An Econometric Evaluation of the Latvian Labour Market and How it Functions

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Like other countries that joined the EU on 1 May 2004, Latvia is supposed to join the Eurozone at some point. In circumstances where the government’s ability to use fiscal stimulus is restricted by EU fiscal discipline, the only shock absorption mechanism available to a Eurozone member state is a flexible labour market. The goal of the thesis was to evaluate the degree of Latvian labour flexibility and the role of labour market institutions in its formation. First, the thesis analyses Latvian labour market institutions relative to other European countries and the institutional changes that took place after the beginning of the recession in 2008. It was shown that in general labour market institutions in Latvia tend to be rather restrictive – the tax burden on labour is relatively high, employment protection legislation norms are strict, and the ratio of minimum wage to average earnings is high. Yet the thesis identifies several signals suggesting that law enforcement in Latvia is weak as compared to other EU countries, which allows for a flexible reaction of labour market participants to changing market circumstances.

Second, the thesis analyses adjustment of the Latvian economy to adverse shocks in the past and estimates real wage flexibility, using a structural VAR model. It was shown that real wages in Latvia are relatively flexible, which enabled recovery of the Latvian economy from the recession in the aftermath of the 2008 crisis without resorting to realignment of the nominal exchange rate.

Third, it was shown that the equilibrium unemployment rate (NAIRU) declined between 1996 and 2008, suggesting increased efficiency of the labour market. The equilibrium unemployment rate increased during the latest recession but the increase was minor. Factors that significantly affected the dynamics of NAIRU were labour emigration (downward impact) and the ratio of the minimum wage to average remuneration of employees (upward impact). Finally, using a macroeconometric model of the Latvian economy and a unique dataset of EU fund expenditures derived from project-level data, it was shown that fund-financed activities aimed at raising the qualifications of the labour force had contributed to higher shock absorption capacity of the Latvian labour market.

To conclude, the results suggest that the Latvian labour market is flexible and that EU funds have contributed to increased efficiency. At the same time, there is evidence suggesting that
the flexible reaction of the labour market is to a large extent achieved by employers circumventing the formal rules. This in itself creates distortions in the market - the efficiency of the economy could be increased if resources spent on getting around the regulations were spent more productively. Moreover, deviations from the formal rules, being provoked by the strictness of the rules, undermine the merit of labour market institutions, which are there in the first place to protect workers and increase their welfare.