SUPPLEMENTAL MEMORANDUM OF UNDERSTANDING

(Fifth addendum to the Memorandum of Understanding)

BETWEEN

THE EUROPEAN UNION

AND

THE REPUBLIC OF LATVIA

SUPPLEMENTAL MEMORANDUM OF UNDERSTANDING
(Fifth addendum to the Memorandum of Understanding)

between the European Union and the Republic of Latvia

1. **On 20 January 2009 the Council of the European Union (EU) adopted a Decision (2009/290)[1] to make available to Latvia medium-term financial assistance of up to EUR 3.1 billion.** This financial assistance shall be made available during three years starting from the first day after the entry into force of the Council Decision, with a maximum average maturity of seven years. The EU assistance should be provided in conjunction with a loan from the International Monetary Fund of SDR 1.5 billion (1200% of Latvia's IMF quota or 1,071% of the revised IMF quota, around EUR 1.7 billion) under an IMF Stand-by arrangement approved on 23 December 2008. The Nordic countries (Sweden, Denmark, Finland, Norway and Estonia) are to contribute EUR 1.9 billion together, the World Bank - EUR 0.4 billion, the European Bank of Reconstruction and Development, the Czech Republic and Poland - a total of EUR 0.4 billion, bringing the total to EUR 7.5 billion over the period to January 2012.

2. **The EU financial assistance is provided in support of the Latvian authorities' Economic Stabilization and Growth Programme** ("Programme") to maintain domestic and international confidence in the financial system, address the budgetary imbalances, contribute directly and indirectly to improving competitiveness, and strengthen the economy's growth potential by a range of structural reforms. Implementation of the measures proposed in the Programme would help to lay the groundwork for sustainable convergence and Latvia's goal of entry to the euro area.

3. **Four instalments have been provided by the EU financial assistance for a total amount of EUR 2.9 billion**. 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 after completion of the first review mission and the broad fulfilment of the economic policy criteria laid down in the Memorandum. The third and fourth instalments of EUR 0.5 and EUR 0.2 billion were released on 11 March 2010 and 21 October 2010, respectively, following completion of the second and third review missions, and broad fulfilment of the economic policy criteria, as laid down in the first and second Supplemental Memoranda of Understanding. The fourth review mission concluded that the outlook regarding external financing improved and further funding from international medium-term financial assistance was not needed. As a result, no funds were released after the fourth review, and there are no plans to release additional funds after the completion of the fifth review. The improved economic and financial situation is creating favourable conditions for the central government to continue borrowing in international capital markets under reasonable terms in the future, though risks remain due to uncertain liquidity conditions in Europe.

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[1] Amended by Council Decision 2009/592

4. **The Commission services carried out the fifth review mission in cooperation with the IMF staff from 28 October to 10 November 2011** to assess progress made with respect to the specific conditions of the EU financial assistance, as laid down in the fourth Supplemental Memorandum of Understanding. Based on the findings of the mission, a Compliance Note sent by the authorities on 24 October 2011 and the consultation of the Economic and Financial Committee on 15 December, the specific economic policy criteria were considered to be broadly fulfilled. Since the previous review mission, further budgetary and structural measures, supported by an improved macroeconomic outlook (the economy is expected to expand by 4.5-5% in 2011), ensured compliance with the policy programme. In particular, this conclusion reflects:

(a) **Achievement of the 2011 budget target of 6% of GDP in ESA95 terms as set in the SMoU**: the fiscal deficit is expected to be below 4.5% of GDP, including the exceptional budgetary impact of restructuring of Mortgage and Land Bank (MLB) and financing provided to cover Air Baltic losses. Higher than projected economic growth in the first half of the year, as well as continued robust tax revenues, contribute to the improved outlook for public finances. Despite the mid-year increase in appropriations for some budgetary items (in particular those related to the implementation of the social safety net) and some increase in local governments' spending, expenditure has overall been contained.

(b) **Progress made in identifying key measures to be taken with the 2012 budget to achieve a deficit of no more than 2.5% of GDP in ESA terms** (see paragraph 5.a for details).

(c) **Progress made as concerns strengthening the fiscal framework**. The authorities have extensively discussed the draft Fiscal Discipline Law (FDL) with the programme partners. The draft FDL, as well as draft amendments to the Constitution to ensure higher legal standing of the law, have been adopted by the government and submitted to Parliament on 6 December. The current draft law clearly defines: (i) principles of a counter-cyclical fiscal policy; (ii) a fiscal balance rule as an instrument for a sustainable and counter-cyclical policy; (iii) a debt rule; (iv) transitional provisions, including consistency with the SGP provisions; and (v) escape clauses, moral sanctions, and monitoring and reporting requirements to ensure compliance with the fiscal rules. The draft FDL will target balanced budget and the medium-term objective of the budgetary policy will be accordingly revised once the new fiscal framework is adopted.

(d) **Progress made with strengthening tax administration and combating the grey economy**. In 2011 the authorities have, inter alia, strengthened institutional capacities, expanded international cooperation agreements with customs authorities, and improved cooperation with sectoral business associations. While battling the grey economy is an important component of the fiscal adjustment strategy, the revenue yield is uncertain and hard to quantify.

(e) **Significant financial system stabilisation measures taken**, in particular, to strengthen supervision of the non-resident business segment. The sale strategy of the MLB commercial assets was decided by the Cabinet of Ministers and submitted to the Commission (DG COMP) on 2 November 2011 and the sales process has started in line with the agreed timetable for subsequent steps. Citadele Bank sale strategy was adopted in May and the initial bids were received by end-October 2011.

(f) **Progress in addressing structural reforms.** The authorities have taken several steps as concerns the EU structural funds, notably put additional safeguards to smooth-out the absorption of EU funds over the year, re-allocated EU funds from non-performing activities, started planning for the 2014-2020 financing period, and ensured that the EU co-financed programmes for research and development are finally started. The authorities have completed a concept paper on social security. They also made a re-assessment of active labour market policies and diverted additional European Social Fund financing for such programmes (around EUR 50 million), progressed with identifying solutions for more effective state-owned company and real estate management, as well as amended public procurement procedures (increased ex ante checks, expanded electronic and centralised procurement).

5. **Implementation of policy intentions for 2012 and onwards,** to be assessed within the Post Programme Surveillance (PPS) framework (see paragraph 9 below), relate to consolidating the gains made thus far while setting the stage for stable public finances, sustained growth and a low-inflation environment. The fulfilment of agreed policy intentions will be assessed at the first PPS mission expected in spring 2012. The Commission has received assurances that the Cabinet of Ministers will take all necessary steps to ensure implementation of the commitments outlined in this SMoU, while commitments which the Constitution stipulates are under the purview of Parliament will remain subject to the legislation process and final approval by the Parliament.

(a) **Concerning budgetary consolidation,** through the adoption of the 2012 budget, the Latvian authorities aim for a fiscal deficit in 2012 of no more than 2.5% of GDP (ESA terms), with a view to fulfil the ECOFIN Council recommendation to correct the excessive deficit position and to meet the Maastricht deficit criterion. Following the correction of the excessive deficit, the authorities will pursue further reduction of the ESA deficit towards the medium-term objective in line with the provisions in the preventive arm of the Stability and Growth Pact, achieving an improvement of the structural deficit by 0.5% of GDP annually as a benchmark. Every over-performance in 2012 would clearly help towards achieving the medium–term objectives earlier.

The authorities stand ready to submit a supplementary budget for Parliamentary approval if the measures included in the 2012 budget are not sufficient to meet the 2.5% deficit target (ESA95).

(1) Key measures to be taken with the 2012 budget include:

– **On the revenue side in 2012:**

- **Improving tax compliance** by: (i) cancelling interest and fines on unpaid taxes to facilitate the collection of those tax claims (LVL 15 million); (ii) reducing the tax-free movement of excise goods on the non-EU border from daily to weekly (LVL 1.5 million); (iii) increase the gambling tax on slot machines and game tables by 15% (LVL 2.2 million); (iv) strengthening the regulation of the gambling industry (LVL 0.7 million) and (v) increasing the resources assigned to the State Revenue Service (LVL 1.2 million).

- **Broadening the VAT base** by applying reverse VAT on scrap metal and construction activities and **applying a 10% withholding personal income tax** on sales of scrap metal (LVL 9.6 million).

- **Broadening the real estate tax base** to: (i) include auxiliary buildings (larger than 25 m2), houses and land for religious organisations not used for religious purpose, and parking lots (LVL 0.5 million); and (ii) give municipalities the option of abolishing the 25% upper limit on the annual increase in the real estate tax on land (LVL 3.5 million).

- **Strengthening of the presumptive taxation of small and micro enterprises** by ensuring that the general personal income tax regime is applicable to personnel provided by large companies to microenterprises to minimise their tax liability (LVL 2.7 million).

- **Increase the financial stability levy** rate from 0.036% to 0.072% (LVL 2.3 million).

– **On the expenditure side in 2012:**

- **Keeping the public sector wage bill at the level of 2011.** In order to support the implementation, the authorities will continue to: a) cap vacation allowances at 25% of the monthly wage in state and local governments till 2013 (LVL 8.1 million). Moreover, the authorities will also continue to: b) cap the daily provision allowance for employees of the Ministry of Defense, Ministry of Justice, and Ministry of Interior at the 2011 level (LVL 18.7 million). In this context, by end-April 2012, the authorities will prepare a new strategy on public administration. This strategy will, inter alia, normalize the distribution of employees within the unified wage grid based on effective skills-assessment, and introduce central control over the establishment of new posts. The authorities also intend to prepare proposals to reform the wage grid and make it more fair towards low-paid employees, award best performers and attract highly-skilled officials (e.g. by setting wages for higher positions closer to private sector levels), as well as prepare proposals for a scheme to reward outstanding performance of public sector employees.

- **Create incentives for local government to reduce spending, while safeguarding social safety net and investments** by (i) further restricting local government borrowing limit (LVL 20 million), while extending the borrowing capacity to investment projects not co-financed from EU funds, (ii) reducing the share of personal income tax redirected to local government budgets from 82% to 80%, while safeguarding transfers to less prosperous local governments and continuing to co-finance 50% of GMI benefits through 2012 (LVL 10 million); and (iii) reducing the central government's share in co-financing of housing benefits for local governments from 20% to 0% from end-April 2012; (LVL 2.5 million).

- **Capping other expenditure**: freeze at 2011 levels compensation payments to landowners engaged in conservation activities till 2013 (LVL 5.9 million).

- **Reducing road maintenance expenditures and subsidies for public transportation providers** (LVL 10 million and LVL 5 million, respectively).

- **Reducing subsidies** for agriculture (LVL 6.5 million), and the **grant** for Riga International Airport (LVL 0.2 million).

- **Reducing expenditures** at the Ministries of Interior (LVL 1.2 million) and the Ministry of Health (LVL 2.7 million), as well as the Ministry of Welfare by: (i) implementing controls to limit the duration of sick leave (LVL 3 million); and (ii) submitting a proposal to the Parliament to reduce replacement rates for long-term sickness benefits.

(2) Key measures to be taken in 2012 with effect from 2013 include:

- The authorities will sell EU emission trading permits (LVL 25 million).
- The authorities will: (i) consider lowering existing thresholds for tax rates on residential property with a view to ensure a broadly equal distribution of the housing stock between the three tax brackets; (ii) abolish the 25% limit on annual increases in the real estate tax on land (LVL 10 million); and (iii) carry out cadastral reform to properly reflect the depreciation and market value of residential housing.
- By September 2012, the authorities will adopt a comprehensive reform of the state family benefits and social assistance system to improve targeting to the poorest families, and will review tax exemptions for children (potential saving LVL 10 million).
- The authorities will reform in the course of 2012 the social safety net system to protect the poor, improve incentives to work and reduce poverty traps.
- The authorities will: (i) continue to limit the maximum amount of maternity, paternity, parental, unemployment and sickness benefits until the end of 2014; (ii) submit to Parliament - together with the 2012 budget - a proposal to continue to cap the replacement rate of maternity and paternity benefits at 80% starting from 2013 (LVL 5.3 million in 2013); (iii) keep in place the ceilings on social contributions for high income earners beyond 2014 - this will limit the maximum amount of social insurance that high income earners can receive.

(b) **To improve revenues further**, the authorities plan to provide sufficient resources and incentives to the State Revenue Service (additional LVL 4 million within 2012 budget compared to 2011), and to ensure stricter implementation of internal control standards and administrative, pecuniary, and criminal fines within the public sector. The authorities intend to implement soonest possible the measures proposed in the action plan for fighting grey economy and illicit trade: i.e., implementing the zero declaration of income and assets for physical persons and measures to speed payment of tax arrears, establishing a "white list" of companies, continue expanding agreements with sectoral associations, enhancing exchange of information among tax compliance enforcement institutions, reviewing penalty system, enforcing tax audits, limiting tax-free trade crossings of borders with non-EU countries, regulating online gambling industry, and other measures. Additional revenue may be generated over time by better SOE and real estate management. Public debt could also be reduced by divestment of certain assets, including orderly privatization of companies that should not belong in the public sector, and sale of minority holdings in companies where public participation is not justified.

(c) **As regards further savings in expenditure**, the State Chancellery will continue undertaking functional audits to identify functions that can be abolished or performed more efficiently. The authorities intend to review options for rationalizing the system of social benefits and improving the sustainability of the pension system that is consistent with the long-term stability of the social security system, building, inter alia, on the recommendations of the World Bank public expenditure review and IMF technical assistance. The authorities will submit to the Parliament legislative proposals to increase, starting from 2014, the early and statutory retirement ages and the qualification period for retirement. The authorities will consider the options of linking retirement age to life expectancy after the former has attained 65. In addition, the authorities will review the possibility of extending the suspension of pension indexation, while protecting the poorest pensioners. The elimination of supplementary pension payments for pre-1996 working years for new retirees will take effect from 2012. The authorities are committed to preserving the sustainability of the three pillars of the pension system and to restoring contributions to the second pillar to 6% of gross salaries by 2013, provided that the budgetary situation improves in line with forecasts. The authorities plan to keep reductions in social insurance allowances (unemployment, sickness, parental, and maternity and paternity benefits) in force until end-2014. The authorities are also committed to maintaining a comprehensive social safety net programme for 2012, and to improve the targeting of the allowances: this is to be supported by improvements in the administration of Social Safety Net Strategy. The authorities have also committed to continue funding half of GMI payments centrally for the full year 2012 and to co-finance the housing benefit until end-April 2012; and, in the first half of 2012, in cooperation with the European Commission and the World Bank, will prepare reforms of the safety net, GMI and tax system in order to protect the poor, while increasing incentives to work.

(d) **In other areas of the programme**, the authorities:

– have submitted a revised **Fiscal Discipline Law** (FDL) to the Parliament on 6 December 2011, which will clearly define the key principles of fiscal discipline and set an objective of zero general government balance in the medium term. To support the FDL, the authorities also submitted to the Parliament constitutional amendments to make the law more effective. Within six months of the FDL's approval, the authorities intend to submit a medium-term budget framework law to the Parliament, so that it comes into force at the latest with the 2014 annual budget. In the course of preparations for the 2013 budget, the authorities will use a non-binding version of the medium-term budget framework for 2013-2015. The new law will provide a multi-annual framework for budgeting procedures and, in accordance with the FDL, will set binding expenditure ceilings for 2+1 years on a rolling basis. It will also include a prohibition on raising spending within the year due to over-performing revenues, and limit the possibility of introducing expansionary fiscal measures after adoption of the budget. These measures are aimed at preventing a return to pro-cyclical policies and the fiscal indiscipline that contributed to the economic crisis.

– have committed and publicly announced their plan to **sell MLB's commercial assets**, and aim to sign final sales agreements by end-March 2012. While they committed to sell all assets of the commercial part, they may decide not to sell some commercial assets if bids are considered to be below the value which can be obtained by recovering them directly. Such assets will be carved out of the remaining development bank and placed in the Latvian Privatization Agency for a more gradual workout (managed by Parex), but only if this helps to maximize value to the state. Once the commercial parts of MLB will have been sold or transferred to the Latvian Privatization Agency, the authorities will ensure that it does not engage in deposit taking activities, and transform the development bank into a development institution.

– have committed to **sell Citadele Bank**. Final bids are expected to be presented to the Cabinet of Ministers in mid-January 2012 and the sale of the bank should take place by end-March 2012.

– have taken prompt action to **stabilize Air Baltic**. The authorities will ensure that Air Baltic does not create new fiscal liabilities in the future, and manage the company in a manner consistent with best practice in public financial management. Necessary steps have been taken to notify the European Commission about the planned joint investment with the private shareholder.

– will take **measures to promote growth and jobs** through competitiveness and efficiency, including improving performance of the public administration, accelerating EU fund absorption and making it more efficient, strengthening public procurement and competition, supporting R&D&I as well as active labour market policies, improving the business environment, and adequate access to finance for companies with a view of favouring productive investment, while refraining from further tax increases on labour. Reforms in education system will also be continued to achieve quality and international competitiveness of educational institutions, as well as to link higher and vocational education with labour market demand. The authorities also intend to take a number of measures that would support low-inflation environment, notably by increasing competition and price transparency, and contribute to meeting Maastricht inflation criteria in a sustainable way.

6. **The specific economic policy criteria and the reporting requirements are laid out in Annex I and Annex II**, respectively, to this Supplemental Memorandum of Understanding, which is the fifth addendum to the original Memorandum. The Annexes form an integral part of this Supplemental Memorandum and replace previous Annexes.

7. **Given the overall stabilisation of the financial system reducing potential banking sector funding needs, the remaining funds currently in the sub-account for banking sector support at the Bank of Latvia can be released for the purpose of financing general government needs,** following formal approval by the Commission upon a request by the Finance Minister, and in accordance with the following schedule, whereby progress is to be assessed by the Commission and IMF:

   - The remaining EUR 249 million: on the basis of progress with the sale of Citadele Bank – EUR 100 million – and of the commercial assets and liabilities of MLB – EUR 149 million.

   The above-mentioned amounts could be used for liquidity support when implementing the sales. Should there be insufficient progress with the sale of MLB and Citadele Bank's assets under the remaining time span of the programme, meaning that the remaining funds cannot be unblocked before end-January 2012, assessment of the relevant conditionality will be carried out under the PPS.

8. **As regards the separate EU funds account,** established at the time of disbursement of the second EU loan of July 2009 (EUR 1.2 billion), the Treasury proposal to discontinue it and channel the EU financing via the single general Treasury account will be reviewed ahead of the first PPS mission.

9. **Upon expiration of the Balance of Payments assistance programme on 20 January 2012, Latvia will be subject to Post Programme Surveillance (PPS),** being managed

by the Commission as an integral part of the existing procedures and surveillance mechanisms. This is in accordance with the established EU procedure for providing financial assistance for non-euro area EU Member States. Upon expiry of the programme and until repayment of a large fraction of the EU loans (up to 70% of total loans), Latvia will continue to provide the Commission with information laid out in Annex II, including prior information on major policy intentions that may jeopardise the repayment of EU loans. PPS missions will be aligned with the IMF's Post-Programme Monitoring to avoid duplications and ensure efficient use of resources. Two PPS missions per year are planned and close cooperation with the IMF will be ensured in the post-programme period. Staff from the ECB will be invited to participate in the missions.

10. **All notices in relation with the present Supplemental Memorandum shall validly be given if in writing and sent to:**

For the European Union

European Commission, DG for Economic and Financial Affairs, B-1049 Brussels, Fax No.: (+32-2) 296.48.85

For the Prime Minister

State Chancellery, Brīvības blv. 36, Rīga, LV-1520, Fax No.: (+37 1) 67 28 04 69

For the Ministry of Finance of Latvia

Ministry of Finance of Latvia, Smilšu iela 1, Rīga LV-1919, Fax No.: (+37 1) 67 09 55 03

For the Bank of Latvia

Bank of Latvia, K.Valdemāra 2A, Rīga LV-1050, Fax No.: (+37 1) 67 02 24 20

For Financial and Capital Market Commission

Financial and Capital Market Commission, Kungu iela 1, Rīga, LV-1050, Fax No.: (+37 1) 67 22 57 55

11. **For Latvia, this Supplemental Memorandum shall become effective after completion of internal procedures required under the Laws of Latvia**. The Supplemental Memorandum may be amended upon mutual agreement of the parties in the form of an Addendum. Any such Addendum will be an integral part of the Memorandum and become effective according to the same procedures as the Memorandum.

Done in Brussels on 21.12.2011 ....and in Riga on.........in five originals in English language.

LATVIA

Represented by

Valdis Dombrovskis

The Prime Minister

Andris Vilks

Minister of Finance

Ilmars Rimšēvičs For the responsibilities of the BoL

Governor of the Bank of Latvia

Jānis Brazovskis

Acting Chairman of the FCMC

EUROPEAN UNION

Represented by the

EUROPEAN COMMISSION

Olli Rehn

Member of the European Commission

ANNEX 1

SPECIFIC ECONOMIC POLICY CRITERIA

The undersigning Latvian authorities commit to:

1. General Programme Conditions

(a) Achieve a deficit of below 4.5% of GDP in 2011 and aim at a deficit of no more than 2.5% in 2012 in ESA95 terms, to fulfill the ECOFIN Council recommendation to correct the excessive deficit position.

(b) Discuss with the EC and IMF major policy intentions in relation to the Programme, in particular those that may jeopardise repayment of the EU loans.

(c) Use any additional revenue or savings relative to deficit targets to achieve a lower than targeted budget deficit, to accelerate EU funds expenditure within the budgetary deficit targets or increase funding for active labour market and social safety net measures.

A: FISCAL CONSOLIDATION AND FISCAL GOVERNANCE REFORMS

2. To ensure fiscal discipline:

(a) submit to the Parliament Fiscal Discipline Law in view of its planned adoption by mid-2012; within six months of the FDL's approval, submit a medium-term budget framework law to the Parliament, so that it comes into force at the latest with the 2014 annual budget; in the course of preparations for the 2013 budget, use a non-binding version of the medium-term budget framework for 2013-2015.

3. To fight grey economy and tackle illicit trade:

(a) with key actions to be completed by end-January 2012 at the latest, continue implementing key measures of the adopted strategy for fighting the grey economy, notably the declaration of incomes and assets for physical persons, the measures to speed payment of tax arrears and the limits to tax-free trade at the border with non-EU countries, establishing "white list" of companies, expanding agreements with sectoral associations, enhancing exchange of information among tax compliance enforcement institutions, and enforcing tax audits; the authorities also plan to provide sufficient resources and incentives to the State Revenue Service (via additional LVL 4 million funding in the 2012 budget compared to 2011), and ensure stricter implementation of internal control standards and administrative, pecuniary, and criminal fines within the public sector.

(b) by end-January 2012, adopt an Action Plan of State Law Enforcement Institutions for 2012 to activate fight against smuggling and illegal circulation of cigarettes, alcohol and fuel.

(c) by end-March 2012, review the system of payments by the Treasury with a view to introduce suspension of payments to companies that have tax or other liabilities towards the state, while respecting existing legislation.

4. **To ensure adequate financing for social needs and a transparent and cost-efficient delivery of social assistance:**

(a) within the 2012 budget, ensure adequate financing for social safety net, in particular the continuation of central government co-funding of Guaranteed Minimum Income for the whole year and co-financing of the housing benefit until end-April 2012.

(b) by end-March 2012, carry out a study on social assistance, including assessment of the extent of benefit dependency and effect on incentives to work, impact on alleviation of poverty, practical implementation of co-participation requirement and feasibility of introducing several levels of the "needy" status instead of one cut-off point. By end-September 2012 adopt a reform with a view to better targeting the social assistance and develop a permanent and effective social safety net.

(c) authorise the local governments to access administrative databases containing information on the income and assets of the social assistance clients in order to avoid misuse of the system.

(d) re-instate contributions to the 2nd pension pillar to 6% from January 2013, provided that the budgetary situation improves in line with forecasts, while preparing an analysis regarding the balance between private 2nd pension pillar fund managers' fees and actual investment performance; review the system of counselling contributors/customers to ensure that they receive full and adequate information on risks inherent in the volatility of active pension plans' returns.

B: FINANCIAL SECTOR MEASURES

5. Following the sales strategy adoption on 1 November 2011 and review and approval of bids, the authorities will sell the commercial assets of MLB by end-March 2012 and transform the development bank into a development institution in line with an action plan for the creation of a single development institution. Once the commercial parts of MLB have been sold or transferred to the Latvian Privatization Agency, the bank will not be allowed to attract any new private deposits (except for current accounts directly related to the disbursement or repayment of development loans). The FCMC will ensure compliance with this commitment.

6. Continue implementing the sales and work-out strategies for Citadele Bank and Parex Bank, as approved by the Cabinet of Ministers on 17 May 2011, in view of completing Citadele Bank sale by end-March 2012.

7. By end-June 2012, based on external consultant's recommendations, approve the action plan – with a view to implement it by end-2012 - for optimization of the system of development financial institutions and integration, as appropriate, of different development institutions operating on behalf of the government (i.e., merging development part of MLB with other state institutions to create one development institution); private deposits will not be permitted; avoid direct lending of the development institution, except where concessional programmes are already approved, or in instances where the lending is: (i) associated with the delivery of products not offered by the commercial banks or non-bank financial institutions; (ii) dependent on highly specialized knowledge that commercial banks or non-bank financial institutions do not possess: or (iii) of too small volume or too risky to be of interest to commercial banks or non-bank financial institutions; MLB will not start any new direct loan programmes until action plan for the new development institution is approved; all funding that

MLB has been allocated for the implementation of national financial engineering instruments has to be safeguarded and transferred fully to the development institution once it is set up; to improve professional monitoring and transparency once the development institution is set up, establish a Consultative Council chaired by the Ministry of Finance and comprised of members from key ministries and social partners, Association of Commercial Banks, as well as renowned international financial institutions with expertise in development activities.

8. To guarantee sufficient expertise and capacities of the Latvian Guarantee Agency (LGA) to assume EIF Holding Fund activities, by end-March 2012 undertake an independent assessment of LGA's capacities (the Terms of Reference and final report should be reviewed by the EC); to engage professional financial experts in the management of LGA activities, all appointments to the Executive Board are to be made in consultation with the EC; by end-March 2012, a representative from renowned international financial institution with extensive expertise in development activities is to be appointed to the Steering Committee of the EU funds financial engineering activities; as regards LGA's liquidity management, limit liquidity holdings with the Mortgage and Land Bank to no more than 30% of total LGA liquidity.

C: STRUCTURAL ISSUES AND REFORMS

9. To ensure adequate, efficient and transparent management and implementation of EU funds:

(a) within the ERDF activity "Development of Research Infrastructure" ensure that the incurred expenditure by the intermediate body from ERDF reaches at least EUR 50 million in 2012 and EUR 65 million in 2013; on a broader level, take action to achieve the national targets for R&D expenditure as stipulated in the Latvian Strategic Development Plan for 2010-2013.

(b) by end-March 2012, set additional safeguards in the system and procedures for quality monitoring and control of construction of EU co-financed roads and bridges (e.g., increasing standard warranty periods), based on the recommendations on improvements in these areas – to be made public - by the independent experts (JASPERS and the independent European Commission audits).

(c) by end-May 2012, inform the Commission on actions to strengthen evaluation capacity at the public and private institutions (e.g., in-depth training on evaluation tools and methods) and improve quality of evaluations related to implementation of the Structural Funds.

(d) by end-June 2012, inform the Commission on the measures taken to improve the efficiency of the EU-funded projects in the area of Strengthening Institutional Capacity.

(e) in the course of 2012 properly prepare the programming period 2014-2020. To this end, by end-May 2012, to achieve maximum effectiveness and efficiency, make steps to ensure that EU funds investments are more focused and targeted at a smaller number of priorities as compared to 2007-2013 period; by end-April 2012, outline directions for further optimizing/simplifying EU funds management system (e.g., reviewing the number of intermediate bodies and further strengthening the role and decision-making powers of the Managing Authority) as a possible way to reduce administrative burdens and avoid overlapping functions.

(f) by end-June 2012, consult with the Commission on proposals to delegate decision-making for technical decisions to the level of Managing Authority (e.g., implementation of activities).

10. To improve management and performance of human resources and decision-making in the public administration:

(a) by end-April 2012, and with a view to submit them to government for approval by end-July 2012, the authorities will prepare: a new strategy on public administration, inter alia, establishing a stronger institutional model responsible for Human Resource and recruitment policy and payroll, normalising the distribution of employees within the unified wage grid based on effective skills-assessment, and introducing central control for the establishment of new posts; proposals to reform the wage grid to make it fairer towards low-paid employees, award best-performers and attract highly-skilled officials (e.g. setting wages for higher positions closer to private sector levels); proposals to reward the performance of public sector employees through earnings and career developments.

(b) by end-May 2012, adopt more transparent and clearly structured national planning system, including through a reduction of the number of strategies and a review of the legal and hierarchal status of plans and strategies currently in force.

(c) by end-May 2012, introduce measures to ensure wider implementation of subsidiarity principle in decision-making, including by delegation of more responsibilities for technical and administrative decisions to the ministerial level.

11. To promote more efficient use of energy and natural resources:

(a) by April-2012, further progress should be made through effective implementation of the energy-related EU legislation, with a focus on the applicable elements of the Third Package, and, in particular, securing the financial independence of the national regulator and the competition council, and promoting more competition in the energy sector.

(b) undertake immediate and effective implementation of the Renewable Energy Directive; by end-2011, make efforts to adopt the draft Renewable Energy Law (adopted in the first Parliamentary reading in June 2011).

(c) by end-April 2012, strengthen actions and, where possible, start new initiatives to improve energy performance of buildings, make a survey or inventory of multi-apartment buildings and public buildings like schools focusing on the needs for insulation and reducing waste of energy, and allocate sufficient funding within existing energy-efficiency programmes (or devise a new programme) for improving insulation and installing thermostats and individual heat meters, where necessary.

12. To implement effective active labour market and education policies:

(a) in the framework of the 2012 budget, improve the system of wage subsidies and/or consider introducing tax reliefs that stimulate employment of the long term unemployed, accompanied with credible safeguards to avoid substitution effects (dismissal of existing workers); improve the supply of up-skilling measures within the voucher system for the training of the unemployed.

(b) continue reforms in vocational education by, inter alia, consolidating the number of vocational education institutions and assessing the study programmes in line with labour market needs; implementing the "money follows pupil" financing model; continue reforms in higher education by assessing and consolidating the study programmes, concentrating the resources, and implementing the new financial model; continue reforms in the science sector by carrying out an external evaluation of the implementation of the science and innovation policy and of the performance of research institutions, using findings and recommendations from such evaluation to prioritise and better use the scientific capacity and the available resources.

13. To improve state owned asset and real estate management:

(a) by end-2011, adopt the "Concept paper on the role of SOE", providing the grounds for assessing whether companies or participations are to be maintained in the public sector, and envisaging plans for possible dismissal of non-core assets.

(b) by mid-December 2011, adopt the "Concept paper on SOE governance" that sets principles for setting up a centralized SOE manager, relations with line ministries, measuring SOE performance, revising dividend and remuneration policies, and reviewing supervisory institutions of government and municipality-owned companies.

(c) by end-January-2012, set a precise timetable for the steps leading to the new governance model, to be fully effective by the end-March 2013 at the latest, including adopting a special law on SOE management, transferring assets/companies under the new SOE management authority, adopting all legal decisions by related companies, as well as starting divesting non-core assets; present clear plans for equipping the centralized SOE manager with appropriate staff and resources, including competitive remuneration to attract internationally-competitive financial experts.

(d) by end-2011, agree on plans for finalizing centralization of state real estate management under the State Real Estate Agency, deciding which real estate assets to hold or auction-off and which to transfer to the Agency, centralizing decisions on real estate investment projects in the process of state budget drafting, with key actions, including the transfer of assets to the Agency, to be completed by end-2013.

(e) take further steps to shore up Air Baltic in a manner consistent with best practice in public financial management to ensure that it does not create unexpected future fiscal liabilities, as well as notify the European Commission of any state aid implications.

14. To strengthen public procurement:

(a) within 2012 budget, allocate sufficient funding (ca. LVL 0.3 million compared to 2011 budget) for additional staff/resources to the Procurement Monitoring Bureau and the Ministry of Environmental Protection and Regional Development: to further expand ex ante controls; add new EPS catalogues (i.e., fuel); implement from April 2013 administrative responsibility/penalties for public procurement procedure violations; and deal with growing number of procurement procedure disputes.

(b) by end-2011, in cooperation with the relevant organized business organizations (and considering effects on micro and small enterprises), submit legal proposals on making centralized municipal procurements compulsory; limit the scope of "in-house" procurements, in particular by submitting to the Cabinet of Ministers draft amendments to the procurement law providing for a more precise definition of the "in-house" exception, taking into consideration CJEU case-law and best practices from other Member States.

(c) by end-2011, propose the legislation on administrative responsibility/penalties for violations in public procurement processes with a view to have the legislation enter into force and its provisions implemented by the Procurement Monitoring Bureau by April 2013; the Procurement Monitoring Bureau as the central public procurement supervisory body shall be granted the right to impose administrative penalties for violations of public procurement.

15. To strengthen competition in open markets:

(a) within 2012 budget, allocate additional funding (in 2012 additional LVL 0.15 million compared to 2011 budget) to the Competition Council to employ sufficient number of highly-skilled staff for undertaking market investigations, ensuring compliance of EU and national competition law and equal and fair competition among companies, and fostering competition advocacy.

(b) by mid-2012, implement proper assessment and control system of observance and uniform application of criteria for commercial activities of government and municipalities' authorities, including ports, according to which public persons may perform commercial activities only if (i) the market is not able to ensure the implementation of public interest in the relevant field, or (ii) a natural monopoly exists in the relevant sector ensuring public availability of the relevant service, or (iii) a strategically important sector is concerned.

(c) by end-June 2012, in view of possible additional budget revenues and enhanced competition, review ports' taxation regimes (special economic zones) and make efforts to increase the effectiveness and transparency of their governance.

16. To support job creation and the business environment (including Doing Business rankings), make steps to adopt the new Construction Law by end-March 2012 at the latest.

ANNEX II MONITORING AND REPORTING REQUIREMENTS

(Untill expiration of the BoP Programme on 20 January 2012 the reporting requirements set in the fourth Addendum will be place; from 20 January 2012 onwards below reporting will be required under the PPS)

During the PPS, the following indicators and reports shall be made available to the Commission by the relevant authorities. Furthermore, reporting information provided to other programme partners shall also be provided to the Commission:

Monitoring fiscal developments

- Quarterly Treasury cash-flow assessment of central government financing needs.
- Quarterly revenue and expenditure break-down of social budget, including data on social benefits' hand-outs (unemployment, family, etc).
- Quarterly state basic budget expenditure breakdown per type of expenditure for each ministry or other relevant budget entity.
- Quarterly revenue and expenditure break-down of local governments, including data on GMI hand-outs and other benefits included in category "other social support".
- Quarterly information on central government (i.e., ministries and agencies) and state owned companies' staff and remuneration levels, institution-by-institution.

Monitoring financial developments

- Bi-weekly summary of foreign exchange transactions (BoL interventions and Treasury fx market sales).
- Bi-weekly balance of outstanding deposits.
- Bi-weekly balance sheet of the BoL (in the current format).
- Quarterly report on the evolution of the parent banks' exposure towards Latvia, which encompasses all forms of debt instruments and capital as well as net deposits provided to banks in Latvia.

Monitoring structural reforms

Structural Funds and Cohesion Fund

- At the middle of each quarter consolidated and cross-checked reports on expenditure and revenue forecasts regarding overall EU and other foreign financial assistance, distinguishing clearly between government spending on behalf of the EU and spending corresponding to the national (public and private) co-financing; advance payments – declarable and not declarable paid to final beneficiaries; disbursed amounts from final beneficiaries to final recipients of financial engineering instruments; reaching the Structural Funds and Cohesion Fund annual expenditure targets set in annual forecasts to EC of payment applications by Fund and by Programme.
- At the end of each quarter, report on the management capacities of the SF Managing Authority, Audit Authority, Certifying Authority and the Intermediate Bodies: number of staff and total remuneration by body, including comparison with 2011 and previous quarters.
- At the end of each quarter, report on progress reaching targets for R&D expenditure as stipulated in the Latvian Strategic Development Plan, indicating amounts, sources of funding (EU programmes, national, private) and percentage from GDP reached.
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Active Labour Market and Social Policies

- Semi-annual reports on the implementation of the Active Labour Market Measures including number of participants, problems encountered and solutions proposed.
- Semi-annual reports on poverty, social safety net and pensions, including description of measures taken/planned and trends in poverty indicators (including allocations on GMI).
- Semi-annual reports on health care, including descriptions of measures taken/planned and analysis of the main indicators.

A copy of all information requests and reports shall be sent to the to DG ECFIN mailbox (ecfin-lv-bop-data@ec.europa.eu), as well as to current recipients of the reporting system.