if their employment income increases, the benefits are withdrawn at the same rate as income rises (Zasova & Ždanovica, 2014). Although the level of the benefits is low, this can create disincentives to increase labour supply and creates the risk of a poverty trap. This problem could be addressed by allowing a certain number of hours of work per month for beneficiaries of social assistance, as is the case in some other countries, such as Germany, without a reduction in benefits, as a way for the long-term unemployed to maintain attachment to the labour market, or by activation measures.

As the Latvian economy was hit by the crisis, the Latvian government chose the internal devaluation strategy. An alternative to the internal devaluation was a nominal devaluation of the national currency – the lat, and although some existing estimates suggested that this was likely to result in a less prolonged recession (IMF, 2009), the nominal devaluation was never considered a suitable option by the Latvian government.

4.1 Wage and productivity change during the recession

The key to the internal devaluation strategy is downward flexibility of wages – pay cuts in the public sector and spillovers of the public pay cuts into private sector wages. Recent analysis of the Latvian adjustment to the crisis (Blanchard et al., 2013) however, suggests that wage adjustment in the private sector was moderate and that competitiveness gains were largely achieved via productivity growth. Figure 4.1 shows the dynamics of nominal and real wages in the private and public sectors during the boom and the bust. Private sector wages were growing less excessively before the recession and adjusted by less during the recession.

A comparison of wage dynamics by industry (see figure 4.2) also shows that the most sizeable wage adjustment took place in the public administration sector, where wages before the crisis were considerably higher than in other sectors. This resulted in wages becoming less dispersed across industries.

Figure 4.3 shows changes in the distribution of wages based on micro-level administrative data on wages.¹⁶ The data also suggest that wage dispersion declined slightly over the crisis, as the reduction of wages in upper quintiles exceeded wage reduction in the lower quintiles.

Competitiveness gains were mainly ensured by productivity growth (see figure 4.4): labour share in GDP declined during the recession, pointing to increased competitiveness; nominal unit labour cost was declining in 2009–10 and this trend was especially pronounced in the tradable sector.

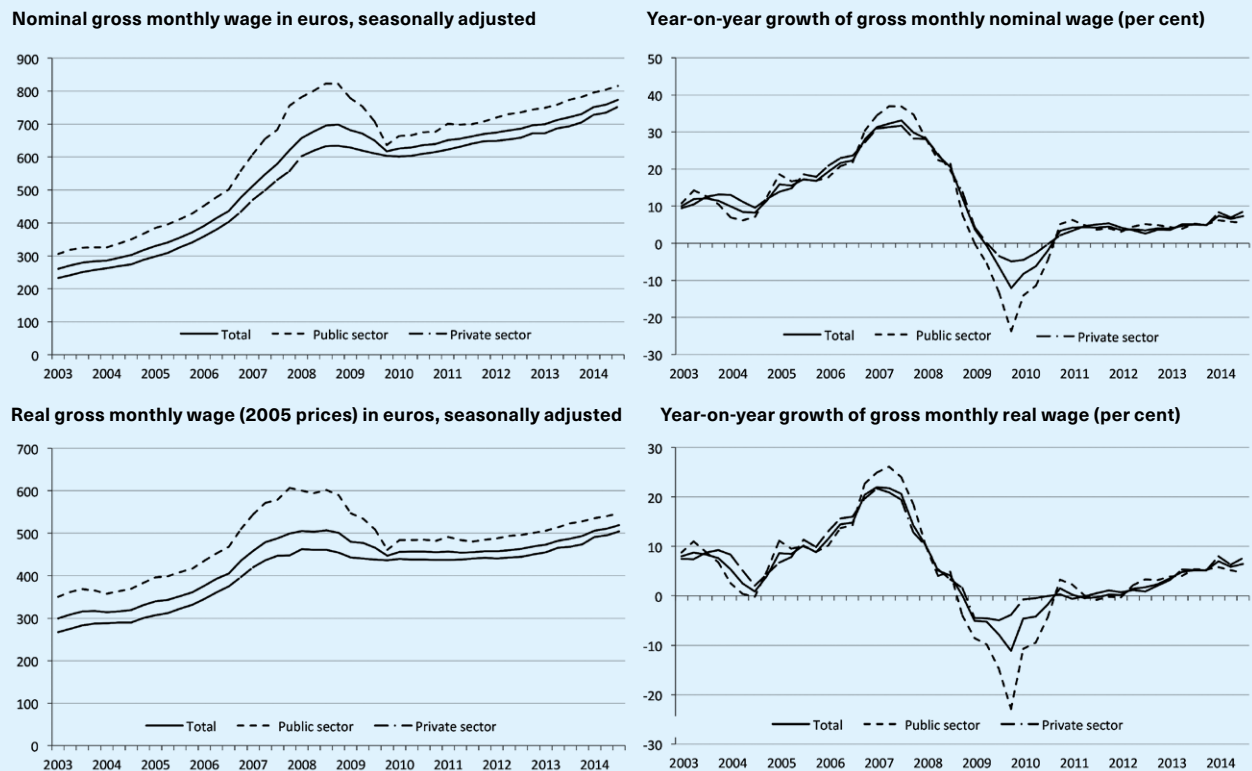
4.2 Wage trend analysis using micro-level administrative data

This report is revisiting the issue of wage adjustment in the private sector during the recession by analysing the dynamics of wages using micro-level longitudinal administrative data on wages of the entire population in 2006–13. The data was provided by the State Social Insurance Agency. The database contains information on gross monthly wages from which social contributions were made. The database contains no information on the number of hours worked, so it is not possible to distinguish between wage cuts and reductions in monthly income that come from reduced workload. Given that aggregate LFS data suggests that the incidence of part-time work increased during the crisis, the inability to distinguish between part-time and full-time workers in the micro-level data is likely to lead to an overestimation of wage cuts. In order to control for this bias as much as possible, calculations were done including and excluding observations that are below the minimum wage, as exclusion of the observations that are below the minimum wage is likely to exclude at least some part-time jobs from the data.

To begin with, figure 4.5 shows the dynamics of the number of jobs, job separations and new hires in the private and public sectors by quarters. Job separation in a particular quarter is defined as an employee–employer pair that was observed in the previous quarter, but is not observed in the current quarter. New hire, on the contrary, implies an employee–employer pair that appears in the current quarter, but was not observed a quarter before.

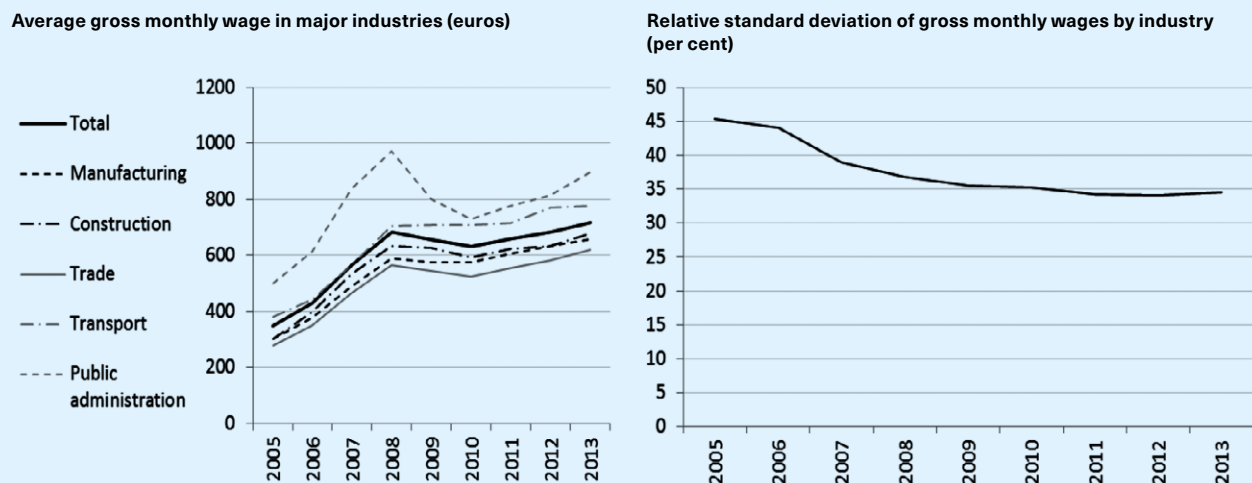
16. The data was provided by the State Social Insurance Agency. The data contains information about wages from which social insurance contributions were made. For more detailed description of the data, see section 4.2.

Figure 4.1 Level and year-on-year growth of nominal and real gross monthly wage



Source: Central Statistical Bureau of Latvia, author's calculations.

Figure 4.2 Average gross monthly wages by industry and dispersion of wages across industries



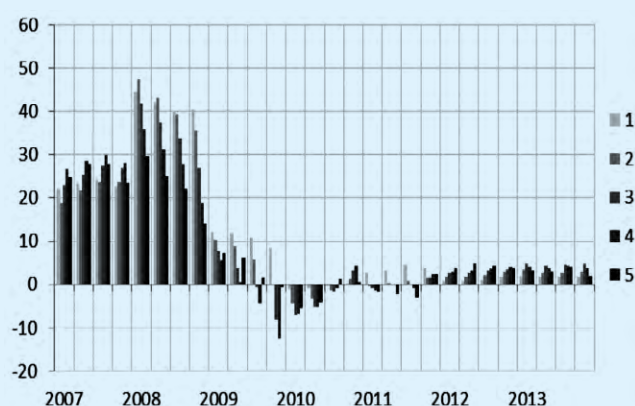
Source: Central Statistical Bureau of Latvia, author's calculations.

The private sector experienced a more protracted reduction in the number of jobs, which began earlier than that in the public sector. On the whole, the number of jobs in both the private and the public sector declined by almost 20 per cent. In the private sector, the reduction in the number of jobs was driven by both a fall in new hires and an increase in job separations, but the

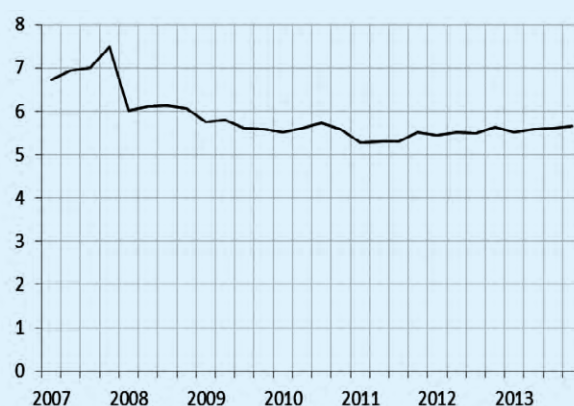
post-crisis gradual recovery in the number of jobs was accompanied by a pick-up in both hiring and separations. In the public sector, the trend was different, as both the number of hires and separations was declining throughout the recession and the recovery, with the exception of the middle of 2009, the time when most of the austerity measures were implemented.

Figure 4.3 Changes in wage distribution, 2007–13

Year-on-year growth of average gross monthly wages by wage quintiles (per cent)



Ratio of average gross monthly wage in the 5th quintile of wage distribution to the 1st quintile of wage distribution



Note: covers both public and private sectors. Monthly wages below the minimum wage are excluded

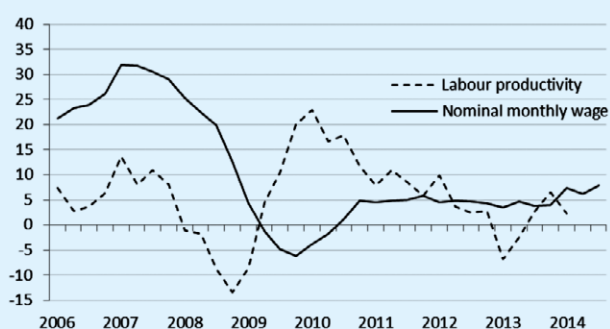
Source: State Social Insurance Agency of Latvia, author's calculations.

Figure 4.4 Labour productivity, nominal wages, nominal and real unit labour cost (ULC) in the economy and in manufacturing, 2006–14

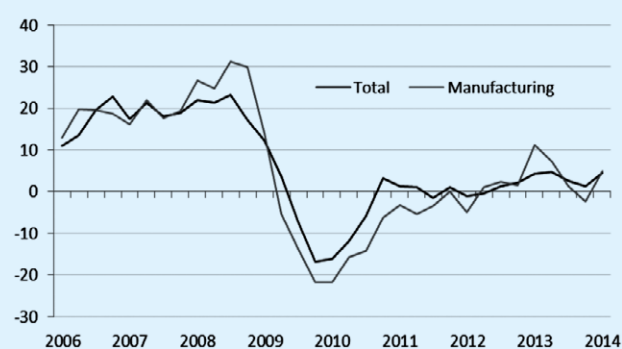
Year-on-year growth in the economy (per cent)



Year-on-year growth in manufacturing (per cent)



Year-on-year growth of nominal ULC (per cent)

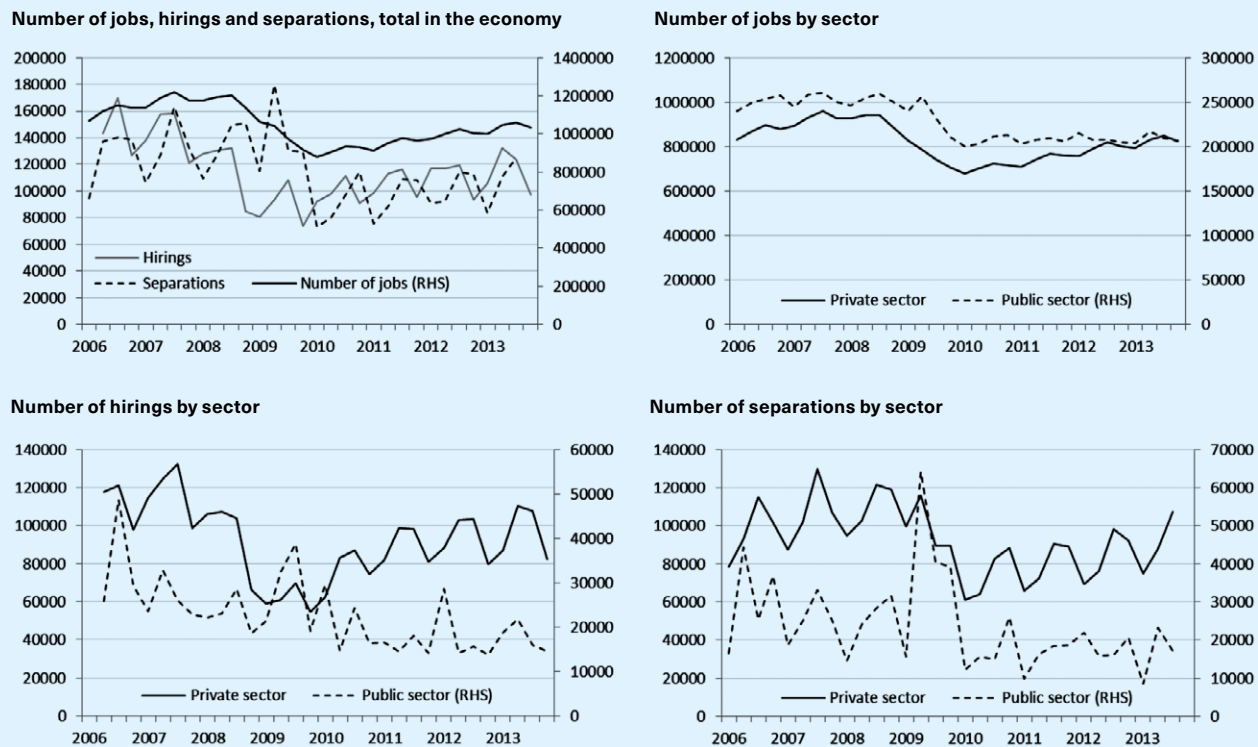


Real ULC (share of compensation of employees in value added, per cent level)



Source: Eurostat, Central Statistical Bureau, author's calculations.

Figure 4.5 Number of jobs, hirings and separations by sectors, 2006–13 (persons)



Source: State Social Insurance Agency, author's calculations.

Figure 4.6 shows the dynamics of the average gross wage for three categories of workers – incumbent workers, new matches and job leavers. Incumbents here are defined as those employees who remained employed with the same employer throughout the period 2006–13. Wages in new matches are wages in the first quarter after a new match is established. Wages of job leavers are wages in the last quarter of employment. The figure reports wages including and excluding observations below the minimum wage.

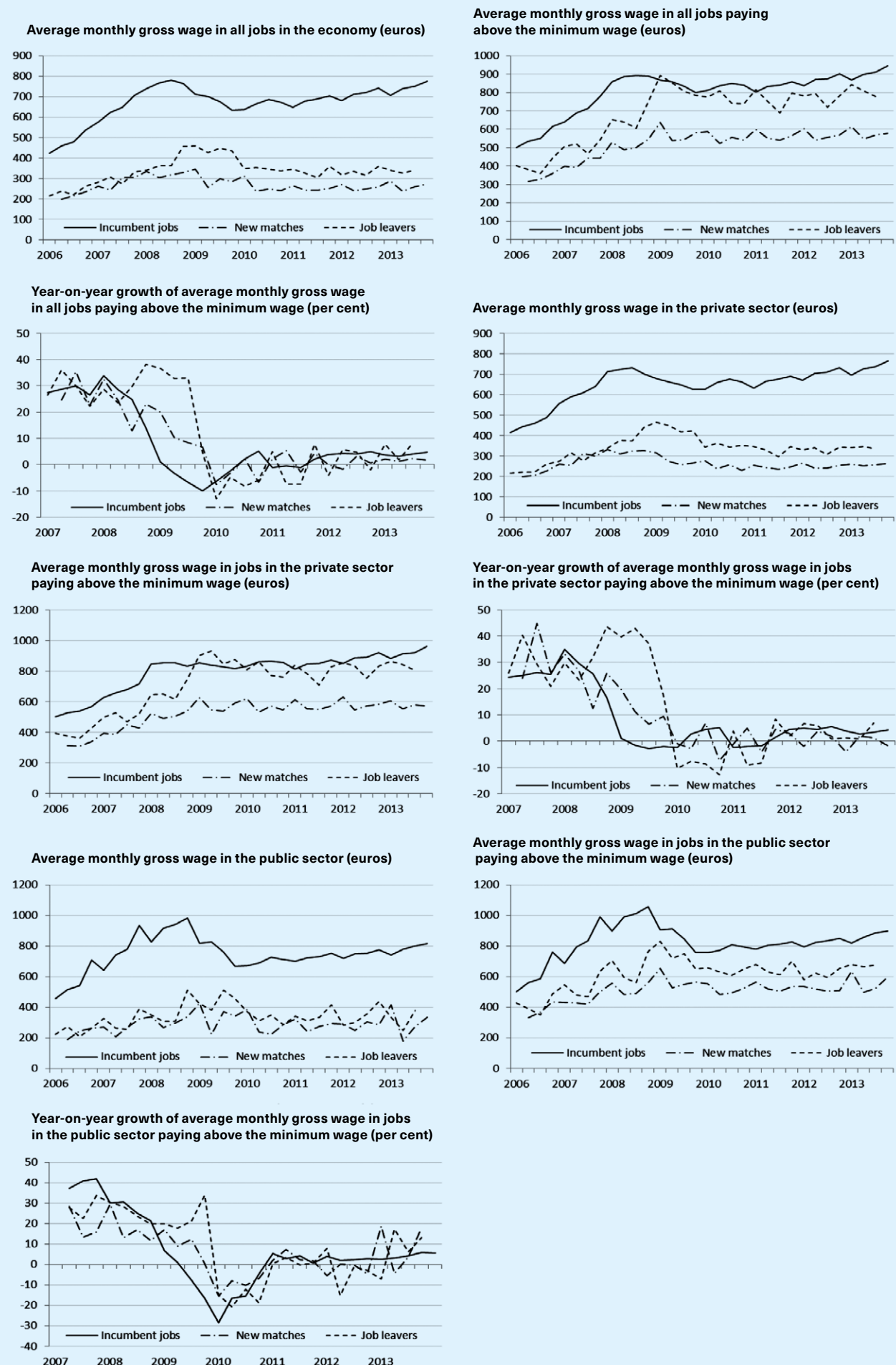
The data suggests that wages in the private sector declined by much less than wages in the public sector. Wages of incumbent workers in the private sector declined hardly at all, if observations below the minimum wage are excluded, which implies that the (minor) reduction in the private sector wages was mainly due to the fact that wages in new matches were considerably below the wages of incumbents.

Wage adjustment in the public sector was much more sizeable, suggesting a weak link between the wage cuts in the public and the private sector. In the private sector,

wages are predominantly bargained at individual level – trade union density is low, and the impact of the trade unions, especially in the private sector, is virtually non-existent. Therefore, the fact that wages of incumbent workers in the private sector hardly declined, despite considerable wage cuts in the public sector and a very high unemployment rate, suggests that employers could be reluctant to cut wages of the existing workers, this being consistent with the view that wage cuts can negatively affect workers' morale and productivity. Therefore, labour costs were mainly cut via recruiting new workers at lower wages, not via cutting wages to the incumbent workers.

Wage cuts in the public sector were implemented via the introduction of a single public pay system, which strictly defined wages for various position types and which replaced the pre-crisis system, which was not very transparent and allowed for various supplementary contracts and bonuses. Now, as the economy is recovering, the public pay system introduced during the recession is regarded as excessively rigid and limiting possibilities to attract workers with adequate skills.

Figure 4.6 Average monthly gross wage in incumbent jobs, new matches and wages of job leavers, 2006–13



Source: State Social Insurance Agency, author's calculations.

4.3 Minimum wage policy and “envelope” wages

One of the central issues in the public debate is envelope wages¹⁷ and their role in labour market adjustment during the crisis. According to the existing evidence (Williams, 2009), the prevalence of envelope wages in Latvia is one of the highest in the EU. This report makes an attempt to infer dynamics of the prevalence of envelope wages during the recession, by analysing changes in wage distribution.

Despite the recession, the minimum wage in Latvia was raised three times (in 2008, 2009 and 2011) from €171 per month in 2007 to €285 per month in 2011. It was raised further to €320 in 2014. As a result of these changes, the ratio of the minimum wage to median wage increased from 0.36 in 2007 to 0.48 in 2013 (OECD data), which puts Latvia approximately in the middle of OECD countries ranked by the size of the minimum wage relative to median earnings. In Estonia, for example, the ratio in 2013 was much smaller (0.39), and in Lithuania it was slightly higher (0.52).

The share of employees receiving the minimum wage or less than the minimum wage is quite large: according to LFS data, in 2012 it was 20.6 per cent of all employees, but in 2013 the share declined slightly and amounted to 16.7 per cent. Anecdotal evidence, however, suggests that most of the official minimum wage recipients are in fact getting additional income in “envelopes”.

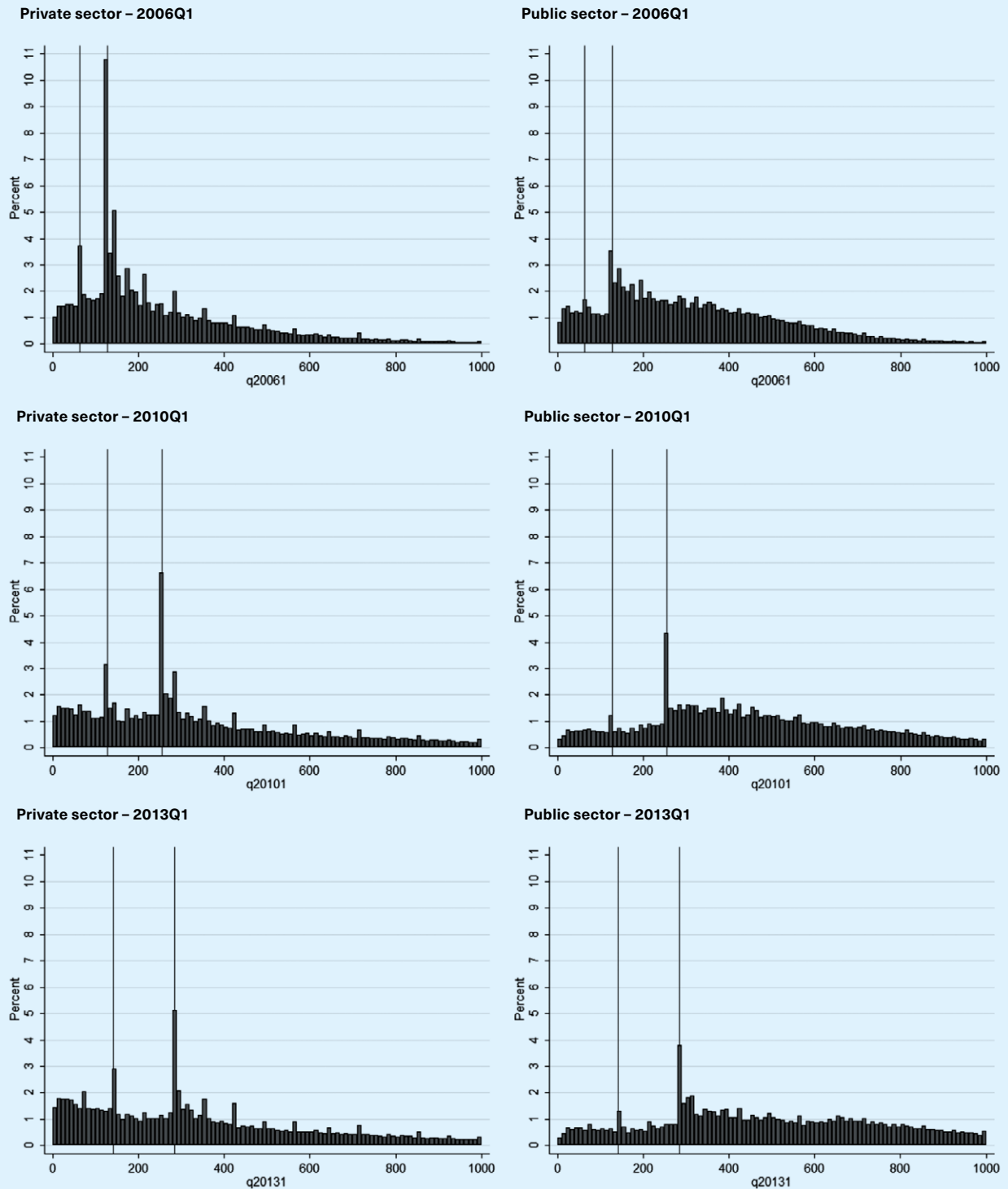
Figure 4.7 shows the distribution of average monthly wages in the private and public sectors in the first quarter of 2006, 2010 and 2013 (wage distributions in other years are shown in the Annex). Before the recession, there were notable spikes around the minimum wage and 50 per cent of the minimum wage in the private sector, but in the public sector the spikes were much less pronounced. The spikes can be a symptom of a binding minimum wage. If this is the case, the increase in the minimum wage during the recession would have arguably led to the spikes becoming more prominent. Another possible explanation of the spikes is envelope wages.

The spikes became considerably less pronounced in the private sector, and became more pronounced in the public sector. Envelope wages presumably do not exist in the public sector, thus the spikes becoming more pronounced in the public sector is consistent with the idea of a binding minimum wage. A reduction in the spikes in the private sector, however, is not consistent with this explanation, given the strong increase in the minimum wage. The reduction in the spikes in the private sector might signal that the prevalence of envelope wages declined during the recession, possibly because of compositional changes in employment, as employment share in the most problematic sectors (construction and trade) declined.

This result suggests that official wage data might underestimate the true wage adjustment that took place over recession, yet the extent to which this could have affected the true wage dynamics is hard to determine. On the whole, however, analysis of wage dynamics suggests that adjustment in labour costs in the private sector took place mainly through newly employed workers, who were employed at wages that were considerably below the incumbent workers' wages. Nevertheless, the adjustment in labour costs was apparently not sufficient to preclude a large fall in employment, and a sharp and protracted increase in unemployment.

17. This is where employees receive part of their wage from their employer as cash payments (“in envelopes”) that are undeclared.

Figure 4.7 Distribution of average gross monthly wages in the private and public sectors in the 1st quarters of 2006, 2010 and 2013



Note: Minimum wage in 2006 = €128.06, in 2010 = €256.12, in 2013 = €284.57; vertical lines in the graphs indicate the minimum wage and 50 per cent of the minimum wage. Wages above €1,000 are not shown on the graphs.

Source: State Social Insurance Agency, author's calculations.

Active labour market policies (ALMPs)

5

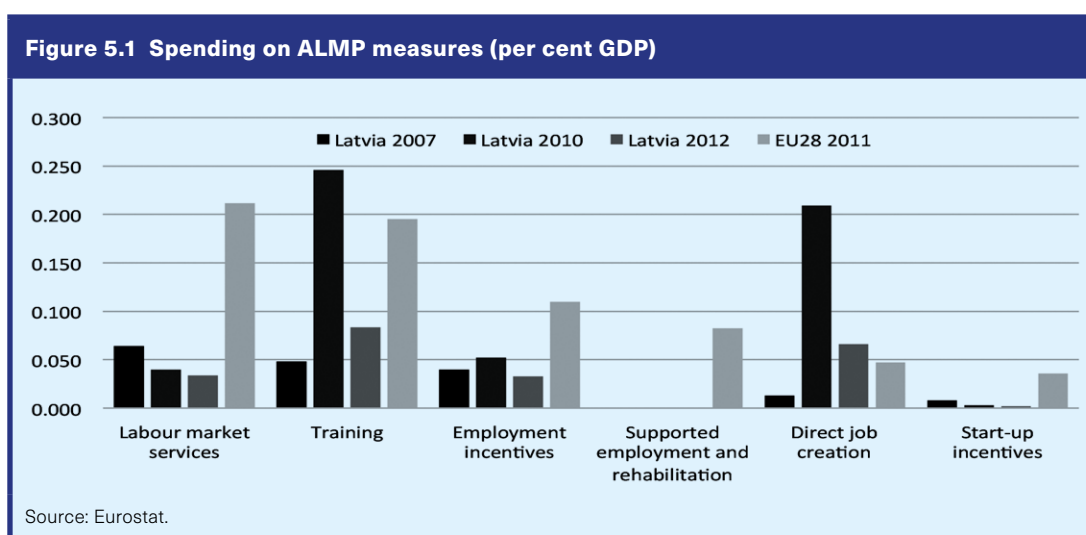
Figure 5.1 reports changes in ALMPs in Latvia during the crisis and compares spending on ALMPs as a share of GDP with the average spending level in the EU-28.

In the crisis years there was a massive increase in spending in two categories – direct job creation and training. This reflects two main directions of ALMPs that were followed to mitigate the negative consequences of the crisis: first, temporary subsidized employment in local governments (this explains the increase in the financing of direct job creation) and second, training programmes for employed individuals at risk of becoming unemployed and training programmes for the unemployed. The latter, in combination with the increased number of unemployed, explains the rise in expenditure on training.

The temporary employment programme “Workplaces with Stipends” was a major source of support for the unemployed who were not eligible for the unemployment benefit (see section 3.2 for details). The programme was initiated in September 2009, when most of the unemployed who lost jobs in the early phase of the crisis were no longer eligible for unemployment benefits. Given the weak labour market and deteriorating economic prospects, this called for additional financial support and activation measures for the long-term unemployed; therefore, this programme, which allowed

for a maximum of six months employment per year, and paid €142 per month to the participants, was initiated. The programme was implemented until 2011, but as of 2012 it was replaced by a similarly designed “Temporary Public Works Programme”, which was in place until the end of 2014.

There were a number of training programmes implemented in response to the crisis. A training programme for the most vulnerable groups was initiated in the second half of 2009 (Ministry of Welfare, 2010). The programme was targeted at part-time employed and self-employed persons, and the idea was to make part-time employment an opportunity to devote time to the acquisition of new skills. Participation in the programme was limited to six months, and participants were paid a stipend of €100 per month. Participants received special vouchers that could be used for a training programme from a training provider that the person could choose themselves (the person could choose among training providers approved by the State Employment Agency (SEA)). The amount the voucher covered was up to €711 (LVL500) for vocational further education programmes and up to €427 (LVL300) for vocational perfection programmes (Ministry of Welfare, 2011b). The majority of programme participants in 2009–10 (almost 50 per cent of all participants) were employed



in trade or manufacturing. The training programmes most in demand were English language courses, IT training, training in accounting and training for data input specialists.

As of the second half of 2010, the training programme for the vulnerable groups was gradually transformed into a life-long learning training programme for the employed. The main modification was that the new life-long learning programme was targeted at individuals above 25, but participants could still select training providers themselves and use special vouchers issued by the SEA. As of 2011, the voucher scheme was extended to training of the unemployed. The training is provided on the “first-come-first-served” basis, i.e., there are no priority rules within a particular training programme.

The system of vouchers was a successful arrangement. Before vouchers were introduced, it was the SEA that decided on the most appropriate training provider. With the introduction of the voucher scheme the system became more flexible and arguably ensured better matching of training programmes to the needs

of unemployed people or vulnerable employed people. Other advantages include simpler administration and competition between providers of the training (World Bank, 2013c).

Hazans and Dmitrijeva (2013) estimated the effectiveness of various ALMP programmes using administrative data and applied counterfactual methods to address the question as to whether subsequent labour market performance of ALMP programme participants was better than that of similar untreated unemployed persons. They considered different training programmes: occupational training, informal education programmes and employer-provided subsidized training. On the whole, they found that ALMP-financed occupational training programmes and informal education programmes have been effective and improved the labour market performance of the participants both in the short and medium term. Training programmes provided by employers were found to be the least effective, and Hazans and Dmitrijeva (2013) concluded that there is “no case for general expansion of subsidized employer provided training in Latvia”.



Conclusion

In the 2000s Latvia survived one of the strongest boom-bust cycles in the world. Adjustment to the recession took place under a fixed exchange rate and with very limited room for fiscal maneuvering, which placed most of the adjustment burden on the responsiveness of the labour and the product markets.

The Latvian labour market is generally regarded as being flexible, with trade unions playing a very small role and wage bargaining taking place mostly at the individual level. Wage adjustment in the 2008-09 recession, however, was apparently not sufficient to prevent a sharp reduction in employment. The unemployment rate surged from less than 6 per cent to more than 21 per cent, and wage adjustment in the private sector was mainly achieved through paying lower wages to the newly employed, while wages of incumbent workers declined less strongly.

In response to the growing unemployment and falling aggregate incomes, the government implemented a number of major reforms, such as increasing the generosity of unemployment benefits and social safety nets, providing subsidized jobs and reforming training programmes for the unemployed. Generally, the reforms have been successful in alleviating the social consequences of the crisis and were well targeted. The scope of the reforms, however, was arguably not sufficient, as, for example, financing of social assistance programmes remained remarkably low compared to other countries, despite a considerable increase in spending. While combating poverty and risks of social exclusion remain major challenges, the direction of some of the reforms implemented after the acute phase of the crisis (e.g. move to decentralized financing of social assistance benefits and a reduction in GMI benefit) raises concerns.

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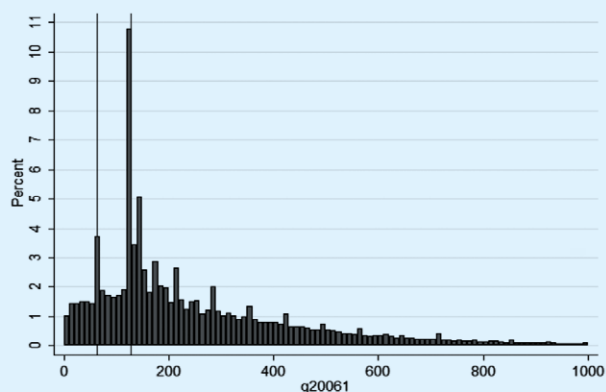
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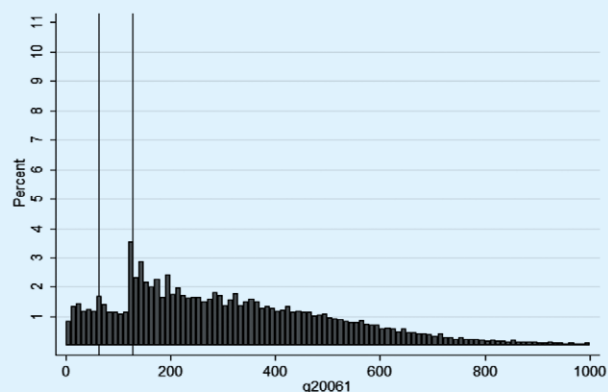
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Annex. Distribution of average gross monthly wages in private and public sector in the 1st quarter of 2006–13

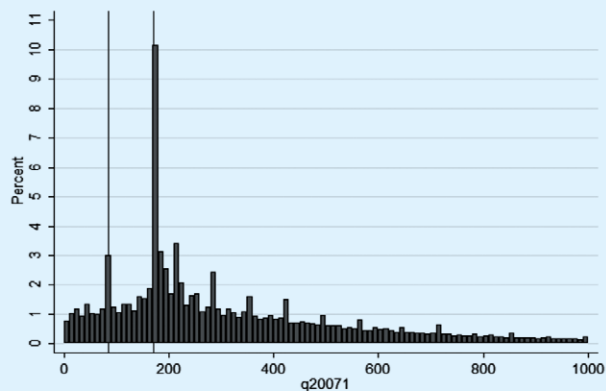
Private sector – 2006Q1



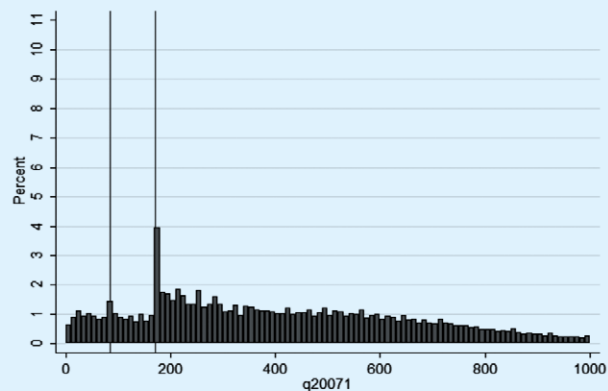
Public sector – 2006Q1



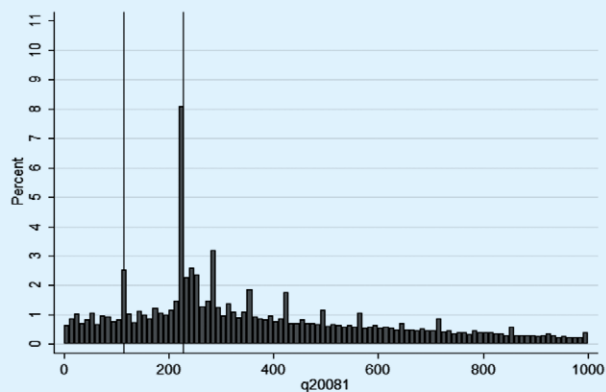
Private sector – 2007Q1



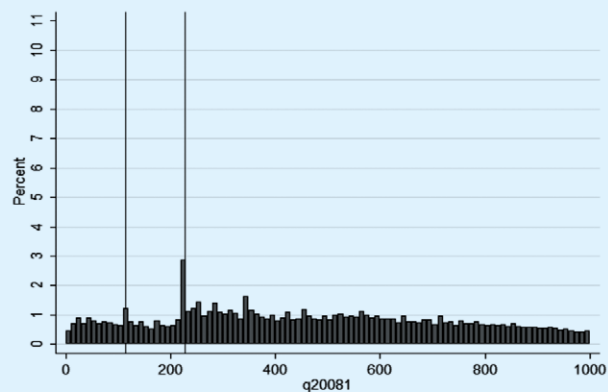
Public sector – 2007Q1



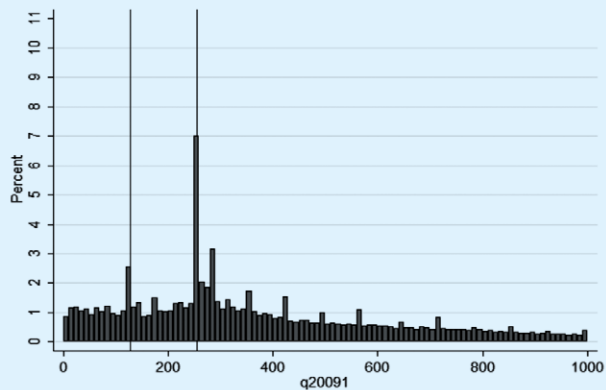
Private sector – 2008Q1



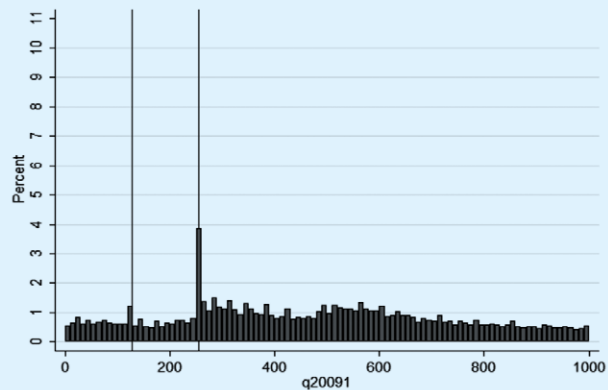
Public sector – 2008Q1



Private sector – 2009Q1



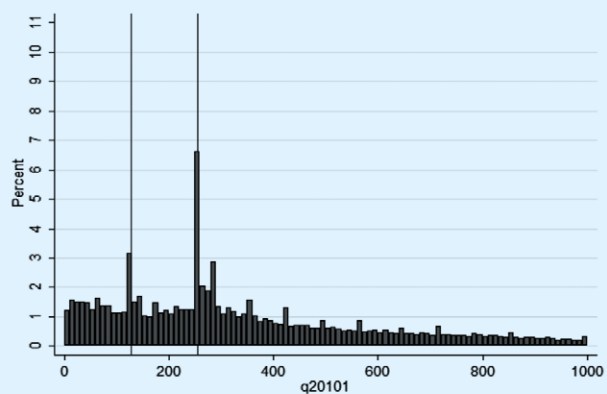
Public sector – 2009Q1



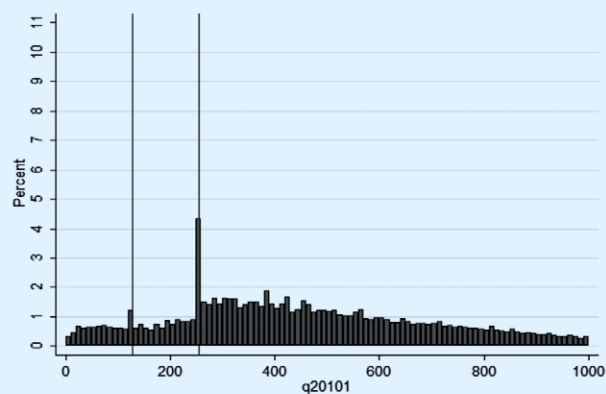
Note: Minimum wage in 2006 – € 128.06, in 2007 – € 170.74, in 2008 – € 227.66, in 2009–10 – € 256.12, in 2011–13 – € 284.57.

Source: State Social Insurance Agency, author's calculations.

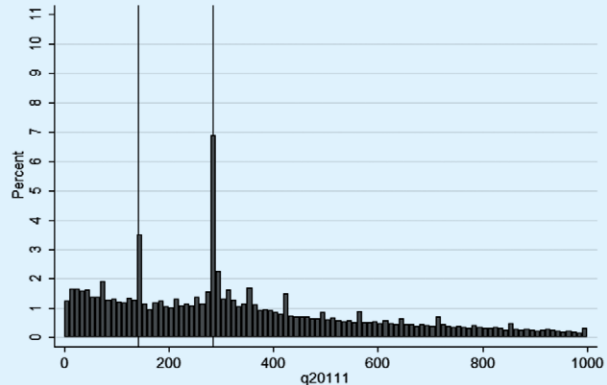
Private sector – 2010Q1



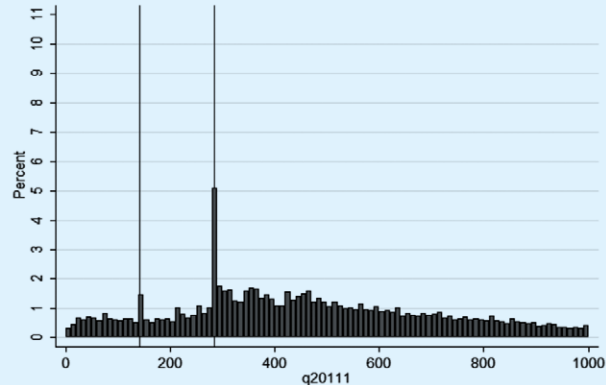
Public sector – 2010Q1



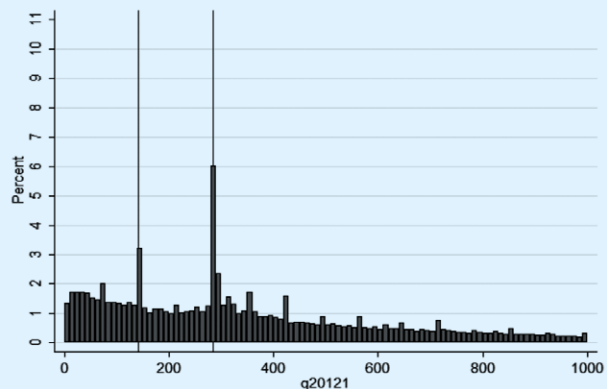
Private sector – 2011Q1



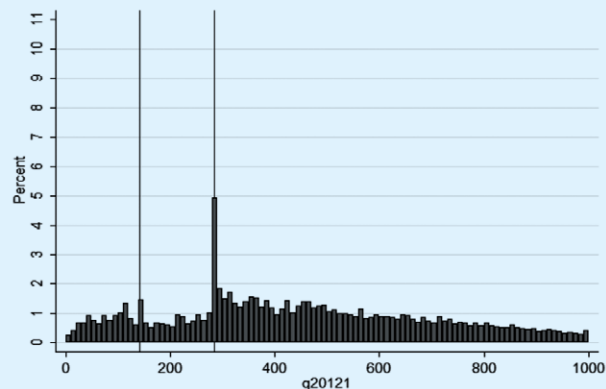
Public sector – 2011Q1



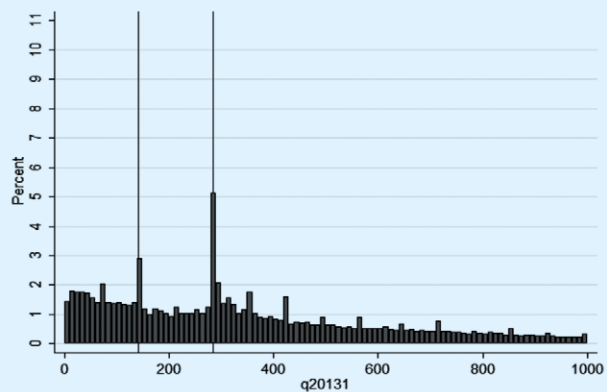
Private sector – 2012Q1



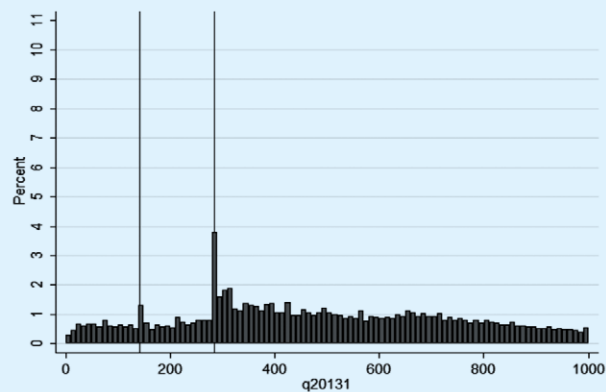
Public sector – 2012Q1



Private sector – 2013Q1



Public sector – 2013Q1



Note: Minimum wage in 2006 – € 128.06, in 2007 – € 170.74, in 2008 – € 227.66, in 2009–10 – € 256.12, in 2011–13 – € 284.57.

Source: State Social Insurance Agency, author's calculations.