Full Schedule of Recommendations:
30.12.2014, the Ministry of Finance reply
26.01.2015, Council comments and suggestions

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1.	**3. Numerical fiscal conditionality assessment**	Conclude a MoU with the Ministry of Finance (hereinafter – MoF) for the exchange of information and cooperation in the monitoring of fiscal discipline.
		MoF, 30/12/2014: Council initiative about the Memorandum of understanding (hereinafter – MoU) on the exchange of information and cooperation on fiscal surveillance, calls for the proposals to prepare for the MoU.
		Council's reply, 26/01/2015: Council's representatives held informal consultations on 7 January 2015 and 12 January 2015 with the MoF Fiscal Policy Department, the MoF Economic Analysis Department and Deputy State Secretary for Tax Policy, and informed the Council during meeting on 15 January 2015. The MoU would cover the information exchange for reviewing the key fiscal documents, while the Council feels it would not be able to devise independent assessment of the macro-economic forecasts and the output gap at the current level of funding provided.
2.		Prepare measures to achieve budget balance in 2015 and 2016, the appropriate adjustments in the annual budgetary plans to avoid the consequences of Article 11 of the Fiscal Discipline Law (hereinafter – FDL), resulting into the increase in the budget target balance to compensate the accumulated budget balance lagging the target in excess of the 0,5% of GDP during three years consecutive years taking into account the estimated budget balance the shortfall by 0,3% of GDP in 2014.
		MoF, 30/12/2014: According to the MoF 2014 forecasts the general government structural balance (hereinafter – the structural balance) is forecast at 1,3% of GDP, which is 0,3% above the law "On the medium-term budgetary framework for 2014, 2015 and 2016." 2014 projected value. An increase of 0,1 percentage points make up the balance of the cyclical components of an increase from 0,1% of GDP in the law "On the medium-term budgetary framework for 2014, 2015 and 2016" 2014 forecast values of 0,2% of GDP. Increase of the cyclical component is explained by the GDP changes resulting from changes in the methodology of calculating GDP and does not change as a result of the national economic situation. The state budget 2015 and the medium-term budgetary framework for 2015-2017 is prepared under the

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		conditions of the FDL. Thus, the MoF believes that if there is no observable adverse deviation from the predicted macroeconomic growth scenario, the 2015 and subsequent fiscal years, the projected figures will be met. On the other hand, if the MoF identified downside macroeconomic risks and negative trends will be observed in the performance of fiscal indicators, the MoF will ensure that both the current budget year and also if necessary in the coming years the FDL fiscal conditions will be met. FDL Article 11 provides for the automatic correction mechanism triggering after an actual structural balance of the accumulated value of the offset from the minimum value of the planned structural balance of at least 0.5% of GDP. However, it is important to note that the assessment of a given year (n-1) the actual book value of the minimum forecast value is carried out in a given year to the following year (n) 1 December. At present, it is quite difficult to judge what will be the actual value of the structural balance in 2014 offset from the intended and whether it will be necessary to carry out the mentioned corrections from the FDL Article 11.
		Council's reply, 26/01/2015: The Council points at serious downside risks, which may trigger the effectiveness of the Article 11 mechanism for 2018 or 2019 taking into account the deterioration of the macroeconomic conditions unless the Government devises compensatory measures.
3.	**4. Macroeconomic Outlook and the output gap**	Request the MoF to prepare a broader explanation of the output gap estimates, including the economic reasoning for the key assumptions.
		MoF, 30/12/2014: Regarding to the output gap and potential GDP calculations, we inform that the MoF is ready to prepare and present information about the Council interest in addition to the issues of the output gap estimates. At the same time, taking into account that on 17 October and November 21 November 2014 Council working groups meetings the MoF has provided the explanation of the nature of these calculations and ask to prepare a more detailed request for information of interest to the Council or unclear issues related to MoF output gap estimates. Although such Council task is not assigned by the FDL to improve fiscal planning process, it is considered that it would be helpful if the Council to draw up a separate opinion on macroeconomic indicators forecasts before work starts on the other fiscal indicators forecasts preparation. We therefore invite the Council to consider the possibility, in preparation for the macroeconomic projections of the Stability program, the medium-term budget framework law and for the annual state budget law, prepare a separate opinion on the MoF macroeconomic indicators forecasts.

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		Council's reply, 26/01/2015: The Council would require agreement with the MoF on endorsing the macro-economic forecasts fixed in the MoU mentioned with the response to recommendation 1 and support to ensure adequate capacity of the Council to accomplish this task.
4.		Request the MoF to explain the second principle of the fiscal policy, i.e. savings requirement, according to which the budget should be prepared and executed with a surplus, while the economy preforms with positive output gap, to ensure balanced budget over the economic cycle, provided that the economic situation allows.
		MoF, 30/12/2014: It should be noted that this principle FDL determined so that the surplus should be built if "the economic situation allows it." This principle requires the economic cycle balanced budgeting, which in theory means that the structural balance is zero. Positive output gap should be the case for the budget with the surplus, but in the case of negative output gap the budget may allow the deficit. In practice, however, has been a derogation from this principle, stating that the structural balance in the medium-term objective is -0.5% of GDP. This means that the general government budget in surplus is created only when the output gap is positive and exceeds 1.4% of GDP. It should be noted, too, that does not mean real savings with the Treasury accounts, because long-term stabilization reserve in accordance with the law received the cash flow surplus transfer, if any, established within the State general budget and is not earmarked for specific purposes and from the point of view of public debt service is more profitable to build savings, rather than reduce the public debt size.
		Council's reply, 26/01/2015: Council draws attention that there is slight inconsistency in the FDL regarding the formulation of the balanced budget principle and the MTO of -0.5% of GDP.
5.		Address the need for additional fiscal space in the medium-term budget framework for 2015-2017 in order to be able to respond adequately to the challenges and to realise the Government's priorities, taking into account that the 2015 and 2016 fiscal space actually has been already exhausted before the start of the budget process.
		MoF, 30/12/2014: MoF agrees with the recommendation.
6.		Attach to the draft Annual budget law and draft Framework law the explanation of the planned structural reforms to promote sustainable economic development and effective use of the budgetary resources.

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		MoF, 30/12/2014: EU economic policy surveillance and coordination cycle, called the European Semester up to 30 April of each year shall be submitted to the European Commission the national reforms and Stability / Convergence programs. Progress Report on the Latvian National Reform Program "Europe 2020" strategy in the context of the implementation of the EU Council reviews progress in the execution of the recommendations, as well as Latvian quantitative targets "Europe 2020". As the EU Council Recommendations and the "Europe 2020" goals are also drawn to the implementation of structural reforms, the National Reform Program also described progress in the implementation of structural reforms. At the same time the MoF draws attention that the Law on Budget and Financial Management provides that starting from the 2016 mid-term budget framework draft law preparation process will take place in parallel with the Stability program and National reform programs. In view of the foregoing considerations, the MoF sees no need to increase the administrative burden of duplicating information on the progress made in implementing structural reforms in a number of policy documents.
		Council's reply, 26/01/2015: Council in general agrees with the MoF reply hoping that the budget documents in the future will present adequate links with the National reform program review and update process.
7.	**5. Fiscal Policy Challenges**	Prepare tax policy strategy, to accompany the Stability Program for 2015 -2018 with the objective of allowing to achieve the Government's goal tax burden at 1/3 of GDP by 2018.
		MoF, 30/12/2014: State Audit Nr.5.1-2-32 / 2013 "On the Latvian Republic 2013 report on the state budget and the budgets of local governments" implementation of the recommendations in Annex 1 Part II plan provides that the MoF until 15 June 2017 develops a medium-term tax policy that is associated with the medium-term Latvian National Development Plan 2014-2020. Currently, the MoF has started work on tax policy guidelines for the development of the medium term, which, inter alia, will provide analysis on trends in tax revenues increase up to 1/3 of GDP.
		Council's reply, 26/01/2015: Council reiterates that despite active MoFs work to reduce the shadow economy the Government lacks updated tax policy document, which leads to strengthening the capacity of public finances, to ensure national security and sustainable and adequate public services. Therefore the Tax policy strategy

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		development should not be postponed until 2017, as proposed in the MoF's response. Current macroeconomic developments point at lower prices, which on one hand is good news for consumers, but on the other hand means less optimism in the business environment, in new project borrowing and accelerated economic development. Lower inflation and slower growth of the economy as a whole compared to the projections for 2015 approved the state budget threaten tax revenue plan, and points to the risks for increased budget deficit this year. The Government's action plan (draft available here) would not realistically allow meeting the Government commitments without move from the current less than 28% of the tax burden, that might not be satisfactory volume to perform at the necessary qualitative service level. As well as the currently used tax burden is not in line with the goals mentioned in the Government declaration. Since the most effective measures to reduce the shadow economy have been already incorporated in the 2015 budget, reducing the shadow economy alone may not be enough to overcome the decline in the share of tax revenues to GDP taking into account the current tax policy commitments. The Council has not yet assessed the full fiscal impact of priority measures in the welfare, education reforms, health care and defense reflected in the draft Government action plan, which could exceed the revenue potential at the current tax policy.
8.		Consider the options for tax base expansion, including value added tax, which could be simultaneously accompanied by measures to alleviate the impact of higher rates on socially vulnerable population.
		MoF, 30/12/2014: Law "On Personal Income Tax", Paragraph 90 of the Transitional provisions provide that personal income tax rate in 2015 will be reduced from the current 24% to 23%. In 2015 it is not expected to increase the non-taxable minimum. At the same time, according to decision of the Cabinet of Ministers of 10 November 2014 (minutes No 61, 29.§ "Informative report "The opportunities to increase revenue""), Paragraph 4 of the given task – the MoF until 30 April 2015 should submit to the Cabinet an informative report with proposals for the introduction of differentiated non-taxable minimum starting from 2016 where the complex assessment will be done about the personal income tax easements and the tax burden on labor reduction.
		Council's reply, 26/01/2015: Council draws attention that there has been no serious consideration of the tax policy measures to compensate for the risks of economic slowdown and falling tax revenue to GDP ratio.
9.		Strengthen the regulatory framework to contain the "shadow" economy.
		MoF, 30/12/2014: As done up to now the most important measures of the shadow economy mitigation include economic

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		operators (whose main activity is not lending) loans to the taxation of personal income tax (hereinafter – PIT), as well as board members in the minimum wage taxation of PIT. Similarly, significant measures of economic activity was the suspension of liquidation and the simplified mechanism for activation by preventing fictitious registration and use of the possibility of fraudulent transactions in chains, as well as the changes introduced in the regulation for the use of cash registers. Also this year, set up the Council to combat the shadow economy, which will include public authorities and non-governmental organizations is an important step towards the development of cooperation between the institutions involved in the fight against the shadow economy. In addition, the MoF in cooperation with the State Revenue Service (hereinafter –SRS) and the social partners has been elaborated a number of measures which will come into force on 1 January 2015. The most important of them is the board members personal liability for the belated tax payments. It is also an improvement of the information exchange process between financial institutions and the SRS, the disclosure of information on taxpayers paid tax amount. The implementation of the Declaration for leasing and lending services (non-banks) companies.
		Council's reply, 26/01/2015: Council agrees with the reply.
10.		Examine all options for the cancellation of the tax exemptions. Simplify the tax system by reducing the multiple rates and the number of exemptions in support of efficient State Revenue Service operation.
		MoF, 30/12/2014: Given that the area of taxation is one of the most important aspects of evaluation of investment environment and attracting investment is stability, it is not clear what is meant by the recommendation – "Consider all the possible cancellation of tax relief." We agree that the tax system should be simple and effective to administer, and tax incentives should be of limited and should be routinely evaluated their effectiveness, but cannot accept the setting that all exemptions would be inadequate and should be assessed in the cancellation (this is also contrary to the further recommendations, such as an increase of non-taxable minimum). The tax system should be not only simple, but also fair. Exactly because of fairness there are introduced separately exemptions for tax incentives, such as the PIT exempt certain types of compensation (e.g. travelling allowance). The SRS enhancement is to be welcomed, but it has to be reasonable and in line with the interests of taxpayers. Most of the direct tax exemptions are targeted to specific groups of taxpayers and implemented for a specific purpose. For example, PIT reimbursement for medical and educational expenses are covered if the

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		state does not fully cover the costs, but these are essential for the inhabitants. Contributions to private pension funds and long-term life insurance are facilitated to stimulate individuals to make savings.
		Council's reply, 26/01/2015: The Council regards the evaluation of the effectiveness of tax exemptions very important for ensuring social equity and delivering on the government policies. We are looking forward to receive such analyses from the MoF.
11.		Consider the options for replacing the personal income tax rate reduction with an increase in tax-exempt income, thus reducing the tax burden on lower paid workers, promoting the legalisation of employment and the general drive to return to the formal labor market rather than relying on social benefits. The Council supports the plans for the progressive tax exemption.
		MoF, 30/12/2014: We support the recommendation that further reduction of tax burden on labor should be moving to the range of persons with low incomes, however, a progressive income tax system alone does not guarantee that a person will choose to work instead of having to choose to receive benefits.
		Council's reply, 26/01/2015: The Council believes that further delays in reducing tax wedge on low paid workers would ultimately strengthen the hand of the proponents of progressive income tax rate as an alternative. Progressive income tax rates could jeopardize the implementation of the tax discipline and the need to limit the risks of tax evasion.
12.		Examine the options for property tax increase, together with the review of cadastral values, to improve the equity of income distribution. Long-term residents in areas with high cadastral values should be allowed to capitalize the increase of the property tax, the settlement of which may be deferred until the property is being transferred.
		MoF, 30/12/2014: The recommendation states: 1) examine the possibilities of the property tax increase, together with the review of the cadastral value to improve the equality of income distribution; 2) long-term living residents in areas with high cadastral value, allow to capitalize on the growing property tax, payment for which is likely to be postponed until the re-registration of property. On the recommendations of the first part – allow us to draw attention to the real estate tax rate (for the tax rate corridor) has been transferred to local governments.

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		We believe that with the recommended methods to achieve the objective in principle is not possible, bearing in mind the following: as this is contrary to the law "On the real estate tax" the essence and meaning. Firstly, the property tax base is the cadastral value of the property to be determined by the State Land Service, mainly based on the real estate market analysis data. So the primary factor that determines the amount of property tax is the real estate location and market value. Consequently, we believe that the cadastral value can not be used as a tool for the real estate tax revenue increase or reduction in the administrative or smoothing between different national territories. Secondly, all the revenue from the property tax are credited to the local government budgets, so the law is delegated to local authorities the right to tax administration within and determine the tax rate within the range prescribed by law and to grant tax relief for certain categories of taxable person up to 90% of the tax amount calculated. On the recommendations of the second part – allow us to draw attention to the Law "On Real Estate Tax" already provides for the right of tax authorities to decide on suspension of payment of the declared place of residence and the forearm to the land property rights for the transition to another person, before assessing the taxpayer's social status and financial solvency. However, when assessing the possibility of extending the tax deferral right, please remember that the real estate tax of 100% is channeled into the local government budgets, so if it is intended for a wide range of tax deferral (in accordance with the recommendation), they have updated the question of new funding requests from the state budget authorities as delaying the tax, they will not be able to exercise their usual functions. It is for this reason, to extend this provision to a broader range of taxpayers are not expected. We would like to point out also that the Recommendation 10 suggests just the opposite – to examine all the possible cancellation of tax incentives rather than additional enforcement options. Although the property tax is administered by the municipality, in our opinion, the tax element of the review should follow a similar approach.
		Council's reply, 26/01/2015: The Council believes that the revenue potential of the residential property taxation has not been used as the revenue from this tax lags behind the average levels in the EU. The Council would like to invite the MoF tax experts for discussion on this matter.
13.		Transfer of certain state government services to the private sector, thus demonstrating a clear strategy to reduce public spending in the medium term, specifically, explore the possibility of using better targeted

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		grants and services to support vulnerable groups, in order to increase the benefits and effectiveness of the delivery.
		MoF, 30/12/2014: Development Planning System Improvement Action Plan 2014-2016 (approved on 25 February 2015 by the Cabinet Order No. 84), the MoF in cooperation with the Cross-Sectoral Coordination Centre the task to analyze the possibility of introducing a sectoral policy planning and evaluation expenditure. The deadline set 1st quarter of 2015. In addition to the recommendations expressed in the report Summary the Council indicates that one of the possible options of a tax increase would be to raise tax rates on capital, which is not used in production. Please pay attention that the law "On Corporate Income Tax" for increasing the corporation taxable income for expenses that are not connected with the economic activity and that the amount of expenditure by applying a multiplier factor of 1,5. By contrast, virtually impossible to raise tax rates on capital, which is not used in the production, because the corporate income tax applicable to income earned rather than capital. In turn, the appointing authority shall apply to distribution of income, which in various combinations creates an effective tax rate of ~ 24% (15% corporate income tax at the level of + 10% personal income tax level).
		Council's reply, 26/01/2015: The Council believes that the revenue potential of taxing the owners of capital not employed has not been used as the revenue from capital taxation lags behind the average levels in the EU. The Council would like to invite the MoF tax experts for discussion on this matter.
14.	**6. Fiscal risk assessment and the adequacy of the fiscal stability reserve**	Endorse the Government's fiscal risk declaration taking into account the Council's proposals.
15.		Provide the public with adequate information regarding the boundaries of the Government's obligations and promote the purchase of private insurance for businesses and households to reduce fiscal risks associated with natural disasters and business risks.
		MoF, 30/12/2014: In general, the occurrence of natural disasters and unpredictable business risks, the government is not a direct obligation to the risk of the affected entities to provide support from the state budget (except in the laws and regulations assigned cases or in specific agreements in some cases). Such aid from the state budget rather specific risk cases can be described as a moral obligation to the government or public expectations, business / industry pressure to provide support. But for sure, one can not deny the specific cases in which, for example, in order to maintain a particular

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		sector of regional competitiveness, the government's interest to provide support from the state budget (such as support for the dairy sector, the need for which arose due to increasing competition in the dairy sector due to the sanctions on imports to the Russian market). From a fiscal point of view of risk management to mitigate the impact of such risks on the state budget are difficult to predict, given the specific nature of the risk / probability of unpredictability. Currently, the solution to such unforeseen risks to mitigate the impact on the state budget can be made, or of specific state budget program "Funds for unforeseen events", or the allocation of funds from the fiscal space, if available.
		Council's reply, 26/01/2015: The Council agrees with the MoF opinion, while the promotion of private insurance should be promoted and the government actions compensating for unforeseen events occurring for businesses not discouraging the development of private insurance.
16.		Improve the risk management in the state owned corporations, which are classified to the general government sector to ensure access to timely information on activities that may have an impact on the fiscal balance management.
		MoF, 30/12/2014: Corporations are one of the identified and fiscal risks contained in the Fiscal risks declaration. The MoF agrees that the general government sector included the state owned corporations need to improve risk management, and it was identified additional fiscal measure required to reduce the risk of ensuring enhanced quality control of the financial activities of the state owned corporations prepared projections, provided that for central public authority which holds shares in a specific corporation, manage and analyze financial performance risks affecting the next three years and provide to the MoF. Thus, using the information with a higher level of confidence there will be provided more accurate forecasts for the general government budget preparation and decrease the possible offsets between the financial data plan and the actual execution. At the same time informing that the MoF evaluate additional potential solutions to the fiscal projections for improving the review of the existing legal framework in order to ensure timely receipt of data on the general government sector state owned corporations' financial activities. Furthermore, it is also weighted probability to update the laws provide the restrictions that would minimize such corporation unintended consequences for the country's fiscal performance.
		Council's reply, 26/01/2015:

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		The Council acknowledges the complication of assessing the government balance risks caused by the state and local government owned corporations classified to the general government sector. The Council will continue studying these risks and looks forward to cooperation with the MoF for mitigating such risks.
17.		Review the realism of the local government budget balance in the Framework law projections, taking into account the agreements reached for the local government borrowing and the past trends in the fiscal balance of the local government's sub-sector.
		MoF, 30/12/2014: Municipal budget forecasts in 2015-2017 were discussed at the request of the Council at the Council's meeting on 21 November 2014. At this meeting the MoF explained what factors could affect the municipal budget balance over the medium term forecasts. Local government budget on a cash flow basis in 2015 is projected a deficit in the coming years and a total revenue will be balanced with the expenditure that will provide stable revenue growth. Local government budget deficit is projected mainly in the light of the deficit of the EU funds side, a part of the basic functions are projected surplus, similar to what has been the actual performance of the previous years. Since today is not accurately known the new 2014- 2020 programming period and EU funds flow directly to local government budgets, so that the medium-term deficit is projected lower part at the EU funds. Given that the current projections, most of the EU funding is going to the State general budget, but it is not broken down by activity and thus it is not reflected in the municipal budget, thus it is difficult to provide precise forecast of the local co-financing of EU funds, but part of it has already been taken into account. As previously explained, the local government budget revenue and expenditure projections take into account the previous year execution trends, individual forecasts of macroeconomic indicators (for example, the average wage growth, inflation) as well as local government borrowing trends. Municipal budget projections for the medium term will be reviewed in April 2015 in the preparation of the general government budget forecasts for Latvia's Stability Program 2015-2018, and in the fall in the preparation of the draft law "On the medium-term budgetary framework for 2016, 2017 and 2018".
		Council's reply, 26/01/2015: The Council acknowledges the particular features of the cycle related to the implementation of EU funds and will continue following closely the developments related to the impact of local government financial operations on the general government fiscal balance.
18.		Propose establishing the fiscal safety reserve for 2016 in the amount of 26.9 million euro or 0,1% of GDP and in 2017 at 37.3 million euro or 0,13% of GDP.

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		MoF, 30/12/2014: 2016 distributable fiscal space was about as big as the 2015 fiscal space. If in 2016 would be set fiscal safety reserve, in 2015 part of the additional new policy initiatives should be supported rather than from priorities perspective as evaluating the effect of the 2016 base year. Also take into account the fact that the macro-economic uncertainty creates a high probability that its current 2016 fiscal space for medium-term budget framework law 2016-2018 development time can vary considerably, and the differences can be both an increase and a reduction direction. Given these circumstances, the MoF took the view that it is more important to give funding priority needs, the fiscal reserves were abandoning. The MoF does not agree with the Council analysis justifying the 0,13% fiscal safety reserve need, because as deviations from the approved expenditure in the social security budget is symmetric fiscal security reserve, this factor is not built. Recalling that, in accordance with the FDL, fiscal security reserve is created for those cases where deviations in the medium term unrelieved. According to the Medium-Term Framework Law 2015, 2016 and 2017, and in accordance with the FDL, Fiscal safety reserve for 2017 is 0,1% of GDP.
		Council's reply, 26/01/2015: The Council view's establishing the fiscal safety reserve for 2016 in the amount of 26.9 million euro or 0.1% of GDP and in 2017 at 37.3 million euro or 0.13% of GDP essential for achieving the objectives of the FDL. Meanwhile, the Council finds that the methodology applied by the Government regarding the risks of cost of the social insurance benefits exceeding the funds appropriated for this purpose with adverse impact on the fiscal deficit continuing on increasing direction. The Council is looking forward to cooperate with the MoF on the methodology of assessing the fiscal risks and providing adequate security in the forthcoming budgets.