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The Foreign Investors Council In Latvia Position On Macroeconomic policy

1. Macroeconomic conditions

The previous FICIL position paper on macroeconomic policy was more pessimistic than the consensus view on economic prospects at that time, but it was clearly not pessimistic enough. Global financial crisis since the last Meeting has accelerated the unwinding of Latvia's economic imbalances and negatively affected exports as well as access to external financing. As a result, we are looking at GDP contraction by perhaps close to 20% in 2009.

The good news — most of the correction has already happened, as indicated by preliminary GDP data for Q1 and the fact that current account was in surplus in early 2009. However, even as quarter-on-quarter contraction slows down sharply during the rest of the year, the downturn that has already taken place is deep enough to impose extraordinary fiscal policy challenges on the Government. While there is no easy way out, there are ways how to: (i) alleviate short-term pain, and (ii) reduce damage and leverage the benefit of the crisis for long-term development prospects of the country.

2. Summary of recommendations

We recommend:

- To speed up the use financial resources at the Government's disposal to stimulate economic activity in ways their impact is magnified manifold, primarily via guarantees as well as promoting the flow of EU funds.
- To accelerate and deepen structural reforms to safeguard the availability of foreign financing and improve the long-term growth potential of the country. A systemic view is required to set economic policy priorities and accelerate the shift of resources towards established and emerging clusters.
- To continue the tax reform, focusing it on improving long-term growth incentives; reduce the risks of tax evasion and corruption.
- To improve labour market policies to mitigate the social unrest associated with the rise in long term unemployment and risks of crime.
- To communicate clearly the Government's strategy both to the public and civil service.

3. Rationale

Measures to revive economic activity

Lack of internal reserves and limited access to external borrowing precludes Latvia from undertaking large-scale fiscal stimulus. However, there are opportunities to leverage government spending in the way that generates increasingly stronger impetus to boost economic activity. It is especially unfortunate that a prime example of such a policy tool – provision of loan guarantees – has been hindered by a failure to finalize administrative procedures. It seems that export guarantee program is finally approaching its implementation, and we urge the Government to

follow closely whether the program is successful and swiftly make any necessary adjustments if slip-ups are discovered.

Besides guarantees, EU Structural Funds are hugely important both from macroeconomic point of view (contribution to aggregate demand) and as a tool to raise productivity in both public and private sectors. We urge to speed up the flow of funds by increasing their volumes and widening eligibility criteria (e.g. regulations often limit access to funds for large companies thus restraining their export potential). Normally Structural Funds support is provided after the projects are implemented, but due to the global credit crunch companies often find it difficult to obtain up-front financing – so there should be a well functioning mechanism to receive advance payments (e.g. the current mechanism relies on bank guarantees which are often hard to obtain given the global credit crunch and uncertainty about the actual inflow of the EU Structural Funds). Supranational funds (EBRD, EIF) should be used to the greatest extent possible to co-finance the EU-fund related investments, provide access to working capital in a form of credit lines.

Structural reforms

We fully support the recent shift towards structural issues rather than a simple linear cut in budget expenditures, but we also believe that the Government is still lagging in its response to developments in the economy and a considerably more pro-active down-to-fundamentals revision of public sector functions and activities is necessary, i.e. so far too little, too late is done. We are increasingly worried that the Government is not taking timely and adequate action to ensure the fulfilment of obligations assumed as conditions for obtaining external financing, thereby threatening availability of the funding itself.

Reforms are lagging and, as far it can be seen from public discourse, they are not sufficiently deep. Such half-step measures amplify uncertainty and, as a result, businesses find it increasingly difficult to plan their activities. To yield results, reforms need to be introduced more rapidly and deeply. We see a lack of a solid teamwork on the part of the Government, as some ministries are too busy drawing “red lines” which austerity program supposedly may not cross. This weakens decision-making capability and undermines the public support to structural adjustment strategy. At times ministries identify themselves as representatives of social groups (e.g., farmers or teachers), not as institutions that implement overall state policy (in, respectively, agriculture or education). Discussions are often focused on how to cut costs in the current system while in many cases changing the system itself would both provide bigger savings and better services in the long run (e.g. in education, health care and public administration).

We see it necessary for the government to take a systemic view. In addition to overall measures towards improving business environment like reducing administrative burden, there needs to be a targeted support towards industries where market dynamics already have formed viable clusters (e.g. wood, metal, food processing and pharmaceutical industries) as well as trying to accelerate the emergence of new ones (e.g. foster integration between energy sector and wood industry cluster).

Tax evasion and the risk of corruption

We see a strengthening trend towards tax evasion. This is worrying and needs to be addressed urgently as it deepens budget problems and significantly impairs social security net, puts honest and transparent businesses at disadvantage, thus deepening this recession and slowing down the subsequent recovery. Latvia risks finding itself in the vicious cycle of rising taxes on shrinking tax base as taxpayers either shift into grey economy or emigrate when global economy starts to recover. This may permanently deplete the future growth potential.

How to address this problem? FICIL has previously suggested that taxes on real estate should play a larger role and we maintain this position. These should be seen as an opportunity to lower income taxes. In general we support the previous increase of VAT rate as of 1 January 2009. This is in line with our earlier proposals, however we also suggested that personal income tax (PIT)

should be lowered sufficiently to compensate the overall fiscal effect, so that overall taxation level is not raised. We understand why government chose to increase tax burden at this moment but maintain our position that personal income tax should be lowered further in the future. We support government's overall goal of extending PIT base (applying it to capital gains, for example), so that rate can be lowered without reducing budget revenues.

Moreover, we would like to question the wisdom of introducing the full VAT on hotel services that is largely a tax on exports and directly lowers competitiveness of Latvian businesses. Similarly, introducing different VAT tax rates on fuel-wood and natural gas is questionable.

We commend the efforts of the Government to reduce the use of positions in the boards of state owned companies as "welfare" for political insiders. These companies should be run by a lean, professional and adequately compensated management.

Labour market policies

In recent months unemployment has risen dramatically and forecasts suggest that it will continue to rise throughout 2009–2010 and might start to decrease only in 2011. We are concerned that the measures taken so far (e.g. employment subsidies, proactive organisation of public works, guarantee and access to funding support criteria linked to social tax payments) are not sufficient to address adequately the issue of long-term unemployment and limit social/crime risks related to it. FICIL is ready to take part in drafting such policy positions and actively participate as an employer in introducing them. The Government should take more care for the rising number of unemployed and increasing number of households which find themselves in a position being unable to make their mortgage payments. To mitigate such adverse effects and the risk of social unrest, the Government should consider introducing temporary instruments to support borrowers such as the Government guarantees for restructured mortgage loans where the property is primary place of residence, or by increasing investment in social housing.

Legal framework of insolvencies

Considering increasing amount of bankruptcies we urge government to reform the foreclosure process and propose to amend the Insolvency Law. The average duration of creditors' meeting's convocation and organization of auction should be decreased substantially. Maximum duration should be weeks not months and the foreclosure process should become more transparent. We note that largest foreign investors (including banks) find it hard to settle their claims in the current legal environment. The norms introduced by the Legal Protection Process can lengthen the settlement of claims to 3-5 years after which the original meaning of dispute might have been lost. We believe that it is in interests of the society as a whole to have short, transparent and straightforward bankruptcy/rehabilitation process of companies. Existing system of bailiffs is inefficient and too costly. The reimbursement of administrators and bailiffs should be determined pursuant to a success fee depending on their results.

Communication

As has been shown by other countries, structural reforms cannot be successfully implemented if social ownership of the package is weak. We urge the Government to clearly communicate to the public on the necessity of reforms, the intended activities and explain the expected results of it:

1. Clearly define the current situation, the key risks and opportunities involved
2. Make a credible program of improvements by setting clear objectives and timeline
3. Clearly indicate what the public must do to help to speed up a successful restructuring – inspire the sense of ownership in the reform package
4. Through internal communication ensure cohesive action on part of the Government and all levels of civil service (e.g. current high uncertainty often harms motivation and paralyzes activities of civil servants)