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ECONOMIC AND FINANCIAL AFFAIRS

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EUROPEAN UNION BALANCE OF PAYMENTS ASSISTANCE

LATVIA

EC STAFF REPORT FROM THE 3RD REVIEW MISSION TO RIGA (LINKED TO THE 4TH INSTALMENT)

Executive Summary

The Commission services carried out the third review mission in cooperation with the IMF staff from 25 May to 7 June 2010 to assess progress made with respect to the conditions attached to the fourth instalment of the EU financial assistance, which amounts to EUR 0.2 billion. **Based on the findings of the mission and a Compliance Note sent by the authorities on 14 May 2010, the Commission considers that the specific economic policy criteria,** laid down in the second Supplemental Memorandum of Understanding, **are broadly fulfilled.**

In particular, this conclusion reflects implementation of the measures included in the 2010 budget, which should ensure achievement of the deficit target of no more than 8.5% percent of GDP, and progress by the authorities in identifying key measures in order to complete the budgetary consolidation over the medium term. Concerning the implementation of the 2010 budget, the authorities have ensured adequate expenditure control and proposed measures to increase the efficiency of the State Revenue Service and combat the grey economy. Progress is being made as concerns strengthening of the fiscal framework with ongoing design of a fiscal responsibility law and the management of the public administration through a public sector wage grid. As regards structural reforms and improvement of business environment, there has been some progress; however, more determined action is still warranted. Significant financial system stabilisation measures have been taken, in particular as regards the restructuring process of the Parex Bank in view of its privatisation and, to a lesser extent, to complete the transformation of the Mortgage and Land Bank.

Given the progress made and the existing scope with respect to the 8.5% of GDP deficit target for 2010, the EC and the IMF have approved in part the authorities' request to increase 2010 budget appropriations to foster the absorption of EU funds (entailing an increase of the allocation of LVL 200 million, or almost 1.6% of GDP). This brings the overall budgetary spending related to EU funds in 2010 to almost 8% of GDP, which is expected to have a significant impact on the economy countering the recessionary effect of other consolidation measures. In addition, should there be evidence in the remainder of the year of further fiscal space available under the deficit target, a further increase in 2010 appropriations for EU Structural Funds and Cohesion Fund spending by up to LVL 132 million (ca. 1.1% of GDP) would be considered.

Conditions for the fifth instalment relate to consolidating the gains made thus far while setting the stage for fulfilling the Maastricht criteria by 2012. Concerning budgetary consolidation, the authorities are committed to achieving a fiscal deficit of no more than 6 % of GDP in ESA95 terms in 2011, after securing 8.5% of GDP in 2010. Preliminary estimates suggest that a further LVL 395-440 million in net measures will be needed to achieve the 2011 target. The authorities are also considering increasing appropriations from the EU Structural Funds and Cohesion Fund by a further LVL 250 million next year, on top of the significant amount already envisaged, which would require an additional LVL 30 million in measures to offset the increased co-financing needs. For 2012 further significant adjustment will likely be needed to bring the deficit below the 3% of GDP target.

Overall, the programme is proceeding well, although significant risks are present. Fiscal adjustment since mid-2009 has been very high, through the implementation of the 2009 supplementary budget and passage of a restrictive budget for 2010. This is an achievement in a challenging political environment. However, as stipulated in the revised SMoU and the

Letter of Intent, much remains to be done, in particular to complete the fiscal adjustment in the years ahead in line with ECOFIN recommendations. Risks relate to pre- and post-election budgetary slippages - some minor ones having already materialised, the potential financial market spill-overs from tensions in other European economies, and a difficult socio-economic situation with high unemployment during next years. The fact that the government has now a minority in Parliament increases the challenges in terms of ensuring full implementation of the 2010 budget and preparing the budget for next year, as well as of undertaking decisive steps to make the economy more competitive and dynamic.

The balance-of-payments situation is much better than initially expected, and some funding under the programme may not need to be drawn. International reserves amount to 240% of the monetary base and therefore provide ample buffer in case of unfavourable developments in capital markets. Given the improved economic environment and the much stronger financial position, the authorities requested not to draw all available funds at this review but to treat those from bilateral lenders as credit facilities, while the loans by international lenders will continue to be drawn as scheduled.

1. Introduction

On 20 January 2009 the ECOFIN Council approved EU medium-term financial assistance for Latvia totalling up to €3.1 billions under the Balance of Payments (BoP) facility for non-euro area Member States. The EU assistance is part of a coordinated package of international financial assistance totalling up to €7.5 billion over the period to end-2011. Contributions from the EU, either multilaterally under the EU BoP (€3.1 billion) or bilaterally from several EU Member States (€2.2 billion), total €5.3 billion, with the remaining part provided by the IMF (around €1.7 billion), the World Bank (€400 million) and the EBRD (€100 million).

The EU financial assistance shall be disbursed in six instalments. The amount of the first instalment was EUR 1 billion, released on 25 February 2009 after signature of the Memorandum of Understanding ("the Memorandum"), while a second instalment of EUR 1.2 billion was released on 27 July 2009 and a third instalment of EUR 0.5 billion was released on 11 March 2010, after completion of the first and second review missions and the broad fulfilment of the economic policy criteria laid down in the Memorandum and in the first Supplemental Memorandum of Understanding, respectively.

The Commission services carried out the third review mission in cooperation with the IMF staff from 25 May to 7 June 2010 to assess progress made with respect to the specific conditions attached to the fourth instalment of the EU financial assistance, as laid down in the second Supplemental Memorandum of Understanding, instalment which amounts to EUR 0.2 billion. Based on the findings of the mission and a Compliance Note sent by the authorities on 14 May 2010, the Commission considers that the specific economic policy criteria are broadly fulfilled.

During the mission, a provisional agreement was reached between the Commission staff and the Latvian authorities on the third Supplemental Memorandum of Understanding (SMoU). On 8 June 2010, the Cabinet of Ministers approved the third SMoU, based on the mandate given to the government by the Parliament in January 2010 to negotiate new conditionality linked to further disbursements and sign the revised SMoU and the LoI.

The fourth instalment shall be released after consultation of the EFC (done on 24 June) and signing of the third SMoU.

2. Macroeconomic and Financial Developments

2.1. Macroeconomic Outlook

The severe recession that started in early-2008 technically ended in the first quarter of 2010, when GDP increased by 0.3% from the previous quarter. Nevertheless, the cumulative output loss during this long recession exceeds 25%**.** The GDP data reflects the ongoing rapid shift of the economy towards the external sector. In Q1 2010, GDP was 6% lower than a year earlier, with private consumption falling also by about 6%, government consumption by 14%, gross capital formation by about 18%, but exports volume increased by 4.6%. Recent high-frequency data also confirms the encouraging trend for exports and suggests a stabilization of domestic demand. Goods exports increased by 33.4% in April, from a year earlier (+14.3% in Q1) and the DG ECFIN Economic Sentiment Indicator (ESI) for Latvia points to a steady improvement. However, the recovery remains fragile due to the continuing deleveraging in the financial sector and the difficult labour market situation. In addition, uncertainties regarding the future tax policy delay investment decisions ahead of the parliamentary election.

The recession has led to a rapid increase in unemployment and a fall in hours worked per employee, but also to a significant nominal reduction of full-time equivalent gross wages, thereby strengthening the competitiveness of the Latvian economy. The unadjusted rate of unemployment increased from 9.9% in the fourth quarter of 2008 to 20.4% by the first quarter of 2010[1] (registered unemployment has fallen from above 17% in the beginning of year to 15.8% in June). Gross wages decreased by 8.3% y-o-y in the first quarter of 2010 (with public sector wages falling by over 14%). Gross private sector wages fell by 4.7% y-o-y, but wage reductions were probably larger than the officially reported figures suggest[2]. Nominal unit labour costs decreased by about 9% in 2009 and are projected to fall by about 11% in 2010.

Macroeconomic projections supporting the third review remain close to those of the second review and build on the Commission services' spring forecasts, updated during the mission. In particular, growth projections were raised to reflect better outturn data over the first few months of 2010, than previously expected. The changes since the last review remain small, taking into account the inherent uncertainties of the Latvian economy at the current stage of the business cycle.

		2008	**2009**	**2010**	**2011**	**2012**
Real GDP growth rate	December 2008 Programme	-4.6	-5.0	-3.0	1.5	n.a.
	Revised baseline projections, Dec. 2009	-4.6	-18.0	-4.0	2.7	3.8
	Commission services' spring forecast	-4.6	-18.0	-3.5	3.3	n.a.
	Revised baseline projections, May 2010	**-4.6**	**-18.0**	**-3.5**	**3.3**	**4.0**

[1] Labour Force Survey data for the age group of 15-74 years, as presented by the Latvian Central Statistical Bureau in it publication.

[2] Official wage statistics are distorted by composition changes (lower-paid, less-qualified employees have disproportionately become unemployed in the downturn) and by the large grey economy (it being easier to cut the undeclared part of wages, because there is no need to rewrite contracts and also because a large share of the workforce is already reported to be earning the statutory minimum wage, so 'officially' there is no room to cut wages further).

HICP inflation	December 2008 Programme	15.5	5.9	2.2	1.3	n.a.
	Revised baseline projections, Dec. 2009	15.3	3.3	-3.7	-2.5	0.0
	Commission services' spring forecast	15.3	3.3	-3.2	-0.7	n.a
	Revised baseline projections, May 2010	**15.3**	**3.3**	**-2.0**	**0.0**	**0.5**
Unemployment rate in %	December 2008 Programme	6.7	9.0	11.0	11.2	n.a.
	Revised baseline projections, Dec. 2009	7.8	17.5	20.0	18.8	17.5
	Commission services' spring forecast*	7.5	17.1	20.6	18.8	n.a.
	Revised baseline projections, May 2010	**7.8**	**17.3**	**21.0**	**19.2**	**17.9**
Current account balance**	December 2008 Programme	-14.8	-7.3	-5.5	-5.5	n.a.
	Commission services' autumn forecast	-13.0	+6.8	+5.4	+3.4	+2.7
	Commission services' spring forecast	-13.0	+8.7	+8.3	+4.6	+2.2
	Revised baseline projections, May 2010	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**

* Eurostat definition, (but the baseline projections correspond to age group 15-64 of the Labour Force Survey)
** percentage of GDP

GDP growth projections were revised up from the last review to -3.5% in 2010, +3.3% in 2011 and +4.0% in 2012. The most significant change in terms of GDP composition concerns exports, which perform much better than expected in December (for 2010, volume growth of +5.0% versus 0.0%). On the other hand, the fall in private consumption is expected to be somewhat lower (for 2010, -9.0% is the current projection vs. -10.0% in December) and the negative figure is almost exclusively the result of the negative carry over from 2009.

After the dramatic increase in unemployment in 2009, the labour market adjustment is projected to progress at a slower pace. In the second half of 2010, employment is expected to remain broadly stable and the unemployment rate may start to decrease due mainly to outward migration and other forms of withdrawal from the domestic labour market. After a reduction of 11.9% in 2009, compensation of employees per head is set to fall markedly also in 2010.

The inflation projections increased since the previous review. Although businesses are generally reluctant to reduce prices as a response to lower demand, domestic factors develop broadly as expected, with wages and domestic demand exerting downward pressure on consumer prices. However, import prices rose much faster than expected earlier. In particular, the global energy price increase hit consumers with a considerable time lag and the March and April HICP data surprised on the upside. Accordingly, the inflation profile of the programme was revised up, with an increase to -2.0% in 2010 (-3.7% in December) and 0% in 2011 (-2.5% in December).

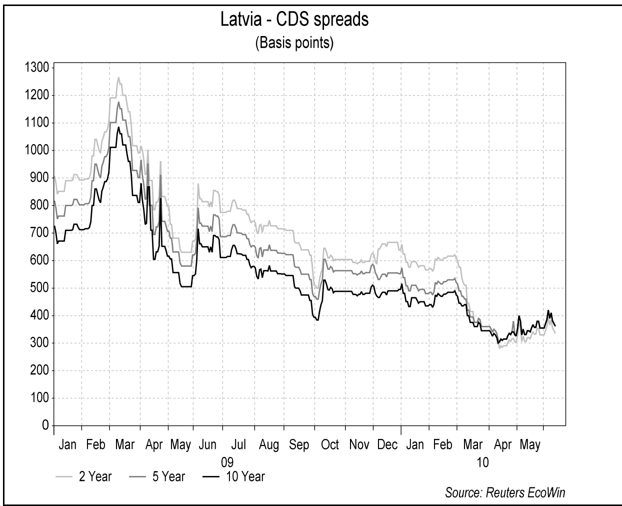
The **external account** registered a surplus of 11.0% of the GDP in 2009, as the goods and services balance improved by some 12 percentage points of GDP in a year and as the income account turned positive due to losses recorded on FDI in Latvia. Net lending vis-à-vis the rest of the world is expected to remain similarly high in 2010. Price and cost **competitiveness** measured by all REER indices continue to improve and further improvements are expected, as price and wage correction is underway and as a weaker euro will appear in the NEER. The domestic cost adjustment, together with efforts to shift economic resources to the tradable sector is expected to strengthen further the basis for a sustainable export-led recovery.

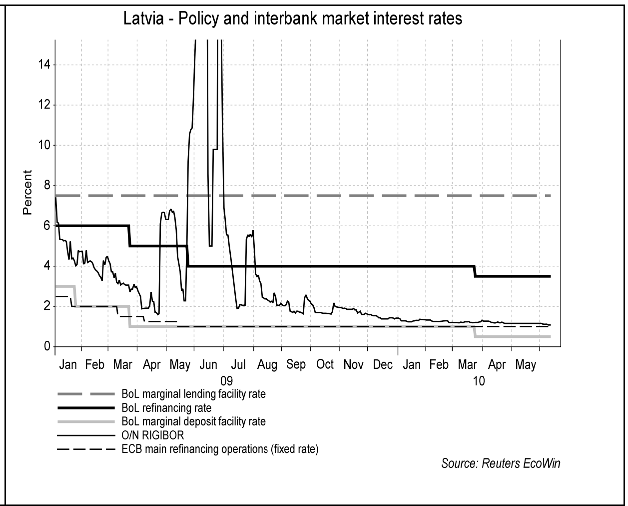
2.2. Financial Market Developments

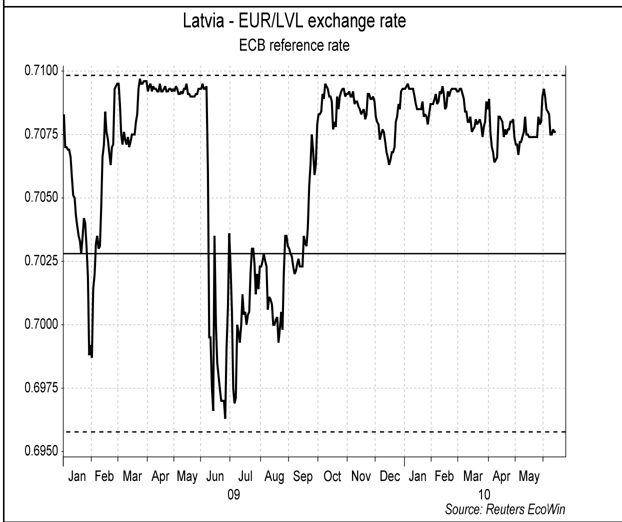
Financial market conditions have remained stable and, so far, have proven largely resilient to the tensions in the euro area peripherals. Since the previous review, there have been no pressures on international reserves and the exchange rate. Boosted by the disbursement of the program money in Q1 2010, the reserve coverage ratio stands above 240%. The contraction of currency in circulation has come to an end and the banking system's excess reserves with the Bank of Latvia (BoL) have continued to grow. Reflecting the ample liquidity in the banking system, money market rates and yields on Treasury bills have declined substantially. The more stable economic and financial situation is also evident in narrowing CDS spreads (albeit they have increased somewhat since April) and the announcement by the rating agencies Moody's and S&P to upgrade their outlook on Latvia from negative to stable. Nevertheless, the financial sector stability continues to hinge largely on the authorities' ability to deliver the consolidation package agreed with international lenders. Therefore, rising market tensions cannot be excluded in the run-up to October elections, in particular in case of political positioning which is inconsistent with the programme strategy and may prelude to disagreements with international lenders and/or difficulties in the preparations for the 2011 budget.

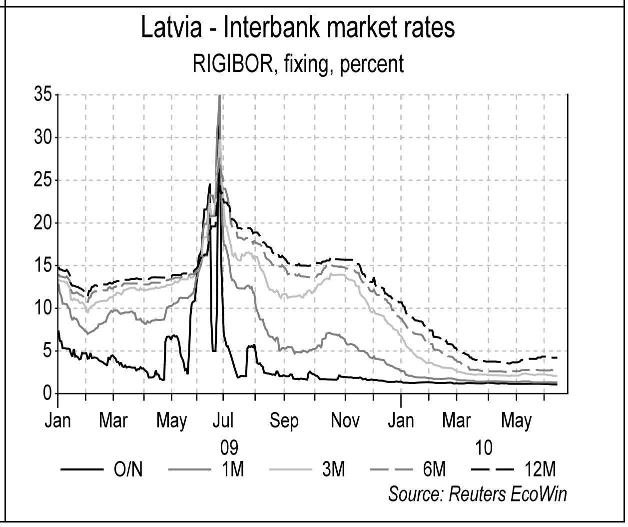
The Bank of Latvia has taken steps to further strengthen its liquidity management. In March, the BoL Council decided to introduce a 7-day deposit facility with a view to promoting predictability of excess reserves in the banking sector. The interest rate on the 7-day deposit facility was set to 1%. At the same time, the BoL Council cut the refinancing rate to 3.5% from 4.0% and the interest rate on the overnight deposit facility to 0.5% from 1.0% so as to motivate banks to use the new 7-day facility. The major share of commercial banks' excess liquidity is now placed in the 7-day facility.

Following the successful launch of a 2-year T-bond programme, the State Treasury successfully issued a new benchmark 3-year T-bond in April, **thereby extending the domestic securities market yield curve.** While this is a positive development, recent concerns about sovereign debt sustainability in some euro-area countries have led to a more cautious behaviour also among Latvian-based banks. The authorities report lower demand for government domestic securities, in particular for longer-term maturities. Therefore, any further extension of the domestic yield curve is subject to declining interest rates and the absorption capacity of domestic institutional investors, in accordance with the Treasury's borrowing strategy. The State Treasury continues to monitor conditions in international markets. According to the Treasury’s current funding plan, no funding on the international markets will take place before 2011 and will then be subject to market conditions (there are no liquidity pressures expected to do it earlier).









In the banking sector, the signs of stabilisation observed during the previous review mission have been confirmed, even though return to profitability could not be expected in the short term. The ratio of non-performing loans is still increasing and reached 18.4% of the loan book in April. The deterioration is mainly due to the construction sector loan portfolio, while the quality of residential mortgages and of loans to manufacturing and trade activities has stabilized. Future development of non-performing loans remains highly uncertain, due in particular to the significant and growing share of restructured loans, which reached 18.1% of total loans in March. Overall, banks posted losses of LVL 134 million in the first quarter of 2010. However, these losses have been fully offset by capital increases by almost LVL 150 million since the beginning of 2010. Consequently, the capital adequacy ratio stood at 14.5% in April, well above the minimum requirement of 8%. This implies a capital buffer against rising non-performing loans of LVL 892 million, or almost 6% of the total loans portfolio. Regular stress tests by the Bank of Latvia also indicate an improved resilience of the banking sector. Hence, while credit risk remains an issue, it is unlikely to be in 2010 of a scale sufficient to put banks' solvency at risk.

With respect to banks' liabilities, returning deposit inflows account for a substantial improvement in their liquidity situation. Both resident and non-resident depositors' confidence has been restored, as evidenced by the continually increasing deposits since the beginning of the year. Between December 2009 and May 2010, resident deposits increased by 6.7%, while non-resident deposits gained 8.8%. In addition, the euroisation process of resident deposits, which came to a halt in July 2009, is beginning to reverse. The share of resident's foreign currency deposits reached 56% at the end of May 2010, down from 61% in August 2009. In the current context of a standstill in bank credit expansion, the increase of deposits, which is partly due to government deficit spending funded from international loans, result in an improving liquidity situation for banks. The liquidity ratio, as calculated by the banking sector supervisor, was at a historical high of 67.3% at the end of April. Simultaneously, the building-up of excess reserves, kept on short-term accounts at the Bank of Latvia, has continued and reached LVL 656 million at the end of May, i.e. more than 6% of total deposits at banks. Despite this general improvement, liquidity risk should be closely monitored, as abrupt changes in depositors' behaviour could quickly deplete banks' liquidity cushions.

3. Implementation of the SMoU Conditions

3.1. Implementation of 2010 Budget

Since the previous review mission, the 2010-2011 macroeconomic outlook has improved, supporting compliance with the policy programme, including the 2010-2012 fiscal consolidation path to achieve a deficit of below 3% of GDP by 2012. Implementation of the measures included in the 2010 budget adopted by the Parliament on 1 December 2009 is progressing well and no significant deviations from the budgetary projections are envisaged. In the table below (cash forecasts agreed with the IMF), the 2010 deficit forecast amounts to 8.5% of GDP in ESA terms, which exactly corresponds to the deficit ceiling and is close to the Commission services' spring forecast of -8.6%. However, this level, almost unchanged from the spring forecast, results from several updates:

	2010 post budget	2010 mission	2011 (initial)	2011 mission
REVENUE	4 718	4 842	4 581	4 623
tax revenues	3 308	3 335	3 269	3 324
direct taxes	*2 094*	*2 041*	*2 073*	*2 002*
CIT	77	98	79	102
PIT	823	770	836	775
SSC	1 103	1 086	1 065	1 034
RET	91	87	93	91
indirect taxes	*1 214*	*1 294*	*1 196*	*1 322*
VAT	690	795	670	807
excise	483	459	484	475
other	41	40	42	40
non tax revenues	585	598	526	508
foreign financial assistance	825	909	786	791
EXPENDITURE	5 584	5 724	5 698	5 610
primary expenditure	5 301	5 514	5 312	5 366
remuneration	1 170	1 182	1 170	1 182
goods and services	652	689	638	689
subsidies	1 141	1 213	1 213	1 138
social support **(1)**	1 775	1 796	1 712	1 718
international collaboration	14	17	14	17
payments to EU budget	140	140	140	145
capital expenditure	409	477	425	477
interest payments	283	210	386	244
cash fiscal balance	-866	-882	-1 117	-987
cash balance as % GDP	-7.3%	-7.2%	-9.3%	-7.9%
cash / ESA adjustment **(1)**	-65	-161	-109	-186
ESA net borrowing	-931	-1 043	-1 226	-1 173
GDP	11918.4	12213	11979	12563
as % of GDP	**-7.8%**	**-8.5%**	**-10.2%**	**-9.3%**
adjustment needed	% GDP		**-4.2%**	**-3.3%**
	mil. LVL		**-507**	**-420**

(1) compared to the table included in the previous note for the EFC, social support expenditure and cash/ESA adjustment indicated in the first column already include the impact of the end 2009 Constitutional Court decision on pensions (permanent impact of 1% of GDP+2009 repayments amounting to 0.5% of GDP)

- **on the revenue side**, additional outturn data for April and May showed an improvement, particularly for VAT, thanks to a decrease of the pace and stock of refunds. An improvement was also recorded for PIT, social contributions, and excises, despite yields for these taxes still being below initial expectations, partly due to implementation problems for some measures included in the 2010 fiscal package. Overall, the forecast for tax revenues is now better than assumptions underlying the spring forecast, and even slightly higher than initial expectations associated with 2010 budget. The impact of additional EU structural funds related projects would also bring LVL 84 million additional revenues (cf. foreign financial assistance).

- **on the expenditure side**, the increase compared to the budget projections (and to the assumptions underlying the spring forecast) is due to additional EU structural funds-related expenditure, which amounts to LVL 200 million (see below), mostly impacting subsidies and capital expenditure. However, this evolution is partly offset by lower interest payments. The decrease by 70 million LVL has two explanations: lower interest rates, and intention of the authorities not to draw all funds available under the programme given the improved environment: bilateral disbursements from Member States would only be treated as credit facilities, which already brings the interest base down by LVL 500 million.

- **despite the positive cash/ESA correction related to the repayment of 2009 pension cuts** (disbursed in early 2010, but already recorded under the 2009 ESA deficit), **the overall cash/ESA adjustment currently planned is more negative than expected**: the updated breakdown of planned EU structural funds related expenditure (see below) and revenue show that, in cash terms, Latvia will benefit in 2010 from a large windfall effect, with foreign financial assistance revenues significantly exceeding expenditure on behalf of the EU, also in view of additional advances provided to Latvia following a decision at EU level in the course of the June. This leads to a negative correction of the cash deficit by the same amount, in order to net out the windfall effect in cash terms.

As already mentioned, given the progress made and the pre-existing scope with respect to the 8.5% of GDP deficit target for 2010, the EC and the IMF have partly approved the authorities' request to increase 2010 budget appropriations to foster the absorption of EU funds. This entails an increase of the allocation for EU Structural Funds and Cohesion Fund related projects by LVL 100 million and an additional spending of LVL 100.5 million on EU agricultural payments, totalling almost 1.6% of GDP. This brings the overall budgetary spending related to EU funds in 2010 to almost 8% of GDP, which is expected to have a significant impact on the economy countering the recessionary effect of other consolidation measures. In addition, should there be evidence in the remainder of the year of further fiscal space available under the deficit target, a further increase in appropriations for EU Structural Funds and Cohesion Fund spending by up to LVL 132 million (ca. 1.1% of GDP) would be considered this year.

3.2. Preparation of 2011 Budget

Preliminary estimates suggest that a further LVL 395-440 million in net measures will be needed to achieve the 2011 deficit target of no more than 6 % of GDP in ESA95 terms. This is less than what was expected after the completion of the second review mission (LVL 800-900 on two years, with some frontloading), which reflects the improvement of macroeconomic assumptions in the meantime: the better outlook leads to higher tax revenues forecasts, and also to a decrease of interest payments (due to the intention of the Latvian authorities not to draw all funds available under the international financial assistance programme). This explains the improvement of the 2011 baseline deficit forecast (-9.35%, as opposed to -10.2% after last review mission, and -9.9% in the Commission spring forecasts). The authorities are also considering further increasing appropriations from the EU Structural Funds and Cohesion Fund by LVL 250 million on top of the significant amounts already included in the baseline, which would require an additional LVL 30 million in measures to offset the increased co-financing needs.

For the 2011 budget, preparatory work is well underway to identify a menu of options for the new government to reduce the deficit to no more than 6% of GDP. The budget will only be finalised after Parliamentary elections in October; however, preparing such a menu of options for expenditure cuts and possible revenue increases by end-October will enable the new government to quickly submit the budget for Parliamentary approval. Thus far, possible measures with an aggregate potential yield of around 3% of GDP have been identified. The final menu, to be completed by end-October will include more measures, and will be significantly larger than the consolidation needed, to give the incoming government a meaningful choice.

As regards expenditure cuts, the authorities are considering options that would enable the new government to rationalize expenditure while protecting the poorest in society, building among other things on the recommendations of a recent World Bank public expenditure review. Areas of possible savings include: (i) reforms to public administration, including the possible elimination or consolidation of government agencies: (ii) reducing direct subsidies to enterprises (including state and local government owned ones, 0.5-1.2% of GDP); (iii) further cuts in the wage bill of state-owned enterprises and (iv) budgetary consolidation in local governments. The authorities are also considering options for rationalizing the system of social benefits, including by additional targeting and by introducing changes to ensure the sustainability of the pension system. The State Chancellery and the Ministry of Finance are also undertaking a functional review of expenditure to identify those functions that can be abolished. The authorities have requested an IMF technical assistance mission to help identify further savings, especially regarding subsidies and social insurance benefits, while protecting the poor.

As regards revenue increases, in April this year the authorities published a tax reform strategy, which includes several revenue-raising measures which could be introduced as part of the 2011 budget. The strategy proposes increasing consumption taxes – with due consideration of the impact on poorer households - to support fiscal adjustment, and to lower labour taxes when fiscal conditions allow, in order to reduce the tax wedge. For example, aligning all VAT rates to the standard 21% VAT rate could yield LVL 95 million (0.8% of GDP) in revenues, although net savings could be somewhat lower given the need for compensatory measures to protect those with low incomes. Increasing property taxes – consistent with a recent technical assistance report from the IMF – could raise an additional 0.5% of GDP. The authorities are also considering proposals to increase revenue from the annual car tax in a progressive manner, and to remove allowances which prove to be inefficient. The authorities will intensify efforts to improve tax administration and encourage tax compliance and have prepared a list of actions, some of which are already being approved and implemented.

3.3. Debt developments

Although general government gross debt still remains rather low (36% of GDP in 2009), it is projected to be on a rapidly growing trend, but remaining below the 60% of GDP reference value. In the Commission services' spring forecast, it was projected to rise to 48.5% of GDP in 2010 and 57% of GDP in 2011, assuming full take-up of the international financial assistance being extended to Latvia during the period up to 2011. However, as the authorities do not intend to draw all funds available under the programme given the improved environment, the evolution of the debt is likely to be more benign.

Box1: Summary of the fiscal consolidation to date

After almost two years of large fiscal consolidation, it is worthwhile assessing the effort done so far, through **the end-2008 first corrective measures, the 2009 supplementary budget, and the 2010 budget**. Overall, **the consolidation effort would amount to around 15% of GDP** (2010 GDP), even after excluding the direct negative impact of some expenditure cuts on the revenue side.

	2008 outturn	2010 mission	evolution	measures (LVL mill.)	% GDP	baseline evolution
REVENUE	5 722	4 842	84.6%	455	3.73%	
tax revenues	**4 737**	**3 335**	**70.4%**			**62.8%**
direct taxes	*3 005*	*2 041*	*67.9%*			*64.1%*
CIT	503	98	19.5%			19.5%
PIT	1 029	770	74.8%	30	0.25%	71.9%
SSC	1 402	1 086	77.5%	55	0.45%	73.5%
RET	71	87	122.5%	30	0.25%	80.3%
indirect taxes	*1 732*	*1 294*	*74.7%*			*60.6%*
VAT	1 117	795	71.2%	135	1.11%	59.1%
excise	541	459	84.8%	110	0.90%	64.5%
other	74	40	54.1%			54.1%
non tax revenues	**555**	**598**	**107.7%**	95	0.78%	**90.6%**
foreign financial assistance	**430**	**909**	**211.4%**			**211.4%**
EXPENDITURE	6 254	5 661	90.5%	1398	11.45%	
primary expenditure	**6 190**	**5 451**	**88.1%**			**105.9%**
remuneration	1 676	1 182	70.5%	494	4.04%	100.0%
goods and services	922	689	74.7%	233	1.91%	100.0%
subsidies	1 305	1 213	93.0%	92	0.75%	100.0%
pensions **(1)**	954	1 172	122.9%			122.9%
other social support	429	561	130.8%	25	0.20%	136.6%
EU budget, international collaboration	166	157	94.6%			94.6%
capital expenditure	738	477	64.6%	261	2.14%	100.0%
interest payments	**64**	**210**	**328.1%**			*n.a.*
EU structural funds related spending **(2)**	685	978		293	2.40%	

(1) 2010 forecast excluding repayments for 2009 cuts

(2) the impact of this additional expenditure, mostly on behalf of the EU, should be discounted from the overall evolution of subsidies and capital expenditure (on the revenue side additional revenues are not taken into account as well). This leads to increase the assessment of the overall consolidation effort by 2.4% of GDP

On the expenditure side, the table above indicates that discretionary cuts would amount to around 11.5% of GDP. The corresponding breakdown can be explained as follows:

- 4% of GDP for remuneration cuts, given sizeable cuts already decided end 2008 (around LVL 200 million), plus LVL 240 million for the full year impact of the 2009 supplementary budget (this figure including a lower-than-expected outturn), plus 45 million LVL cuts in the local wage bill planned in 2010.;
- 2% of GDP for cuts in goods and services, with steps almost entirely taken when designing the initial 2009 budget;
- More than 5% of GDP regarding cuts in subsidies and capital expenditure (mostly ministries of health, transport, defence, education and culture) after correction from the increase of EU structural funds related expenditure;
- 0.2% of GDP due to the reduction of certain social allowances for high-income recipients (2010 budget).

The effort seems **quite fairly divided across different types of expenditure** (taking into account the need to protect safety nets) at the significant exception of pensions, where expenditure is significantly higher than it was in 2008, partly given the 21 December 2009 Constitutional Court decision, which led to cancel all cuts already implemented. Another issue to pay attention to is the breakdown of the effort across layers of Government, and notably the involvement of local governments, which benefited the most from tax increases under the 2010 budget.

On the revenue side, the global effort indicated is less than 4% of GDP, but the gross amount (neglecting the direct negative impact of some expenditure cuts) amounts to 6% of GDP. Both numbers also include one-offs for more than 1% of GDP (diversion from second pillar social contributions). The breakdown of the effort on the revenue side can be explained as follows:

- More than 1% of GDP thanks to the increase of **VAT** rates between 2008 and 2009. The gross yield would even amount to more than 1.5% of GDP (if excluding the negative impact of cuts in current expenditure);
- Almost 1% of GDP linked to **excise tax**, mostly because of the rate increases decided between 2008 and 2009 (alcohol, tobacco, oil), plus smaller measures within the 2009 supplementary budget (beer) or the 2010 budget (gas);
- Regarding **PIT** (0.25% of GDP) and social contributions (0.45% of GDP), gross measures are significantly higher than the net effort, given the large direct impact of remuneration cuts of almost LVL 500 million (the gross

consolidation efforts would therefore amount to respectively 1.15% and 1.35% of GDP);

- **Real estate tax** has also contributed to the consolidation effort by 0.25% of GDP, thanks to new measures included in the 2010 budget.
- **Non tax revenues** measures amount to 0.8% of GDP, mostly consisting in increased dividends thanks to higher pay-out ratios in state owned companies, plus the impact of higher vehicle fees.

*When assessing the overall gross effort on **PIT** (LVL 140 million) one should keep in mind that the authorities initially decreased the rate from 25% to 23% between 2008 and 2009, which already offsets – from a multiyear point of view - two thirds of the increase from 23% to 26% decided under the 2010 budget (with only LVL 30 million left). Second, current fiscal forecasts already include lower than expected savings for some other measures under the 2010 budget (implementation problems). These other measures, together with the impact of the decrease of the non taxable minimum decided in the 2009 supplementary budget, would still yield around LVL 110 million.*

*The overall gross effort concerning **social contributions** mostly results from the full year impact of the diversion of second pillar contributions, the rest corresponds to smaller measures under the 2010 budget, the yield of which has been decreased under the current forecasts in line with what was done for PIT (see above).*

Consequently, **more than two thirds of the consolidation already undertaken is expenditure based, while the remaining third is revenue based**. This composition seems therefore in line with best practices based on past international experience. Overall, in relative terms the effort has been larger on indirect taxes than on direct taxes, which also appears in line with the corresponding best practices:

	2008 revenues (1)	net measures	gross measures (2)	effort in relative terms (2/1)
direct taxes	**3005**	**115**	**335**	**11.1%**
CIT	503			
PIT	1029	30	140	13.6%
SSC	1402	55	165	11.8%
RET	71	30	30	42.3%
indirect taxes	**1732**	**245**	**305**	**17.6%**
VAT	1117	135	195	17.5%
excise	541	110	110	20.3%
other	74			

NB: the evolution for real estate tax indicated above should be used carefully given the very low initial taxation levels.

However, the share of tax increases between the various categories of the population is more questionable, with latest moves on PIT even having a regressive impact.

3.4. Fiscal governance reforms

As regards the SMoU condition on **extending unified public sector job position catalogue to local governments** and ensuring that wages of local government do not exceed upper limits of the public sector wage grid (by end-March 2010 – see Annex II), the State Chancellery together with the Ministry of Finance have prepared the necessary regulations of the Cabinet of Ministers. However, their approval has been delayed, in particular due to objections from the local governments. Since a Parliament approval is required, it is unlikely that the amendments to the Law on Remuneration System for Central and Local Government Institutions will come into effect before the elections. Nevertheless, the Ministry of Finance is performing a strict financial supervision and analysis, based on monthly reports by local governments, to ensure that 2010 local government wage bill is reduced in line with the fiscal consolidation package.

As regards the **September 2009 recommendations by the State Audit Office** regarding the assessment of implementation of the 2008 State budget and budgets of local governments, the Ministry of Finance has prepared an action plan. So far only three of the recommendations have been implemented (land registration by local governments and granting of state guarantees), while nine recommendations are still pending.

A draft policy paper on long term tax reforms (for period 2011-2016) named "Guidelines for development of system of taxes and fees" has been elaborated by the Ministry of Finance. The draft guidelines have been submitted to the Cabinet of Ministers for approval. Overall, the guidelines go in the right direction by proposing, inter alia, to shift the tax burden away from income taxes to consumption/wealth taxes, as well as streamlining the system of fees and non-tax revenues, however, there is a certain resistance from the social partners on some of the proposed measures (e.g., raising the reduced VAT rates to standard 21%).

In order to find solutions for ensuring **a sustainable pension system**, the Ministry of Welfare is preparing a concept paper on future changes in social insurance system, including the pension system. The main preliminary proposals include, inter alia: (i) increasing the retirement age from 2016 onwards; (ii) shifting the source of funding for services that are not covered by social contributions (i.e., supplements to old-age and disability pensions and parent's benefits); (iii) suspending the payment of supplement to pension to newly granted old age and disability pensions, and (iv) increasing the minimum insurance record of taking rights for state old age pension. While the proposals are overall commendable, they are unlikely to generate significant budgetary savings in the short-term, as the main idea is to shift a large part of social budget expenditure to the state basic budget.

As regards **the review of social insurance benefits system** (SMoU deadline of end-June 2010), the Ministry of Welfare has preliminarily proposed, inter alia, that (i) from January 2011 parental benefits should be excluded from the system of state social insurance benefits and linked with the child care allowance; (ii) from January 2013 limitations on paid-out maternity benefit, paternity benefit and sickness benefit should be cancelled; (iii) from January 2012 unemployment benefit payment period will be the same as before July 2009 (no longer 9 months for all unemployed). Once again, the draft proposals mostly go in the direction of cancelling the temporary limitations on pay-outs of social insurance benefits, rather than rationalizing or targeting better the social expenditure from 2012/2013 onwards.

On the SMoU condition for **effective sanction procedures for individual misuses of public funds**, in February 2010 the amendments of Law on Disciplinary Responsibility of State Civil Servants were approved, whereby the Minister of Finance was granted right to initiate disciplinary action on grounds of misuse of budgetary funds. Also, the amendments stipulate explicitly that if a civil servant has been found guilty for misuse of public money, it may lead to a punishment of dismissal from the job. The Finance Ministry is not planning to develop secondary (Cabinet-level) regulatory acts, since all sanctions and types of punishments are stated in the Law. Here it must be noted that so far there have been very few actual cases of sanctions being put in place, suggesting that implementation of the respective sanction procedures should be improved.

As regards the SMoU condition **to strengthen the capacity of the Authorities managing EU funds** to control and decide on EU funds spending, the Cabinet of Ministers adopted a decision on 23 February 2010, empowering line ministries to reallocate budgetary appropriation away from underperforming activities and projects without a specific government decision. The Managing Authority analyses the absorption progress on a weekly basis, while monitoring meetings involving all institutions involved in the EU funds implementation take place once every two months. Overall, there seems to be a great progress in this field, mainly due to the effective performance by the Managing Authority.

On reforms in **public administration**, the Chancellery has developed a draft concept paper "on Simplification of General and Specialized Civil Service System", which entails simplification of civil service and introduction of general civil service in local governments; the concept paper is expected to be approved by the government by 1 July 2010. The authorities are slowly progressing with strengthening career development and performance-based assessment/remuneration components (part of the concept paper), however much remains to be accomplished. The Chancellery is also implementing an EU co-financed project aiming to establish a single human resource management IT system, but its effective application will only start from mid-2011 at the earliest.

On budget preparation and monitoring procedures, an IMF technical assistance mission took place in April 2010, with participation of Commission staff. Technical assistance's recommendations address the budget formulation (budget classifications, MTB, budget structure and preparation cycle), designing the Fiscal Responsibility Law and expenditure controls (commitment control, financial plans and cash forecasting, special revenues, accounting, payroll and audit). Based on the mission recommendations and contribution from the EC fiscal experts, a **draft Fiscal Responsibility Law** has been prepared in time to meet the SMoU conditionality (end-May 2010), and will be submitted to the government and the Parliament in coming weeks.

3.5. Financial sector measures

Financial sector supervision has been satisfactorily strengthened through adequate credit risk analyses and close monitoring of banks' foreign currency exposure. Steps have been taken to ensure that banks are adequately capitalized and that losses are adequately provisioned. A number of positive regulatory initiatives, mainly with respect to liquidity and credit risk management, have been taken. Cooperation with foreign supervisory agencies has proved to be of high quality. Amendments to the credit institutions law have been drafted with the view of transposing provisions of the CRD II.

Foreign banks operating in Latvia have committed to remain involved in Latvia's banking system. In letters sent to the FCMC in February 2010, several large foreign banks restated their commitment to remain involved in Latvia as a parent to their respective subsidiaries/branches, and to comply with all regulatory requirements.

In compliance with the SMoU condition, **the Parex bank re-structuring plan** has been completed and submitted to DG COMP on 31 March 2010. The plan is now in its implementation phase, and the government is committed to launch the restructuring at the beginning of August 2010. Also, in line with the SMoU condition, the Cabinet of Ministers adopted in February 2010 amendments to the Credit Institution Law, which stipulate that **interest payments on subordinate debt** of former Parex Bank shareholders should be discontinued from 1 July 2010; however, these amendments are currently still in the Parliament.

A transformation plan of the Mortgage and Land Bank was submitted to DG COMP by end-May 2010, as set in the SMoU; however, it was agreed with the authorities that it will need to be improved. Accordingly, the Cabinet decided early June that, as a first step, an independent consultant will be hired to advise the authorities in the preparation of transformation plan of the Mortgage and Land Bank. The Ministry of Finance has been tasked to ensure that the EC decisions on state aid and the EU structural funds regulations are applied properly, and devise a transformation plan building on the advice of the consultant. Also, a high-level working group will be established to oversee the transformation process.

3.6. Structural reforms

As regards measures to address the high unemployment rate, **the capacities of the State Employment Agency** (SEA) have been somewhat strengthened, including by internal resource re-allocations and by providing apprenticeship places with ESF funds. However, the situation remains unsatisfactory, as SEA case-handlers seem overburdened and, most likely, cannot devote sufficient time and efforts to help effectively the unemployed. **The strategy for the transition from short-term crisis labour market policy measures** (public works program) to traditional active labour market policy measures (training, re-qualification, facilitating self-employment, business start-ups) was submitted to the Commission in March. Overall, there seems to be a lack of sense of urgency on the need to set up and adequately finance effective training programs that would allow the unemployed to raise skills and find work in other sectors of the economy.

On public procurement there has been substantial progress. Amendments to the Public Procurement Law specify, inter alia, the terms of exclusion from public procurement tenders companies that are suspected of engaging in illegal employment activities. Also, amendments stipulate centralization and wider utilization of electronic procurement system as compulsory for the direct public administration institutions (specific group of goods and services).

On tackling the grey economy, the special working group has prepared a preliminary report and short/medium-term action plan for the reduction of shadow economy. Of around 60 proposed measures there are a lot of useful and long-overdue actions. However, their implementation may be uncertain due to objections from certain business associations or political parties. Moreover, to tackle grey economy and illicit trade effectively, additional resources will need to be allocated to, inter alia, State Revenue Service, Labour Inspectorate and the Customs Authority.

As regards measures **to support small and micro companies**, there has been some progress (e.g., patent payments, reduced payment for LLC establishment, simplified accounting procedures, etc). Unfortunately, the draft law "On Tax on Microenterprises" seems to be poorly designed (currently being reviewed in the Parliament). There is little **access to financing for SMEs and micro companies** through programs supported by concessional funding, as the Mortgage and Land Bank- and EIF-managed facilities have so far proved rather ineffective, though ongoing steps should help overcome the bottlenecks.

The regulations for **ERDF financing for RTD** have been approved, except for the largest sub-program "Development of Research Infrastructure", thus part of the EU funding may be absorbed later than initially envisaged. As regards the SMoU condition to **review state and local government-owned companies** in view of possible restructuring (privatization), an inter-institutional working group has been established to prepare proposals by end-2010. As a useful interim step, there is an ongoing work to compile a full list of state and local government-owned companies.

4. Third Supplemental Memorandum of Understanding

The 3rd SMoU, signed by Commissioner Rehn in July 2010, spells out the conditions of the next disbursements. Modifications were proposed in areas of fiscal governance, structural reforms and financial sector issues. Conditions were made more specific and deliverables defined as precisely as possible, with strict and clear deadlines. This approach has served well with the second SMoU. Overall, the authorities have taken the SMoU conditions and underlying deadlines seriously, prioritizing the SMoU conditions in the overall government decision-making framework. By including specific conditions in the SMoU, a strong momentum has been given to a number of important issues (e.g., tackling the grey economy, absorption of EU funds, public procurement, etc). The EC/IMF teams worked closely to ensure that the new SMoU and LOI are fully consistent, though these documents are different in structure and emphasis because of the EC's and IMF's different mandates and institutional procedures.

The general programme conditions include the deficit targets of the consolidation path as specified in the Council EDP recommendation. It is stipulated that the government must consult with the EC and the IMF on policy decisions with major fiscal impact. The SMoU also states that any additional revenue or savings achieved relative to deficit targets should be used to achieve a lower-than-targeted budget deficit or, after consultation with the EC and IMF, to accelerate EU funds expenditure (within the budgetary deficit targets) or increase funding for active labour market policies and social safety net measures. This clearly emphasizes the budget expenditure priorities agreed with the authorities.

Specific economic conditions relate to fiscal consolidation, fiscal governance reform, financial sector and structural reforms. Conditions on **fiscal consolidation** reiterate the need to devise a menu of options to facilitate the adoption of the 2011 budget, in line with a deficit target of no more than 6% of GDP, as well as prepare concrete proposals concerning the pension and the social insurance benefits systems. Conditions on **fiscal governance reform** relate to the preparation of the Fiscal responsibility Law, the management and performance of human resources in the public administration and the functioning of state and local government–owned companies. **Financial sector** measures focus on the monitoring and supervision of cross-border institutions, the restructuring plan for Parex, the transformation plan for MLB, the optimisation of financial development institutions, and progress with market-based debt restructuring. Conditions on **structural reforms** are set with a view to improving the management and the performance of the public administration, accelerating EU fund absorption, strengthening public procurement, supporting active labour market and lifelong learning policies, improving the businesses environment and supporting export promotion measures.

5. Programme Financing

Given the improved economic environment and the much stronger financial position, the authorities requested not to draw all available funds at this review but to treat part of the funds as credit facilities (see Annex I). Completion of this review by the EC and the IMF potentially unlocks around €1 billion in additional funding from the EC, the IMF and the Nordic countries, the Czech Republic and Poland. Given the much stronger financial position, the authorities requested only to draw the disbursements from the EC (200 m EUR) and the IMF

(SDR 90 million or roughly 100 m EUR), as well as 100 m EUR previously approved by the World Bank. Hence, while bilateral lenders remain committed to provide funding within the programme, their pledged funds will be considered as credit facilities. This relates to the pledges by the Nordics (Denmark, Estonia, Finland, Norway and Sweden) for a total of 1,900 m EUR and, possibly (given that this yet remains to be decided with the authorities), to those by Poland and the Czech Republic for a total of 300 m EUR. Any undrawn funds will remain available to Latvia provided that the country sustains its record of satisfactory programme performance. Decisions on future drawings will be made on a review-by-review basis.

6. Conclusions

All in all, it can be considered that the conditions laid out in the SMoU with respect to the fourth instalment to Latvia are broadly fulfilled. In particular, on the budgetary front, strict implementation of the 2010 budget is undertaken and additional measures for 2011 budget are being considered. This is strengthening the public finance outlook and has helped to improve confidence regarding the commitment and capacity of the government to undertake appropriate policy responses. Among other conditions, progress has been made as concerns fiscal governance, in particular, strengthening of the EU funds Managing Authority, extending unified public sector wage grid, and preparing a new Fiscal Responsibility Law. As concerns the financial sector, there has been good progress: the authorities have submitted the Parex restructuring plan to DG COMP and are in the process of preparing the bank for privatisation, while important steps and commitments have been taken as regards the transformation of the Mortgage and Land Bank. Significant progress has been achieved on structural reforms and improvement of business environment. Looking forward, while risks exist, the commitments undertaken provide useful reassurance as to the capacity of the country to ensure the adjustment necessary to a successful completion of the programme.

Annex I: Latvia: financing contributions and profile, quarterly disbursements

Projected financing, millions euro	2008 Q4	2009 Q1/Q2	2009 Q3	2009 Q4	2010 Q1/Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	**Total**
Total	**591**	**1 000**	**1 474**	**200**	**694**	**405**	**226**	**226**	**126**	**126**	**227**	**5 296**
EU		1 000	1 200		500	200		100			100	**3 100**
IMF /1	591		194		194	107	126	126	126	126	127	**1 716**
World Bank				200		100	100					**400**
EBRD			80									**80**
Nordics /2												*1 900*
Others /3												*300*

/1 Euro values change due to exchange rate effects
/2 DK, EE, FI, NO and SE; total EUR 1,900 mn in credit facility arrangement
/3 CZ and PO; total EUR 300 mn possibly in credit facility arrangement

Annex II: The SMoU Conditions for the Fourth Instalment

General Conditions

* Preparation for the 2011 budget should be started in the first half of 2010. The authorities will consider options for future fiscal adjustment by mid-year. By end-October 2010, technical proposals with savings or additional revenues for a total amount larger than fiscal consolidation needed in 2011 shall be prepared.
* Any additional revenue or savings achieved relative to deficit targets should be used to achieve a lower-than-targeted budget deficit or, after consultation with the EC and IMF, to accelerate EU funds expenditure within the budgetary deficit targets or increase funding for ALMPs and social safety net measures.
* The authorities have committed to take measures to increase the efficiency of the State Revenue Service and combat the grey economy.
* In the beginning of each quarter, in cooperation with the IMF, the World Bank and the Commission, social safety net policies taken in the previous quarter will be assessed by the government and, if deemed appropriate, an increase in funding will be considered (up to 0.5% of GDP for 2010 as a whole).

Specific Economic Conditions

	Fiscal consolidation	**Fiscal governance**	**Financial sector**	**Structural reforms**
February				* Take measures to **improve effectiveness and scope of public procurement** (standardized methodologies, centralising public and municipality procurements, using Electronic Procurement System). COMPLETED: PROCUREMENT LAW AMENDMENTS HAVE BEEN APPROVED BY THE PARLIAMENT
March	* Extend job (position) catalogue including local government and ensure that wages of local government do not exceed upper limits of the **public sector wage grid.** Local governments should secure a reduction in the 2010 local government wage bill consistent with the projected savings in the fiscal consolidation package. PARTLY/ONGOING: WHILE THE NEEDED AMENDMENTS ARE PREPARED, THE UNFIED WAGE GRID IS NOT YET APPLIED TO LOCAL GOVERNMENTS * Specify how to implement the September 2009 **recommendations by the State Audit Office** on the implementation of 2008 State budget	* Within the framework of the Law on Disciplinary Responsibility of State Civil Servants, put in place **effective sanction procedures for individual misuses** of public funds. PARTLY/ONGOING: WHILE ADDITIONAL AMENDMENTS HAVE BEEN PREPARED, THE MAIN ISSUE REMAINS ACTUAL APPLICATION	* The **restructuring plan of Parex Banka** should be spelt out in further quantitative details and submitted to the European Commission. COMPLETED * The Government should submit to the Parliament the necessary **legal measures in order to discontinue interest payments on subordinated debt** contracted by Parex Banka. COMPLETED * A **debt restructuring strategy to be launched** (capped at 82 million LVL of the issued guarantees). COMPLETED (WAS CANCELLED DUE TO LACK OF INTEREST	* Have a strategy in place to **progressively replace the temporary** ESF-financed emergency **public works programme**. COMPLETED * Adopt the proposals as regards **tackling the grey economy** (increasing the intensity of controls and improved coordination among relevant authorities, applying dissuasive administrative fines). PARTLY/IN PROGRESS: SOME MEASURES ARE IN PLACE, BUT MORE ARE EXPECTED IN COMING MONTHS * The **special programme for the support of small and micro** companies shall be operational (changes in taxation and bookkeeping laws, access to microcredit financing).

	PARTLY/ONGOING: NOT ALL RECOMMENDATIONS HAVE BEEN IMPLEMENTED		FROM BANKS AND TO THE ONGOING MARKET-BASED RESTRUCTURING)	PARTLY/IN PROGRESS: WHILE THE PROGRAMME HAS BEEN DEVISED AND PRESENTED TO THE PARLIAMENT, IT SEEMS OF INSUFFICIENTQUALITY
April		* Prepare a strategy on how to **integrate the institutions and human resources management** experts in charge of the management and planning of human resources within the public administration. SLOW PROGRESS		* Take measures to **approve all the regulations for the ERDF financing for RTD activities** for the full period until 2013 and start signing project agreements by end-2010, and implement them in 2011. PARTLY: TWO OF THE ACTIVITIES ARE GOING FORWARD WELL, BUT THE BIGGEST ONE IS FACING DELAYS
May		* Complete review of budget preparation and budgetary control and prepare a **new Fiscal Responsibility Law** (m-t budgetary framework, limits on budget revisions, fiscal rules, etc). IN PROGRESS	* A comprehensive action plan for implementation of the medium-term **strategy for the Mortgage and Land Bank (MLB)** should be adopted. IN PROGRESS	* **Review state and local government-owned companies** and their subsidiary companies against the criteria set in the Latvian State Administration Law (performing publicly important functions) with a view to a possible restructuring. IN PROGRESS: NEW DEADLINE SET IN THE THIRD SMoU (END-2010)
June	* Prepare a **policy paper on long-term tax reform**. IN PROGRESS * Prepare **changes in the pension system** to be implemented in 2011 and review all special pension regimes and retirement ages. IN PROGRESS * **Review the social insurance benefits system,** so that appropriate changes can be implemented after 2012. IN PROGRESS			* Take steps to **improve the business environment**, including by: a) making an inventory of authorisations and propose a roadmap for simplification; b) introducing one-stop agencies at the regional level, with back-office functions centralised and possibly outsourced to private partners; c) ensuring a wider application of e-governance services and e-signature. IN PROGRESS, HOWEVER GREATER SENSE OF URGENCY IS WARRANTED