

## We shouldn't get tired

by Pauls Raudseps 24 nov 2010

The assistance program to Latvia is often associated with the IMF, but in fact, out of the 4.2 billion euro Latvia receives, 2.7 or two thirds are a loan by the EC, and it is with the Commission that the government has to agree the program conditions. Gabriele Giudice is Head of EC delegation since the stormy Spring of 2009, and now in an exclusive interview to the journal IR he reveals his views on the 2011 budget.

### **How would you evaluate the measures with which the government hopes to reach the deficit decrease in 2011?**

The Commission has concerns about some measures included in that plan. When we agreed that the consolidation in 2011 could be approx. 280 million lats, we also agreed that lowering the deficit should come by high quality measures. Budget consolidation needs to be sustainable, no temporary measures should be used. Also, the measures need to promote long term growth of the economy and there needs to be a fair distribution among the different groups of the society.

Right now it does not seem that all government's proposals correspond to those principles, this is why we continue our discussions with the government to find out if it can find better measures. Such that would improve the effectiveness of the state sector and, if need be, also such that improve incomes. This does not mean one does it only by raising tax rates. One can also increase the taxable base and fight the grey economy. But in general, effectiveness of the public sector needs to be improved, since it is possible to ensure the same, or even better, services for a lower price.

### **Do you have a specific goal how much of the consolidation amount should be from higher taxes and how much from lower expenditures?**

No. Latvia has big expenditures and small incomes. This difference needs to go down to at least 3% of GDP, but in future it should be even lower to have a sustainable budget.

I believe that it is clear to the government and to the whole society, that it is possible to have a more effective public sector, but the gains in this field are not possible in short term, therefore it is easier to solve a part of the said difference with increased income. However, over the last years different studies were made on how budget consolidation was done in different countries, evaluating both the sustainability of the changes and their effect on growth. Most often problems are created by too high expenditure, which have grown too quickly, therefore a more sustainable solution is to decrease expenditure.

Of course, one can also change the distribution of the tax burden, and the government strategy to move taxes from labor to consumption, including to real estate, corresponds to the goal to regain competitiveness, which Latvia needs to reach.

### **A considerable part of the consolidation plan is made up by decreasing contributions to second pension level. How does the EC see it?**

We believe that there should be a more sustainable, structural way to decrease the deficit, because this could only be a temporary source of income. We have given a rather clear indication that better measures could be found to decrease the deficit.

### **Expenditures in Latvia's social budget exceed income, and without reforms the situation will only worsen. Do you see how Latvia can renew balance in social budget? Will we**

**need to decrease pensions somewhere in the future?**

This is a very sensitive question. Earlier the government tried to do something, but then it turned out that the way they did it did not correspond to the Constitution. As I understand, for the moment they are not ready to tackle this. This is the government's competency. We try to remind that the difference between the income and expenditure in the budget is still quite big, total consolidation for 2011 and 2012 is very big.

In Summer we thought that it could be 800 or 900 million lats, now we think around 700, 750, maybe 800 million. If in 2011 this is decreased by 280 million, it leaves a very large amount for 2012. It will be necessary to think what measures are less harmful for the economy and how the consolidation so far has influenced different groups of population. Salaries have been influenced quite a lot, tax burden on the production part of the economy has grown, but pensions have remained intact, but they have grown considerably over the last years.

If we talk more widely, it is necessary that the social contributions reach their goal. There are benefits which possibly go to too many people, and then those really in need have too little money left. Thus, possibly, benefits or some grants could be decreased, and the money handed more purposefully to those who need it. They could even receive more, but the budget in general would still save.

**Some hope that in 2012 there will be not that much of consolidation necessary, as economic growth will increase income.**

I would also be happy to think like that, but we need to be careful. Of course, the economic situation is much better and growth restarted earlier than expected. But it is not quicker than expected, it just started earlier.

In future growth will not be as fast as before the crisis, it will be around 3.5% or 4%. This is above the economic «potential», therefore soon there will be bottlenecks. Already now there is a shortage of qualified labor in some sectors. If investments do not grow, there will be a shortage of production capacity. This can slow down growth tempo and increase inflation. There are also risks in the global economy. We hope they will not come true, but if they do, negative influence on Latvia could be big.

We have to remember that the aim for 2012 is not a deficit of 3%, but lower than that. This aim is set so that the EU could evaluate Latvia's readiness for euro. But there can be doubts if a country with a deficit of 6% in 2011 and close to 3% in the next year has really ensured a sustainable budget. Who can guarantee that there will be no return to a higher deficit when the decision on euro is taken? Eurozone is now having problems because it turned out that some countries are not stable enough. It is very important to give a signal that you take this challenge seriously.

**So the problems of Greece and Ireland have made the EC much more cautious?**

Estonia is a state with a sound economy and strong economic fundamentals, they never had any big problems, they resolved their challenges quickly, but they were evaluated carefully. In future, the countries which create reasons to be criticized, put themselves in a risky position. This does not mean there are prejudices, but evaluation will be serious.

**You are connected with the assistance program for Latvia almost from the very beginning. Has something surprised you over this time?**

What has happened in Latvia is unprecedented. Budget consolidation amounts are impressive. People have understood that the growth of previous years was not sustainable and now they

need to return to a more normal life. It is important, especially comparing with difficulties in other European countries, where the reforms are much smaller than in Latvia.

**The government has said that they want to pass the budget already this year. Is that real?**

It is good to show that the state can resolve challenges. I think it is real, and we trust that over the remaining time the government will continue to work to improve proposals for the 2011 budget.

In conclusion I would like to say that Latvia has really achieved something special, overcoming the crisis which was probably the deepest in the world. It would be a pity if you stopped half way. Getting tired now would create risks. Latvia has already done something historical – implemented a very large budget consolidation and has been able to quickly return to growth. This contradicts many economists' theories and assertions over the last years that Latvia will not make it. It proves to the world that a country with large reforms can still preserve confidence in the government and to give it a mandate to continue its work.

It also contradicts the intuition of many politicians in Europe and elsewhere. They think it is better not to reform anything because then they will lose in next elections. Latvia has very quickly started to move out of the crisis. Now it is very important to exit the emergency situation and to transit to sustainable growth, but this requires reforms which promote the growth of economy. There should be long-term thinking and not enjoying the moment when life is going up again, or imagining that only others will have problems.