

UNICE TASK FORCE ON ENLARGEMENT
2002 REPORT ON CANDIDATE COUNTRIES' PROGRESS
TOWARDS EU ACCESSION

LATVIA

June 2002

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A. Executive summary

Latvia is experiencing remarkably high growth rates and increased economic integration with the EU as well as with Russia, making the country's accession to the EU increasingly attractive to the EU Member States. From the perspective of the business community, Latvia's progress in meeting the requirements of EU accession is continuing in a positive manner. Improvements have taken place in the areas of customs and immigration procedures, public procurement legislation, combating corruption and the executive's consultation of the business community.

Nevertheless, the Latvian government must still make efforts to create a welcoming business environment that is consistent and predictable for the investor. The following actions are recommended in key policy areas of relevance to business:

Actions recommended

- Improve implementation of the Acquis in the areas of free movement of persons, in particular as regards immigration formalities.
- Efforts should be made to maintain a clear and consistent regime governing enterprise registration and types of enterprises and their structures.
- The tax administration needs to work on adequately identifying and punishing tax-evaders in order to minimise the existing distortion in competitiveness between law-abiding tax-payers and tax-evaders.
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- Tackle remaining practical customs problems relating to administrative capacity.
- Enhance resources, infrastructure, capacity and competence of the judicial system.
- Improve the level of competence and fairness in delivery of municipal services throughout the country and improve the accountability of the municipalities to their constituents and to the national government.
- Quality reform in education, in both professional training and retraining, is long overdue.
- Improve the distribution of functions in government for planning and coordination of structural instruments to make best possible use of EU financial assistance and to design a functional plan for regional development.
- Improve infrastructure in the regions, in particular as regards roads.
- Tackle remaining corruption problems e.g. by ensuring that the new anti-corruption agency is respected and effective, and by prosecuting and punishing corrupt officials.
- Structured dialogue between the government and the business community should be supported and applied to new fields such as cluster development.

B. Introduction

Latvia's economic growth in 2001 and at the beginning of 2002 was noteworthy even on a global basis. Latvia's largest trading partner is the European Union and Latvia is well on its way to becoming integrated in the EU in terms of trade and investment. Latvia is also regaining important trading ties with Russia, signalling an improvement in relations that will make Latvia's accession to the EU increasingly attractive to the EU Member States.

Nevertheless, the Latvian government must still undertake significant efforts to create a welcoming business environment that is consistent and predictable for the investor.

My goal in this report is to indicate the perceptions and concerns of the business community about the actual business environment on the ground. This is based on my experience in Latvia since 1991 in a variety of capacities, including founder and president of four international companies, as Chairman of the Board of the Swedish Chamber of Commerce in Latvia and as a business representative in structured dialogue groups between the business community and the Latvian government.

C. Economic context and developments / Investment climate

Latvia enjoyed a growth rate in GDP of 7.6% in 2001, becoming the frontrunner of all the EU accession countries for the second year in a row. This record demonstrates a successful macroeconomic policy that has been consistently maintained by successive governments. This rate of growth and its sustainability is particularly remarkable in light of the general slowdown in the world economy in 2001.

The growth of GDP was fostered by an increase in the volume of trade by 10.6% (18.8% of GDP): 9.5% in transport, warehousing and communications (15.4% of GDP), 9.5% in manufacturing (14.9% of GDP) and 13.9% in commercial services (11.4% of GDP). Overall, the development has been spread relatively equally among the different sectors of economy. This trend allows us to be optimistic about the near and medium term prospects for the economy. Foreign direct investment flows have steadily increased and a 10% annualised increase was observed from January until September, 2001. In 2001 the most rapid growth of investments was in energy, trade, transport and communications industries.

D. Progress in adoption, implementation and enforcement of acquis

In preparing the following review of progress in adopting, implementing and enforcing the acquis, consultations have been undertaken with representatives of the following: Latvian Employers' Confederation, Foreign Investors' Council in Latvia, Swedish Chamber of Commerce in Latvia, British Chamber of Commerce in Latvia, German – Latvian Business Association, American Chamber of Commerce, National Economy Council, Latvian Chamber of Commerce and Industry, a number of sectoral associations and individual companies. The author of the Report also held discussions with the representatives of a number of relevant government agencies and international organisations.

The following sections will outline areas where businesses have expressed concern regarding the free flow of goods, services, capital and people, as well as possible distortions of competition¹. One common thread is that any difficulties with government policy, regulations or administrative burdens reported by foreign or EU companies are no different from the problems affecting local companies, since national treatment of foreign investors is a reality in Latvia.

¹ Some of these topics are not directly acquis-related; they are nevertheless closely linked to the considerations of the Internal Market.

Progress on the main recommendations from the UTFE 2001 Report (contained in the Fiche on Latvia's progress towards EU accession, published by UNICE in October 2001) is described below. Each section also describes the main deficiencies in key policy areas of relevance to business (even in cases where there was no explicit recommendation from the UTFE 2001 Report).

Free movement of labour

- **UTFE 2001 REPORT RECOMMENDATION: There are problems with immigration formalities for business personnel from Member States. The implementation of the acquis in the areas of free movement of persons should be improved.**

As noted in the 2001 report, overall, foreign businesses note that immigration procedures have improved. However, the recommendation made last year still holds true – it is necessary to further modernise the system and to ensure adoption of the new immigration law. A new immigration law has been in draft form for a long time. One positive aspect is that interested parties have had an opportunity to comment on it and make their inputs, but there is slow, seemingly wilful delay in the enactment of the law.

Company Law

- **UTFE 2001 REPORT RECOMMENDATION: The new commercial law is likely to improve conditions for doing business in Latvia. But the law has not sufficiently taken into consideration the business community's views.**

The Commercial Law that came into effect on January 1, 2002 was the result of many last-minute discussions between legislators and representatives of the business community. On the whole many of the concerns of the business community, such as protection of minority shareholders and liability of board members were included in the amendments adopted in early 2002. See the related discussion below on public/private cooperation.

There will be a long transition period from the former enterprise registration regime to the one now being applied to newly established companies. A problem that is only now being understood is the risk and confusion inherent in maintaining two parallel legal systems governing the establishment and operations of enterprises. This will require, first, a better understanding on the part of the relevant authorities on how these co-existing systems interact, and, second, a lot of education for companies to understand the meaning and implications.

Taxation system

Even though not directly acquis-related, businesses have expressed a number of concerns regarding taxes and tax administration. The complaints largely arise out of a single phenomenon: the inability of the tax administration adequately to identify and punish tax-evaders, thus causing a distortion in the competitiveness between law-abiding tax-payers and tax-evaders.

- Specifically, there exist deficiencies in the system of tax administration that foster unfair competition between firms that pay all their taxes versus those that evade payment of taxes. Legitimate businesses complain that the tax administration does too little to identify and penalise companies that are evading tax payments, but

instead cracks down on those who are already paying taxes, since they are easier to find and penalise. The evasion of social insurance contributions, which represent a significant cost factor to legitimate businesses, is especially acute. Payment of part of the salary “in the envelope” is still widespread, causing unfair competition between companies that pay all applicable taxes and those that do not, and resulting in low social protection for a large number of employees. In addition, the services of law-abiding tax-paying companies are ultimately more expensive than the services provided by tax-evaders.

Since this is an area where the Latvian tax administration needs advice on how this problem is addressed in other countries, some of our recommendations for the Latvian Government to minimise tax evasion and reduce the black economy that could be drawn from the experience of other countries include:

1. Identify those industries in which tax evasion is most pervasive and develop and use risk-assessment methods in selecting the companies to be audited.
 2. Stop the use of false insurance premium systems in tax evasion.
 3. Increase training of tax auditors in techniques to uncover tax evasion, in carrying out analytical audits, in distinguishing between real and false transactions and the correct application of transfer pricing.
 4. Cooperate more intensively on a practical level with national revenue services in EU countries to learn their practices in combating evasion.
 5. Collaborate closely with target industry group heads and industry organisations to involve them in addressing tax evasion within industry. Industry itself should have control mechanisms over its participants to ensure the establishment of a level playing-field.
- Given that tax legislation in Latvia is relatively new, not yet explicitly elaborated and therefore often requires interpretation, a business may find itself in a situation where State Revenue Service officials have a different interpretation from the one applied by the business. The resulting penalties are too high -- they are currently 100% or even 200% of the outstanding tax amounts. This is very detrimental, particularly in comparison with more flexible and less harsh penalty systems like the ones used in many EU Member States. There has been no progress on this issue and the Ministry of Finance believes that the current system of sanctions is effective. Most EU investors, on the contrary, see the existing system of sanctions as ineffective, because it acts as a deterrent to payment for fraudulent tax-payers and at the same time puts a disproportionate risk on legitimate businesses willing to invest in new innovative activities, the tax treatment of which is yet to be established in practice.

Customs and border-crossing

- **UTFE 2001 REPORT RECOMMENDATION: There have been noteworthy improvements in all aspects of customs procedures and clearance, but some practical problems remain to be tackled.**

As noted in the 2001 Report, customs-related legislation is in place and work has begun to fine-tune those regulations and improve their quality in relation to the EU Customs Code and its implementing regulations.

A common observation in any transition economy, including Latvia, is that problems remain with implementation of the laws and regulations. There continue to be inconsistencies in interpretation and application of the laws and regulations, in part due to the high level of discretion given to individual customs officers.

In addition, the Customs authority appears to be incapable of planning and managing the introduction of some special measures or additional provisions in the customs offices and posts throughout this small country. For example, the reinforcement of customs valuation without any training of customs officers – and no planning and oversight of the process – caused significant disruptions in the normal trade operations of companies that have been importing the same inputs for years. The situation was then normalised through training of officers and oversight of the process, however all of this should have been anticipated and done beforehand, without incurring disruptions for legitimate businesses. Such cases evidence a striking lack of administrative capacity in vital parts of the public administration.

Functioning of courts

- **UTFE 2001 REPORT RECOMMENDATION: In order to create a credible judicial system, its resources, infrastructure, capacity and competence need to be enhanced.**

It is quite clear that we cannot expect that the problems related to the credibility and functioning of the judicial system would be resolved in a year's time. However, the business community feels that too little progress has been made in this regard, as no clear decisions have yet been taken on how to proceed with strengthening the autonomy and independence of the judicial system, on the increase of remuneration for judges and on the ways to ensure adequate level of competence of judges dealing with application of corporate law, tax and customs law, etc.

Public procurement

One of the most pernicious forms of corruption is the one involved in public (at the national and municipal levels) procurement of goods and services from private firms. On January 1, 2002, a new law on State and Municipal Procurement came into effect and a new controlling institution was established to oversee the procurement process at the state and municipal levels. Although it is too early to make any determination regarding the effectiveness of the new law and office, these changes are welcomed by the business community, particularly if they impose standard procedures throughout the country and ensure an opportunity to appeal.

Functions of municipalities

Realistically, the investor interacts much more often and on a much more regular basis with municipal-level institutions than with state-level ones. Therefore, the competence of the municipalities in delivering public services is particularly important from the viewpoint of the investor. In Latvia, whether by design or default, there is a very modern system of decentralised government whereby local self-governments are relatively independent of the central government. This is a welcome situation, provided, however, that the investor can expect a standard level of competence and fairness in delivery of services throughout the country. Unfortunately, this is not the case.

For example, there are clear conflicts of interest where municipalities act as entities of both public and private law, thus often creating a distortion of competition. In areas, such as passenger transportation, outdoor advertisement and construction, the municipality acts as an entity of public law by issuing the necessary permits to private companies and at the same time acts as an entity of private law by providing the same services on the market. Unless clear rules are established to deal with these situations of potential conflict of interest, this creates a distortion of competition and favouritism. There is only a very limited

understanding of this problem in the municipalities and no attempts to clarify the applicable rules have been made yet. An additional concern is the low level of accountability and transparency in local governments throughout the country, which deters open competition and creates certain entry barriers for newcomers.

The national-level institutions, such as the Municipal Affairs Board (a government institution) and the Union of Local Self-Governments (a representative body of the municipalities) tend to be meek and lack the drive and staffing (or competence) adequately to address the problems presented in and by the municipalities.

Education and training

The Government has declared that its aim is to foster the development of a knowledge-based economy in Latvia. While in full agreement with this policy line, businesses can see very few practical steps to achieve even a fraction of these ambitious aims.

Many businesses, especially outside the capital Riga, find that a significant constraint on their activities is the lack of a qualified labour force. The graduates of vocational schools and higher education establishments lack practical training and often need to be trained on the job. The older generation needs to be retrained to be able work with new technologies and adapt to the new work environment. Not only is there insufficient government support for this, but often it seems that there is insufficient governmental (and especially by the Ministry of Education and Science) understanding of the problem.

In general, the evaluation of the situation as given in the 2001 UTFE Report is still accurate. What is important to note this year is that with the rapid development of the economy in the past years, companies feel that the problems in the education system are now, more than ever, translating into direct constraints for development of their businesses. Quality reform in education is long overdue.

Regional policy and coordination of structural instruments

The distribution of functions for planning and coordination of structural instruments between a number of ministries and agencies is not clear, despite the recent reorganisation of the involved institutions (merging of Secretariat of the Special Tasks Minister for Cooperation with International Financial Institutions into the Ministry of Finance). The reason I am highlighting this issue is that at the current state of development, when it is quite clear that Latvia already is not and will not be a low-cost country, it needs purposefully to develop its comparative advantages (geographical location and human resources). To do this, the Government needs to be able to develop a much more thought-out economic development policy and be able to utilise the upcoming increasing EU financial assistance to achieve these goals. Currently, this does not appear to be the case, and therefore the institutional set-up for the coordination of structural instruments and the appropriation and use of these funds should be closely monitored. Once this is accomplished, businesses will begin to feel the benefits and will act upon the opportunities offered by a well-designed and well-implemented policy of regional development.

Corruption

- **UTFE 2001 REPORT RECOMMENDATION: There have been attempts to combat corruption, but it remains a problem. The unclear role of the new anti-corruption agency needs to be sorted out.**

The Law on the Anti-Corruption Bureau (ACB), though previously expected to enter into force by the end of the first half of 2002, is yet to be adopted in the Parliament. At the same time the 2002 budget foresees financing for the ACB in the amount of LVL 370,000. There are mixed feelings in the business community about the possible efficiency of and necessity for such a bureau, particularly since it is not structurally independent of the government. Some of the foreign and local businesses feel that the adoption of the Law on the ACB and its subsequent establishment will be more of a foreign policy activity and might not materialise in increased efficiency in the fight against corruption. The Foreign Investors' Council in Latvia believes that, although the establishment of such a ACB is a welcome step, there is a perception that this will be a politically controlled organisation and concerns about how this body will be viewed. To improve the work of the ACB and make it more transparent, FICIL has suggested that an independent committee comprised of law-abiding Latvian citizens from both public and private sectors be set up to monitor the work of the ACB and regularly report to the public.

At the same time, it should be noted that the State Police and Security Police have intensified the fight against corruption in their own ranks and in the public administration at large. A Security Police Telephone Hotline (7208964) has been operational for some time. Though some reports have been submitted using this vehicle, this telephone hotline has not been advertised widely.

At the time of the writing of the UTFE 2001 Report, there were no instances of corrupt officials being prosecuted. At this time, however, there are an increasing number of such cases. It is important that the Latvian government understands that such cases must be prosecuted to the maximum extent, and that more of them need to be uncovered and publicised, regardless of how damaging it is to the short-term reputation of the government or the country. In the long run such openness should benefit both.

Societal integration and language law

- **UTFE 2001 REPORT RECOMMENDATION: Latvia's linguistic versatility is an asset that should be fully utilised, not least considering the entrepôt nature of the Latvian economy.**

As noted in the UTFE 2001 Report, an issue that is of surprise and concern to incoming investors is the "Latvianisation" of proper names and surnames. This may cause unnecessary administrative difficulties, and it is difficult to appeal such a decision, because it is a pervasive societal approach and an idiosyncrasy of Latvian grammar that the foreigner may feel significantly alters his or her identity. A recent court case was brought by a woman who did not want her name to be "Latvianised". The compromise decision by the highest court was that her name would be Latvianised in official documentation, but she could maintain the original spelling in parentheses. This decision was not viewed enthusiastically by the foreign investor community, since the primary problem of changing the person's name in official documentation remains.

The Latvian-speaking population and the Russian-speaking population continue to live in fairly different information fields, which exacerbates the differences in opinion and the

understanding of daily processes and developments in the country. Unless concerted effort is made to involve and engage all parts of society in decision-making process on issues of importance for every inhabitant of the country, there is a danger of losing the support of more loyal parts of the Russian-speaking population. There is a need for adequate policies to address this issue.

Privatisation

- **UTFE 2001 REPORT RECOMMENDATION: The quality of the privatisation process, with delays, false starts and lack of transparency, causing deep distrust among investors, needs to be enhanced.**

This recommendation arose from the general feeling among business about the privatisation of the few remaining large enterprises, in particular the Latvian Shipping Company. After failed attempts to attract a strategic investor, the Government took a decision to start the process with the privatisation of a 34% stake through a public offer for vouchers. The intentions are to sell (for money) a 51% stake to a strategic investor in the second round. The results of this privatisation attempt remain to be seen and are being closely monitored by the business community.

As the privatisation process of companies is approaching its finishing stage, the Privatisation Agency is slated for liquidation with its remaining functions to be handed over to other agencies.

Infrastructure

- **UTFE 2001 REPORT RECOMMENDATION: The infrastructure in the regions, in particular as regards roads and telecommunications, should be improved to support more equally distributed economic development in the country.**

Not much progress can be reported on this recommendation. The construction and repair of roads has not been carried out on the planned or even minimum-maintenance scale because of the lack of resources in the Road Fund. Leaving the issue of specific fiscal arrangements to the authorities, many businesspersons feel that a solution to the long overdue financing problems for the country's road infrastructure needs to be found if Latvia is to realise its economic potential as a transit hub and spread economic development to poorer regions within the country.

Public/private cooperation

- **UTFE 2001 REPORT RECOMMENDATION: Even though the executive has made much progress in involving the business community in decision-making process, the government's dialogue with business needs improvement, not least in the parliament.**
- **UTFE 2001 REPORT RECOMMENDATION: The capacity-building of Latvian business organisations should be supported.**

As noted in the UTFE 2001 Report, business organisations are playing an increasingly important role in giving advice to government policy-makers on legislation affecting the business community. As a result of this invitation by the government to continue to engage in structured dialogue, business associations like the Foreign Investors' Council in Latvia have enhanced their institutional capacity by creating new full-time staff positions. At the same time, the Latvian government has undertaken business cluster development and will apply a similar approach to structured dialogue in consolidating the concerns of cluster members. We are pleased that the Latvian government has identified a model which works and that the European Commission has acknowledged this. In 2001 the European Commission Enterprise Directorate-General granted CC BEST status to these efforts to improve the business environment and reduce administrative barriers by engaging the business community in structured dialogue. These efforts need to be maintained, further developed, and, where possible, even disseminated to other EU accession countries.

In addition, the cluster initiative has received praise from businesses, which have noted that this is an example of European Commission PHARE technical assistance money being well spent.

Although members of the business community have expressed their hope that the Parliament will invite interested parties to hearings to air their views on draft or proposed legislation, this mechanism is still not being implemented to a satisfactory extent. There is a need to establish better channels of communication between the members of Parliament and the public. This could involve publicising hearings or making the home page more interactive. But first, members of Parliament need to recognise that they are not only accountable to their electorate once every four years.

An interesting development to minimise the isolated decision-making of Parliament is an initiative undertaken by the State President. The Office of the President has begun to function more like an upper house of Parliament as an additional review mechanism before legislation may come into force, inviting affected parties to speak out on behalf of the law adopted by the Parliament but not yet signed into force by the President. The President has used this instrument to send some controversial legislation back to the Parliament for reconsideration, such as the Commercial Law after some last-minute potentially harmful provisions were put into it by Parliament. While the business community welcomes this initiative by the President, many see it as a stop-gap measure before Parliament actually develops a real ability to consult with affected parties.

E. Conclusions and recommendations

From the perspective of the business community, Latvia's progress in meeting the requirements of EU accession is continuing in a positive manner. Some recommendations that have been raised in consultations with representatives of the business community have been discussed above, and are summarised here.

- **There continue to be problems with immigration formalities for business personnel from Member States. The implementation of the acquis in the areas of free movement of persons should be improved and new legislation should be adopted and implemented.**
- **Efforts should be made to maintain a clear and consistent regime governing enterprise registration and types of enterprises and their structures.**
- **The tax administration needs to work on adequately identifying and punishing tax evaders in order to minimise the existing distortion in the competitiveness between law-abiding taxpayers and tax evaders. Specifically, the tax administration should:**
 - **Identify those industries in which tax evasion is most pervasive and develop and use risk-assessment methods in selecting the companies to be audited.**
 - **Stop the use of false insurance premium systems in tax evasion.**
 - **Increase training of tax auditors in techniques to uncover tax evasion, in carrying out analytical audits, in distinguishing between real and false transactions and the correct application of transfer pricing.**
 - **Cooperate more intensively on a practical level with national revenue services in EU countries to learn their practices in combating evasion.**
 - **Collaborate closely with target industry group heads and industry organisations to involve them in addressing tax evasion within the industry.**
- **Reduce tax penalties.**
- **There continue to be noteworthy improvements in all aspects of customs procedures and clearance, but some practical problems relating to administrative capacity remain to be tackled.**
- **In order to improve the credibility and effectiveness of the judicial system, its resources, infrastructure, capacity and competence need to be enhanced.**
- **Improve the level of competence and fairness in delivery of municipal services throughout the country.**
- **Improve the accountability of the municipalities to their constituents and to the national government.**
- **Quality reform in education, both in professional training and retraining, is long overdue.**
- **Improve the distribution of functions for planning and coordination of structural instruments.**

- **There have been attempts to combat corruption, but it remains a problem. Efforts need to be made to ensure that the new anti-corruption agency is respected and effective.**
- **Prosecute and punish corrupt officials.**
- **The infrastructure in the regions, in particular as regards roads, should be improved to support more equally distributed economic development in the country.**
- **Structured dialogue between the government and the business community should be supported and applied to new fields such as cluster development.**
- **Parliament needs to establish better channels of communication between the members of Parliament and the public.**

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