

## **Gabriele Guidice: "You have too many envelopes" Head of EC [mission] in Latvia recommends to fight with shadow economy**

**Latvian government has not been able to eliminate shadow economy and to carry out audit of state functions, said in the interview the new head of EC mission to Latvia Gabriele Giudice (GG). The biggest donor expects from us strong observance of all the agreements, and there will be no allowances made to the minority government. Penalty – there will be no payments.**

"Biznes i Baltija" was the first of all media to which GG gave interview. The discussion took place in his office in the Commission.

### **There will be no allowances for being a minority government**

*- Is the Commission worried about the political crisis in Latvia and will the fact that the biggest coalition member has quit the government have any consequences on the attitude of international lenders?*

Even if Latvia currently has a minority government, it is holding on. Despite recent developments, the Cabinet is to the same level responsible for sticking to the agreements with the EC signed in February. We intend to continue our cooperation with Latvia on previous conditions and we really hope that there will be no difficulties there.

*- What are your views on what the People's Party did?*

They have to evaluate their actions themselves. EC is not going to judge Latvia's internal matters. What we expect is strong implementation of all measures which have been inserted in 2010 budget, keeping the passed taxes and the economic regime. If the minority government manages to keep to the course taken earlier, we do not expect anything more. Not sticking to commitments will result in not paying out the next amount. I hope that all parties in the parliament realize that.

### **Populism might leave us without money**

*- Will the situation become more strenuous closer to the elections?*

Of course, the opposition will have bigger temptation to take populist decisions like lowering taxes, etc. Everybody is doing their pre-election campaign, wants to be liked by the electorate, we understand this perfectly. It will probably be more difficult for the government to work, when the elections are closer, however, the opposition has already several times supported the government's decisions, and we really hope that they will act accordingly also this time.

*- Lowering VAT from 21% to 10% for hotel business was already passed in several stages in the parliament. What is your position on that?*

According to our financial service calculations, the losses in budget will amount to 8 million lats. This is not much, however, it is a step in opposite direction, away from budget consolidation. What is worse, there is a big danger that also representatives of other sectors will want the same allowances. Besides, one always has to look at the example of other

countries – in Germany a similar allowance was introduced for tourism sector, however, now they are thinking about returning to the old scheme.

### **"We are just reminding"**

*-Latvia needs to do away with imbalance in the 2011 budget by more than 400 million lats. EC has many times said that it does not force upon Latvia any concrete measures, but you sure have some recommendations?*

The main aim is to reach budget deficit below 3% of GDP in 2012 to be able to introduce euro in time. EC has counted that in the coming two years an adjustment of 800-900 million lats will be necessary, so a concrete amount for next year is not yet known. In May, when we get to know the data for 1<sup>st</sup> quarter, we will be able to give more concrete information.

The amount of course will be very big in any case, and in this context it is really important to execute the 2010 budget. We also expect that the government starts to technically prepare the 2011 budget so that the new parliament after the elections could approve it on time.

We do not recommend anything concrete, we remind Latvia that in exchange for the financing the EC expects the promised consolidation. By the way, I would like to note that the interest rate, 3,25% a year, on which you are getting the EC money, is unbelievably low. Global markets are also anxiously waiting if Latvia will carry out the promised cuts.

In 2011 we expect that Latvia will successfully absorb the co-financing from EC structural funds. You are getting an amount of approx 4% of GDP – not many receive such an impressive present.

### **Ambiguous achievement**

*- Is the introduction of progressive income tax for the population still an EC priority?*

Your government had a big problem last year – how to raise budget revenues, not losing competitiveness of the country, and how to stay attractive for investors at the same time.

A single tax rate has its advantages – quite simple administration, but to collect a progressive tax you need more time and more people who also need to be trained. So, if Latvia will decide on a progressive tax, EC will welcome that step, but it will never insist on it.

I would like to stress: your country succeeded with a consolidation which was unprecedented in Eastern Europe in the last 50 years. It is very impressive, even if it was reached partly with not the best methods.

### **Audit and shadow economy not manageable**

*- So what did we have to do instead?*

It would have been better to carry out a thorough functional audit of all state and municipal sector, see what expenses you can give up and to reach the expenditure cuts that way. By the way, the work was started, and I hope it will be continued.

The main thing is fight with shadow economy, the size of which is one of the biggest in Europe. Even income from higher taxes will go down drastically if nobody will pay them. Studying the speed of decrease of salaries in Latvia over the last months, I noticed that in

many sectors they went down for about 10-15%, but in building and retail trade by 4-5%. I suspect that in those sectors there are already too many "envelopes", therefore there was really no room for any bigger official decreases.

### **Raising residential property tax is advisable**

*- Technical mission of IMF advised to raise the real estate tax to 1,5%, with some allowances. Is that acceptable for EC?*

That is not an IMF recommendation, just a conclusion made by their experts: it is very important to understand it right. However, the real estate tax in Latvia is lower than in most countries. Contrary to income, it is very difficult to hide a property, and it is easy to administer that tax collection. Of course, the rate has to be proportional to one's incomes, and also to the size and richness of the property. Raising this tax is an effective way to raise budget incomes, however, if Latvia manages to reach the aim in other ways, we will not be against.

### **What could have happened**

*- Some economists and politicians say that EC and IMF help is just doing wrong to Latvia and that our country needs to reject it as quickly as possible. What could happen?*

Last summer when the government was amending the 2009 budget, there was serious risk of not receiving any payments, and then the salaries in the whole public sector would be not just cut by one fourth, but they would be not paid at all. I fear that not everybody really understands that. We are here not to have fun, but to help the country. And we already see the result: global markets have relatively calmed down and Latvia is regaining trust, and international rating agencies are reviewing their forecasts.

*- Did the authorities respond to your expectations and did they not do too much? IMF recently said that Latvia last year reached budget deficit of 7,1% of GDP, although it could have afforded 13%. Maybe some tight measures were needless.*

Most difficult thing last year was to understand what the Latvian government can do, is it able to implement a hard program. We are very happy with the results. I do not think that the authorities overdid something, they always have to be apprehensive and prudent. You saw yourself what happened with the pensions: now you have to pay compensations, and it is possible without additional cuts, just thanks to real austerity policy.