FOREIGN INVESTORS COUNCIL IN LATVIA

Position Paper No.1

27 May 2010

Position Paper on Macroeconomic policy

1. Executive Summary

The recession in Latvia is formally over following a two-year contraction. But the end of the recession does not automatically imply stable economic growth from now on – the economy will grow, but it will be fragile in the beginning. Growth in one quarter may be followed by a contraction in another. Exports have been recovering while domestic demand is weak and is expected to remain so for some time. Albeit unemployment seems to have peaked and is gradually decreasing, international evidence shows that it will remain elevated for years. Job creation is weak and given the current institutional framework and business environment quality there is no reason to expect that it will improve sharply. The future growth will also be weighed down by grey economy, which is widening.

2. Recommendations/Suggestions

In order for Latvia to maintain and improve its competitiveness, we see it necessary to address the following issues jointly and without delay:

(i) Structural reforms must be implemented with no delay and they must be reflected in the 2011 budget

(ii) The business environment must be improved, setting clear and ambitious targets to climb up in the World Bank's Doing Business rankings and Global Competitiveness Index by World Economic Forum.

(iii) Support development of financial markets, strengthening the role of risk capitalists, stock and debt markets, etc.

(iv) Provide support for job creation

(v) Reduce the role of grey economy (tax evasion and corruption)

(vi) Organise the public sector based on *Lean principles* without compromising on the quality of the services provided. Implement a functional audit and outsource services to the private sector.

3. Rationale

The recession in Latvia is formally over as seasonally adjusted GDP is reported to have grown in 1Q 2010 by 0.3% quarter-on-quarter following a two-year cumulative contraction of ca 26%. But the end of the recession does not automatically imply stable economic growth from now on – the economy will grow, but it will be fragile in the beginning. Growth in one quarter may be followed by a contraction in another. Exports have been recovering since mid 2009 while domestic demand is weak and is expected to remain so for some time. Deleveraging is still to deepen. Albeit unemployment seems to have peaked and is gradually decreasing, international evidence shows that it will remain elevated for years. Job creation is weak and given the current institutional framework and business environment quality there is no reason to expect that it will improve sharply. Long term unemployment will deplete future growth potential via loss of labour skill and emigration. The future growth will also be weighed down by grey economy, which is widening and has grown to unacceptable levels. Popular support of politicians and policy makers is dramatically low.

Unless the global economy faces a double dip, the Latvian economy will grow. Due to recession undershoot we are likely to see somewhat better growth rates than the market consensus currently expects. This euphoria coupled with approaching elections may stall structural reforms. Yet, if structural reforms are not completed when the rebound runs out of steam, the economy may start to stagnate (i.e. low growth rates relative to those in the EU), which means very weak or no convergence, thus enforcing emigration and deepening medium-to-long term problems.

Estonia is expected to join the euro zone already in 2011 and, due to previously tighter and more forward-looking fiscal discipline, is able either to keep tax rates stable or lower them. Tax cuts are most likely to relate to labour taxes. Estonian credit risk ratings will be soon improved and interest rates will decrease well below those in Latvia. This will support Estonia via (i) diverting some of the foreign investment away from Latvia, (ii) improving its competitiveness due to lower interest rates than in Latvia.

- Risk of reform fatigue: structural reforms shall be implemented without delay to use the current recovery momentum in the global economy that supports growth and eases the short-term pain of structural change. We believe that reforms take a realistic shape and have a true impact on the economy only when reflected in the government budget structure, i.e. as changed targets and evaluation criteria for disbursement of funds. The window of opportunity to implement such reforms is brief – the next municipality elections in 2013 mean that it must be done within the 2011 and 2012 budgets. To yield fundamental results and support return to a sustainable growth path, the brunt of the adjustment must lie on the 2011 budget with the 2012 budget left for fine tuning. If this opportunity is missed, we risk a very low growth that will be unable to create jobs. Therefore we urge to draft clear options for structural reforms without delay so that it is possible for the new Parliament to pass an appropriate 2011 budget in due time rather than start by investigating what the reforms could consist of. There are clear structural targets in Latvia's Letter of Memorandum of understanding with the EC that must be met. Few key areas that we see as most important include professional and higher education, insolvency procedures, fiscal discipline, tax policy (please see the position paper on tax policy).

- Ease of doing business (i.e. World Bank's Doing Business rankings and Global Competitiveness Index by World Economic Forum): set challenging targets and clear responsible persons, and measure their performance against this benchmark. The rankings of specific sub-indices clearly show the weaknesses of the Latvian institutional framework and provide a clear and straight forward blueprint for the elements that need to be improved. For example, insolvency procedures need to be fastened, made simpler and less expensive to return assets to economic activity and thereby boost growth and reduce long term unemployment risks. Also, flexibility of lay-off rules should be improved to encourage higher employment even before firm signs of economic recovery are confirmed.

- Diversified financial markets (i.e. banks cover only a part of financial scenery): to improve and diversify access to funding it is necessary to support the functioning of a more efficient stock market, debt market, venture capital, and others. Pan-Baltic integration of such markets is necessary. The bust has shown that banks will not fill in all the financial market niches that could be particularly crucial for start-ups and other young businesses. Without such support, businesses could be starved of financial resources and recovery will be slow.

- Labour market (i.e. long term unemployment): the current labour market strategies deal with skills' retention which is meaningless in the medium to long term if no job creation strategies are pursued. Possible actions involve temporary tax breaks/reductions when hiring youngsters (i.e. first employment) and long term unemployed. Only private sector job creation must be supported. Mass jobs must be created as skill levels of those unemployed are fairly low.

- Grey economy: if the current tolerant attitude towards tax evasion continues, it will divert FDI, permanently reduce asset value, make risk assessment less transparent and interest rates higher, hamper diversification of financial markets, etc. As a result, convergence with the EU will stagnate, driving up emigration and making long-term issues such as pension system sustainability more acute. The current methods suggested and employed by the government rely too much on repressive methods that will be counterproductive or of a very small effect. We believe that grey economy must be reduced using both "stick and carrot". To this end we see it necessary to view the tax system reform both as a way to improve taxpayers' motivation to pay taxes and reduce the ability to evade taxes (see the position paper on tax policy). This must be complemented by null declaration, incentives that encourage paying taxes also for former tax evaders, and tough repressive measures if one is found to evade taxes after the implementation of such policies. It must be stressed that both "stick and carrot" measures must be implemented jointly and as soon as possible (preferably in 2011), as a delay of "a carrot" (e.g. as the ministry of Finance has suggested that Personal income tax could be reduced only after 2014) would only increase the tax burden for those paying taxes and make tax evasion more appealing.

- Public sector: organise the public sector based on *Lean principles* without compromising the quality of the services provided. Implement a functional audit and outsource services to the private sector. A functional audit that was started in 2009 must be continued and firm decisions must be reached, which should lead to a clear blueprint for services which the public sector is/is not providing, and the principles upon which such services are outsourced to the private sector.