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Latvia's Economic Disaster Heralded as a Neoliberal "Success Story": A Model for Europe and the US?

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A generation ago the Chicago Boys and their financial supporters applauded General Pinochet's anti-labor Chile as a success story, thanks mainly to its transformation of their Social Security into Employee Stock Ownership Plans (ESOPs) that almost universally were looted by the employer grupos by the end of the 1970s. In the last decade, the Bush Administration, seeking a Trojan Horse to privatize Social Security in the United States, applauded Chile's disastrous privatization of pension accounts (turning many over to US financial institutions) even as that nation's voters rejected the Pinochetistas largely out of anger at the vast pension rip-off by high finance.

Today's most highly celebrated anti-labor success story is Latvia. Latvia is portrayed as the country where labor did not fight back, but simply emigrated politely and quietly. No general strikes, nor destruction of private property or violence, Latvia is presented as a country where labor had the good sense to not make a fuss when faced with austerity. Latvians gave up protest and simply began voting with their backsides (emigration) as the economy shrank, wage levels were scaled down, and where tax burdens remained decidedly on the backs of labor, even though recent token efforts have been made to increase taxes on real estate. The World Bank applauds Latvia and its Baltic neighbors by placing them high on its list of "business friendly" economies, even though at times scolding their social regimes as even too harsh for the Victorian tastes of the international financial institutions.

Can this really be a model for the United States or Europe's remaining social democracies? Or is it simply a cruel experiment that cannot readily be emulated in larger countries un-traumatized by Soviet era memories of occupation? One can only dream …

But the dream is attractive enough. In a page one The New York Times feature article accompanying that paper's celebration of the Obama Administration's Fiscal Cliff commitment to budget cutting, Andrew Higgins provides the latest attempt to applaud Latvia's economic and demographic plunge as the "Latvian Miracle." The newspaper thus has fallen in line with the surrealistic Orwellian attempts to depict Latvia's austerity and asset stripping as an economic success as rendered in the brochures distributed by the Institute for International Finance (the now notorious Peterson bank lobby "think tank") and international financial institutions from the IMF to the European Union banking bureaucracy. What they mean by "success" is slashing wage levels and leaving the tax burden primarily on labor and lightly on capital gains, without spurring a revolution or even Greek style general strikes. The success is one of psy-ops and engineering of consent Edward Bernays style, rather than of successful economic policy.

Latvia is the country that has come closest to imposing the Steve Forbes tax and finance model advanced during his failed Presidential campaign : a two-part tax on wages and social benefits that are near the highest in the world, while real estate taxes are well below US and EU averages. Meanwhile, capital gains are lightly taxed, and the country has become successful as a capital flight and tax avoidance haven for Russians and other post-Soviet kleptocrats that has permitted Latvia to “afford” de-industrialization, depopulation and de-socialization.

Higgins’ article nurtures two enduring misperceptions of the Latvian Crash of 2008 cultivated by its government advisors picked from the ranks of global bank lobbyists and austerity hawks. First, this star pupil of the international financial community “proves” that austerity works. Second, Latvians have accepted austerity at the polls. A Potemkin Village of austerity progress has been built by neoliberal lobbyists such as Anders Aslund for visiting journalists and policymakers. In the main, these visitors have accepted this Theresienstadt-like “tour” for reality.

Typically trafficked tales of Latvia as a Protestant morality play (an image we presented in our June Financial Times article on Latvia) depict plucky but stoic Balts confronting the crisis and wage reductions not with Mediterranean histrionics, but by getting busy with work. This idea appeals to certain smug middle-class prejudices and stereotypes in countries whose populations have not had to suffer economic experiments in neoliberal horror. While there is some truth in the characterization of Balts as taciturn and slow to protest, the cultural traits argument is a poor attempt at developing a short hand for explaining Latvia’s situation. They are authored by people bereft of an on-the-ground understanding of what has happened to Latvia. Meanwhile, “work” (employment) would be nice, Latvia’s unemployment remains high at 14.2% despite a significant portion of its population having departed the country.

Anyone with actual experience in Latvia will see the dissonance between myth and reality regarding the government’s response to the crisis. First, Latvians most emphatically did protest both the corruption and proposed austerity following the fall 2008 crash. This was most evident at the massive January 13, 2009 protest in Riga attended by 10,000 people. This was followed by a series of protests by students, teachers, farmers, pensioners and health workers in the next months.

It is not in the character of neoliberal regimes to be sympathetic to such protests, peaceful or not. Committed monetarists, they were not going to yield on policy. So Latvians moved on to the next stage of protest.

‘No People, No Problem’: the Great Latvian Exodus

A harsh austerity regime was imposed and protests did abate. What happened?

In a word, emigration. At least 10% of Latvians have left since EU accession in 2004 and access to the Schengen Zone. This exodus accelerated following the economic crash in late 2008. The problem was evinced in one Latvian student protest placard that read, “the last student out at the airport, please turn off the lights!” Latvia’s population is small enough for the bigger EU countries to absorb its departing workforce. And on balance, the nation has been experiencing emigration since its independence from the Soviet Union in 1991, when neoliberal policies replaced a failing Soviet economy. Yet, rather than lessening over time as one would expect, Latvia, which can ill afford emigration, saw people leaving in ever greater numbers nearly two decades out from independence.

Latvians were reproducing at replacement rates when the USSR collapsed. Its 2.7 million population in 1991 dwindled to an official 2.08 million in 2010 through a combination emigration and a financial environment too precarious to permit marriage and children. And, this "official" number from the 2010 census is quite optimistic. Demographic reports originally showed a figure of 1.88 million in 2010. Some Latvian demographers even stated their belief that this lower number was inflated. Latvian demographers report government pressure on census takers to come up with a number above the psychologically significant 2 million threshold. This success (yet another neoliberal Potemkin Village illusion) reportedly was achieved, in part, by using a government website to count Latvians as resident in the country even when they were just visiting to see relatives or check on property.

Regardless of the veracity of the lower or higher numbers, both are unsustainably low and represent a slow euthanizing of the country. While many Russians quickly left at Latvia's independence, most subsequent emigrants have done so for economic reasons. Within a half-year of the initial protests, emigration accelerated and the number of children born in the country plunged as Latvia's economy crashed and its government intensified fiscal austerity.

Austerity's defenders rejoin that the country had two national elections and could have changed economic course. But they spin the details that explain just why Latvia's policymaking elite have managed to remain remarkably constant over the past twenty years. Latvia's two parliamentary elections both before and since the crisis have turned on endless ethnic politics. Austerity policy has been associated with mostly ethnic Latvian parties, while more social democratic alternatives have been associated with ethnic Russian parties. To be sure, both ethnic communities were divided over economic policy, but it was mainly the ethnic framing of economic policy that ensured austerity policies would prevail in a country still traumatized by the Soviet occupation and divided over what economic policy to take in the wake of the 2008 crisis.

Latvia's economic collapse was the deepest of any nation when the financial bubble burst in 2008. Hot money flows had inflated its property markets to world-high levels, thanks to its neoliberal minimal taxation of real estate that was the complemented by onerous taxation of labor. Given how deep the plunge was, there was room for the inevitable bounce up thereafter – hailed as a recovery.

When one looks at the details, the so-called recovery was centered on four sectors. First, is Latvia's correspondent (offshore) banking sector that attracts and processes capital flight. Already a site for illicit transfer of Soviet oil and metals to world markets before independence, Latvia became a major destination for oligarch hot money. The Latvian port of Ventspils was an export terminal for Russian oil, providing foreign exchange that was a Soviet and later Russian embezzler's dream. Figures such as the notorious Grigory Loutchansky of Latvia and his Nordex became notorious for money laundering. Even Americans were involved, such as Loutchansky's partner, Marc Rich (later pardoned by Bill Clinton) who later took over the Nordex operation.

The Latvian government signaled its intentions to defend this offshore banking sector at all costs (including imposing austerity on its people) when it bailed out Latvia's biggest offshore bank, Parex. European Commission and IMF authorities gave a massive foreign loan for Latvia that in part enabled the government to function after bailing out Parex and thus its correspondent (offshore) accounts and continued payment of above-market interest rates to "favored" (read: "well connected") customers.

Although not in the league with London, New York and Zurich as a criminogenic flight capital center, Latvia has carved out a substantial niche in the global money laundering system. According to Bloomberg: "As non-European inflows into Cyprus stagnate, about $1.2 billion flooded into Latvia in the first half of the year. Non-resident deposits are now $10 billion, about half the total, regulators say, exceeding 43 percent in Switzerland, according to that nation's central bank." These are big amounts in view of the fact that Latvia has only about a quarter of Switzerland's population and merely a tenth of its GDP. While this activity might make many bankers rich, it does little to develop Latvia's economy. Moreover, it represents a beggar thy neighbor policy that permits Latvia to benefit from taking capital out of developing post-Soviet neighboring countries.

Second, Latvia's emergency response to the crisis was to ratchet up clear cutting of forests. Latvia inherited massive woodland reserves from the Soviet policy of converting farmland to forest. Export growth in this category reflects asset stripping post-Soviet style. That patrimony is being drawn down. While significant, one must remember that given Latvia's far northern latitude, it takes fifty to a hundred years to replace trees to maturity. So this resource cannot be indefinitely sustained. Moreover, the move to develop more value-added processing of Latvia's forests has been frustratingly slow. Promises by the chief consumers of Latvian logs (e.g., Sweden and others) to process logs into timber, paper and other products, have mostly been talk, with little action.

Third, the fact that Latvia's neoliberalized economy has been de-industrialized over the past two decades means that nearly any increase in post-crash manufacturing represents growth in percentage terms. Latvia has nearly no effective labor protections, and only the weakest unions to advocate for decent working conditions and salaries (or even sometimes to be paid at all). Wages can be pushed down from what already were poverty levels, while businesses deploy labor in any fashion they see fit, without regulatory structures to protect workers. Simultaneously, Latvia's labor costs are far higher than are economically necessary, thanks to the punishingly high set of labor and social taxes designed to keep capital gains and real estate taxes comparatively low. Even so, wages and "flexibility" have made Latvian labor cheap enough to encourage some enterprise. Yet, there are also real centers of innovation and entrepreneurial talent, but they mostly succeed in spite of Latvian government policy, not by support from it.

Europe's recent star export performers on a percent basis have been Latvia and Greece – a metric that makes sense only as a bounce up from a big post crash . Latvia's per capita purchasing power is well below that of even Greece. The modest uptick in manufacturing and exports is positive, but Latvia still is ranked last in Europe for innovation and R&D investment as percentages of GDP. The lack of investment in innovation,combined with anti-labor tax and finance policy, thus limits manufacturing's potential for much faster growth as Latvian labor costs are higher than needed, due to regressive taxation.

Fourth, there has been growth in the previously underdeveloped agricultural and transit sectors. This has been encouraged by food-price inflation in recent years and better policy and planning from the Ministry of Transportation. Although transit historically has been among the most corrupt parts of the Latvian economy and government, centers of excellence have emerged in that ministry that have leveraged up Latvia's transit potential. Russia's agreement to use its rail lines to permit supply of American troops in Afghanistan via Latvian ports hasn't hurt either.

The most revealing part of the New York Times' mostly puff piece on behalf of budget cutting that can be seen as a model for America to grin and bear the coming austerity, only comes in the concluding comments by economists in Latvia who reported: “The idea of a Latvian ‘success story’ is ridiculous.” “Latvia is not a model for anybody.” “You can only do this in a country that is willing to take serious pain for some time and has a dramatic flexibility in the labor market.” In short, it can’t be done in any real democracy.

For governments able to ignore the will of the people (an expanding trend in rich developed countries), the Latvian model can only be applied if one’s country is:

– Small enough, willing enough, and able to let at least 10% of population emigrate, headed by the most talented and multilingual freshly minted graduates;
– Demographically secure enough to see family formation, marriage and birth rates plummet;
– An ethnically divided population that enables politicians to play the ethnic card to distract population from economic issues; and
– A depoliticized Post-Soviet population willing to give up protest after short period.

Any larger country attempting this level of austerity would need to find an outlet for the some 10% of its people leaving. For the United States, that would mean countries willing to take 20 million American workers. Last time the authors checked, neither Canada nor Mexico had the willingness or capacity to take these numbers, and not enough American students have yet studied Mandarin to do China’s laundry.

Latvia still has a well-educated population with highly developed design sensibilities. Its skilled workers are known for their creativity and attention to detail. With better economic policy, less anti-labor tax policy, less subsidy of real estate and finance and more investment in innovation – the opposite of what The New York Times celebrates as Latvia’s success story – it could replicate the successes of its Scandinavian neighbors. The alternative is for its neoliberalized economy to produce “recovery” in a way reminiscent of Tacitus’ characterization, put in the mouth of the Celtic chieftain Calgacus before the battle of Mons Graupius: Rome’s victories “make a desert and they call it peace.” Neoliberals call austerity and emigration “stability” and even economic growth and recovery, as long as people don’t complain or demand an alternative.

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