

ANNEX 1. RECOMMENDATIONS PROGRESS

1 Fiscal policy challenges

Recommendations

1. The Council recommends a cautious fiscal policy for the remainder of 2015, bearing in mind the likelihood of having to correct the fiscal balance for 0.5% of GDP in case of significant deviations.

The forecasted general government budget balance for 2015 is -1.3% of GDP, which is better than the forecast used when planning the 2016 state budget. See section 3.1 for further details.

2. Reaching a tax-to GDP ratio of 1/3 should be the key objective while developing a tax policy and administration strategy, focusing on the reduction of the shadow economy, improving the efficiency of tax collection, as well as reviewing tax rates and eliminating exemptions.

Limited progress. *Several measures introduced during the preparation of the 2017 state budget aim to reduce tax evasion and tax exemptions. However, work on the tax policy will only commence in early 2017. The most recent Shadow Economy Index for the Baltic Countries suggests that in 2015 the shadow economy in Latvia decreased by 2.2% points of GDP.*

3. Consider the reduction of income inequality when designing future tax policy; in particular, look at increasing the tax burden on dividends and other capital income not used for reinvestment.

No progress.

4. Increase budget revenues in a growth friendly manner by fully utilising the potential of property taxes and environmentally related taxes.

Limited progress. *The revenue plan for 2017 includes higher revenues from environmental taxes, but the revenue potential of property taxes remains underutilised.*

5. Consider eliminating skill mismatch by increasing the professional relevance of the skills and qualifications provided by educational establishments to improve the long term productivity of the Latvian labour force.

Limited progress. *Support for STEM disciplines has been increased. Of particular note is the decision made on 16 August 2016, which made 8.92 million euro available in 2017 and 11.16 million euro annually in both 2018 and 2019. Support for vocational education has been increased, and a recent publication¹ notes that the role of employers is being strengthened in legislation². Support and funds for R&D have been increased, both in the academic and commercial sectors. Furthermore, the long-discussed teacher's salary reform was implemented. These efforts indicate that progress is being made on some of the issues identified in the 2015 Monitoring report.*

6. Consider addressing overall health system efficiency and sustainability by optimising the distribution of funding with the objective of improving population health status indicators and decreasing amenable mortality rates.

No progress. *Additional funding has been granted to the Ministry of Health. Even though the funds will be used to improve population health indicators, it is unlikely that the measures will have a positive effect on the efficiency and sustainability of the health care system.*

¹ Daija, Z., Kinta, G. and Ramina, B. (2016) *Supporting teachers and trainers for successful reforms and quality of vocational education and training: mapping their professional development in the EU – Latvia*, available at: <http://www.cedefop.europa.eu/en/publications-and-resources/country-reports/supporting-teachers-and-trainers-successful-reforms-an-12>, accessed on 03/10/2016.

Assessment of the Declaration of Fiscal Risks

Recommendations

1. Accept the SFR approved by the Government, while reiterating the need for the fiscal security reserve and stressing the need to survey all possible sources of fiscal risk.
2. Include risks arising from the financial sector in the SFR since these have been significant in the past. Risks related to possible capital calls from the European Stability Mechanism and their future impact should also be carefully assessed.

Limited progress. Risks arising from the financial sector have been included in the SFR, but the analysis is incomplete.

3. Improve the quality of risk assessment by collecting information pertaining to all fiscal risks and, if possible, quantify them in order to have a reliable estimate of their potential fiscal impact.

See section on the Assessment of the Statement of Fiscal Risks.

4. Provide a more detailed description of how probabilities are assigned to particular risks to facilitate the review process for independent institutions.

See section on the Assessment of the Statement of Fiscal Risks.

5. Ensure collection and exchange of information to improve risk management and develop procedures to prevent sudden impacts on the fiscal balance.

See section on the Assessment of the Statement of Fiscal Risks.

2 Macroeconomic outlook and output gap

Recommendations

1. While the Council generally approves the MoF's macroeconomic forecast as a basis for drafting the state budget for 2016 and setting the budget framework for 2017/18, it strongly encourages the MoF
 - a) to provide a more profound sensitivity analysis of the macroeconomic scenario;
 - b) to develop, based on the sensitivity analysis, a back-up plan for the realistic case of budget revenues falling short of the estimates.

No progress.

2. Regarding medium and long term development, structural reforms in order to boost potential GDP growth should be implemented, addressing the issues of a decreasing labour force, a rigid investment sector and the mismatch of the economically active population's skills and abilities with the labour market's requirements.

No progress.

3 Assessment of compliance with numerical fiscal rules

Recommendations

1. The Council recommends to treat the allocation for the fiscal security reserve as an activity related to the determination of the numerical fiscal targets and to determine the expenditure ceilings starting from 2017 including the allocation for the fiscal security reserve.

Recommendation taken. the fiscal security reserve adopted together with the fiscal space decisions.

2. The MoF should develop a procedure for ex post of the structural balance and correction mechanism, preferably in consultation with the Council.

***Limited progress.** The SFR covers ex post assessment of MTO execution, as well as the numerical fiscal rules are recalculated with the updated information provided by the MoF. There is still room for improvements regarding comparison of national and EC methodology of fiscal rules assessment and correction mechanisms.*