

2018

Latvia's Stability Programme for 2018-2021

RIGA, 2018



LATVIJAS REPUBLIKAS
FINANŠU MINISTRIJA

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Abbreviations

UN	United Nations
USA	United States of America
AWG	Economic Policy Committee's Working Group on Ageing Populations and Sustainability of Public Finances
FDI	Foreign direct investment
CSB	Central Statistical Bureau of Latvia
EC	European Commission
ESA	European System of Accounts
EU	European Union
MoF	Ministry of Finance
FDL	Fiscal Discipline Law
FCMC	Financial and Capital Market Commission
Framework Law	Medium-Term Budget Framework Law
PIT	Personal Income Tax
GDP	Gross domestic product
LALRG	Latvian Association of Local and Regional Governments
LBFM	Law on Budget and Financial Management
Cabinet	Cabinet of Ministers
NDP 2020	National Development Plan 2014 – 2020
OECD	Organisation for Economic Cooperation and Development
MPC	Mandatory procurement components
OPEC	Organisation of the Petroleum Exporting Countries
CPI	Consumer price index
VAT	Value Added Tax
PYLL	Potential years of life lost
Regulation No 1175/2011	Regulation (EU) No 1175/2011 (16 November 2011) of the European Parliament and of the Council amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies
CIT	Corporate Income Tax
SGP	Stability and Growth Pact
IMF	International Monetary Fund
SRS	State Revenue Service
Treasury	The Treasury
MTO	Medium-term objective of budget balance in structural terms
HCV	Hepatitis C virus
MTO SGP	Medium-term objective of budget balance in SGP terms
SMSIC	State Mandatory social insurance contributions

1. GENERAL ECONOMIC POLICY GUIDELINES AND OBJECTIVES

The Stability Programme of Latvia is a medium-term policy document, describing Latvian fiscal policy for 2018 – 2020 and has been prepared following the conditions and guidelines of the SGP implementation and prepared in accordance with the requirements of Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies. Section 28 of the LBFM states that the Cabinet, till April 15 of the current year, shall submit to the Saeima (Parliament) the Latvia's Stability Programme.

After the slowdown of economic growth in 2016 to 2.2%, the Latvian GDP growth rate in 2017 has considerably accelerated, reaching 4.5%, being the most significant increase since 2011. Acceleration of the economic growth in 2017 was, mainly, ensured by the growing external demand and restoration of investment activity in Latvia, as the flow of the EU funds resources grew, moreover, the private consumption was comparatively strong last year. All leading international organisations also forecast strong global economic growth for 2018. According to the IMF's January forecasts the global economic growth will still accelerate from 3.7% in 2017 to 3.9% in 2018. In 2017, the volume of incoming FDI in Latvia also restored, as the net flow reached 640 million euro, thus returning to the historically average level, after a significant fall in 2016. According to the MoF calculations, the potential GDP growth will range from 3.2 – 3.4% in the medium term, which is similar to the previous two years. Although the current economic growth points to the upswing in economic cycle, the MoF position with regard to the potential long-term growth is based upon cautious approach, because, along the expected positive impact of Tax Reform on the business environment, potential growth in the future will be restricted by such structural factors as a shortage of labour and the low level of investments.

The course of development of the fiscal policy of the Latvian government has remained the same – to implement such budget policy that would allow to raise sustainably the quality of life of Latvian population. Thus, the State budget for 2018 has been developed, based on the approach that (i) ensures adequate State budget funding for the State defence capacity building, (ii) by implementing the tax policy reform, creates favourable conditions for stimulating business environment and reduces the inequality in population's income, as well as (iii) ensures additional State budget funding for the sectors forming the cornerstones of the State economy – healthcare, improvement of demographic situation and maintenance of the roads. When implementing the above mentioned courses of development, the government, concurrently, takes into account the fiscal policy implementation principles, based upon the fiscal discipline conditions.

Fiscal forecasts show that the general government budget deficit in 2018, excluding fiscal risks, will make 0.9% of GDP, and, in 2019, at no-policy changed and excluding fiscal risks, it would grow to 1.0%, but in 2020 and 2021 would reduce, correspondingly, to 0.4% and 0.3% of GDP. According to the fiscal discipline rules the general government budget deficit may not exceed 0.9% of GDP in 2019 and 0.4% of GDP in 2020 and 2021.

2. ECONOMIC SITUATION

2.1. EXTERNAL ECONOMIC ENVIRONMENT

The latest data of the IMF show that, in 2017, the **global economy** reached the steepest growth over the period of last six years, growing by 3.9%, as compared to the year before. Over the period of one year the forecasts for the world, in general, and, especially, for the large developed countries and Eurozone have been unchangedly raised, and the sharp growth in these countries was the one to determine the acceleration of the total global growth rates. In general, the growth in the developed countries last year accelerated to 2.3%, as compared to 1.7% in 2016, with the growth rates increasing the most in the USA, Germany and Eurozone, as a whole. The growth of developing countries improved, as well, accelerating from 4.4% in 2016 to 4.7 per cent in 2017, but these improvements were not as sharp, though. The economic growth of China accelerated to 6.8%, while Russia, after the fall of two years, reached about 1.8% growth of the GDP.

In the largest export market of Latvia – the EU, last year, for the first time since 2007, the economic growth was achieved in all member States, and the GDP, as compared to 2016, grew by 2.4%, being the sharpest increase over the period of the last decade. Acceleration of growth in the EU was ensured both by strongly growing domestic demand promoted by improvement of the situation on the labour market and positive business and consumer confidence indicators, and by the growth of the global trade activity, increasing the external demand. By the end of the year, the EU economic confidence index (ESI (*Economic Sentiment Indicator*) index) reached the highest level since 2000 and remained close to this level also in subsequent months.

Significant growth acceleration last year was observed also on the key **Latvian foreign trade partner countries**, *inter alia*, in Lithuania the GDP growth rate accelerated from 2.3% to 3.8%, in Estonia – from 2.1% to 4.9%, in Germany – from 1.9% to 2.2%, in Poland – from 2.9% to 4.6%. At the same time, in two other significant Latvian foreign trade partner countries – United Kingdom and Sweden – the growth rates slightly slowed down. In United Kingdom it was mainly due to uncertainty with respect to the expected exit of the country from the EU, but in Sweden the economic growth rates have already been quite high in the previous two years, slowing down to 2.4% in 2017, which is still good growth rate.

Table 2.1. GDP growth rates and forecasts in the largest economies of the world, % compared to previous year¹

	2016	2017	2018f	2019f	As compared to the IMF October 2017 forecasts	
					2016	2017
World	3.2	3.7	3.9	3.9	+0.2	+0.2
Developed countries	1.7	2.3	2.3	2.2	+0.3	+0.4
Eurozone	1.8	2.4	2.2	2.0	+0.3	+0.3
United Kingdom	1.9	1.7	1.5	1.5	0.0	-0.1
USA	1.5	2.3	2.7	2.5	+0.4	+0.6
Japan	0.9	1.8	1.2	0.9	+0.5	+0.1
Canada	1.4	3.0	2.3	2.0	+0.2	+0.3
Developing countries	4.4	4.7	4.9	5.0	0.0	0.0
China	6.7	6.8	6.6	6.4	+0.1	+0.1

¹ World Economic Outlook (WEO) Update, January 2018, IMF

India	7.1	6.7	7.4	7.8	0.0	0.0
Russia	-0.2	1.8	1.7	1.5	+0.1	0.0

All leading international organisations forecast strong global economic growth also for 2018. According to the IMF's January forecasts the global economic growth will still accelerate from 3.7% in 2017 to 3.9% in 2018 and similar forecasts regarding the global economic growth were also expressed in March by the OECD. The growing investments and global trade activation will continue to ensure the growth in the world and it will be additionally promoted by tax allowances in the USA, as well as the fiscal stimulation measures implemented by Germany. Similar global economic growth will be preserved also in 2019, when according to the IMF's forecasts it will remain at the same 3.9% level.

Also in 2018 and 2019, like in 2017, the global economic growth acceleration will be ensured mainly by the developed countries, first of all, the USA, where the economic growth in 2018 will accelerate to 2.7%, but in 2019 it will compincrease 2.5%. In 2018, economic growth in Eurozone will remain at a comparatively high 2.2% level, but in 2019 it will compincrease 2.0%. Strong growth will be preserved also in the key Latvian foreign trade partner countries, where it will also exceed that of EU average in subsequent years.

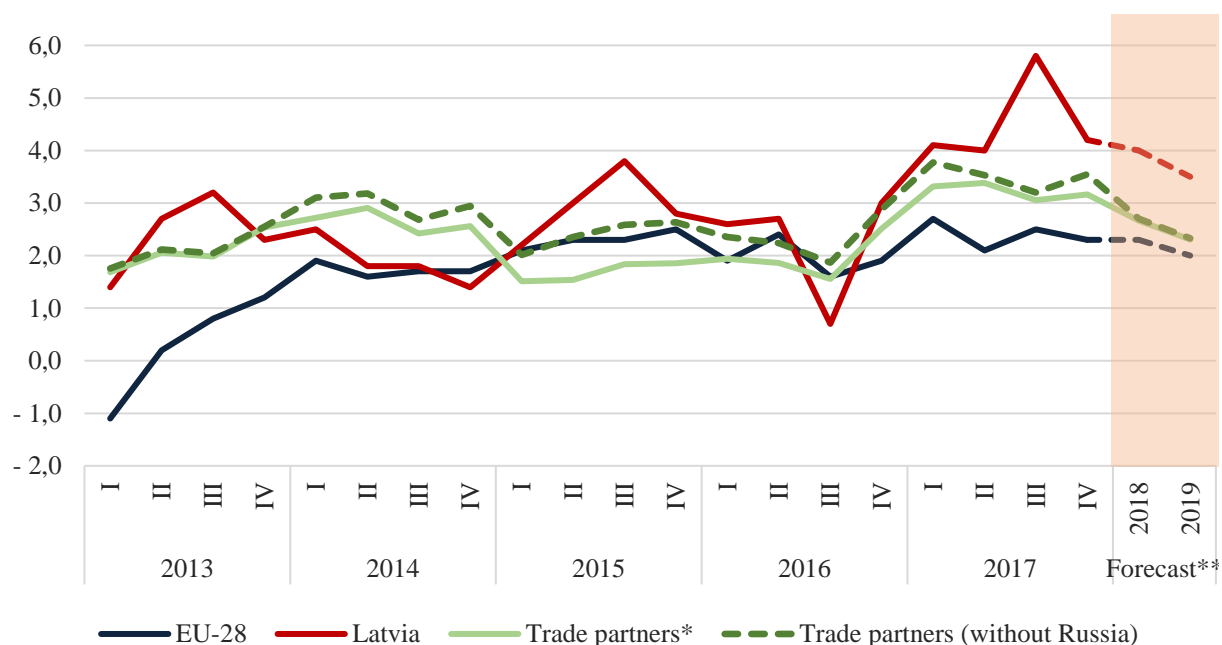


Figure 2.1. GDP growth rates and forecasts of Latvia's partner countries² and the EU, %

In general, the weighted average economic growth of the seven key foreign trade partners of Latvia will compincrease 2.7% in 2018 and 2.3% in 2019. Over the period of last year, the economic growth forecasts of the Latvian trade partner countries, similar to those of the world, as a whole, have improved considerably, and, at present, the forecasted growth of the partner countries for 2018 is by 0.4 percentage points higher than it was a year ago, during the preparation of the Latvia's Stability programme for 2017 – 2020.

Along with the increase in food and energy resources prices on the global market, in 2017 the total **level of inflation** in the world has increased quite significantly. In general, in the

² Average growth in Latvia's main external trading partners (Lithuania, Russia, Germany, Sweden, United Kingdom, Poland), weighted with the average export rate of particular country in 2017. Data source: Eurostat; European Economic Forecast - Winter 2018, European Commission; MoF calculations.

developed countries of the world inflation compincreased 1.7% in 2017, as compared to 0.8% in 2016, while the total level of inflation in the developing countries remained at the level of 4.1%. Oil prices, after the decision of the Organization of the Petroleum Exporting Countries – OPEC reduction of the extraction volumes, in 2017, in general, increased by more than 20%, as *Brent* crude oil price grew to 55 dollars per barrel on average, while the prices of unprocessed food according to the Food and Agriculture Organisation (FAO) data in 2017 were, in general, by 8% higher than the year before, with an especially steep increase in milk prices.

Inflation in Eurozone last year increased to 1.5%, as compared to 0.2 per cent in 2016, however it is still lower than the desirable level of inflation established by the European Central Bank, which is close to, but slightly below two per cent. As the core inflation remained low, affected by comparatively weak labour market development and limited wage increase, the total inflation dynamics in Eurozone is still predetermined, mainly, by the fluctuations in the prices of energy resources. In 2018, inflation is forecasted to remain at 1.5% level, but in 2019 it will slightly grow, reaching 1.6%. In the developed countries of the world, in general, the increase of the level of inflation is expected in 2018 to 1.9 per cent.

2.2.CURRENT ECONOMIC DEVELOPMENT

After the slowdown of economic growth to 2.2%, in 2016, Latvia's GDP growth rate in 2017 has considerably accelerated, reaching 4.5%, being the strongest increase since 2011. Acceleration of the economic growth in 2017 was mainly ensured by the growing external demand and restoration of investment activity in Latvia, as the EU fund investment flow grew, moreover, the private consumption was comparatively strong last year.

The steady domestic demand ensured the growth of private consumption, which reached 5.1% in 2017. Private consumption was facilitated by continuously growing wages, which last year showed the sharpest increase since 2008, reduction of unemployment, as well as the more active lending activity, as the amount of the newly issued loans to households continued to grow in 2017. Also public consumption increased last year – by 4.1%.

However, **the strongest growth last year was demonstrated by investment, as gross fixed capital formation increased by 16.0% in 2017**. After stagnation in 2014 and 2015 and a significant fall in 2016, the investment increase last year was, to a large extent, determined by the activity of the EU funds' investments for the planning period of 2014 – 2020, that will ensure investment growth also this year and in the subsequent years.

About one half (in 2017 – 45%) of the total investments into the gross fixed capital formation is compincreased of non-financial investments, and last year the volume thereof increased by 0.3 billion euro or 14.9% at current prices, constituting 2.4 billion euro. The largest share of non-financial investments was registered in the following sectors – public administration and defence (21% of the total non-financial investments in 2017), transport and storage (16%) and manufacturing (12%). The growth of the non-financial investments in the above mentioned sectors last year, as compared to 2016, was observed in all sectors, for example, investments in the public administration and defence sector were by 41.1% higher than the year before, in the transport and storage – by 13.5% and manufacturing – by 3.6% higher. Considerable growth of the non-financial investments – by 114.1% – in 2017 was recorded in the real estate operations; thereby the share of the non-financial investments of this sector last year compincreased 9%. Investment growth was recorded also in trade and certain other sectors, smaller in terms of their share, while the non-financial investments reduced in the electricity and gas supply sector, as well as in information and communication services, etc. smaller sectors.

In 2017, the volume of incoming FDI in Latvia also restored, as the net flow reached 640 million euro, thus returning to the historically average level, after a significant fall in 2016.

It should be noted that the volume of incoming FDI in Latvia in 2016 had reduced to 134 million euro, which was mainly determined by a one-off factor – significant reduction of equity in *Swedbank AS*. The decision of the commercial bank on the reduction of its equity was related to the optimisation of the capital structure, thereby reducing the capital stock by 367.9 million euro. Even though this one-off factor considerably affected both the FDI's incoming flow and the volume of accrued FDI, it had no effect, whatsoever, on the country's economic development, as the scope of basic activities of the commercial bank remained at the same level and *Swedbank AS* is still very well capitalised. In 2017, the increase in the volume of incoming FDI flow was mainly determined by the growth of investments in the equity funds by 979 million euro. In addition, foreign investors have reinvested 280 million euro of profit from basic activities into further development of the companies. Nevertheless, having fulfilled the liabilities towards direct investors and sister companies, disbursed the dividend and covered credit liabilities, the FDI inflow in debt instruments was negative or 618 million euro. Thus, the net FDI flow last year compincreased 640 million euro. In general, the largest investment inflows were in the gas supply, wholesale and retail trade, real estate operations and transport sectors, mostly from Sweden, Estonia, Lithuania and Luxembourg.

Furthermore, the **EU funds' investments** have also had a positive effect on the GDP growth and total investment dynamics in 2017. According to the assessment of the MoF, in 2017, the EU funds' investments increased the GDP growth by 1.3%, which is considerably more than in the previous year. Within the 2014 – 2020 EU funds planning period, the volume of the EU funds' investments compincreased 404 million euro in 2017, as opposed to 225 million euro in 2016. Thus, as the EU funds' investments flow increased, the positive effect on the GDP development increased. Larger flow of the EU funds' investments reflected in the total investment activity in the country.

In 2017, exports of goods and services at unchanged prices increased by 4.8%, which is a slightly sharper increase than in the previous year. Export growth was ensured by a favourable external economic situation, *inter alia*, in the key Latvian trade partner countries. In turn, import of goods and services increased even sharper – by 9.5%. Thus, last year the goods and services foreign trade balance in Latvia deteriorated by 2.8 percentage points and the trade balance demonstrated a deficit of 3.7% of GDP.

In 2017 as a whole, the situation in the international trade of goods has improved noticeably. According to the latest statistical data, in 2017, for the first time in this decade, a positive GDP growth was concurrently recorded for absolutely all EU Member States, thus increasing the average GDP growth in the EU to 2.4%, which is the sharpest growth over the last decade. Last year, the value of exports of Latvian goods to the EU grew by 7.0% and with the share of 71.5% in the total exports of goods it was the largest market for Latvian goods. Total exports of goods in 2017 increased by 10.0%, reaching the value of 11.4 billion euro. Thus, the record was set, as the value of exports, over the period of one year, grew to the highest level since the beginning of the statistical accounting. It should be noted that, over the period of last decade, Latvian exporters have been able to raise the value of exported goods twofold.

The increase of the value of exports of goods has been achieved in all largest categories of goods, however, the total increase of exports was facilitated the most by the increase in exports of agricultural and food products, as well as metals and the products thereof by 19.8% and 22.1% respectively. Good export growth rates last year were demonstrated also by other categories of goods – chemical industry goods, machinery and equipment, mineral products, etc. In breakdown by countries, in terms of value, the largest export growth in 2017 was achieved to Russia – by 36.6% or 221 million euro, thus, Russia still remains the third largest Latvia's goods export market, with the share of 7.3%, following Lithuania and Estonia. Strong growth of exports of goods last year was recorded also to the USA, Estonia and Sweden, while

the largest falls in the value of exports of goods were in exports to countries like Algeria, Gibraltar and Cyprus.

In turn, the growth of imports of goods last year was higher than the growth of exports, reaching 14.6%. It is important to note that a sharper growth of imports of goods in 2017, in general, is attributable to a considerably better economic situation. Latvia's economic growth rate at unchanged prices in 2017, as compared to the previous year, has doubled, and even tripled at current prices. Steeper economic growth has reflected also in the considerably higher investment and construction activity, therefore it is obvious that demand for machinery, metals and construction materials grows, thereby also stimulating the growth of imports. In addition, it should be noted that Latvian airline *Air Baltic Corporation AS*, by modernising the aircraft fleet, performed significant investments, supplementing its fleet by six new aircrafts and increasing the imports of goods in sum total by 256.5 million euro in 2017. Deducting the import of aircrafts, the growth of imports of goods in 2017 would have compincreased 12.9%. In general, growth of imports of goods last year was recorded in all the largest categories of goods, however the largest and steepest increase in the value of import was recorded for agricultural and food products, mechanical equipment and goods, as well as mineral products – by 17.0%, 18.4% un 19.7% respectively.

Also the exports of services, despite the considerable fall in exports of financial services, last year increased by 6.9%, reaching 4.9 billion euro, being the all–time highest volume of exports of services. It was mostly facilitated by the increase in revenue from exports of transport services, as well as information and computer services. The increase in exports of transport services last year was, in general, facilitated by both comparatively steady volumes of transit traffic and increase in carriage by road. The growth of cargo carriage by road vehicles abroad by 15.9% that is 117 million euro last year provided the largest contribution both to the export of transport services and to the total growth of export of services. Also, the value of air and sea transport services rendered to foreigners increased, correspondingly, by 9.6% and 4.7%. While the growth of exports of air transport services was triggered by a larger number of passengers in the Riga Airport, the growth of exports of sea transport services, in turn, was related to the increase in the sea transport support services, mainly, in repairs and other commercial services. In turn, revenue from cargo carriage by rail reduced by 7.9% in 2017.

Last year, the value of exports of other services also continued to increase slightly steeper than in 2016, for example, the export of information and computer services, as well as construction services has increased – by 31.2% and 38.3% respectively. Notwithstanding that the number of guests entering Latvia in 2017 has grown and also the duration of their stay has increased, spending of foreign guests, in general, remained at the level of the previous year, reducing merely by 0.1%. In light of more stringent requirements in the field of anti–money laundering and counter–terrorist financing, as well as due to the introduced sanctions against certain countries of the Commonwealth of Independent States, the value of export of financial services in 2017 decreased by 16.9% or 75 million euro. This was evidenced by the fact that the export of the rendered financial services to residents outside the EU has reduced by 68 million euro, while to the EU residents – only by 6 million euro.

Growth of imports of services in 2017 was slightly steeper than the growth of export, as the value thereof increased by 8.7%. However, in monetary terms, the growth of exports of services by 315 million euro was, nevertheless, larger than the growth of imports by 212 million euro, as compared to the year before. The import of services was also mainly facilitated by all types of transport services, except for rail transport services. Total imports of transport services increased by 11.8%. In addition thereto, imports of information, construction and financial services grew, as well. Even though the expenditure of Latvian population abroad last year grew only by 1.8%, together with transport services, it forms the largest part of the total import of

services. In the total imports of services, transport service makes up 30.5% or 806 million euro and the expenditure of Latvian population abroad makes up 24.2% or 639 million euro.

Current account

In 2017, in light of the increase of the goods account deficit, the current account balance became negative. Over the last year the current account dynamics is predetermined exactly by fluctuations in export and import of goods. If in 2016 a considerable fall in the value of goods' import was the main cause for increase of the current account surplus to 342 million euro, then in 2017 the increase of the current account deficit to 204 million euro was determined by a significant increase in import of goods. Thus, last year, the current account deficit compincreased 0.8% of the nominal GDP. In general, the increase of the current account deficit corresponds to acceleration in investment activity and is not indicative of the overheating of an economy. Current account deficit is, to a full extent, covered by the EU funds investments inflow into the capital account. Furthermore, the average three–year level of the current account of the balance of payments of Latvia (0.1% of the nominal GDP) is considerably lower than the threshold stated in Alert Mechanism Report (-4% of GDP), being one of the indicators for identifying the unbalanced macroeconomics.

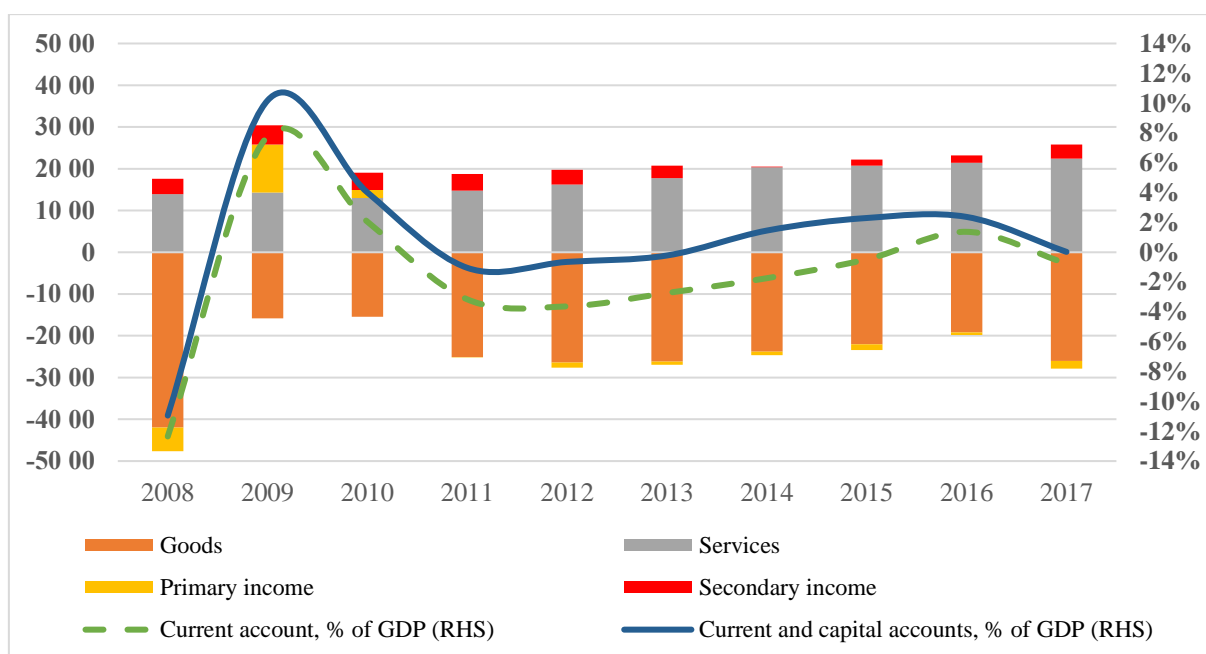


Figure 2.2. Components of the current account of Latvia's balance of payments (million EUR) and current and capital accounts in percentage of GDP³

Acceleration of the economic development rates, having started already at the end of 2016 both in Latvia and in the key Latvian partner countries, has promoted a steeper growth of foreign trade. Even though the value of goods' export increased by 10%, the increase in import was even higher, thus increasing the goods' account deficit and the current account balance, as a whole. The deficit of the goods' account last year increased by 684 million euro and compincreased 2 602 million euro. Also services foreign trade in 2017 was upward, nevertheless the growth in services' export, in absolute terms, was steeper than import, therewith increasing the services' account surplus by 104 million euro to 2 245 million euro. Services' account surplus slightly reduced the goods' account deficit, therewith the net foreign

³Data source: Bank of Latvia and the MoF calculations.

trade balance, in general, in 2017, was with a smaller – 357 million euro deficit. To compare, in 2016, foreign trade balance of Latvia was with 223 million euro surplus.

In 2017, the balance of primary income account deteriorated by 120 million euro, therewith comprising the account deficit in the amount of 182 million euro. Deficit growth was mainly determined by the growth of the income gained by foreign residents from the investments previously made in Latvia. In turn, higher incoming investments from the European Fisheries Fund and the European Social Fund as well as the increase in transfers of income gained by Latvian residents abroad, facilitated the growth of the balance of the secondary income account by 154 million euro to 334 million euro, thus fully compensating the growth of deficit in the primary income account.

According to the sectoral breakdown, the largest positive contribution to the GDP growth in 2017 was provided by manufacturing and construction sectors. Last year manufacturing demonstrated the steepest growth since 2011, as the added value generated by the sector grew by 8.0% last year, as compared to the year before. Manufacturing growth last year was all-embracing, however the largest positive contribution was ensured by a sharp increase in output volumes of mechanical engineering and metalworking sub-sectors, as well as manufacturing of computers, electronic and optical equipment. Stable development was observed also in the two largest manufacturing sub-sectors – wood-processing and manufacturing of food products, which increased by 2% and 4% respectively. As the investment activity restored, the construction sector in 2017 grew by 19.4%. This increase was ensured not only by higher EU funds' investments inflow, stimulating the construction of engineering structures, but also by growing investments in the sectors, where private investments traditionally prevail, *inter alia*, construction of office buildings, trade buildings, petrol stations. Therewith, construction volumes of engineering buildings at current prices last year were by 31.9% higher than the year before and the construction of non-residential buildings, over the year, grew by 23.5%, while in the construction of residential houses the fall by 7.9% was registered last year.

In 2017, unexpectedly good results were demonstrated by the **transport and storage sector**, which, despite the falling transit volumes, was able to reach 7.3% growth. This, similarly to manufacturing, was the sharpest increase over the period of last six years. The growth in the transport sector last year was ensured by growing cargo carriage by road, as well as the sharp increase in the airport and sea passenger carriages, while the volume of cargo carriage by rail reduced by 7.9% and the cargo turnover in ports – by 2.0%. Last year good growth was demonstrated also by the largest sector of Latvia's economy – trade, as the added value of the sector increased by 5.2%, facilitated by the increase in private consumption. In 2017, the growth of value added was demonstrated also by many other sectors associated with domestic demand – information and communication services increased by 6.2%, professional, scientific and technical services – by 6.0%, education – by 5.5%, public administration and defence – by 3.6%.

The sole sector experiencing the fall in 2017 was the **financial and insurance activities**, which, as compared to 2016, reduced by 16.6%. The fall in the sector was mainly attributed to the reduction of the non-resident business service in Latvia. Especially sharp fall for the sector of financial services was in the fourth quarter, when, as compared to the fourth quarter of 2016, it reached 26.0%.

After improvements in 2016, last year the situation of the loan portfolio of commercial banks in Latvia deteriorated, as the total loan portfolio at the end of 2017, as compared to the end of 2016, reduced by 4.6%, comprising 14.4 billion euro. Resident loan portfolio last year reduced by 2.8%, while the fall in the non-resident loan portfolio was sharper – by 14.0%. It should be noted that the share of residents in the total loan portfolio structure is significantly

larger, at the end of 2017 constituting 86.1%, which is 12.4 billion euro, while the share of non-residents' loan portfolio over the year reduced by 1.5 percentage points and compincreased 13.9% or 2 billion euro. Over the period of 2017 the quality of the portfolio of commercial banks continued to improve, because the share of the loans overdue for more than 90 days in the loan portfolio of the banks decreased to 4.1%. Improvement of the quality of the loan portfolio was ensured by the changes in the residents' loan portfolio, where the share of the loans overdue for more than 90 days fell from 3.5% at the end of 2016 to 2.9% at the end of the last year. Meanwhile, the share of the non-residents' loans overdue for more than 90 days grew from 9.6% to 11.1%.

In 2017, the amount of newly issued loans constituted 2.5 billion euro, which is a fall by 23.9%, as compared to 2016. *Inter alia*, the amount of the newly issued loans to residents reduced by 24.0% and to non-residents – by 23.6%. It should be noted that the fall in the newly issued loans to residents last year was determined by the decrease in the newly issued loans to resident businesses. After a considerable increase in 2016, the volume of the newly issued loans to businesses reduced by 38.0%, returning to the level of 2015. In turn, the amount of the newly issued loans to households continued to grow – by 13.1%, as compared to 2016, with a particularly high increase in loans for house purchase and repair. In turn, the amount of the newly issued loans to non-residents is decreasing ever since the fourth quarter of 2015. By the end of 2017, total deposits in Latvian commercial banks compincreased 20.3 billion euros, which, as compared to the year before, is a fall by 5.1%. This reduction was determined by decline in non-resident deposits by 12.0%, stimulated by FCMC's activities by implementing more rigid supervision of the non-resident segment and combating money laundering and terrorism financing. At the same time, the resident deposits in commercial banks remained at the level of the previous year. At the end of the last year, the share of non-resident deposits of total deposits reduced to 39.7%, this share is gradually reducing ever since 2015, when, at the end of the first quarter of 2015, the non-resident deposits compincreased 54.8%. Out of all non-bank deposits, 0.9% were long-term (more than 5 years) deposits, and their volume over the year decreased by 23.0%, which was determined by the fall in both resident and non-resident long-term deposits.

In 2017 the average inflation in Latvia increased to 2.9%, which, as compared to the previous years, when inflation was around zero, is to be considered as a comparatively strong growth. A steeper increase in consumer prices was recorded in the first half of the year, when the average inflation constituted 3.1%. However, in light of a slower increase in prices of food and fuel in the second half of the year also the increase in consumer prices became weaker, comprising 2.7% on average during this period. On the whole, the largest contribution to the changes in consumer prices in 2017 was determined by the increase of prices of food, especially, as the prices of dairy and oil products grew. Higher oil prices in the global markets directly affected the increase if fuel prices in Latvia. Overall, the prices of goods last year were by 2.8% higher than in 2016, which was to a large extent caused by external factors. In turn, the prices of services, which reflect the economic trends in the local market, grew by 3.2% in 2017. Stronger wage and private consumption growth increased the core inflation to 1.6% in 2017 from 0.7% in 2016.

In 2017, **the unemployment rate in Latvia** reduced steeper than in the previous year, according to the labour force survey data forming 8.7% of the economically active population, which is by 0.9 percentage points less than in 2016. The unemployment rate of the previous year had reduced by 0.3 percentage points. Also the registered unemployment rate reduced steeper in 2017, which, along with the steeper economic growth, was also affected by legislative changes, extending the period required to be employed, in order to qualify for receipt of the unemployment benefit. At the end of December of 2017, the registered unemployment rate

compincreased 6.8% – by 1.6 percentage points lower than at the end of 2016. In turn, the number of registered unemployed during 2017 reduced by 19.4% to 63.1 thousand at the end of December.

In 2017, after the one-year break, the number of population employed in the national economy increased, as well, which, as compared to 2016, has grown by 0.2%, achieving 894.8 thousand. As the statistics on the occupied workplaces, the number of workplaces in 2017 grew the most in the construction sector – by 7.3% and in information and communication services – by 5.4%, while the number of workplaces occupied in trade, financial services and real estate sector has slightly reduced – correspondingly, by 1.0%, 1.4% and 0.5%. Along with the sharpened economic growth, the demand for employees has grown in the economy, while the supply is limited by unchangedly falling number of working-age population. As a result, last year the number of job vacancies has quite sharply grown, which, as compared to 2016, has increased by 2.6 thousand or 17.9%. The highest share of job vacancies in 2017 was in the public administration, defence and compulsory social security sector – 4.6%, as well as in manufacturing and in construction sector – 2.3% out of all workplaces.

Along with the sharper economic growth, also **the wage growth** became sharper in 2017. Average monthly gross wage, as compared to the year before, increased by 7.9%, comprising 926 euro. The steepest wage growth last year was observed in the private sector, where the average wage grew by 8.3%, while in the public sector the wage grew by 7.4%. Nevertheless, higher average wage level is still in the public sector, where the average wage in 2017 was 951 euro, while in the private sector it compincreased 915 euro. The real net wage growth in 2017 became slightly slower, determined by a higher level of inflation, and the real wage grew by 4.0%.

Last year, the steepest gross wage growths were registered in the sector of professional, scientific and technical services, as well as in the education sector – by, correspondingly, 11.8% and 10.3%. There was no wage decrease recorded in any sector last year, while the weakest wage increases have been for those employed in the real estate activities and other service activities. The highest gross wage last year remained in the sector of financial and insurance activities – 1 921 euro, while in the accommodation and catering services it was more than three times lower – 634 euro.

In general, economic performance in Latvia last year was very good, representing one of the strongest GDP growth rates in the EU. The growth was determined by the combination of both internal and external factors, and, as a result, the increase was registered in almost all sectors of national economy. Besides, good preconditions are observed for a comparatively sharp economic growth also this year, as the favourable external environment and the EU funds' investments inflow continue.

The medium-term macroeconomic development scenario of 2018 – 2021 has been drafted in February 2017. When drafting the forecasts of macroeconomic indicators, the MoF organised discussions with the experts of the Bank of Latvia and the Ministry of Economics, as well as the EC and the IMF experts. The updated medium-term forecasts of macroeconomic indicators have been presented also to the Fiscal Discipline Council, which has approved them on 14 February 2018.

The latest EX and IMF 2018 winter forecasts have been used as a basis for the external environment underlying the Latvia's export forecasts. According to the EC forecasts, the GDP of the EU Member States will grow on average by 2.3% in 2018 and by 2% in 2019, which is, correspondingly, by 0.2 and 0.1 percentage points more than in the previous forecasts. In general the GDP forecasts of all Latvian trade partner countries for these years, as compared to the previous forecasts, will be increased, which are also compatible with the sharp growth of the EU economic sentiment index. Therewith, the MoF forecasts are based upon the assumption

that the economic development of the key Latvian trade partners, *inter alia*, Russia, in 2018 will be steeper than forecasted in June of 2017, when preparing the economic forecasts for this year's budget.

It is forecasted that **export** goods and services export will grow slightly steeper than the external demand, with the growth fluctuating slightly below 4% per year during the period of forecasts. In turn, **import** of goods and services this year will increase by 7.6%, exceeding the export growth, which will also be affected by the import of new aircraft of *Air Baltic* airline company. In light of the steeper economic development and investment growth, the import growth in the medium term will be slightly steeper than the export growth.

Table 2.2. Growth and Related Factors

	ESA code	2017 ⁴	2017 ⁴	2018f	2019f	2020f	2021f
		million euro	Growth %				
1. GDP at 2010 prices	B1*y	22 792	4.5	4.0	3.4	3.0	2.9
2. GDP at current prices	B1*y	26 851	7.7	7.2	6.5	5.8	5.4
GDP by expenditure at 2010 prices							
3. Private consumption	P3	14 395	5.1	6.1	3.5	2.8	2.6
4. Public consumption	P3	3 841	4.1	3.1	2.8	2.8	2.6
5. Gross fixed capital formation	P51	4 554	16.0	11.2	9.0	7.1	7.0
6. Changes in inventories and acquisition of valuables	P52+P53	862	-	-	-	-	-
7. Exports	P6	14 189	4.4	4.0	3.9	3.8	3.8
8. Imports	P7	15 049	9.2	7.6	4.7	4.6	4.5
Contribution to GDP growth							
9. Final domestic demand			6.8	6.6	4.6	3.9	3.7
10. Changes in inventories and acquisition of valuables	P52+P53		0.8	-0.1	-0.5	0.0	0.0
11. Exports imports balance	B11		-3.1	-2.5	-0.8	-0.8	-0.8

After low volumes of investments in 2016, last year the growth of **investments** (gross fixed capital formation) was significantly influenced by the resumption of the EU funds introduction. Sharp EU funds investments inflow observed also at the beginning of 2018, which gives grounds to consider that the EU funds introduction will significantly influence the volume of investments also in 2018, and they will continue growing also in 2019 and 2020. The scenario provides for the growth of investments also on the basis of own funds of the businesses and the growth of loans issued to the businesses. As the amount of loans issued to non-banks has practically not been changing already for the period of last three years, then it is expected that along with the positive lending growth also investments will grow. Thus, it is expected that the investment growth rates will exceed the overall economic development rates – they will reach 11.2% in 2018 and 9% in 2019.

Development of **private consumption** in the medium term will be closely related to the trends on the labour market and positive impact of the *Tax Reform* on the income of population. Therewith, the growth in private consumption in 2018 is forecasted in the amount of 6.1%. In the subsequent years, with the rates of the wage increase becoming slightly slower, also the rate of the growth in private consumption will reduce, falling slightly below the GDP growth rate.

⁴ Data published till 28 February 2018.

According to the forecasts the wage increase in the medium term will remain close to the productivity growth, still slightly exceeding it in 2018.

According to the baseline scenario Latvia's **GDP** in 2018 and 2019 will grow by 4.0% and 3.4%, correspondingly (in the Stability programme for 2016 – 2019 the forecasted GDP growth was 3.3% in 2017 and 3.4% in 2018). It is expected that the domestic demand will be the main growth trigger in 2018 and 2019. In the following years the GDP growth rates will gradually reduce by 3% in 2020, becoming close to the potential growth level.

Inflation

In 2017, changes in consumer prices reached the sharpest increase since 2012, increasing on average by 2.9% per year, as compared to 2016. It was a very characteristic trait for the last year's that consumer prices' fluctuations were mainly affected by external factors. Increase in food and oil prices on the global market, mainly determined by the balancing of the supply and demand, left an impact also on inflation in Latvia. Thus, the increase in food prices in Latvia, in 2017, explains almost one half of the increase in consumer prices, on the whole. Food prices increased on average by 6.0%, *inter alia*, prices of dairy products, fresh vegetables and butter grew, correspondingly, by 11.9%, 11.3% and 48.7%. It should be noted that also in the EU, as a whole, food prices have been one of the defining factors for increase of inflation. In 2017, prices of food increased also in the neighbouring countries, Lithuania and Estonia, correspondingly, by 3.6% and 5.7%. According to the data of the Food and Agriculture Organisation of the UN, unprocessed food price index in the world, in 2017, increased by 8.1%, with the steepest increase exactly in the prices of dairy products. Dairy products supply on the international markets slightly reduced last year, as the supply and demand parts levelled out thus affected the prices in the upward direction.

Increase in consumer prices last year was affected also by considerable increase in fuel prices by 8.3%. Substantial increase in fuel prices was recorded exactly at the beginning of the year, when in the first quarter of the year fuel was by 17.3% more expensive than in the respective period of the previous year. In the following months the increase in fuel prices slowed down, and in December the annual increase already compincreased only 4.8%. Already in 2016, the average oil price per barrel was 43.5 US dollars, then, in 2017, the annual average price increased to 53.3 US dollars per barrel, thus it has directly affected the fuel prices also in Latvia. It should be noted that, in 2017, the fuel prices have increased for the first time since 2013, but they are still about 20% below the historically highest fuel price recorded in 2012.

Over the period of 2017, the explicit upward trend in the price changes has been created by significant increase in the prices of insurance services by 28.6%, which was mainly determined by the increase in the prices of the compulsory civil liability insurance of the owners of motor vehicles. Besides, a steady price increase during the entire period of last year was recorded for telecommunication, healthcare and catering services.

Tax changes taking place last year have also caused a slight additional inflation effect. According to the MoF calculation, approximately 0.3 percentage points of the increase in consumer prices in 2017 was provided by the changes in excise duty on alcoholic beverages and cigarettes, as well as the application of 21% VAT rate to house managers. The VAT on house managers has been introduced since 1 July 2016, therewith an increasing impact on inflation was observed also in the first half of the previous year.

In January and February of 2018, the consumer prices grew, correspondingly, by 2.0% and 1.8%, as compared to the respective period of 2017. It is worth noting that, unlike the trends of previous year, when the increase in consumer prices was determined mainly by the increase in food prices, at the beginning of this year the structure of changes of prices is more levelled

out among the increase in prices of food, energy resources and separate business (commercial) services.

Food prices in January this year over the year increased by 2.2% and by 1.3% in February. Increase in food products was determined by the increase in prices of meat, dairy and oil products, especially, butter. At the same time, vegetable and sugar prices declined. It should be noted that the increase in prices of meat, dairy and oil products at the beginning of this year echoes the high increase in prices of the previous year. Due to the achieved high base at the end of the last year also in the first two months of this year and, most likely, in the following months the prices of meat, dairy and oil products, in annual terms, will continue to grow. However, it should be noted that the pressure of food product prices on the average inflation will decrease by the middle of this year. Also this year the changes in food prices are determined by the trends on the global markets and, judging from the data of the Food and Agriculture Organisation of the UN on the prices of unprocessed food in the world, the food price index in January and February this year declined, correspondingly, by 3.2% and 2.7%, with the main fall in the price of sugar, dairy and oil products. With the time shift, similar trend will be observed also in Latvia. Stabilisation of food prices is reflected by the fact that, as compared to the previous month, in December and January the food prices, on the whole, remained practically unchanged.

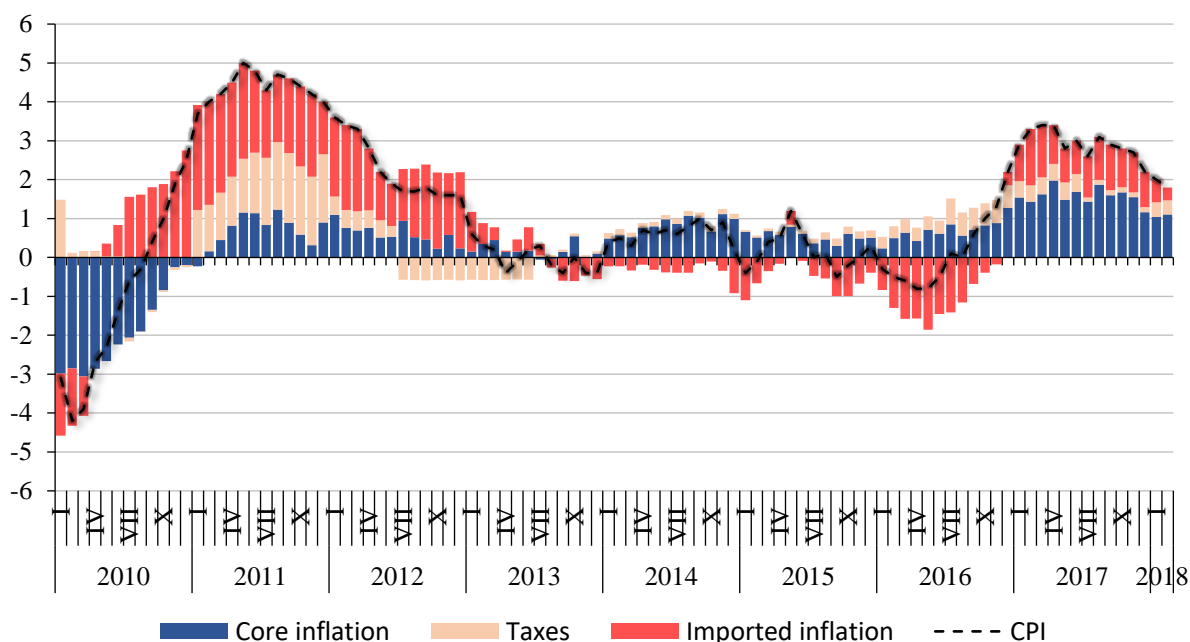


Figure 2.3. Annual inflation according to a source of origin⁵

At the beginning of 2018, also the prices of goods and services related to energy resources continued to grow. Thus, in light of higher oil prices on the global markets, as well as the increased excise duty rate for fuel, starting from the beginning of this year, in January, the fuel prices, as compared to January 2017, increased by 4.3%, and in February – by 5.2%, as compared to February 2017. In addition thereto, also gas and heat energy became more expensive.

Out of other services increasing the average inflation, the increase in prices of healthcare services by 4.0% on average in the first two months of this year must be mentioned. The price growth was mainly determined by the changes in prices of outpatient services. Also the

⁵Data source: CSB, MoF calculations

accommodation and restaurant service became more expensive, as well as services of insurance of road vehicles. In general, all types of services included in the consumer goods basket became more expensive on average by 3.3% in January and by 3.6% in February, as compared to the respective period last year.

According to the MoF forecasts, in 2018, consumer prices will increase on average by 2.8%. The input of increase in food prices in the total inflation will be smaller than the year before, however also in 2018 exactly this category of consumer products will ensure the largest input to the increase in consumer prices. Higher oil prices on the global markets and increase of the excise duty rate for fuel will increase the fuel prices also this year. The excise duty rate will be increased also for alcoholic beverages – starting from March this year, and for tobacco products – from July. According to the MoF assessment the increase of the excise duty rates for fuel, alcoholic beverages and tobacco products in 2018, on the whole, will increase the average inflation by 0.9 percentage points. In turn, the VAT decrease for vegetables and fruits characteristic to Latvia to 5%, will reduce the average inflation of 2018 by 0.1 percentage points. Along with the steadily growing wage, also the prices for commercial services will continue to grow, especially, the prices of healthcare services, restaurant and accommodation, as well as recreation services.

In turn, inflation in the medium term will reduce to 2.4% in 2019 and to 2.1% in 2020 – 2021. It is expected that the fluctuations in prices of raw materials on global markets will be insignificant; therewith the pressure of prices of food and energy resources on consumer prices in Latvia will be moderate. The lack of availability of the labour force will maintaining high wage growth, which will directly promote also the increase in prices of services. Additionally, it is planned that also in 2019 the excise duty rate will be increased for tobacco and alcohol, and in 2020 the excise duty will be again increased for tobacco, alcohol and also fuel.

Labour market

Along with the steeper economic growth, the number of population employed in national economy started to increase again in 2017, growing by 0.2% to 894.8 thousand. Reduction of unemployment became steeper, as well, as the unemployment rate, according to the labour force survey data, declined by 0.9 percentage points to 8.7% of economically active population. Even though the demand for employees is growing, steeper growth of employment is limited by the declining number of working-age population, and, in 2017, along with increase in the number of employed population, also the number of job vacancies increased quite significantly.

The development of the labour market also in the medium term will continue to be determined, concurrently, by both steeper economic growth and declining number of the working-age population, when, over the period of recent years, the number of population aged between 15 – 74 years in Latvia has declined on average by 1.8% per year. Therewith, economic activity of the population will continue to grow, which, already in 2017, has reached its historically highest level, when already 68.9% of all population aged 15 – 74 have been actively involved in the labour market as employed or job-seekers. As compared to the year before, the level of economic activity in 2017 had grown by 0.7 percentage points. The increasingly growing involvement of population in the labour market is promoted by growing demand for employees and wage level, with the average wage last year growing at the steepest rate ever since 2008, gradual increase in the retirement age, changes in the age structure of population, where the share of economically less active youth among all working – age population is decreasing. At the same time, the total number of population employed in the national economy will not considerably increase. In 2018, according to the MoF forecasts, it will only grow by 0.1% to 896 thousand and will remain at such level also for the next two years.

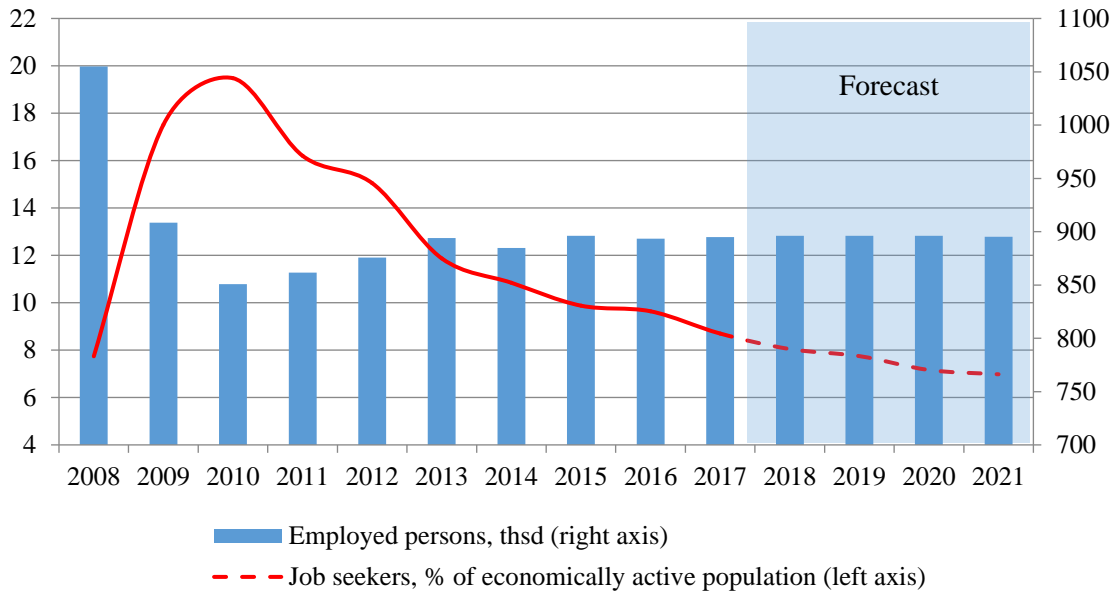


Figure 2.4. Employment and unemployment in 2008 – 2021

Overall, during the period since the peak of the economic crisis in 2010, the number of population employed in the national economy has increased by 45.3 thousand or 5,2%, but it is still significantly – by 161.4 thousand or 15.3% – lower than the level reached in 2007, based on both negative natural population growth and high emigration during the post-crisis period. Over the recent years, about 20 thousand people leave Latvia each year, but the total number of population aged between 15 – 74 years reduces by about 25 thousand per year. Sharper expected growth of population income in the coming years might restrict emigration processes, but the number of the employed population will still be affected by demographic processes, where the number of people exiting labour market will exceed the number of youth entering it.

The unemployment rate in the medium term will continue to decline, which will also be determined by a steeper economic growth and influenced by the decrease of the number of population aged between 15 – 74 years. According to the MoF forecasts, in 2018, the unemployment rate will decrease to 8.0%, but over the period till 2021, it will gradually decline to 7.0% of the economically active population.

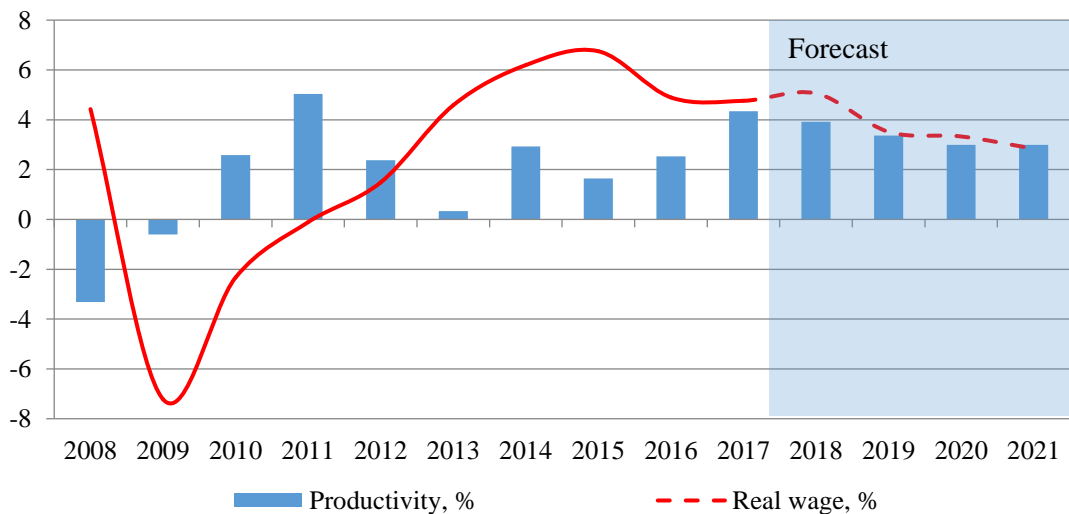


Figure 2.5. Changes in productivity and real wage, % against the previous period

It is expected that the average gross wage, which in 2017 had increased by 7.9%, in 2018, will increase at the same rate – by 8.0%, reaching the total of 1 000 euro over the year. Harsh wage increase will be determined by the increasing demand for employees, considerable increase in minimum wage as of 1 January 2018, as well as the increase of expenditure provided for in the State budget for remuneration, including, for the employees in the healthcare sector. In 2019, according to the MoF forecasts, the wage increase will become slightly slower, comprising 6.0%, and afterwards it will gradually decline to 5% in 2021.

Despite a steeper wage increase in 2017, last year, for the first time over the period of the last five years the wage increase has not considerably exceeded the increase in productivity anymore, which is an essential prerequisite for ensuring competitiveness of Latvia. It has been ensured by a stronger economic growth and steeper increase in productivity, and also in the years to come the MoF expects that the wage increase, in general, will correspond to increase in productivity, though still slightly exceeding it in 2018 under the influence of one-off factors.

Cyclical development of economy

Similar to the EU, also Latvian economic development is in the upward part of the cycle, evidenced by steeper than expected economic growth in 2017 and a falling unemployment rate. According to the MoF calculations, the potential GDP growth will range from 3.2 – 3.4% in the medium term.

Potential GDP growth is restricted by the lack of labour force and low investment level. Due to demographic situation, the employment will have a neutral impact during the period of forecasts. Therefore, the potential growth will mainly be determined by the capital and total factor productivity growth.

Already by 2016, the potential growth has been impeded also by the low investment level, but in 2016 the gross fixed capital formation decreased by 15.7% at unchanged prices, affected by delay in inflow of the EU funds. Starting from 2017, capital impact on the potential growth has increased, because of a sharp investment growth, and it is being forecasted relatively steep (about 10%) for the entire period of forecasts. Thus, it will stimulate also the potential GDP growth and, during the period of forecasts, the capital input to the potential growth will be slightly above 2 percentage points.

In turn, the total factor productivity growth since the last economic recession (in 2008 – 2010) has reached the largest input to the potential GDP growth, providing for approximately one third of the potential GDP growth since 2016 and it will make up approximately the same amount also in the period of forecasts.

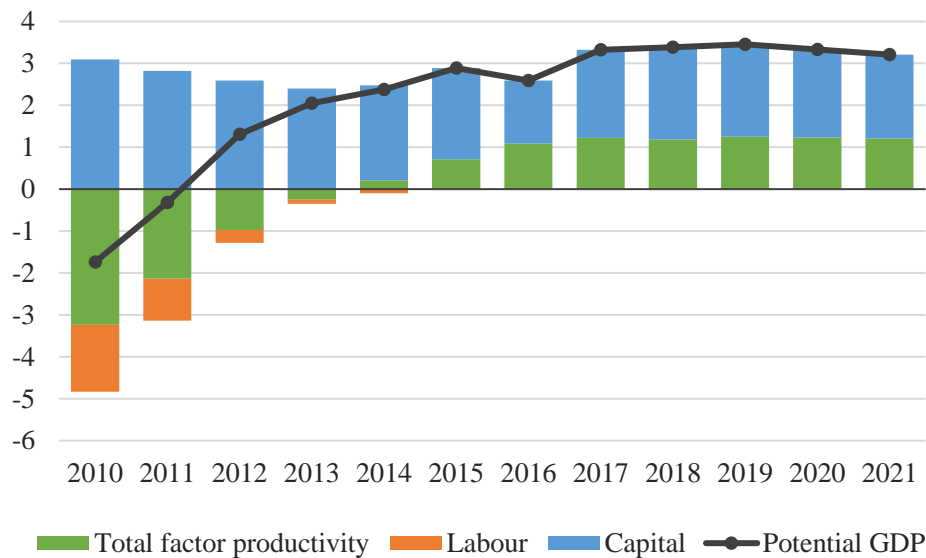


Figure 2.6. Potential GDP growth and input of components, %

According to the MoF assessment, till 2016, Latvian economy has been developing slightly below the potential level. Only starting from 2017, thanks to a steeper, namely, above 4%, GDP growth, the output gap in Latvia has become positive. Nevertheless, in the medium term, it is forecasted that the output gap will reduce, because the GDP growth will gradually slow down to its potential growth. Besides, it is forecasted that the actual wage increase in the medium term will not exceed the growth in labour force productivity, namely, the actual wage increases above the productivity, which might be indicative of high positive output gap, is not forecasted.

Similar medium term output gap estimate was also provided by the EC. Even though according to the EC estimate, starting from 2015, the output gap in Latvia is quite positive, which is based upon wage increase and sharp decline in the unemployment rate, nevertheless it is counterintuitive to the results of the alternative output gap "plausibility tool" methodology developed by the EC itself, taking into account number of cyclical variables, which indicate to the balanced output gap in Latvia in 2017. For example, low inflation, current and capital account balance surplus, as well as the reduction of the net debt to GDP indicate the balanced output gap. Furthermore, the contradiction in the EC estimates is also evidenced by the fact that, in 2016, despite the slowdown of the GDP growth in Latvia, according to the EC estimates the output gap still increased. Nevertheless, in general, starting from 2020, the MoF and the EC forecasts as to the amount of the output are quite similar.

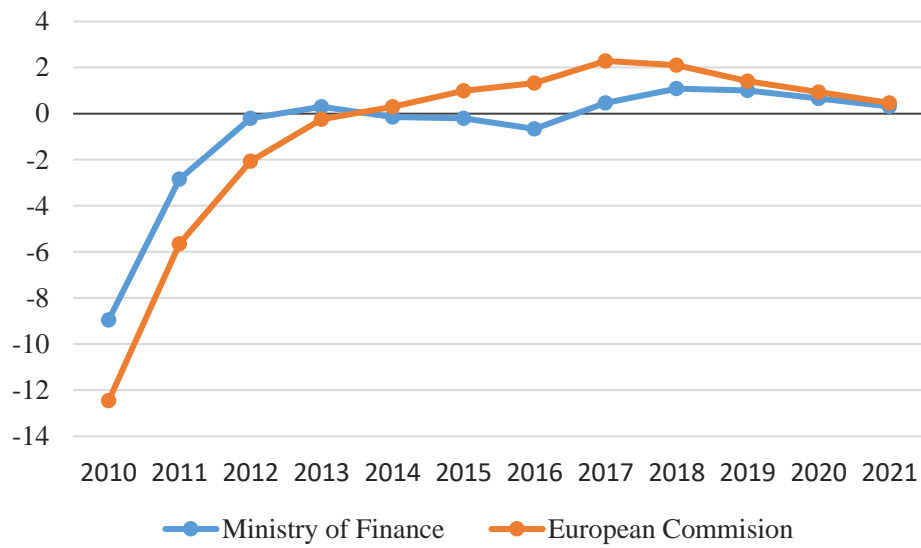


Figure 2.7. Output gap, %

3. GENERAL GOVERNMENT BUDGET BALANCE AND DEBT

3.1. CURRENT FISCAL SITUATION

The general government budget deficit in 2017⁶ was 125.2 million euro or 0.5% of GDP. The amount of the deficit was by 0.3 percentage points or 84.3 million euro smaller than specified for 2017 in the previous Latvia's Stability programme for 2017 – 2020. A lower level of deficit can be explained by better tax revenue, smaller contributions into the EU budget, as well as lower than planned expenditure for social benefits. Due to these factors, the deficit was also smaller than forecasted in the Budget Law for 2017, where it was set at 1.1% of GDP. Good conditions for a steeper growth of labour tax revenue were promoted by a strong economic growth, as a result the number of employees receiving taxable income also increased, and a significant wage increase had been observed in the country – 7.5% in 2017. The general government budget balance in 2017, as compared to 2016, when the balance for the first time since 1998 was in a slight surplus, has deteriorated by 0.5 percentage points of GDP. It should be noted that in 2016 a low level of EU funds' expenditure had been observed, considerably below the planned amount, which, in turn, affected the balance improvements at the State and local government level. It should also be noted that in 2017 the budget balance was deteriorated by 0.5% of GDP by a transaction that reduced *Latvenergo* capital and this funding has been used for disbursement of a one-off compensation to *Latvenergo*. In return receiving the possibility to reduce the amount of State liabilities to subsidise the generation of the electricity and thus reduce the share of the MPC for electricity users. If this transaction, which in essence is considered to be a one-off measure, would be excluded, the general government budget would be well-balanced in 2017.

In 2017, as compared to the previous year, both revenue and expenditure of the general government increased in nominal terms. Revenue has grown by 7.1%, which is a slightly slower growth rate than that of the economic growth last year – by 7.7% at current prices. It can be explained by lower foreign financial assistance revenue, taking into account the stage of implementation of the EU funds' projects, which is not yet creating an instant cash flow increase. In turn, general government expenditure grew by 8.6%. The most significant growth is observed in capital expenditure along with active implementation of the EU funds' projects, a considerable increase in expenditure is also observed in local governments.

Compared to 2016, the general government revenue to GDP in 2017 reduced by 0.2 percentage points, reaching 37.1% of GDP, whereas the redistributed resources through the general government expenditure increased by 0.3 percentage points and accounted for 37.6% of GDP. Since 2012, it has been observed that the amount of the general government revenue of GDP has been stable, while the expenditure-to-GDP proportion slightly fluctuated, driven by lower EU funds' investments. For example, in 2016 the general government expenditure was by 1.2 percentage points of GDP smaller than in 2015, which can be attributed to the completion of the EU funds' cycle for 2007 – 2013.

⁶ The assessment of the MoF of March 2018

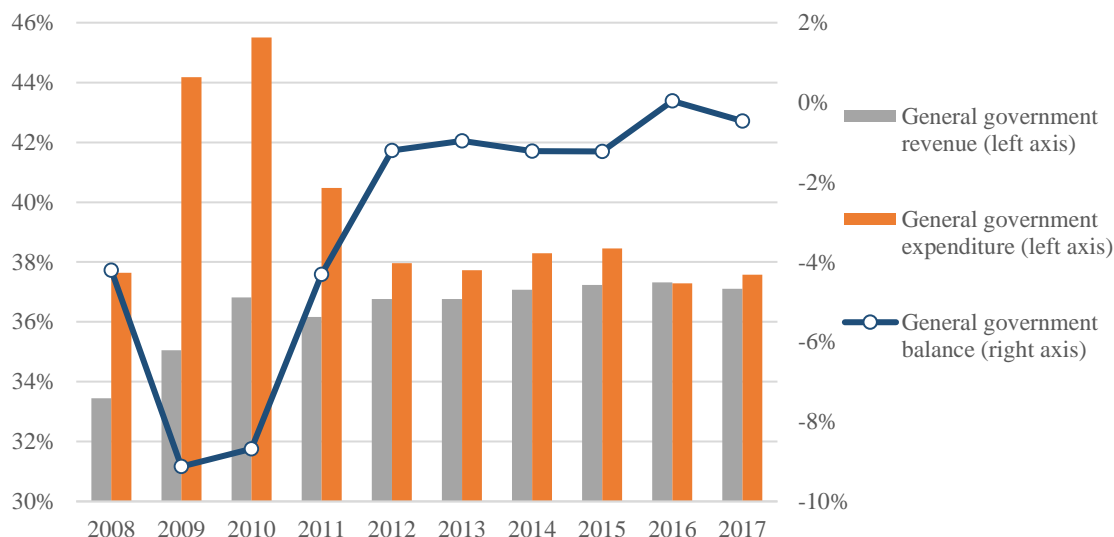


Figure 3.1. General government revenue, expenditure and budget balance⁷, % of GDP

In view of the favourable situation in external environment and growth of investments, Latvia's economic growth in 2017 exceeded the initial forecasts and, together with successful tax administration measures, promoted higher tax revenue than planned. Tax burden last year increased, even though the general government revenue to GDP decreased, which can be explained by lower foreign financial assistance revenue than before. Tax burden in 2017 reached 31.3% of GDP, constituting the largest tax revenue level since the financial crisis. Like the years before, also in 2017 one of the main economic growth boosters was increase in domestic demand. The increase of the average wage and employment stimulated the growth of private consumption. Increase in the tax revenue as a whole was observed for all tax types, however the most rapid increase was demonstrated by revenue from the VAT, PIT and social security contributions.

⁷Data source: Notification on the General Government Budget Deficit and Debt in October 2017 (2008–2016) and the assessment of the MoF for 2017 from March this year.

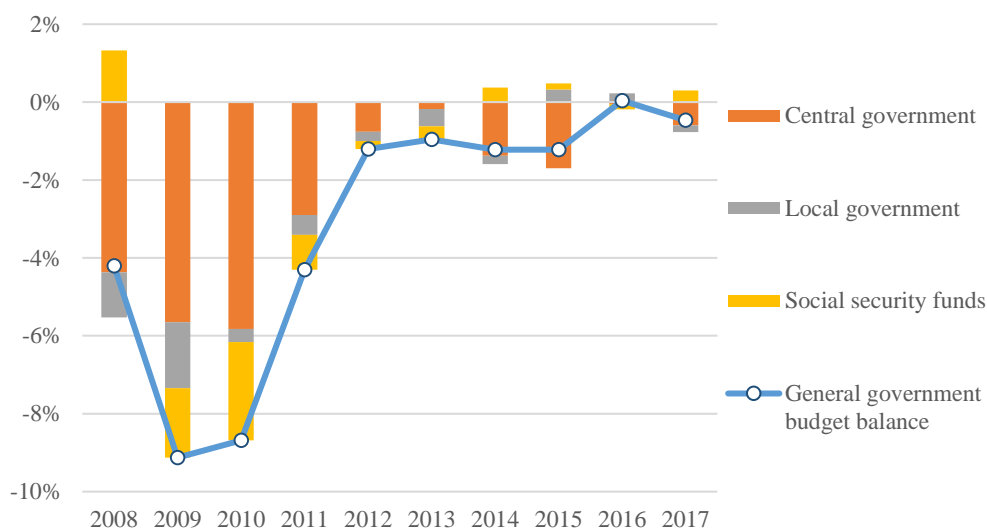


Figure 3.2. Budgetary balance of the general government by sub-sectors⁸, % of GDP

The analysis of contribution⁹ of the general government sub-sectors to the overall fiscal balance, allows to conclude that the negative balance was mainly formed by the central government deficit, comprising 0.6% of GDP in 2017. It should be noted that in 2016 the central government balance was close to a well-balanced level. The local government deficit level in 2017 was 0.2% of GDP, while in 2015 and 2016 the local government budget was with a surplus. Nevertheless, historically there has been a deficit at the local government level, but 2015 – 2016 were marked by lower EU funds' expenditure, resulting in, generally, lower expenditure level and, correspondingly, budget surplus at the local government level. In the subsequent years the deficit is planned at the local government level, which will be influenced by the growth of expenditure, by more co-financing the EU funds' projects for gross fixed capital formation.

Steeper economic growth promoted over-execution of the social security contributions plan by 0.6%. In turn, the historically highest level of economic activity of population promoted the reduction or moderate growth of separate short-term social benefits expenditure, resulting in a surplus in the amount of 0.3% of GDP in the social security fund last year, which was by 0.2% of GDP more than the amount of surplus planned in the Budget Law for 2017. The formation of the surplus in the social security fund is basically determined by the sharply growing wage level over the recent years. The situation in the social security funds is improved also by the government decision, by which as of 2014 the central government through transfers finances supplementary pension payments which were paid from the social security fund.

⁸Data source: Notification on the General Government Budget Deficit and Debt in October 2017 (2008 – 2018) and the assessment of the MoF for 2017 from March this year.

⁹Breakdown of the general government sector into sub-sectors is defined in accordance with the ESA 2010. In the national accounts methodology of the consolidated general budget the central government is identified as the State basic budget, budgets of derived public entities partially financed from the State budget and budgets of the authorities not financed from the budget; social security funds – State social security special budget; local government – local government budgets.

3.2. FISCAL POLICY STRATEGY AND MEDIUM-TERM OBJECTIVE

3.2.1. DETERMINATION OF THE STRUCTURAL BALANCE OBJECTIVE

The fiscal policy strategy of Latvia this year is focussed on achieving two objectives:

(1) The fiscal policy strategy of Latvia, similar to previous years, is based on a condition of a balanced budget during the economic cycle or a condition that the MTO shall not exceed 0.5% of GDP.

(2) In addition to the balanced budget condition, Latvian fiscal policy strategy includes the objective to ensure, by fiscal policy measures, (i) the conditions for the sustainable economic growth of the country, and (ii) the budget tax revenue gradual convergence to 1/3 to GDP.

3.2.2. DETERMINATION OF THE STRUCTURAL BALANCE OBJECTIVE

This section describes the ensuring of the first objective of the fiscal policy and the medium-term objective, but information on the second objective of the fiscal policy is provided in Section 3.2.3.

The achievement of the first fiscal policy strategic objective is ensured by the FDL and the SGP. The FDL adopted in 2013 created a system of setting objectives of the general government budget balance in compliance with the *top-down planning method of a budget balance*. This method allows setting the objectives of general government budget structural balance for each year so that these objectives comply with the conditions of the SGP as well as to calculate minimum nominal balances accordingly (the maximum permissible general government budget deficit or the minimum permissible general government budget surplus). At the same time, there is also the *bottom-up planning method of a budget balance* applied according to which the general government budget balance is forecasted **at no-policy change**. The general government budget balance is also forecasted in compliance with this method.

In a general case, general government budget balances differ according to both methods. If pursuant to the first method, a general government budget balance is larger than by the second method, there is the so-called fiscal space or possibilities at disposal of the government to increase expenditure for the new priorities of expenditure policy or to reduce revenue for new tax policy initiatives. If according to the first method, a general government budget balance is smaller than by the second method, the government shall carry out consolidation measures, taking discretionary measures for reducing expenditure or increasing revenue.

In Latvia, the key decisions of budget policy, affecting expenditure and revenue medium-term policy, are not taken in spring, but in autumn along with the *Annual State Budget Law*. During this time, not only the *Annual State Budget Law* is being elaborated, but also the *Framework Law* is being drafted for the three subsequent years. Thus, during an interval between the moment of drafting the Stability Programme for 2017 – 2020 and the moment of drafting the Stability Programme for 2018 – 2021, substantial decisions on fiscal policy have been adopted which have filled all the fiscal space of 2018 and provide basis for implementing the strategy of the Stability Programme for 2018 – 2021. The fiscal effect of these decisions has been included in this Stability Programme in **no-policy change scenario**.

At the same time, in 2017, the process of adoption of decisions of the medium term fiscal policy differed from the usual one, because on 28 July 2017 the Saeima approved the set of draft laws on tax reform, and the legislative changes contained therein created considerable fiscal impact on public finances in the medium term, while according to the usual practice in the autumn cycle, when drafting the *Annual State Budget Law* and the *Framework Law*, the

government and the Saeima adopted additional budget decisions according to defined medium-term budget policy priorities. The decisions adopted within the scope of drafting the Annual *State Budget Law* and the *Framework Law* are described in more detail in Chapter-3.2.3. In turn, information about the measures of the approved Tax Reform is included in Chapter 6.2.

Medium-term Objective

Regarding MTO the same approach is applied, which was set in the previous Stability Programme, defining two different MTOs: national MTO, which remains -0.5% of GDP, and MTO within the meaning of the SGP or MTO SGP, which is set as -1.0% of GDP.

Objectives of Structural Balance for 2019, 2020 and 2021

The general approach provides that, when setting objectives of general government budget structural balance, a multi-stage method is being applied and they should concurrently provide for the compliance with both the national level fiscal rules (balance rule, expenditure growth rule and rule of expenditure inheritance), as defined in the FDL, and with the methodology applied by the EC.

First of all, the objectives of structural balance are calculated by means of the **balance rule**. Two scenarios are developed for verification of the balance rule – one with the national MTO, and another with the MTO SGP, which is a conditional point of reference, to which the deviations are being applied, which result from the implementation of the health reforms. The introduction of two different MTOs in the Latvian fiscal policy is still rooted in the cautious approach, so that the defined objectives of the general government budget structural balance are consistent not only with the national approach, but also to ensure compliance with the SGP conditions.

FDL prescribes that compliance with the balance rule is not the only fiscal rule. When setting the objective of structural balance, also the **expenditure growth rule** has to be taken into account, as prescribed by Regulation No 1175/2011. This rule, in the general case, may determine more ambitious objectives of the general government budget structural balance. The FDL also provides that the central government expenditure is determined in the *Framework Law* for the three subsequent years and this is legally binding (**rule of expenditure inheritance**). Therewith, a situation may occur that retention of the central government expenditure at the level prescribed by the previous *Framework Law* can change the objective of structural balance of the general government budget. However, changes are restricted by a provision of the FDL that if deviations of expenditure exceed 0.1% of GDP, expenditure is not preserved, but is recalculated in compliance with the general government budget structural balance and expenditure growth rules.

Balance objectives according to the balance rule (SGP methodology)

In this section it is determined what the maximum level of the general government budget structural balance objective could be in accordance with the above-mentioned SGP approach. As previously mentioned, the starting position for determining the general government budget structural balance objective in accordance with the SGP approach is MTO -1,0% of GDP. The following table reflects future adjustments.

Table 3.1. Structural balance objective according to the SGP approach

		2013	2014	2015	2016	2017	2018		2019	2020	2021
(1)	VTM	-1.0%	-1.0%	-1.0%	-1.0%	-1.0%	-1.0%		-1.0%	-1.0%	-1.0%
(2)	Pension reform	no 2% uz 4%	-0.5%	-0.5%	-0.5%	0.0%					
(3)		no 4% uz 5%			-0.3%	-0.3%	-0.3%	0.0%			

(4)		no 5% uz 6%				-0.3%	-0.3%	-0.3%		0.0%		
(5)	Health reform						-0.1%	-0.4%		-0.5%	0.0%	
(6)=sum (1;2;3;4;5)	maximum structural balance									-1.5%	-1.0%	-1.0%
(7)	Cyclical component									0.5%	0.5%	0.5%
(8)=(6)+(7)	Cyclically adjusted balance									-1.0%	-0.5%	-0.5%
(9)	One-off measures		-0.3%									
(10)=(8)+(9)	Nominal balance	-1.0%	-1.2%	-1.2%	0.0%	-0.9%	-1.0%			-1.0%	-0.5%	-0.5%

With regard to the deviation model resulting from the increase in contributions to the second pension pillar, Latvia retains a similar principle as in the previous Stability Programme. Nevertheless, it should be noted that the pension reform deviations are not applied anymore in formulating the balance objectives of this Stability Programme, taking into account that the rights to apply them according to the SGP conditions shall not be in effect anymore starting from 2019.

The granted deviations from the MTO due to the implementation of the health reform are preserved in the previous amount, namely, 0.1% of GDP in 2017, 0.4% of GDP in 2018 and 0.5% of GDP in 2019.

Summing up the MTO with the corresponding deviations, for the needs of future estimates the maximum structural balance is obtained, comprising -1.5% of GDP in 2019, -1.0% of GDP in 2020 and -1.0% of GDP in 2021.

After the maximum permissible structural balance of general government budget is clarified, the amount of the nominal balance of the general government budget is calculated, adding the cyclical component of the balance according to the EC's output gap forecasts. It should be noted that the EC output gap forecast for 2019 is based upon the EC Autumn 2017 forecast, but for the coming years, namely, 2020 and 2021, for calculation purposes, it is assumed that this indicator will remain at the level of 2019, which is 1.4% of potential GDP, as the horizon of the EC forecasts does not extend beyond 2019.

In light of the output gap forecasts and by applying the elasticity coefficient of 0.38, the cyclical component is obtained, comprising 0.5 for all years of forecasts.

Summing up the previously determined structural balance level and the assessed output gap, the general government budget nominal balance is obtained, which is -1.0% of GDP in 2019, -0.5% of GDP in 2020 and -0.5% of GDP in 2021.

Balance objectives according to the balance rule (national methodology)

In this section it is determined what the maximum level of the structural general government budget balance objective could be in accordance with the national methodology. As previously mentioned, the starting position for determining the structural general government budget balance objective in accordance with the national methodology is MTO -0.5% of GDP. The following table reflects future adjustments.

Table 3.2. Structural balance objective according to national methodology

			2013	2014	2015	2016	2017	2018	2019	2020	2021
(1)	VTM		-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%
(2)	Pension reform	no 2% uz 4%	-0.5%	-0.5%	-0.5%	0.0%					
(3)		no 4% uz 5%			-0.3%	-0.3%	-0.3%	0.0%			
(4)		no 5% uz 6%				-0.3%	-0.3%	-0.3%	0.0%		
(5)	Health reform						-0.1%	-0.4%	-0.5%	0.0%	
(6)=sum (1;2;3;4;5)	maximum structural balance								-1.0%	-0.5%	-0.5%
(7)	Cyclical component								0.4%	0.3%	0.1%
(8)=(6)+(7)	Cyclically adjusted balance								-0.6%	-0.2%	-0.4%
(9)	One-off measures			-0.3%				0.0%	-0.5%	-0.3%	0.0%
(10)=(8)+(9)	Nominal balance		-1.0%	-1.2%	-1.2%	0.0%	-0.5%	-1.0%	-1.1%	-0.5%	-0.4%

The deviation model resulting from the increase in contributions to the second pension pillar is the same as for determining the structural general government budget balance objective according to the SGP methodology.

Summing up the MTO with the corresponding deviations, for the needs of future estimates the maximum structural balance is obtained, comprising -1.0% of GDP in 2019, -0.5% of GDP in 2020 and -0.5% of GDP in 2021.

After the maximum permissible amount of the structural balance of the general government budget, to be applied in future estimates, is determined, the amount of the nominal balance of the general government budget is calculated, by adding the cyclical component of the balance to the structural balance of the general government budget. Similar to the previous scenario, the cyclical component of the balance is calculated, by multiplying the output gap with the elasticity coefficient of 0.38, only in this scenario the output gap forecasted by the MoF is applied. The cyclical component of the balance is 0.4%, 0.3% and 0.1%, respectively, in 2019, 2020 and 2021.

In this scenario, the short-term revenue decline caused by the tax reform: in 2019 -0.5% of GDP and in 2020 -0.3% of GDP is viewed as the one-off measure.

Thus, by applying the previously determined structural balance, the MoF forecasts on the output gap and the one-off measures, the nominal balance is obtained, which in 2019 is -1.1% of GDP, in 2020 is -0.5% of GDP and in 2021 is -0.4% of GDP.

It should be noted that the application and interpretation of the FDL provisions is under the competence of the MoF and the MoF keeps an opinion that the short-term revenue decline caused by the tax reform, in terms of its essence, is a one-off measure – the revenue decline has no lasting effect and therefore it should not be included in the structural balance. The EC observes a much more conservative policy with respect to one-off measures and it does not exclude from the structural balance absolutely all measures with the short-term fiscal effect (see a technical handbook *Vade Mecum on the Stability and Growth Pact, Box 1.4: Calculating the structural balance* prepared by EC). Thus, the revenue decline caused by the tax reforms within the SGP context will not be recognised on the part of the EC as a one-off measure and, therefore, it is not included in Table 3.1.

Balance objectives according to the balance rule – the choice of structural objectives

When general government budget structural balance objectives are determined and the nominal balance of the general government budget is calculated according to both methods, the

results obtained are compared in nominal terms and the largest nominal value of general government budget balance is chosen in order to ensure compliance with fiscal rules according to both the national methodology and the SGP approach.

Table 3.3. The choice of structural objective

		2019	2020	2021
(1)	Nominal balance (according to SGP approach)	-1.0%	-0.5%	-0.5%
(2)	Nominal balance (according to national methodology)	-1.1%	-0.5%	-0.4%
(3) = MAX (1;2)	The largest nominal balance value (MAX (1;2))	-1.0%	-0.5%	-0.4%
(4)	Cyclical component (national methodology)	0.4%	0.3%	0.1%
(5)	One-off measures	-0.5%	-0.3%	
(6)=(3)-(4)-(5)	Structural balance objective	-0.8%	-0.4%	-0.5%

Once the largest nominal balance value of the general government budget is determined, the balance is converted in structural terms (using the cyclical component and the defined one-off measures according to MoF estimates). Accordingly, the structural general government budget balance objectives are obtained, **which are - 0.8% of GDP in 2019, - 0.4% of GDP in 2020, and -0.5% of GDP in 2021.**

Balance objectives – follow-up verification in accordance with expenditure growth rule and rule of expenditure inheritance.

Then the obtained results are tested, to ensure also the fulfilment of the **expenditure growth rule** and **rule of expenditure inheritance**.

It should be noted that when general government budget structural balance objectives are checked in accordance with the **expenditure growth rule**, nominal expenditure adjustments are subject to MoF forecasts of public debt servicing expenditure, investment expenditure, expenditure for foreign financial assistance projects which match the received revenue from foreign financial assistance, discretionary revenue, as well as the GDP deflator. The permissible expenditure growth, in turn, is calculated by applying combined approach, namely, the initial permissible expenditure growth, corresponding to 10 years' average potential GDP growth in accordance with the MoF forecasts, by means of the EC approach is additionally adjusted by the second pension pillar increase, deviation from the MTO due to the implemented reforms in the health sector. These conditions are essential for the expenditure growth rule to properly take into account permissible deviations from the MTO.

When the determined structural balance objectives are verified in accordance with the expenditure growth rule, we obtain that in 2019 expenditure growth, which is allowed by the expenditure growth rule according to the potential GDP growth, is 2.26%, while the previously determined structural balance objective states that real adjusted expenditure could increase by 0.53%. Having performed the verification of the expenditure inheritance rule, it was detected that the expenditure inheritance rule provides for even slightly stricter condition and, correspondingly, allows for the real adjusted expenditure growth by 0.37%. Thus, the initial general government budget structural balance objective calculated by the balance rule needs to be adjusted more strictly, namely, from -0.83% to -0.78% of GDP.

In 2020, expenditure growth allowed by the expenditure growth rule is 2.33%, while the real adjusted expenditure growth allowed by the initially determined general government budget structural balance objective is 2.47%. Therewith, the initial general government budget

structural balance objective calculated by the balance rule needs to be adjusted more strictly, namely, -0.43% to -0.38% of GDP.

In 2021, expenditure growth allowed by the expenditure growth rule is 3.10%, while the real adjusted expenditure growth allowed by the initially determined general government budget structural balance objective is 0.42%. Consequently, in 2021 the initially determined objective of the general government budget structural balance of -0.5% of GDP is maintained.

Therefore, the quantitative fiscal objectives for the next three years have been set, namely, to maintain the general government budget structural balance **at -0.8% of GDP in 2019, -0.4% of GDP in 2020, and -0.5% of GDP in 2021.**

3.2.3. GENERAL FISCAL POLICY OBJECTIVES AND PRIORITY DIRECTIONS FOR 2018 – 2021 – THE ACCOMPLISHMENTS AFTER THE PREVIOUS STABILITY PROGRAMME

As previously mentioned, in Latvia, the key decisions of budget policy regarding expenditure and revenue medium-term policy, are not taken in spring, but in autumn along with the *Annual State Budget Law*. Therewith this section further provides information on the fiscal policy decisions that have been adopted, by the government preparing the Budget 2018 and the *Framework Law* for 2018 – 2020.

The *Framework Law* for 2018 – 2020 implements the general fiscal policy objective – to raise sustainably the quality of life of population – with four medium-term budget priority courses of development:

1) increase of the public defence capacity, ensuring the public defence funding in the amount of 2% of GDP;

2) provision of sustainable and balanced country's economic development, by introducing 0 per cent CIT rate for reinvested profit, reducing the labour tax burden and, within the scope of the state budget possibilities, primarily ensuring the increase of funding for defence, internal security, healthcare, improvement of demographic situation and maintenance of motorways;

3) reduction of inequality in population's income, by increasing the minimum monthly wage, introducing the PIT annual differentiated non-taxable minimum and differentiating the PIT rate;

4) gradual increase of the amount of tax revenue to 1/3 of GDP, by primarily improving efficiency of tax collection.

Latvian fiscal policy medium-term budget priority courses of development in preparation of the Budget 2018 and the Framework for 2018 – 2020 are, basically, unchanged, as compared to the previous budget cycle, however the policy measures for implementing these courses have been adjusted. The formulation of the first course has been adjusted, stating that 2% of GDP funding is ensured in all years of the *Framework Law*, in the second and the third course the policy measures have been supplemented with the most essential tax reform measures and in the second course the fields are enumerated, in which the State budget funding has been increased the most by the current *Framework Law*.

Implementation of the **first priority course of development** has been commenced already on 3 July 2014, by adopting the new *State Defence Financing Law*, which provided for a gradual increase in the national defence funding to GDP until it reaches 2% of GDP in 2020. Given the significant changes in the geopolitical risks, in the Latvia's Stability Programme for 2015 – 2018 the government planned to provide a more rapid increase in the national defence capacity reaching 2% target already in 2018. In the *Framework Law* for 2016 – 2018 the government approved such additional increase for defence expenditure, which in 2018 will ensure the increase of defence expenditure reaching 2% of GDP. The current *Framework Law*

provides that the funding for defence in the amount of 2% of GDP is determined for all years of the *Framework Law*.

Table 3.4. Amount of budget expenditure for financing the defence sector stated in the *State Defence Financing Law*

Year	Amount of expenditure for defence provided for 2018 - 2020 by the law <i>On the State Budget for 2018 and the Framework Law</i> , % of GDP
2018	2.0
2019	2.0
2020	2.0

Implementation of the second priority course of development. The government, within the scope of development of the Budget 2018 and Framework Law for 2018 – 2020, resolved to define as priorities the State defence, healthcare, promotion of demography and maintenance of motorways.

The decision on significant increase of defence funding has already been adopted in the previous two Framework Laws, incorporating the strengthening of not only external, but also internal defence. In turn, the maintaining and inclusion in the top of the list other priorities – healthcare, demographics and maintenance of motorways, derives from the fact that in these key sectors, which form the cornerstones for successful development of the national economy, the problems have been already accumulating for several years.

Health sector has protractedly functioned under the circumstances of too low public funding, which, in turn, as considerably increased the patient co-payment, significantly impeding the satisfaction of the health needs of large part of patients. Increase in funding for health sector is ensured, by increasing the SMSIC rate by one percentage point and allocating it to healthcare, and by means of an authorisation from the EC to apply SGP flexibility tool with respect to structural reforms. It should be noted that the increase of the SMSIC rate ensures stable additional funding for health sector, but the permissible deviation from MTO due to structural reforms is in effect only till 2019. The current *Framework Law* states that in 2020 the loss of funding of the deficit deviation is fully compensated, by granting 144 million euro to health sector from the fiscal space of 2020. Therewith, a stable growth of funding for health sector is ensured.

To ensure sustainable economic growth above 3% of GDP, it is necessary to ensure three factors – gross fixed capital increase, productivity increase and labour force increase. The first factor is largely stable. In Latvia, the increase in labour force is not forecasted, either, because the increase in the retirement age only compensates the reduction of the number of population. Therefore, along with raising productivity, which in the medium term is the key factor for ensuring potential GDP growth, it is also important to implement the policy that would ensure the increase in labour force. In this respect, it is important to create economically favourable circumstances for increase in the number of families with three and more children. Therefore, in the current Framework Law a considerable increase of funding is granted for demographic measures – in 2018 additional funding of 28 million euro has been granted with the base effect on the subsequent Framework years. Basically, it is planned to allocate the additional funding for increase in the benefits for the third child and more children.

Funding for repairs and maintenance of Latvian motorways has been comparatively low, as compared to the neighbouring Baltic States, and the majority of funding is made up by the funding of the EU structural funds. In the subsequent years, the funding of the EU structural funds will decrease considerably, because the road sector has actually already acquired the funding of the EU structural funds granted thereto. These circumstances last year made the issue

on State budget funding for road sector to be very topical, making it necessary to emphasise the issue on linking the fuel excise duty to the road sector funding, as well as to incorporate in the law *On Motorways* regulations that would ensure stable and foreseeable State budget funding growth. At present, the issue is systemically not yet solved and in the following years the discussions are planned regarding the optimal mechanism, *inter alia*, restoration of the potential motorway fund as a special budget. The current Framework Law, as a medium-term solution, provides for increase in funding for maintenance of motorways by 26 million euro in 2018 with the base effect on 2019 and by another 11 million euro in 2020, and it is the most significant increase of funding for this sector in recent years. This increase of funding, in terms of amount, can be compared to the growth of revenue from the increase of the excise duty for fuel adopted within the set of tax reform and conceptually marks the link between new policy measures for fuel excise and expenditure dynamics for the road sector. Together with the planned release of 6% reserve of the EU structural funds for the road sector, it is estimated that these measures would allow ensuring the scope of repair and maintenance works of the roads at the current level.

When assessing **the implementation of the third priority course of development**, in the context of the quality of life of population, it is justified to analyse the average quality of life of population and differences in the quality of life between people with different income levels. An important indicator for the assessment of the average quality of life is GDP per capita, which in Latvia is one of the lowest in the EU (GDP per capita in 2017 is 13 900 euro), while the Gini coefficient, which characterizes the income inequality, in Latvia is one of the highest in the EU (34.5% in 2017).

A number of significant provisions were incorporated in the previous two *Framework Laws* to reduce income inequality of population, such as an increase in the PIT non-taxable minimum, increase in PIT allowances for dependents, improvements in the State social assistance system, and the support scheme to low income households to offset the increase in electricity expenses due to the abolition of the starting tariff since the electricity market was opened, increase of the minimum wage, as well as the introduction of the differentiated non-taxable minimum. The current *Framework Law* provides for the continuation of the launched government policy and the implementation of majority of the tax reform measures approved by the government and the Saeima already starting from 2018 – by raising the minimum wage in 2018 from 380 to 430 euro, significantly increasing the PIT exempt differentiated minimum (refusing from application of the differentiated non-taxable minimum under summarising procedure, and applying it to a full extent on a monthly basis already during the taxation year): In 2018, depending on the level of income, it will range from 0 to 200 EUR per month, in 2019 – from 0 to 230 EUR per month, and in 2020 – from 0 to 250 EUR per month, ensuring a reduction of the electricity mandatory procurement component, as well as a range of events dedicated to solve demographic problems. However, the most significant policy instrument for reducing income inequality is the introduction of a progressive PIT rate, reducing the PIT from 23% to 20% for annual income up to 20 000 EUR.

According to the estimates of the MoF, the tax reform approved in 2017 for labor force measures will have a positive impact on reducing the income inequality of working population. Particularly the income of lower-paid employees will increase substantially as a result of increase of the PIT non-taxable minimum, drop of the PIT from 23 to 20% (income up to EUR 20 000 per year, or EUR 1 667 per month), as well as from increase in the minimum monthly wage from the current 380 to 430 EUR.

Table 3.5. Impact of labor tax reform on the wages of employees (without dependents), euro per month

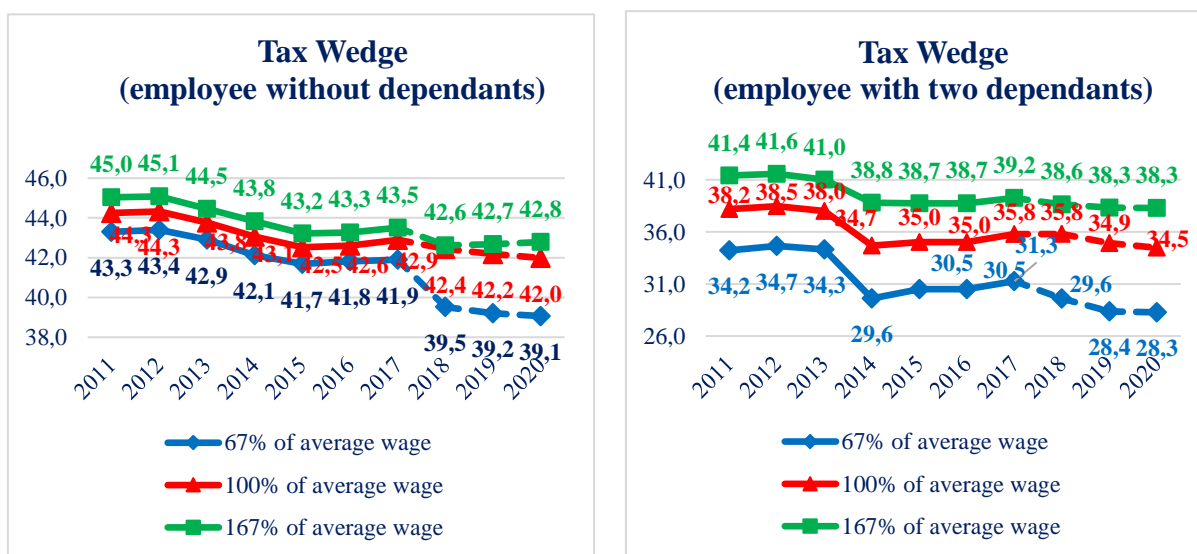
Gross salary	Net income, euro per month						
	2017*	Tax reform			Difference comparing to 2017		
		2018	2019	2020	2018	2019	2020
Minimum wage**	288	346	352	356	58	64	68
600	436	456	462	467	19	26	30
800	571	584	591	596	13	20	25
1 000	705	712	719	725	7	14	20
1 200	841	854	854	854	14	14	14
1 400	979	997	997	997	18	18	18
2 000	1 392	1 414	1 414	1 414	22	22	22
4 000	2 770	2 778	2 778	2 778	8	8	8
6 000	4 149	4 142	4 142	4 142	-7	-7	-7
8 000	5 527	5 506	5 506	5 506	-21	-21	-21
10 000	6 905	6 870	6 870	6 870	-35	-35	-35

* Taking into account the additional recoverable PIT by submitting the annual income declaration in 2018.

** Minimum wage: 380 euros per month in 2017; in 2018. – 2020.g. 430 euros per month

Source: MoF calculations

According to the calculations of the MoF, implementing the planned labor tax changes, the tax wedge for employees without dependants, who receive 67% of the average salary in Latvia, will decrease from 41.9% in 2015 (Eurostat data) to 39.1%.



Source: MoF calculations

Figure 3.3. Changes in the tax wedge after the tax reform

According to the MoF assessment, the tax reform will have a positive impact on the Gini coefficient for employees as well as it will ensure, that there will be the largest PIT allowance for dependent persons among the Baltic States.

Regarding the fourth priority course of development, Latvia has traditionally been the country with comparatively low tax burden, which is also one of the lowest in the EU. In previous Framework Laws, aim to increase tax revenue to 1/3 of GDP was set as a priority. Also in this Framework Law this objective has been maintained, but the emphasis is different.

As previously mentioned, in 2017 an ambitious tax reform, that aims at ensuring a breakthrough in the economy, was adopted, which includes measures that have a direct effect on the medium-term decline in revenue, both as a reduction in the PIT rate and the cancellation of advance payments of CIT. These measures were needed to improve the business environment by reducing labor costs and facilitating the improvement of corporate balance sheets. In this sense, the goal of fiscal policy – to boost growth and raise tax revenues against GDP – is somewhat contradictory and the current Framework Law finds a politically acceptable balance between these goals. The adopted package of tax reforms in this regard is more favourable for securing GDP revenue than the version of the reform described in the previous Stability Program, which set the objective of economic stimulus at the forefront. At present more than in previous years, it has been recognized that it is important to ensure a real increase in revenue to finance national needs rather than focusing primarily on the revenue-to-GDP ratio. If a country provides a longer-term increase in real GDP with policy measures, which contributes to a proportionately higher real income, the revenue-to-GDP ratio is not primarily decisive. Consequently, this priority development direction is not being cancelled, but the question on how quickly this ratio converges to 1/3 is not raised at the forefront, but rather the economic growth is the issue of primary importance.

In order to grant additional funding for the priority courses of development of the medium-term budget, as well as to finance the urgent measures, the fiscal space is needed.

The fiscal space was calculated and reviewed at the 22 August 2017 Meeting of the Cabinet, where the informative report "On the forecasts of macroeconomic indicators, revenue and general government budgetary balance for 2018. – 2020" was reviewed. According to the calculations of the MoF, the initial volume of "fiscal space" in the general government budget in 2018 was +63.2 million EUR, in 2019: – 42.0 mln EUR and in 2020: +107.3 million EUR. Taking into account that for 2019 the fiscal space was initially negative, the Cabinet had to adopt the decisions, which would not only eliminate the negative fiscal space in 2019, but would also ensure the financing of urgent needs. Consequently, decisions were taken at a number of successive Government meetings on measures correcting budget revenues and expenditures.

Table 3.6. Revenue increasing measures (above 1 mln EUR)

The most important proposals approved by the Cabinet, mln. EUR	2018	2019	2020
"Complex measures for the development of the electricity market" (changes in AS "Latvenergo" dividends)	-27.5	3.4	127.1
Payments to the state budget specified by the Bank of Latvia	7.6	7.6	7.6
Changes in revenue from fines imposed by the State Police on road traffic violations fixed by technical means and other measures related to the improvement of road traffic control	6.3	9.8	8.1
introduction of a reduced VAT rate of 5% to fruits, berries and vegetables characteristic to Latvia.	-6.0	-6.0	-6.0
Changes in revenue from dividends paid by state corporations (incl. increase of payable part, specification of profit forecast, additional dividends from JSC <i>Latvijas valsts meži</i> and JSC <i>Latvijas Lotto</i>)	5.7	5.5	3.0
Increase in VAT revenue related to the grant for public transport service providers for covering losses in relation to fare reliefs	2.5	2.5	2.5
Increase of the forecast of other basic budget non-tax revenue	2.1	4.2	4.7
<i>Increase in revenue from realization/ sale of property of forfeit proceeds from crime and additional penalty</i>	<i>1.5</i>	<i>2.0</i>	<i>2.0</i>
<i>Increase in revenue from the sale of the state-owned property following a decision taken by other state institutions</i>	<i>0.1</i>	<i>0.5</i>	<i>0.5</i>

Revenue increase from reimbursement of received and unused budgetary funds in previous years of state budget institutions and organizations	0.5	1.7	1.2
Increase in revenue from the sale of state (municipal) property and capitalization of the tax basic debt	-	-	1.0
Changes in the method of calculation of the state fee for registration activities in the register of construction companies	1.0	1.0	1.0
Increase of tax revenue related to the planned check lottery	0.0	3.3	3.3
Other non-tax measures	1.4	1.5	1.4
Other tax measures	0.1	0.6	0.6

In turn, the increase in funding has been implemented in sectors, defined by the government as medium-term priorities.

Table 3.7. Areas with the most significant increase in funding (above 1 mln EUR) and the most essential expenditure increasing measures

Name of the measure	2018	2019	2020
01. In total, Chancery of the President:	0.0	0.0	0.0
02. In total, Saeima:	0.1	0.1	0.1
03. In total, Cabinet:	0.5	0.5	0.3
04. In total, Corruption Prevention and Combating Bureau	1.0	1.0	1.2
05. In total, the Ombudsman:	0.1	0.2	0.1
08. In total, Society Integration Foundation:	0.4	0.4	0.4
09. In total, Public Utilities Commission:	0.5	0.5	0.5
10. In total, Ministry of Defence:	9.0	0.9	0.9
Other measures (reallocation of funds (including implementation of EU funds), revenue from paid services and increase in other own revenue, etc.)	8.1	0.0	0.0
11. In total, Ministry of Foreign Affairs:	3.1	1.6	1.5
Strengthening Latvia's Diplomatic and Consular Service to defend security and basic economic interests of Latvia	1.7	1.7	1.7
12. In total, Ministry of Economics:	10.1	-17.1	26.9
State guarantees for bank loans for the purchase or construction of housing	4.0	4.0	4.0
Other Decisions taken by the Cabinet (including clarified financing for the support of electricity users)	4.3	-22.8	21.4
13. In total, MoF:	-28.9	-16.6	43.0
Capacity building of institutions of the MoF, incl. for fight with the shadow economy, for achieving the strategic objectives of the SRS (including the remuneration of customs officers, inspectors and financial police)	3.1	3.1	3.1
Continuation of the reform of the administrative structure of the SRS, including the APA (advance agreement on fixing the price) and the transfer pricing capacity building	1.5	1.5	1.5
Other measures (reallocation of funds (including implementation of EU funds), revenue from paid services and increase in other own revenue, etc.)	-12.2	3.4	0.7
Other decisions made by the Cabinet (i.e., clarification of expenditure for the servicing of the state debt, contributions to the EU budget, additional financing for the financing of SRE projects)	-22.8	-26.1	30.4
14. In total, Ministry of the Interior:	18.8	17.0	19.4
Construction of the state border of the Republic of Latvia with the Russian Federation and the Republic of Belarus	3.7	4.0	8.0
Maintenance of the State Border of the Republic of Latvia	1.7	3.0	1.8

Enhancement of the security of the infrastructure of information and communication technologies for the interior sector (information is classified)	1.5	1.5	1.5
Other measures (reallocation of funds (including implementation of EU funds), revenue from paid services and increase in other own revenue, etc.)	3.2	1.5	0.8
Other Decisions taken by the Cabinet (incl. expenses for administering the activities of photo radars, activities of the State Border Guard)	4.2	4.8	4.1
15.In total, Ministry of Education and Science:	19.3	10.1	13.3
Increase in the wages of teachers of higher education institutions under the Ministry of Education and Science	2.2	4.4	4.4
Ensuring the operation of the program of fundamental and applied research projects	1.4	1.4	1.4
Ensuring the fulfilment of state functions in the sport sector at a unchanged level	2.4	2.4	2.4
Additional investments for the implementation of state-owned sports infrastructure development projects	5.9	0.0	4.0
Creation of paralympic sports centre	1.2	0.0	0.0
Other measures (reallocation of funds (including implementation of EU funds), revenue from paid services and increase in other own revenue, etc.)	5.0	1.9	0.4
16.In total, Ministry of Agriculture:	4.8	2.4	2.3
For State Forest Service for the purchase of specialized fire-fighting vehicles	2.5	0.0	0.0
For increasing the administrative capacity for monitoring, ensuring control functions, the fight against animal and plant infectious diseases and the management of EU funds, as well as partial compliance with the Personal Data Protection Regulation, data security, accessibility and legitimacy, and the integration and development of ICT systems.	1.5	1.5	1.5
17.In total, Ministry of Transport:	6.7	2.6	2.6
Railways public infrastructure	4.0	0.0	0.0
Other decisions made by the Cabinet (including a grant to public transportation service providers for covering losses in relation to fare reliefs)	2.5	2.5	2.5
18.In total, Ministry of Welfare:	40.6	44.5	45.2
Increase of the family State benefit	28.2	32.5	32.5
For social institutions for capacity building and social programs in the field of child rights protection and adaptation of IT systems related to these activities	2.6	1.3	1.3
Development of alternative family care forms	3.0	3.0	3.0
Other measures (reallocation of funds (including implementation of EU funds), revenue from paid services and increase in other own revenue, etc.)	-0.7	2.2	2.8
Other decisions adopted by the Cabinet	3.2	2.8	2.8
19.In total, Ministry of Justice:	-15.5	-15.7	12.8
Ensuring operation of the Constitution protection Bureau (classified information)	1.1	0.5	0.5
Modernization of public registers of Enterpincrease registry	1.1	0.0	0.0
Prison infrastructure repair and improvement	1.0	1.0	1.0
Other measures (reallocation of funds (including implementation of EU funds), revenue from paid services and increase in other own revenue, etc.)	7.2	3.5	3.4
Other decisions made by the Cabinet (including the reduction of grant from the general revenue and expenditure for the	-27.4	-21.7	6.8

implementation of the long-term commitment "Implementation of a new prison in Liepaja")			
19. In total, Ministry of Justice (Land Registry Divisions, District (City) Courts, Regional Courts):	0.5	0.2	2.9
Increase of remuneration of judges	0.0	0.0	2.7
21. In total, Ministry of Environmental Protection and Regional Development:	13.1	2.3	-1.0
Strengthening environmental monitoring (incl. salaries for inspectors)	1.5	1.5	1.5
Other measures (reallocation of funds (including implementation of EU funds), revenue from paid services and increase in other own revenue, etc.)	8.9	0.8	-2.6
22. In total, Ministry of Culture:	11.4	10.2	10.5
Sacral heritage conservation program – Riga Sv. Jēkaba Roman Catholic Church Cathedral, Riga Dome Church, Aglona Roman Catholic Basilica, Lestenes Church	2.0	0.0	0.5
Target program for the production of historical and identity – enhancing Latvian films	0.0	0.5	1.0
Other measures (reallocation of funds (including implementation of EU funds), revenue from paid services and increase in other own revenue, etc.)	1.9	1.0	-0.3
Other decisions adopted by the Cabinet	2.8	4.8	4.4
24. In total, State Audit Office:	0.3	0.3	0.3
25. In total, Cross-Sectoral Coordination Centre:	0.0	0.0	0.0
28. In total, Supreme Court:	0.1	0.0	0.5
29. In total, Ministry of Health:	17.3	11.9	11.8
Funding for the reform of the teachers payroll for the Riga Stradiņš University	0.7	1.4	1.4
Other measures (reallocation of funds (including implementation of EU funds), revenue from paid services and increase in other own revenue, etc.)	5.7	0.3	0.1
Other Decisions taken by the Cabinet (incl. expenses for raising the minimum monthly salary to 430 EUR by 1 January, 2018)	10.2	10.2	10.2
30. In total, Constitutional Court:	0.2	0.4	0.4
32. In total, Prosecutor's Office:	0.9	-1.4	4.5
Repair works of office buildings of the Prosecutor's Office on Kalpaka bulvaris 6, Riga	0.1	0.4	1.3
Increase of remuneration of prosecutors	0.0	0.0	2.3
Other decisions adopted by the Cabinet	0.2	-2.3	0.4
35. In total, Central Election Commission:	0.0	0.0	0.0
37. In total, Central Land Commission:	0.0	0.0	0.0
47. In total, Radio and Television:	1.0	0.8	0.8
62. In total, targeted grants to municipalities:	2.9	2.9	2.9
Other decisions adopted by the Cabinet	2.9	2.9	2.9
64. In total, grant to municipalities:	21.1	144.9	239.1
Other Decisions taken by the Cabinet (including compensation to local governments in order to secure tax revenue from the local government budget together with a special grant of 19.6% of the general budget tax revenue)	21.1	144.9	239.1
74. "Funding to be Redistributed within the Process of the Annual State Budget execution"	-18.1	-37.3	-114.1
Providing health financing	0.0	0.0	144.0
Other measures (reallocation of funds (including implementation of EU funds), revenue from paid services and increase in other own revenue, etc.)	-16.5	-8.5	-4.0

Other Decisions taken by the Cabinet (including clarification of the amount of LNG, reduction of financing in the appropriations for the reserve)	-1.5	-28.7	-25.9
State special budget	-9.5	-12.3	-12.6
Strengthening the administrative capacity of the State Social Insurance Agency	1.6	1.6	1.6
Other Decisions taken by the Cabinet (incl. fin. reduction for old-age pensions, reduction of expenses for unemployment benefits in relation to the forecasted decrease in the number of beneficiaries)	-11.3	-14,0	-14.3
Adjustment - excludes funding for raising the minimum wage to EUR 430 and ensuring an increase in employer's state social insurance contributions, which is already included in the scenario of invariable policy	-28.1	-28.0	-28.0

3.2.4. FISCALLY SIGNIFICANT STRUCTURAL REFORMS WITHIN THE MEANING OF REGULATION NO 1175/2011

3.2.4.1. REFORM OF THE PENSION SYSTEM

In 2012, amendments were made to the Law on State-Funded Pensions prescribing a gradual increase in the contribution rate to the second pillar of the pension system, i.e., amounting to 4% in 2013 – 2014, 5% in 2015 and 6% in 2016. The policy does not change. In the previous Stability Program, in the formulation of budget balance targets for 2018, a derogation from the MTO allowed by the SGP in implementing these structural reforms was still applied. In turn, in this Stability Program, deviations from the MTO no longer include the effects of the pension reform, since the possibility of using these derogations from 2019 is no longer valid.

In general, the pension reform is more extensive and comprises also other measures apart from the increase in the contribution rate to the second pension pillar. Recent reforms, coming into force in 2017 and 2018, are described in Section 7.1. under the heading "Long-term development scenario of public finances".

3.2.4.2. REFORM OF THE HEALTH SYSTEM

In the Stability Program for 2016 – 2019, Latvia announced the reform of the health system as a major structural reform with a long-term positive effect on the sustainability of public finances, with the aim of extending this reform to a deviation from the MTO (middle term objective) in accordance with EC communication (Communication from the EC of 13 January 2015 to the European Parliament, the Council, the European Central Bank, the Economic and Social Committee, the Committee of the Regions and the European Investment Bank on the best use of the flexibility in the SGP (COM(2015) 12)). The EC reviewed Latvia's declaration and supported granting of the deficit deviation for the health system reform. In order to comply with the structural deficit safety margin with respect to the reference value prescribed by the Treaty on the Functioning of the EU in amount of 3% of GDP¹⁰, the deficit deviation granted to Latvia comprises 0.13% of GDP in 2017, 0.40 % of GDP in 2018 and 0.50% of GDP in 2019.

¹⁰ For Latvia this index is determined in amount of 1.7% of GDP.

**Table 3.8. Budget deficit tolerable derogation
for implementation of the reform of the health system, %**

		2013	2014	2015	2016	2017	2018	2019	2020
MTO		-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
Pension reform	from 2% to 4%	-0.50	-0.50	-0.50	0.00				
	from 4% to 5%			-0.27	-0.27	-0.27	0.00		
	from 5% to 6%				-0.29	-0.29	-0.29	0.00	
Maximum structural balance		-1.80	-1.80	-1.80	-1.80	-1.69	-1.69	-1.69	
Health reform deficit deviation						-0.13	-0.40	-0.50	

It should be noted that three reforms in the field of healthcare are being discussed in Latvia:

1. Implementation of the “Public Health Guidelines for 2014 – 2020”;
2. Reform of the health funding;
3. Reform of the health system administration.

Implementation of the “Public health guidelines for 2014 – 2020”

Deficit deviation was requested and received for the implementation of the "Public Health Guidelines for 2014 – 2020". The healthcare reform is being implemented from 2014 in accordance with the "Public Health Guidelines for 2014 – 2020" approved by the Cabinet, and the main aim thereof is to prolong the healthy years of life of the Latvian population and to prevent premature deaths, while maintaining, improving and restoring health.

Weaknesses of the Latvian health system mainly refer to the following indicators:

- **Low public funding.** The amount of public funding for health as a percentage of GDP is significantly below the EU average and points to insufficient funding for this sector (see Figure 3.4).
- **Inequality.** The general government funding in the total funding of the health financing system is considerably below the EU average (in Latvia – 57.5%, in the EU – 72.2%)¹¹. This means, that availability of medical services depends on person’s income more than in other countries.
- **Large number of premature deaths due to health problems.** In 2016, the total PYLL (0 – 64 years) was 5 366 years¹² per 100 000 inhabitants, which is a high indicator among the developed countries. A significant part of this indicator can be explained by health problems.

¹¹World Health Organisation data, data for 2015.

¹²Data source: Centre for Disease Prevention and Control.

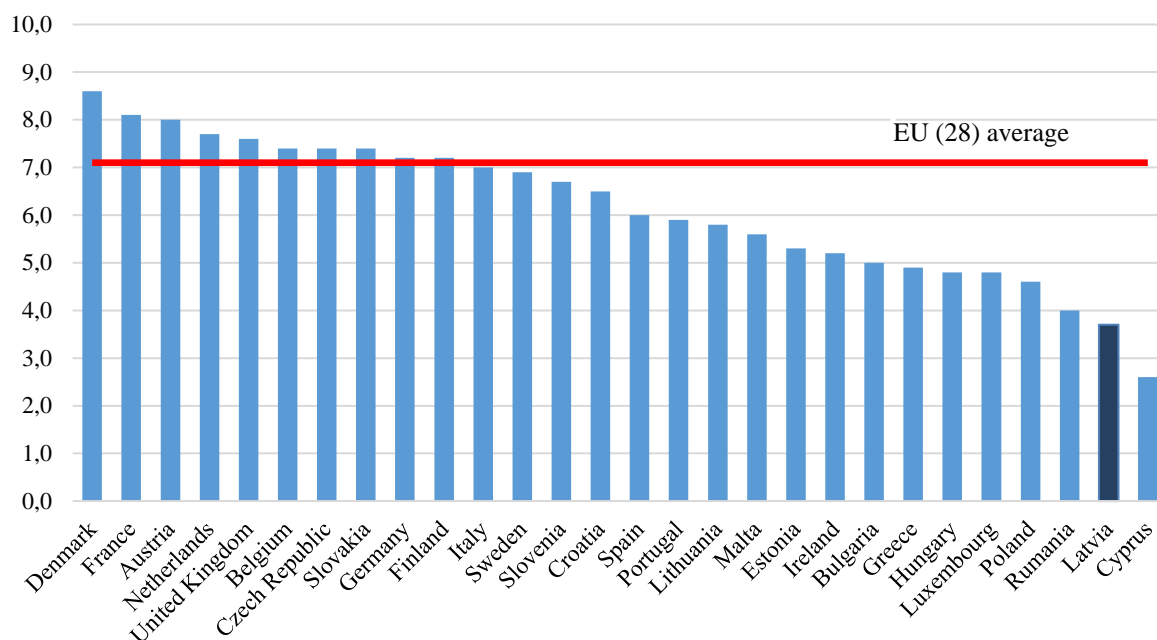


Figure 3.4. Public expenditure for healthcare in 2016 in the EU member States ¹³, % of GDP

It should be noted that these factors are interrelated. The low level of public funding causes a need to finance part of medical services through private funding, but it, in turn, discourages the citizens that cannot afford to invest their private funding to take timely treatment and increases PYLL.

The EU Council already from 2014 has pointed out the above mentioned shortcomings of the Latvian health system, in the context of country specific recommendations, identifying annually that it is necessary to improve the cost–effectiveness, quality and availability of the health care system. Besides, it is pointed out that there is a clear public under–financing of the healthcare sector that negatively affects access to healthcare services for vulnerable members of society.

In the latest country–specific recommendations for 2017¹⁴, **the Council recognizes that Latvia has successfully launched health care reforms**, but access to health care is still limited by high direct payments, long waiting lists, low public funding and inefficient distribution of services. Problems can also be observed in health care efficiency. As a result, the Council recommends Latvia to increase the cost efficiency and accessibility of health care, including reducing direct payments of recipients and long service waiting time.

Within the scope of development of "Public Health Guidelines for 2014 – 2020", the Ministry of Health commissioned a study "Evaluation for the Development of the Public Health Guidelines 2014 – 2020", developed by the University of Latvia. Within the scope of the study **the evaluation of the economic gain** of the indicators of the objectives to be included in the "Public Health Guidelines for 2014 – 2020", arising out NDP 2020, was carried out. As a result, it is concluded that, by ensuring the necessary funding for achieving the reduction of the PYLL indicator set by the NDP 2020 till 2020, the value of the discounted economic benefit in 2014 would make 137.4 mln euro. At the same time, the study points out that a positive impact on

¹³Data source: *Eurostat*

¹⁴ Recommendations have been approved on July 11, 2017. The recommendations do not take into account the additional funding granted in 2018 and the progress made in implementing the health reform in the second half of 2017 and in the first quarter of 2018.

national economy would be generated by the fact that the inhabitants "saved" by 2020 will be able to provide productive input as a labour force for the subsequent 20 years, thus ensuring the GDP growth in amount of at least 443.8 mln EUR (discounted value of 2014). Within the scope of the study the **cost-benefit analysis** was also carried out, resulting in the finding that the additional amount of expenditure to be allocated for achievement of the target for the age group of up to 64 years for the period from 2013 – 2020 in present value compincreases 577 million EUR. Thus, according to the study, it can be concluded, that the additional estimated cost for the period from 2013 to 2020 in the pessimistic scenario exceeds the economic benefits during the relevant period, but in the case of a realistic optimistic scenario, the economic benefits are higher than the investments made in 2013 – 2020 (see Table 3.8)

Table 3.9. Summary of the costs and benefits of the study, mln EUR

Indicator	Economic benefit		Costs
	2013 – 2020	2013 – 2040	2013 – 2020
Reduction of the PYLL indicator until 2020 according to NDP 2020 – <u>pessimistic scenario</u> ¹⁵	137.4	443.8	577
Reduction of the PYLL indicator until 2020 according to NDP 2020 – <u>realistically optimistic scenario</u> ¹⁶	254.9	823.5	

Looking at the results of the study from the perspective of cost-efficiency of the implemented reforms, it is concluded that until 2020 in case of the pessimistic scenario 10 059 PYLL will be prevented, but in case of realistically optimistic scenario – 18 666 PYLL, so the average cost per PYLL prevented in this age group is respectively 57 362 euro in case of pessimistic scenario and 30 912 euro in case of realistically optimistic scenario.

According to the performed estimate, successful implementation of the health reform until 2023 will ensure the growth of GDP rate by 2.2% and will increase the employment of population by 0.6%. While the positive impact of the reform until 2038 might ensure the growth of GDP rate already by 11.26% and the growth of employment, respectively, by 1.81%. Considering fiscal costs, net positive impact on national economy in 2038 will reach 4.83% of GDP.

As compared to other sectors, Latvia during the period of time from 2014 to 2020 has managed to ensure significant increase of funding for the healthcare sector. It has been specifically attained, by means of the SGP flexibility clause in the implementation of the health reform. In addition, from 2018, substantial additional revenues from the increase of the SMSIC (State mandatory social insurance contributions) rate by 1 percentage point are allocated for the financing of the health system.

Table 3.10. Additional funds granted to the health sector according to the medium-term budget framework laws, mln EUR

	2014	2015	2016	2017	2018	2019	2020
Framework Law 2014 – 2016	42	48.9	51				
Framework Law 2015 – 2017		30.6	30.6	30.6			
Framework Law 2016 – 2018			23.3	23.3	23.3		
Framework Law 2017 – 2019				34.3	113.4	149.4	
Framework Law 2018 – 2020					32.0	32.5	32.8

¹⁵The amount of benefits, assuming that the aim of NDP 2020 to reduce PYLL (up to 64 years of age) indicator to 5, 300 per 100 000 inhabitants in 2020 is fulfilled.

¹⁶Amount of benefits, assuming that the PYLL reduction forecasted by the Centre for Disease Prevention and Control till 4 786 years per 100 000 inhabitants is achieved in 2020.

Additional expenditure increases in comparison with previous year (cumulative)	42	37.5	25.4	34.3	111.1	36.5	0.3
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With the above mentioned increase of the funding Latvia has, in general, managed to ensure the growth of funding for the healthcare sector in accordance with the growth of funding planned in the "Public Health Guidelines for 2014 – 2020"(see table 3.9 and figure 3.5).

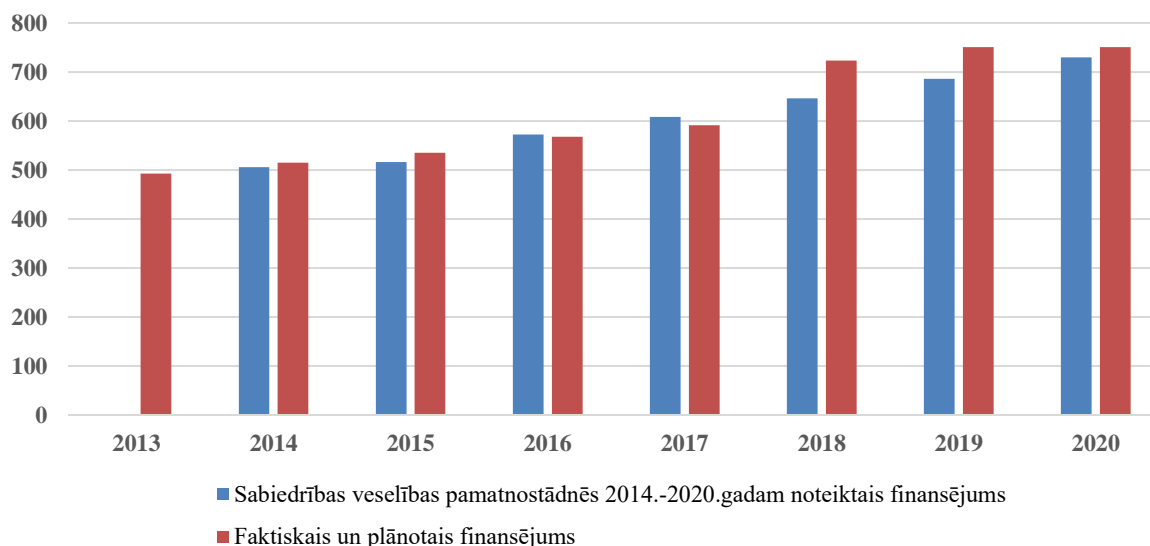


Figure 3.5. Scenario of the growth of funding applied in the Guidelines and the actual growth of funding mln. euros¹⁷

Scenario shown in the figure was used in the previous Stability Programmes, when carrying out the assessment of the fiscal impact of the proposed reform. Therewith, provided that the assumptions used in the assessment remain in effect, **there are grounds to believe that the assessment of the fiscal impact is maintained and the achievement of the PYLL objective is ensured.**

Deficit deviation funding for the period of 2017 – 2019, which is available due to implementation of the healthcare reform – “Implementation of the Public health guidelines 2014 – 2020” – is being used for a group of certain healthcare measures, arising out of the "Public Health Guidelines 2014 – 2020". This group of measures is separated from the rest of measures for improvement of healthcare, stipulating a special procedure for granting and supervision of allocation of resources.

At the same time it should be noted, that, when choosing the health reform measures, for which the deficit deviation funding is to be used, the following criteria are set:

1. The measure must correspond to the "Public Health Guidelines 2014 – 2020";
2. The outcome of the measures financed from the deficit deviation funding in the period of 2017 – 2019 must solve or considerably reduce a certain problem identified in the healthcare system. Measures, which provide for an insignificant effect in solving the problem, may not be financed – such intervention is not to be regarded as reform;

¹⁷The total MoH budget for core functions, mln EUR, years 0 – 64 : scenario in accordance with the research of the University of Latvia: “Evaluation for the Development of the Public Health Guidelines 2014 – 2020” and the actual funding for the above mentioned target group, including the deficit deviation funding.

3. Problem to be solved must be recognised as a healthcare problem in the EC analytical documents.
4. It is possible to create a traceable inputs – outputs – outcome indicator system.
5. The solvable problem provides an input to achieving a positive fiscal effect of the "Public Health Guidelines 2014 – 2020".

The allocated financing of the deficit derogation for the period 2017 – 2019 in the State budget law of the respective year was distinguished in the separate budget programme, as the financing to be redistributed as a result of the annual State budget execution. Only after the Ministry of Health's proposals regarding the use of funding are approved by the Cabinet, the reserved funding is reallocated to implement health reform.

The deficit derogation financing of year 2017 of 0.13% from GDP (34 mln EUR) for the Ministry of Health was redistributed in two stages – on December 20, 2016 and on February 14, 2017 with separate Cabinet decisions, on the basis of informative reports, coordinated with the MoF and specifying the output and outcome indicators. The decisions of the Cabinet protocol intended that the Ministry of Health would control the implementation of the outcome indicators specified in the informative report and information on the progress of the performance indicators in 2017 until March 1, 2018. Simultaneously Ministry of Health carries out the data accumulation, in order to ensure the audit traceability for the fulfilment of the output indicators. The text below provides information on the implementation of the health reform in 2017.

Measure No.1. Improvement of availability of diagnostics and treatment of oncological diseases

Reforms in the field of oncology intend faster patient investigations and access to professionals or more frequent location of the "green corridors" in cases of oncologic illness or suspected cases of oncological illness. The reforms that were launched in the beginning of 2017 provided the implementation of primary diagnostic algorithms in 72 medical institutions, the increase of expert counselling costs in oncology according to established algorithms and the introduction of secondary diagnostic, investigation algorithms in 5 medical institutions, increase of the number of outpatient oncological patients and estimated cost of treatment in 6 medical institutions and increase in the number of oncological patients and the estimated cost of treatment in 7 inpatient facilities, as well as the compensable medication for the increase in the number of unique patients.

Primary diagnosis

In 2017 it was forecasted that additionally 22 thousand patients will be screened for early diagnosis of malignant tumors in locally defined primary diagnostic algorithms for oncological diseases. From January 1, 2017, primary diagnostic algorithms were introduced in 11 most common locations, which were supplemented from November 3, 2017, with other localizations.

Table 3.11. Performance of introduction of the primary diagnostics algorithms

Introduction of the primary diagnostics algorithms	Estimated volume of treatable unique oncological patients			The actual performance for treatable unique oncological patients volume		
	Estimated quantity of patients per year	Funding in 2017, EUR	Average cost in 2017, EUR	The increase in the number of patients in 2017	Funding in 2017, EUR	Average cost in 2017, EUR
72 health care institutions	22 000	659 885	29.99	22 422	637 850	28.45

Source: NHS

Primary diagnosis of oncological illness occurs in the practice of general practitioners, where complaints and symptoms of patients are recognized, that may indicate an oncological illness and the first investigations that can confirm the suspicion of an oncological illness are prescribed. These services are paid as a priority, from financial resources for these purposes. In practice, a situation often arises that patients are being screened for other illnesses, but the result of the examination indicates suspicion of an oncological illness. In these cases, the first of 2017 and the algorithms developed in the framework of the reform in primary health care with the referral of the general practitioner, and later, in the second half of 2017, along with the transfer of other direct specialist, 72 849 primary diagnostic tests were performed for 22 422 unique patients, where the average costs for the implementation of primary diagnostic algorithms are 5% lower than planned. In general, the average cost of primary diagnosis is lower, since 88.18% of all trials were made by laboratory tests, which have lower costs than diagnostic examinations, which forms only 11.82% of total examinations.

Specialist consultations would facilitate early diagnosis and treatment of oncological diseases, patients require timely advice of a specialist. Consequently, within the framework of the oncology reforms, a significant increase in the availability of specialist consultations is planned, providing availability of the relevant specialist (according to the location of the malignant tumor) within 10 working days of referral to the medical institution or submission of the consultation.

According to the scope of availability, it was planned that in 2017, 11 thousand unique oncological patients, who are suspected of oncological illness and diagnosed disease, will use specialist consultations, also including specialist councils for setting the tactics of the treatment. Similarly, in 2017, the range of doctors, who are entitled to send patients to a specialist to receive a consultation in case of suspicion of malignant disease, was expanded. Such a referral can be issued not only by family doctors, but also by gynaecologists (within their competence) and by doctors in five specialized medical institutions.

Table 3.12. Fulfilment of specialist consultations

Specialist consultations according to the set algorithms	Estimated volume of unique oncological patients			The actual performance for unique oncological patients volume		
	Estimated quantity of patients per year	Funding in 2017, EUR	Average cost in 2017, EUR	The increase in the number of patients in 2017	Funding in 2017, EUR	Average cost in 2017, EUR
5 health care institutions	11 000	650 278	59.12	33 683	658 720	19.56

Source: NHS

In 2017, the coverage of consultations of oncological patients formed 306.21% of the annual planned number of unique oncological patients, widening the locations of malignant tumors from the "green corridor", thus continuing to increase the availability of specialists with other illness of malignant tumors.

Secondary diagnostics and examinations

The procedure for the diagnosis of malignant tumors for certain localities provides for treatment authorities specializing in the treatment of oncological diseases, following a specialist consultation, to carry out, as a matter of priority, all subsequent examinations for the secondary diagnosis of oncological patients that ensure the morphological confirmation of the oncological disease and its prevalence.

In 2017 there were planned 14.6 thousand secondary diagnostic oncological patients, to whom, according to the determined algorithms, morphological diagnostics, differential diagnosis, evaluation of the spread of the disease would be carried out.

Table 3.13. Fulfilment of secondary diagnostics and examinations

Secondary diagnostics and examinations	Estimated volume of treatable unique oncological patients			The actual performance for treatable unique oncological patients volume		
	Estimated quantity of patients per year	Funding in 2017, EUR	Average cost in 2017, EUR	The increase in the number of patients in 2017	Funding in 2017, EUR	Average cost in 2017, EUR
5 health care institutions	14 659	2 332 565	159.12	17 880	2 188 921	122.42

Source: NHS

In 2017, the coverage of oncological patients in secondary diagnosis and examinations reached 121.97 of the planned volume.

In the introduction of the system, in its initial phase, in not all cases the acquisition of full planned services was carried out. Consequently, in the first half of 2017, the coverage of treated oncologic patients was lower because of the time needed to adapt the changes in the system and initially the introduction of primary diagnostic algorithms was extended to the 11 most common allocations of malignant tumors which, ensuring equal access, from the end of 2017 are enlarged with other oncological diseases. Additionally, changes have been made in the provision of primary and secondary diagnostic services, thus improving the availability of services

Outpatient treatment

Within the framework of oncological reforms, it is planned to treat ambulatory patients using radiotherapy and chemotherapy methods. The aim of chemotherapy is to achieve full or possibly longer remission (weakening disease and decrease of symptoms) in tumor development, or to remove certain tumor cells circulating in the body (for the prevention of metastases). In turn, radiotherapy is applied to about half of all oncological patients in one of the stages of treatment. Radiotherapy is a highly required treatment method in oncology, based on the destructive effects of ionizing radiation on cancer cells.

In 2017, 3.3 thousand unique oncologic patients were planned to be provided with outpatient treatment using radiotherapy and chemotherapy according to the prescribed algorithms.

Table 3.14. Radiation and chemotherapy

Outpatient radiation and chemotherapy	Estimated volume of unique oncological patients			The actual performance for unique oncological patients volume		
	Estimated quantity of patients per year	Funding in 2017, EUR	Average cost in 2017, EUR	The increase in the number of patients in 2017	Funding in 2017, EUR	Average cost in 2017, EUR
6 health care institutions	3 306	1 178 058	356.34	1 996	1 164 114	583.22

Source: NHS

According to the actual implementation of 2017, the average outpatient treatment costs increased by 63.67% compared to the planned, due to the increase in the number of patients

undergoing long-term treatment and the increase in the number of patients in the use of radiotherapy treatment, which is a cost-effective treatment method. In 2017, available treatment with the most effective type of cure was provided through 138 911 manipulations for 1 996 unique patients.

Inpatient treatment

In the framework of oncological reforms, it is planned to treat oncological diseases in the hospital, providing timely operations. In order to implement faster oncological operations within the framework of existing stationary financing, from 1 April 2017, a surcharge for carrying out complicated primary oncological operation, decided upon by a doctor's council, is determined.

In 2017, 6 000 extra surcharges were planned in treatment institutions for a complicated primary oncology operation for patients with newly diagnosed oncological diseases.

Table 3.15. Fulfilment of stationary treated oncology patients

Treatment stationary	Estimated volume of treatable unique oncological patients			The actual performance for treatable unique oncological patients volume		
	Estimated quantity of patients per year	Funding in 2017, EUR	Average cost in 2017, EUR	The increase in the number of patients in 2017	Funding in 2017, EUR	Average cost in 2017, EUR
7 health care institutions	6 000	2 463 058	410.51	5 633	2 312 402	410.51

Source: NHS

When analysing the actual fulfilment, upon the entry into force on October 31, 2017 of the Regulations No.645 of the Cabinet "Amendments to Regulation No.1 529 of the Cabinet on December 17, 2013" Procedures for the Organization and Financing of Health Care ", premiums were calculated for carrying out a complex oncological operation also in cases of repeated, complicated surgery or complex surgery in several stages for a patient, carrying out only certain preparations for the next operation in the first one. According to the actual fulfilment of 2017, premiums were secured at 93.88% of the annual planned scope for oncology patients, which was explained by the fact, that medical treatment institutions needed an adaptation period to recognize cases.

Compensable medications

Within the framework of oncological reform, it is planned to treat oncological diseases outside ambulatory and inpatient treatment institutions, increasing the availability for patients, according to established algorithms, to receive compensable medications.

In 2017, the availability of compensable medications is planned to increase by 4.4 thousand oncology patients who have begun receiving therapy in 2017.

Table 3.16. Fulfilment of compensable medications

Compensable medications	Estimated volume of unique oncological patients			The actual performance for unique oncological patients volume		
	Estimated quantity of patients per year	Funding in 2017, EUR	Average cost in 2017, EUR	The increase in the number of patients in 2017	Funding in 2017, EUR	Average cost in 2017, EUR
Oncological patients according to specified algorithms	4 494	4 978 416	1 107.79	7 084	5 043 171	711.91

Source: NHS

Considering that in addition to compensable medications, funding was allocated from the implementation of primary diagnostic algorithms, according to the actual fulfilment of 2017, the average cost of compensating medications for the increase of unique oncologic patients, according to the determined algorithms, was realized at 101.3% of the planned average cost of the year. Taking into account the fact that in the patients, who started the treatment in the first half of the year, continued the therapy also in the second half of the year, as well as new patients were added, as a result of which the average cost reduction was realized from the planned amount at the beginning of the year.

It should be noted that the scope of oncological patients receiving compensated medicines reached 157.63% of the planned increase in the number of oncologic patients, partly financed from the system's internal resources.

It can be concluded, according to the performance data of 2017, that the desired outcome of activities in oncology has been achieved and in some cases even exceeded, thus the implemented measures will continue in 2018.

Measure No.2. Availability of secondary outpatient care

Reforms for reducing queues to specialists, diagnostic examinations, day patient facility and outpatient rehabilitation have been launched in March 2017. In order to implement the planned reduction of queues, the National Health Service has concluded contracts with 262 medical treatment institutions for the provision of state-funded additional health care services.

Specialist consultations

In order to increase the availability of secondary outpatient health care services following a referral from a family doctor or specialist, as well as availability without referral to certain specialists, in 2017 an increase in specialist consultations was planned in amount of 270.2 thousand consultations.

Table 3.17. Fulfilment of outpatient specialist consultations

Specialist consultations	Average planned number of consultations	The actual number of consultations in 2017	Planned financing, euro	Financial expenditure in 2017 euro	Average queue length in days			Queue reduction in 2017, %	Queue length with patient behaviour change in 2017	Queue reduction with patient behaviour change in 2017
					Before implementing the reforms	As of 1 January 2018	Queue reduction in 2017			
Health care institutions	270 246	177 317	3 386 187	3 288 372	100.48	58.23	42.25	42.05	50.13	50.35

Source: NHS

According to the actual fulfilment of 2017, the increase in specialist consultations was implemented at 65.61% of the annual projected amount of consultation services. Consequently, it can be concluded that, during the period from March to December 2017, the reduction of queues was ensured within the limits of medical institutions, according to available specialist resources, on average reducing the length of queues to specialist services by 42.05%. At the same time, it is worth mentioning that in each health care institution and in the type of a service the queuing reduction dynamic is different.

During 2017, it was observed that the length of the queues can be reduced in medical institutions where the relevant specialist resources were available, but accessibility to some

specialties has remained unchanged and limited by the number of specialists providing consultations.

Outpatient examinations

Outpatient examinations are one of the most important treatment processes for diagnosing and monitoring the diseases and their changes. In order to increase the availability for patients to receive these state-funded outpatient examinations in 2017, the planned increase in the service volume was 328 thousand services.

Table 3.18. Execution of examinations carried out in 2017

Outpatient examinations	Average planned number of examinations	Actual number of examinations in 2017	Planned financing, euro	Financial expenditure in 2017, euro	Average queue length in days			Queue reduction in 2017, %	Queue length with patient behaviour change in 2017	Queue reduction with patient behaviour change in 2017
					Before implementing the reforms	As of 1 January 2017	Queue reduction in 2017			
Health care institutions	328 076	300 856	7 541 491	7 557 039	40.39	27.10	13.29	32.90	23.33	17.06

Source: NHS

According to the actual fulfilment of 2017, the increase in outpatient examinations was implemented at 91.70% of the annual projected increase in examinations. Consequently, it can be concluded that, during the period from March to December 2017, the reduction of queues was ensured within the limits of medical institutions, reducing the average length of queues to examinations by 32.90%.

It should be noted that by increasing the volume of services available in the most important outpatient services section – outpatient exams, the actual demand from patients who previously did not apply for services due to the availability of the service increased. Similarly, an important factor in the growth of additional examinations is due to an increase in expert advice, which then send patients to examinations, increasing their volume. At the same time, given the fact that patients were sent to more costly examinations in 2017, the actual number of examinations is less than the projected amount.

Day patient facility

A day patient facility service is a treatment or diagnostic service at a medical institution where the patient is provided with treatment and health care for less than a day and provided with treatment services which, due to their complexity, risk or time, can not be provided by outpatients.

In order to increase the availability for patients to receive these state-funded day patient facility services in 2017, the projected increase in the service volume was 62.4 thousand services.

Table 3.19. Execution of day patient facility services

Day patient facility services	Average planned number of services	Actual number of services in 2017	Planned financing euro	Financial expenditure in 2017, euro	Average queue length in days			Queue reduction in 2017, %	Queue length with patient behaviour change in 2017	Queue reduction with patient behaviour change in 2017
					Before implementing the reforms	As of 1 January 2018	Queue reduction in 2017			
Health care institutions	62 472	27 551	5 163 159	5 177 349	407.00	132.10	274.9	67.54	116.04	290.96

According to the actual implementation of 2017, the amount of services provided by the state in the day patient facility was implemented at 44.10% of the projected annual increase of the amount of the day patient facility. Consequently, it can be concluded that, during the period

from March to December 2017, the reduction of queues was ensured within the limits of medical institutions, reducing the average length of queues to day patient facility services by 67.54%. In each health care institution and in the type of a service the queuing reduction dynamic is different.

Outpatient rehabilitation

Outpatient rehabilitation is a set of services aimed at providing persons with certain functional limitations the reduction or prevention of these limitations, as well as the risk assessment and mitigation of complications.

In order to increase the availability of patients in outpatient rehabilitation, in 2017 an increase in the volume of services was planned for 70 thousand services.

Table 3.20. Outpatient rehabilitation

Outpatient rehabilitation services	Average planned number of services	Actual number of services in 2017	Planned financing, euro	Financial expenditure in 2017, euro	Average queue length in days			Queue reduction in 2017, %	Queue length with patient behaviour change in 2017	Queue reduction with patient behaviour change in 2017
					Before implementing the reforms	As of 1 January 2018	Queue reduction in 2017			
252 health care institutions	70 028	58 356	508 470	541 225	500.20	471.80	28.40	5.68	406.16	94.04

According to the actual fulfilment of 2017, the increase in outpatient rehabilitation was implemented at 83.33% of the annual projected increase in rehabilitation. Consequently, it can be concluded that, during the period from March to December 2017, the reduction of queues was ensured within the limits of medical institutions and the available funding, with an average reduction of the length of the queues for rehabilitation services by 5.68%. In addition, we note that not all medical treatment institutions provide outpatient rehabilitation, which results in a 6% decrease in the average number considered as significant.

Taking into account the fact that patients are admitted to medical institutions because of diagnoses requiring a longer rehabilitation process with more cost-intensive services, as a result, the volume of services actually realized was less than initially planned. Attention is drawn to the fact that the most important queues in services where access depends on the capacity of medical institutions and specialists.

It can be concluded that in 2017 the outpatient care activities were successfully implemented and therefore they should continue to ensure that by the end of 2019 the average number of queues in outpatient care decreases by 50%.

Measure No.3. State reimbursable medicines for VHC patients at F3–F4 stage.

In order to reduce the prevalence of VHC and to promote the treatment of infected persons, an increase in the volume of services is provided to compensate for the treatment of hepatitis C in the F3–F4 hepatic injury phase.

Table 3.21. VHC Patients at F3–F4 Stage

Compensated medicines for the treatment of VHC in the F3-F4 stage	Planned number of services	Planned financing, euro	Actual number of services	Expenditure, euro
Health care institutions	203	5 462 883	400	5 462 883

According to the actual implementation of 2017, provision of new generation medicines and adequate treatment for VHC patients at F3–F4 stage was implemented at 197% of the annual increase in availability. This increase is from March to December 2017.

Within the framework of the Health Reform Measures, in 2017, in the framework of the National Medicines Compensation System, the medicines necessary for outpatient treatment were given to 400 additional individuals with hepatitis C – most of them were registered hepatitis C for the first time in 2017, and patients registered in 2016 in the F3–F4 stage, which received direct antiviral preparations.

In 2017, 395 people completed the course and started dynamic monitoring. Out of which a total of 3 months of dynamic monitoring has been completed by 217 people and 88% of those receiving treatment are cleared from HCV. Of these, 3 month dynamic monitoring has been completed by 143 people who received direct antiviral medicines and 140 people were cleared of the virus, suggesting a treatment effect of 98%.

It can be concluded that the reform measure, the provision of state compensated medication for patients with VHC at F2–F4 stage, has been successfully implemented and will continue in 2018.

Based on the successful implementation of the healthcare reform, the interventions will continue, while for their expansion and the launch of new reforms, in addition to the funding allocated in 2017, a financing of 79 million euros will be available in 2018, supported by the Cabinet report on 19 December, 2017 "On Implementation of Health Reform Measures in 2018", it is planned to use the funds to continue the implementation of health care reforms in the following areas:

1. **Improvement of access to health care services and reduction of queues** (including continuing the reduction of queues begun in 2017 for specialists, for diagnostic examinations, day patient facility and outpatient rehabilitation);
2. **To improve the availability of diagnostic and treatment of oncological diseases** (including continuing and expanding the activities begun in 2017);
3. **To reduce the spread of infectious diseases** (including continuing the reforms begun in 2017 for the provision of state compensated medicines for VHC patients in the F3–F4 stage);
4. **To improve the quality and availability of primary health care system;**
5. **To reduce cardiovascular morbidity and to improve the efficacy of disease treatment.**

Table 3.22. Breakdown of additional funding allocated to the health sector reform from the budget deficit of the EC for 2018

	Planned measure	Total funding (euro)
1.	Improving the accessibility of health care services	46 073 209
2.	Improvement of availability of diagnostics and treatment of oncological diseases	29 896 594
3.	Reducing the spread of infectious diseases	16 740 741
4.	Improving the quality and availability of primary health care system	9 664 036
5.	Reducing cardiovascular morbidity and improving the efficacy of disease treatment	11 025 420
	Sum total:	113 400 000

Predicting the potential gain (not loss) of life years in the case of absence of investment, it is believed that the gradual improvement of the health of the population and taking into account minor improvements in previous periods, as well as improvement of the treatment process coordination, including the introduction of e–health, it is expected to slightly improve on the current situation, while access problems would remain, especially to those who are socially vulnerable and turn to the doctor late. In the end, these factors will be reflected in the data as the persistence of mortality rate or even a small increase in the age group of 65 and the minimum decline or even stagnation in the number of potentially lost years of life. In turn, through the above reforms, the potential loss of years of life will decrease, as the life expectancy of the population will increase and the number of premature deaths will decrease (see Table 3.22). Taking into account the projections for the reduction of potentially lost years of life, **it can be concluded that this corresponds to the reduction estimated in the study "Evaluation for the Development of Public Health Guidelines for 2014 – 2020" in line with the increase in funding.**

Table 3.23. Potential loss of life expectancy if investments are made

	2013	2014	2015	2016	2017	2018	2019	2020
Potentially loss of life expectancy without investing	96 670	93 374	88 191	88 191	87 541	86 343	85 045	83 913
Potentially loss of life expectancy with investing				84 371	84 079	83 918	81 372	78 341
Gained Potentially Lost Life Years						2 425	3 673	5 572
<i>Improving the accessibility of health care services</i>						518	904	1 587
<i>Improvement of availability of diagnostics and treatment of oncological diseases</i>						578	687	1 246
<i>Reducing the spread of infectious diseases</i>						534	1 181	1 645
<i>Improving the quality and availability of primary health care system</i>						102	114	216
<i>Reduction of cardiovascular morbidity and to improvement of the efficacy of disease treatment</i>						693	787	878

Source: MoH and CDPC

It should be noted that the decisions on the reform measures and the measures to be supported in 2019 will be adopted later.

The previous two Stability Programmes included the assessment of the fiscal impact of the "Public Health Guidelines 2014 – 2020". Corresponding to this Stability Program is the assessment of the fiscal impact is being adjusted, taking into account the amount of adjusted expenditure in 2017 and the adjusted forecasts for 2018, 2019 and 2020.

Table 3.24. Actual assessment of the macroeconomic impact of the "Public Health Guidelines 2014 – 2020"

Macroeconomic indicators	Annual and cumulative impact on GDP and other key macroeconomic variables ¹⁸				
	X ¹⁹ +5 years	X+10 years	X+15 years	X+20 years	X+25 years
GDP ²⁰	0.55%	2.21%	4.78%	7.88%	11.26%
Gross fixed capital formation	-	-	-	-	-
Employment ²¹	0.24%	0.62%	1.02%	1.41%	1.81%
Direct fiscal impact on primary balance (10) ²²	-0.39%	-0.97%	-0.98%	-0.56%	0.17%
Total impact on primary balance (11) ²³	-0,15%	-0,02%	1.02%	2,71%	4,83%

Reform of the health funding

The funding gap for the deficit will end in 2020 and therefore it was necessary to find a solution to finance a long-term health care system. To this end, the Saeima on 14 December, 2017 adopted the Law on Health Care Financing, which provides for the introduction of state compulsory health insurance from 1 January, 2019. The new health insurance system provides for services to be broken down into the minimum amount of state-funded medical assistance that will be provided to all residents irrespective of the insurance status and a full health service bundle that will be available to persons who contribute to the Social Security Fund or belong to a socially disadvantaged group. Therefore, the system will be fairer and more beneficial for those residents who live and legally work in Latvia and make social contributions.

It should be mentioned that, with the transition to the new model of health financing, the Saeima on 27 July, 2017, adopted the Law "Amendments to the Law" On State Social Insurance ", which stipulates that persons who are paid for the Social Security Fund are subject to health insurance and have the right to receive health care services payable from the state budget, providing that these persons and their employers increase the state social insurance contribution rate by 1%. Thus, it is planned that the revenues from the increase in the Social Security Fund rate by 1 percentage point will be allocated for health financing, which in 2018 will amount to 85.3 million euros, in 2019, 99.6 million euros and 105.5 million euros in 2020.

Reform of the health system administration

Even though the reform of the health system administration is not the issue of deficit deviation and therefore it is not described in Stability Programme, it is, nevertheless, important, in order to ensure more efficient allocation of public funding. Therefore this reform supplements the two other reforms, forming a stable basis for quality and cost-efficient healthcare services.

3.3. FISCAL DEVELOPMENT SCENARIO

The fiscal development scenario is based upon the condition of compliance with the fiscal discipline and implementation of the responsible fiscal policy in Latvia. According to the

¹⁸ Discounted at values of 2014; cumulative effect.

¹⁹ X means 2013.

²⁰ National economy output divided by GDP of 2014 at current prices.

²¹ Employment growth divided by number of employed persons in age group 15 – 64.

²² Direct fiscal impact applicable to the age group of 0 – 64 years.

²³ When assessing the indirect impact on budget, the budgetary balance flexibility is applied - 0.43 (for 5 years) and 0.41 (for 10 and more years).

provisions of the Financial Discipline Law the fiscal policy principles prescribe the formation of a budget balance in the economic cycle or the condition that the structural deficit, in the long term, may not exceed 0.5% of GDP.

Scenario for the medium term is drafted on the basis of the established general government budget balance objectives in structural terms and considering the cyclical component of the budgetary balance in compliance with the updated macroeconomic development scenario. Compared to 2016, when economic growth was moderate, in 2017 GDP growth was significantly faster, surpassing the potential GDP growth rate. As a result, starting from 2017, the cyclical component of the budget balance is projected to be positive in the medium term (0.2% – 0.4% of GDP). In 2021, the growth rate will approach the pace of potential GDP growth.

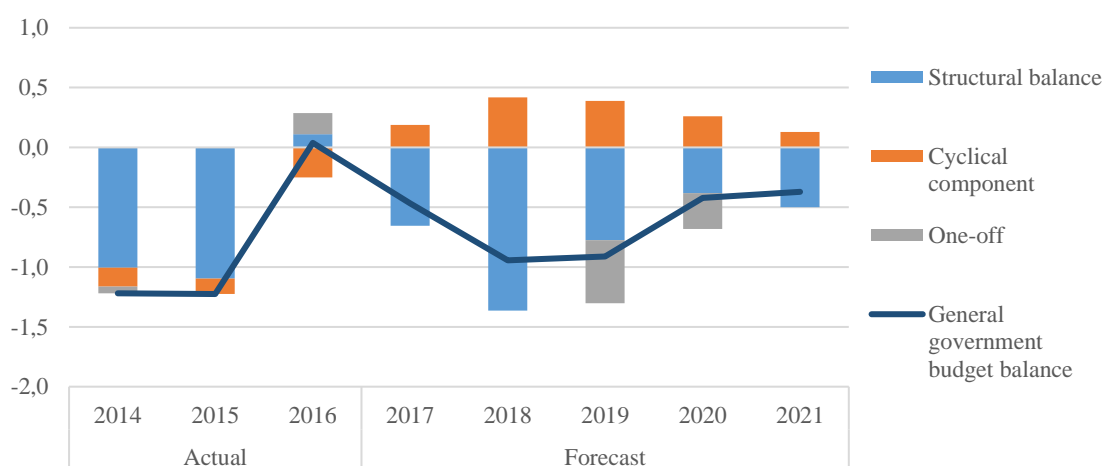


Figure 3.6. Budgetary balance of the general government by components²⁴, % of GDP

The general government budget balance projections for the medium term with a no-policy change were prepared in accordance with the updated macroeconomic scenario, which is the basis for revenue and expenditure projections. The projections also took into account approved central government baseline expenditure for the next three years, as well as expected development in local government budgets, taking into account current trends. The general government budget deficit is expected to be 0.9% of GDP in 2018 (excluding the fiscal reserve) and is at the same level as it was projected at the time of the budget preparation, i.e. Autumn 2017. However, the structural deficit is projected to be 0.2 percentage points higher than the target. In the medium term, in the general government budget at no-policy change scenario, a deficit of 1.0% of GDP is forecasted in 2019, a deficit of 0.4% of GDP in 2020 and a deficit of 0.3% of GDP in 2021.

Table 3.25. Medium term at no-policy change scenario, % of GDP

	ESA code	2017	2018	2019	2020	2021
Net lending (+) or borrowings (-) (B.9) by sub-sectors						
General government	S.13	-0.5	-0.9	-1.0	-0.4	-0.3
Central government	S.1311	-0.6	-1.3	-1.1	-0.5	-0.3
Local government	S.1313	-0.2	-0.1	-0.1	-0.1	0.0

²⁴In the calculation of a cyclical component of a budgetary balance, there was budget semi-elasticity of 0.38 used (Data source: Adjusting the budget balance for the business cycle: the EU methodology, Economic Papers 536, November 2014).

Social security funds	S.1314	0.3	0.5	0.3	0.1	0.1
General government (S.13)						
Total revenue	TR	37.1	36.8	36.1	36.4	35.3
Total expenditure	TE	37.6	37.8	37.1	36.9	35.6
Interest expenditure	D.41	1.0	0.8	0.9	0.9	0.8
Cyclical development						
Cyclical component of the budgetary balance		0.2	0.4	0.4	0.3	0.1
Structural balance		-0.7	-1.4	-0.8	-0.4	-0.4
Cyclically adjusted primary balance		0.3	-0.5	-0.5	0.2	0.4

* The structural balance is presented without including a one-off measure - a short-term reduction in the budget balance caused by tax reform.

In the medium term, the share of general government revenues in GDP is projected to remain stable, reaching 36.8% of GDP in 2018, while in 2019 and 2020 it will decrease to 36.1% and 36.4% respectively. Due to the fact that the Latvian medium-term budgetary framework law is being drafted in autumn, there are currently no decisions on a number of expenditure and revenue items for 2021. According to the fiscal projections practice in such cases, the relevant revenue and expenditure are not planned, for example, revenue from dividends from Latvenergo is not planned in 2021. Therefore, in the fall of 2021, revenue and expenditure projections will vary significantly. Consequently, the latest fiscal projections of the Stability Programme can not be used to explain the dynamics of medium-term fiscal projections.

It is expected that general government expenditure will exceed 37.1% of GDP in 2018 and 2019, but in 2020 and 2021, similarly to revenue, it will decrease, taking into account a low level of the permissible general government budget deficit arising from the structural budget balance objective.

In the central government budget:

- In 2018, a deficit of 1.3% of GDP is expected in the central government budget, which is at the same level as it was set in the state budget law. Compared to the 2017 estimate, central government budget revenues will be nominally increased by taxes on production and imports, where higher revenues from VAT and excise tax are planned, also MPC payments from households will be accounted, which, according to ESA 2010, are classified as general government revenues from taxes on production and imports. Revenues from current taxes on income and wealth will decrease, taking into account tax reform measures in relation to CIT, such as CIT will not be applied to undistributed profits. Capital and property taxes, on the other hand, will remain at the level of 2017.

Compared to the 2017 estimate, the significant changes in expenditure are related to the rising remuneration for employees, which is mainly influenced by the rising average wage, which in turn is affected by the increase in the minimum wage as of 1 January, 2018, as well as, for example, wage increase for health-care workers.

- In 2019, a deficit of 1.1% of GDP is planned for the central government budget, while a deficit of 0.5% and 0.3% of GDP is projected in 2020 and 2021. In the medium term, nominal growth will be secured by taxes on production and imports, which will be mainly driven by increases in VAT and excise tax revenue. At the same time, the growth rate of tax revenue will continue to be affected by the forecasted decrease in property income, mainly due to received payments for the

use of state capital, due to the fact that dividends from AS "Latvenergo" are not planned during the preparation of projections for 2021.

The largest increase in expenditures in the medium-term is planned for subsidies and grants, which, in developing the budget law, will be redistributed for current and capital expenditures, incl. the funding for the reform of the health care system. In line with the updated GDP projections for the medium-term, funding for the defence sector is increased in 2019, 2020 and 2021, reaching a financing level of at least 2% of GDP. As of 1 January of this year, state social insurance contributions in the amount of 1 percentage point are allocated to the state basic budget for the financing of health care. Also, the possible development of derived public entities budgets in the years to come was taken into account, including the construction project of academic centre of the University of Latvia at the Tornakalns.

In social security funds:

- In 2018, revenues are projected at the same level as in the law "On the State Budget for 2018", while the planned expenditures for social benefits, incl. old-age pensions will decrease, thus increasing the previously projected surplus, which, according to the most recent projections, is planned at 0.5% of GDP. By contrast, compared to the 2017 estimate, with the increase in the minimum and average wages in the country, expenditure on social benefits will continue to increase. Similarly, new legislation will enter into force this year, which will improve the welfare of recipients of benefits. For example, the family state benefit from 1 January, 2018 is paid until the child reaches the age of 20 (currently reaching the age of 19) while he is in a general education or vocational education institution. As of 1 March, for the raising of two and more children aged from one year up to 20 years old, the recipient of the benefit receives an allowance for the family benefit. For two children – 10 euro per month, three children – 66 euro per month, and for each subsequent child – 50 euro more than the previous one.
- It should be noted that pension expenditures are planned taking into account the most recent legislative changes that come into force this year. When granting an old-age pension in 2018, the capital index for calculation of initial pension capital for the period from 1996 to 2016 will be 1.0786. Similarly, in 2018, old-age pensions, work record related pensions and pensions in case of loss of supporter, which were granted and recalculated in 2012, 2013, 2014, and 2015 will be revised by applying appropriate capital indexes. In the framework of the tax reform, in 2018, the non-taxable minimum for pension is 250 euros per month, while the PIT rate for pensions up to 1 667 euros per month is 20% and for the part that exceeds – 23%. As of 1 July, 2018, the amount of the allowance to the state pension for one year of insurance record, accumulated before 31 December, 1995, will increase. The allowance for each work year will be 1.50 euros, if by the 31 December 1995 both the retirement age has been reached and the old age or disability pension has been granted. Also, by 1 October, 2018, the amount of old-age pension indexation will depend on the total length of insurance record. If the insurance record is up to 29 years, then the pensions will be indexed, taking into account 50% of the real percentage increase of insurance contributions wage, if from 30 to 39 years – 60%, if 40 years or more – 70%. A pension granted for work under harmful and severe or extremely harmful and difficult working conditions and a length of insurance record will be up to 39 years will be indexed taking into account 60% of the real

percentage increase of insurance contributions wage, but if the insurance period is 40 years or more – 70%.

- In 2019 and 2020, revenue and expenditure is expected to be lower in social security funds than planned under the Law "On the Medium-term Budget Framework for 2018, 2019 and 2020" and the surplus is currently projected. Similarly, in 2021, the trend will continue, with revenue slightly surpassing expenditure and creating a surplus. In the medium term the revenue, mainly made up of the social security contributions, will demonstrate a growth, although the impact will be felt from the reduction in the number of employees. Likewise, an increase is also expected in expenditure, taking into account the projected changes in the number of beneficiaries, as well as in the average amount of paid pensions and benefits.

In the local government budget:

- In 2018, it is projected that a small deficit will emerge in the local government budget. Unlike in previous years, the expenditure forecast has been increased, taking into account the actual data for 2017, and it is projected that the capital expenditure of local governments will increase more rapidly both in the basic functions and in part of EU co-financed projects. At the same time, in 2018 the local government budget expenditure, based on ESA 2010 methodology, will be reduced by payments for the Southern Bridge construction, because expenditure was recognized already in previous years during the actual construction of the object;
- After 2018 it is projected that at no-policy change scenario local government budget will be in a deficit, which is related to growing capital expenditure both in the basic functions and in the EU funds section. With regard to taxes on income, which is the largest revenue position of the local government budget, the impact of tax reform is taken into account, which will result in a 4.9% decrease in PIT revenue in 2019 compared to 2018, which is explained by the fact that the companies will not have to pay PIT on dividends for undistributed profits earned in 2018, as well as the growing non-taxable minimum, relief for dependents and an increasing non-taxable minimum for pensioners. The central government has pledged to compensate above mentioned PIT reduction with a special grant, guaranteeing local government tax revenue in the amount of 19.6% of the actual general budget tax revenue, excluding state social insurance contributions to the state basic budget for health care financing. After 2019, tax revenues will increase by 2.3% – 3.9%. At the same time, it should be noted that according to the updated forecasts major changes are not expected in other revenue positions. It is projected that local government expenditure in the medium term will increase in all positions, except for expenditure for social benefits. The level of expenditure for investments in the coming years will grow mainly on account of the increasing activity in implementing the EU funds co-financed projects. At the same time, in the medium term local government budget expenditure, based on ESA 2010, will be reduced by payments for the Southern Bridge construction, because expenditure was recognized already in previous years during the actual construction of the object.

In accordance with the conditions of fiscal discipline, the maximum allowable structural deficit of the general government budget and the resulting nominal deficit is determined using the top-down budgetary planning method, which ensures the establishment of balance targets that meet the requirements of the SGP. Under these conditions, a deficit in the general government budget in 2019 and 2020 shall be lower, while in 2021 a higher deficit is allowed

than projected in the no-policy change scenario, namely in 2019 and 2020, the fiscal space is negative, but in 2021 it is a little positive. Consequently, if at the current moment the next Annual State Budget Law and the Framework Law were drafted, the Government would have to take discretionary decisions in 2019 and 2020 by cutting general government budget expenditures and/or increasing revenues by 0.15% of GDP and 0.12% of GDP respectively. In turn, in 2021, the government would have access to small resources at a level of 0.01% of GDP to finance budget priorities. In all years, the minimum fiscal security reserve as defined in the FDL in amount of 0.1% of GDP is taken into account in determining the fiscal space.

Accordingly the fiscal development scenario provides for the general government deficit of 0.9% of GDP in 2018, 0.9% of GDP in 2019, 0.4% of GDP in 2020 and 0.4% of GDP in 2021.

Table 3.26. Medium term fiscal development scenario, % of GDP

	ESA code	2017	2018	2019	2020	2021
Net lending (+) or borrowings (-) (B.9) by sub-sectors						
General government	S.13	-0.5	-0.9	-0.9	-0.4	-0.4
Central government	S.1311	-0.6	-1.3	-1.0	-0.5	-0.4
Local government	S.1313	-0.2	-0.1	-0.1	-0.1	0.0
Social security funds	S.1314	0.3	0.5	0.3	0.1	0.1
General government (S.13)						
Total revenue	TR	37.1	36.8	36.1	36.4	35.3
Total expenditure	TE	37.6	37.8	37.1	36.8	35.7
Interest expenditure	D.41	1.0	0.8	0.9	0.9	0.8
Cyclical development						
Cyclical component of the budgetary balance		0.2	0.4	0.4	0.3	0.1
Structural balance*		-0.7	-1.4	-1.3	-0.7	-0.5
Cyclically adjusted primary balance		0.3	-0.5	-0.4	0.2	0.3

* The structural balance is presented to include a one-off measure, a short-term reduction in the balance of payments triggered by tax reforms, as according to the practice of applying SIP provisions, the EC will not recognize it as a *one-off*.

The fiscal development scenario assumes that the required budget consolidation in 2019 and 2020 will be carried out at the expense of reducing central government expenditure, while the fiscal space available in 2021 will be used for additional central government expenditure. It is assumed that the fiscal security reserve is used – i.e. fiscal risks realize in amount of 0.1% of GDP. As the decisions on the budget development section are adopted during the process of budget formation and they are not known for the time being, it is assumed that the required reduction of expenditure in 2019 and 2020 and the increase in expenditure in 2021 will be made proportionally by expenditure categories in respective years, assuming as the basis the share of particular expenditure categories to the total expenditure at no-policy change scenario. When calculating the share of particular expenditure categories to the total expenditure at no-policy change scenario, the following expenditure categories are excluded from the calculation: interest expenditure and capital expenditure transfers. This approach is used because it is assumed that the decisions of the budget development section do not affect decisions on these expenditure categories.

Table 3.27. Fiscal space

	2019	2020	2021
General government budget balance target, % of GDP	-0.91	-0.42	-0.37
General government budget balance at no-policy changed,% of GDP	-0.96	-0.44	-0.26
Fiscal security reserve,% of GDP	0.10	0.10	0.10
Fiscal space, % of GDP	-0.15	-0.12	-0.01
Fiscal space, millions euro	-45.2	-37.8	3.2

3.4. DEVELOPMENT TRENDS OF GOVERNMENT DEBT IN THE MEDIUM TERM

According to the general government budget deficit and debt notification data of April 2018, prepared in accordance with the ESA 2010 methodology, the general government debt at the end of 2017 reached 10.8 billion euro or 40% of GDP. The level of general government debt is mainly affected by the government debt, which at the end of 2017 was 9.6 billion euros²⁵, without significant changes compared to the level of 2016, as in 2017 a USD 1 billion bond repayment was made, by using funds of Eurobond issue in the international financial markets in 2016, and by a new borrowing of 1 billion euros in the international financial markets.

The key principles and medium-term objectives of the central government debt management are defined in the Central Government Debt and Cash Management Strategy approved by the Minister for Finance. In accordance with the Central Government Debt and Cash Management Strategy, the goal of government debt and cash management is to ensure the timely availability of financial resources to cover financing requirement at the lowest possible debt servicing costs while hedging financial risks and at the same time contributing to the development of the domestic financial market. A strategic approach is used for execution of central government debt and budget liabilities while maintaining as much flexibility as possible in selection of borrowing terms in financial markets. It allows limiting financial risks in the long term, as well as ensuring the amount of necessary financial resources to cover the total financing requirement at as favourable and attractive conditions as possible.

The stabilisation of the country's credit rating in A rating group, the investor appreciation on the accomplishments in the Latvian economy in the previous years and the confidence in the long-term development of the state, allows the country to borrow financial resources in the international markets at favourable conditions. This is also represented by borrowing transactions in the international financial markets in 2017, issuing Eurobonds for a total amount of 1 billion euros.

In order to capitalize the long-term benefits from the existing comparatively low EUR interest rate levels and to maintain quality of sovereign debt yield curve in EUR as a reference for new borrowings, in February 2017 the Eurobonds with the longest tenor ever were issued for the first time in the international financial markets – 30 years, fixing the interest (coupon) rate at the level of 2.250%. Concurrently with the 30 years Eurobond issue, which amounted to 500 million a tap of 10-year Eurobond issued in October 2016 was issued in amount of 150 million euros with a yield of 1.062% to the previously fixed interest (coupon) rate of 0.375%. In June 2017, with the continuation of planned borrowing activities to cover financing needs, two Eurobonds of two different maturities were tapped simultaneously in the international financial markets in total amount of 350 million euros: a tap to 10 year bond of 150 million

²⁵ Taking into account the currency outcome of the derivatives linked to the foreign borrowings and debt securities administered by Treasury

euros with a yield of 0.950% at fixed interest (coupon) rate of 0,375%, as well as for a tap to 20 year bond of 200 million euros with a yield of 1,703% at fixed interest (coupon) rate of 1,375%. The funding activities in 2017 cover both – the financing needs of the current year and for the redemption of a three-year domestic T–bond of 220.9 million EUR in January 2018, and a redemption of Eurobond of 400 million EUR in March 2018, flexibility was provided for the timing of the planned borrowing in 2018.

In the domestic financial market, in 2017, Treasury continued regular auctions of T–bonds in the framework of three–year and five-year T–bond programs launched in 2016. The demand for government securities remained high, which means that investors' competition in all auctions enabled funding on financially advantageous terms. Also, in 2017, the interest rates on the five-year domestic T–bonds were close to the historically lowest levels, i.e. close to zero, while in the last auction of the three-year T–bond program (in January 2017) a negative weighted average interest rate was fixed. The persistence of low rate levels can be explained both by the active participation of the Primary Dealers in auctions and the high liquidity of Latvian credit institutions, as well as from the issuer's point of view, the positive trend in the rates on financial markets influenced by the continuation of the European Central Bank securities purchase program in 2017.

Taking into account the central government debt outstanding as of 31 March 2018 and in accordance with the central government debt repayment schedule, the central government debt to be refinanced in the period from April 2018 till December 2021 compincreases 3.9 billion euros (see Figure 3.7). The most of the debt to be refinanced consists of Eurobonds previously issued in the international financial markets, as well as loans received from the World Bank and the EC within the framework of the international loan programme.

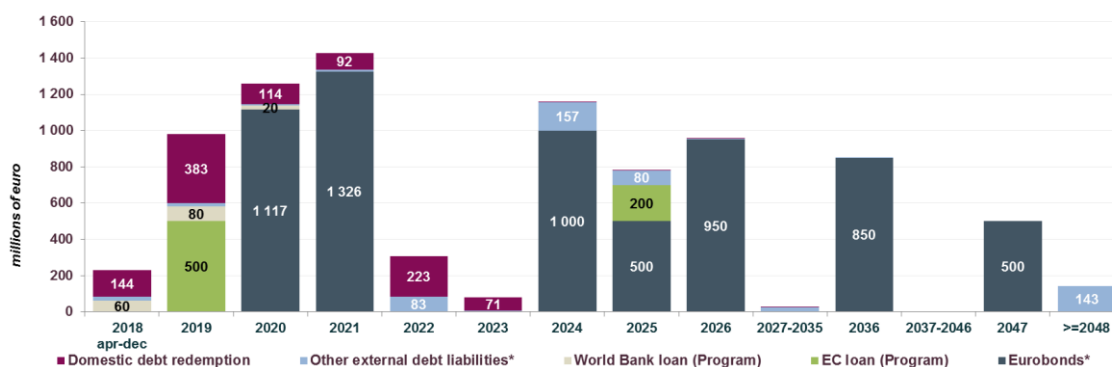


Figure 3.7. Central government debt repayment schedule
(liabilities outstanding as of 31 March 2018, nominal value)

**excl. sectors S130130, S130140, S130330, S130340, as well as on-demand and short–term deposits; According to ECB FX rates of 29 March 2018*

Taking into account the borrowing strategy, in order to manage debt refinancing risk, as well as to ensure optimization of government debt servicing costs in the medium and long term, in the coming years, foreign borrowing instruments will provide major share of the total funding. It is planned that borrowing in the international financial markets will be based on public transactions, maintaining the EUR yield curve with long–term bond issues and maintaining flexibility in terms of borrowing time, currency and maturity, thus to ensure borrowing on favourable conditions. In the domestic financial market, priority is given to promoting the liquidity of government securities, ensuring appropriate investment opportunities for domestic investors, in order to make better use of domestic market potential and to promote the functioning and development of the domestic financial market.

In 2016 and 2017, borrowing both to cover the financing needs of the current year and to repay the government debt at the beginning of next year, the general government debt level stabilized at 40% of GDP in 2017. In the medium term, a slight reduction and stabilization of the general government debt in relation to GDP is projected, confidently complying with the debt condition set by the FDL (see Figure 3.8).

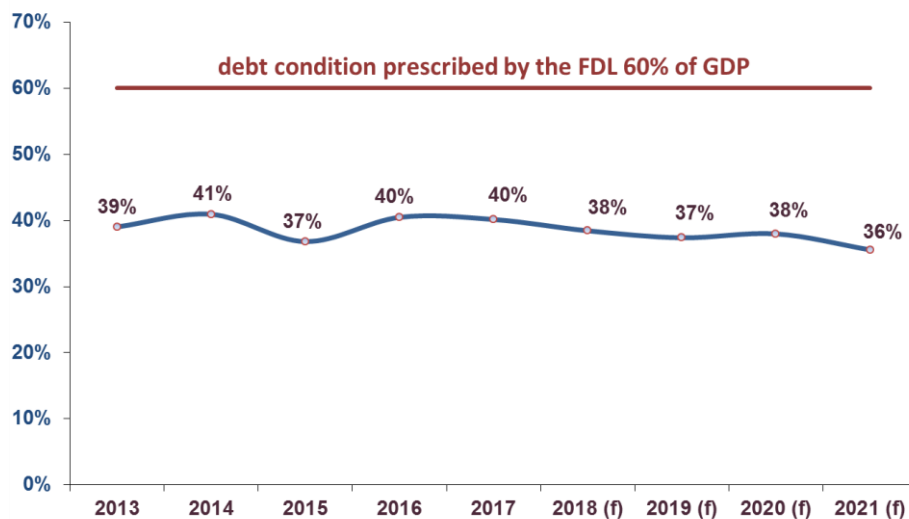


Figure 3.8. General government debt development trends, % of GDP
f – forecast

4. SENSITIVITY ANALYSIS AND COMPARISON

4.1. MACROECONOMIC SCENARIO RISKS

Macroeconomic development scenario, traditionally, is prepared on the basis of cautious forecast, to minimise possible adverse effect on the State budget in the medium term. Therefore, the probability of occurrence of positive risks is slightly higher than the probability of occurrence of negative risks.

In practice, various courses of development are possible, therewith the risk scenarios represent merely technical estimates, based upon certain assumptions, and their purpose is to assess the impact of possible deviations on the State budget. Therefore, on the basis of the macroeconomic risks outlined herein below, two alternative macroeconomic development scenarios are developed for 2018 – 2021. Taking into account that one half of 2018 has almost passed and the implementation of risks is still not observed, it is assumed that the risk scenario will occur in the second half of this year and the maximum impact will be observed in 2019.

Positive risks:

- In light of faster development of financial sector and activation of lending as expected in the baseline scenario, also the economic growth might turn out to be steeper;
- Sharper-than-expected investment growth, on the basis of own funds of the companies, facilitate both by better EU funds introduction and improvement of the external economic environment. A steeper growth may also be ensured by more positive impact of the Tax Reform on the economic development as initially forecasted;
- Faster-than-expected economic growth in the EU and other Latvian trade partners, on the basis of the already protracted stability of the world commodity markets and economic recovery in the developing markets.

Negative risks:

- Steep and uncontrolled reduction of servicing non-resident business in Latvia might cause an unwanted tension in the financial sector;
- A protractedly low investment level, especially, in the processing industry, will reduce Latvia's economic growth potential and possibility of steeper growth;
- Growing geopolitical uncertainty, as well as financial market fluctuations might influence the deterioration of economic situation for the key Latvian trade partners in Russia and the EU and might slow down the export growth of Latvia;
- Growing lack of labour force in economy due to negative demographic trends, which will reduce the number of population in working age, exerting pressure on the wage increase. In turn, a protracted wage increases not corresponding to increase in productivity might reduce the competitiveness of economy and slow down the economic growth in the medium term.

4.2. SENSITIVITY ANALYSIS

4.2.1. OPTIMISTIC SCENARIO

Impact on economy. Economic growth over the last years was, in general, higher than expected, and the MoF forecasts are traditionally cautious, which does not exclude the possibility that the economic growth might be higher than expected. The economic forecasts of Latvian trade partners are also unchangedly adjusted upwards, demonstrating that the economic

growth is in the upward part of the cycle. As the positive sentiment prevails in Europe, economic growth might be higher than expected, which, in turn, would be favourable for the export development and the GDP growth of Latvia.

Table 4.1. Optimistic macroeconomic scenario

	Optimistic Scenario				Deviation from the baseline scenario			
	2018	2019	2020	2021	2018	2019	2020	2021
GDP, at current prices, million euro	28 826	30 930	32 805	34 595	29	258	350	376
- growth at current prices, %	7.4	7.3	6.1	5.5	0.1	0.8	0.2	0.0
- growth at unchanged prices, %	4.1	4.1	3.2	2.9	0.1	0.8	0.2	0.0
Private consumption, growth at unchanged prices, %	6.1	4.5	3.0	2.6	0.0	1.0	0.2	0.0
Public consumption, growth at unchanged prices, %	3.1	2.8	2.8	2.6	0.0	0.0	0.0	0.0
Gross fixed capital formation, growth at unchanged prices, %	11.5	12.0	9.0	7.0	0.3	3.0	1.9	0.0
Export of goods and services, growth at unchanged prices, %	4.5	4.5	4.0	3.8	0.5	0.6	0.2	0.0
Import of goods and services, growth at unchanged prices, %	8.0	6.0	5.3	4.5	0.4	1.3	0.7	0.0
Average wage in national economy growth at current prices, %	8.0	6.0	5.5	5.0	0.0	0.0	0.0	0.0
Employment growth, %	0.1	0.0	0.0	-0.1	0.0	0.0	0.0	0.0

More rapid lending is one more factor capable of promoting steeper economic growth of Latvia. Since the latest economic recession, the volume of loans issued in Latvia has been reducing and adversely affecting the growth. However, since 2015, the volume of issued loans has not been considerably reducing anymore, and according to this scenario the volume of corporate loans might grow steeper than forecasted in the baseline scenario. It will be promoted by better EU funds' introduction, and also a more rapid lending of investments in the industries not related to the EU funds is possible, therewith increasing the competitiveness and exportability of Latvian entrepreneurs. Thus, the growth of investments in 2018 might be by 0.3 percentage points higher than in the baseline scenario, in 2019 – by 3 percentage points higher and in 2020 – by 1.9 percentage points higher than in the baseline scenario. In turn, the export growth from 2018 till 2020 might be, correspondingly, by 0.5 percentage points, 0.6 percentage points and 0.2 percentage points stronger than in the baseline scenario.

As a result, in case of the optimistic scenario, Latvian GDP growth at unchanged prices in 2018 would be by about 0.1 percentage points larger, in 2019 – by 0.8 and in 2020 – by 0.2 percentage points larger than in the baseline scenario.

Impact on budget and debt service. In case of the optimistic scenario, where the tax and non-tax revenue increases, as well as interest expense reduces, the general government budget balance would improve. In case of the optimistic scenario, as compared to the baseline scenario at no-policy change, the general government deficit in 2018 would decrease by 8.4 million euro or 0.03 percentage points of GDP. In 2019, 2020 and 2021 the general government balance would improve, respectively, by 0.2 (74.8 million euro), 0.3 (104.6 million euro) and 0.3 (113.5 million euro) percentage points of GDP as compared to the baseline scenario. In nominal terms, the general government deficit in 2018 would be preserved in the amount of 0.9% of GDP, in 2019 it would reduce to 0.7% of GDP, in 2020 – to 0.1% of GDP and in 2021 – to 0.1% of GDP.

Table 4.2. Optimistic budget scenario, million euro

	Risk scenario				Deviation from the baseline scenario			
	2018	2019	2020	2021	2018	2019	2020	2021
Tax revenue	8 562.2	8 992.3	9 673.7	10 151.1	8.0	70.8	97.4	104.4
Personal Income Tax	1 727.3	1, 654.3	1 693.1	1 763.0	1.7	13.8	18.1	19.2
Corporate Income Tax	222.3	246.1	388.5	394.1	0.2	2.1	4.1	4.3
Value Added Tax	2 436.4	2 655.8	2 861.0	3 034.6	2.4	22.2	30.5	33.0
Mandatory State social security contributions ²⁶	2 649.6	2 806.9	2 977.9	3 142.3	2.6	23.4	31.8	34.2
Non-tax basic budget revenue	454.3	448.5	428.7	324.9	0.4	3.7	4.6	3.5
Interest expenditure in the basic budget	233.3	239.4	272.3	269.3	0.0	-0.3	-2.6	-5.6
General government budget balance, % of GDP	-0.9	-0.7	-0.1	-0.1	0.03	0.2	0.3	0.3
General government debt ²⁷	-	-	-	-	-0.1%	-0.7%	-1.4%	-2.3%

In the case of the optimistic scenario of the economic development, due to tax revenue increase the State budget financial balance would improve, as a result whereof the overall funding need would reduce and, correspondingly, also the lending volume for the respective period, as compared to the baseline scenario. Smaller borrowings would generate savings in the interest expenditure. In case of the optimistic scenario, the interest expenditure in 2019 would be by 0.3 million euro or 0.001% of GDP smaller, in 2020 – by 2.6 million euro or 0.008% of GDP and in 2021, correspondingly, by 5.6 million euro or 0.016% of GDP smaller than in the baseline scenario.

4.2.2. PESSIMISTIC SCENARIO

Impact on economy. The last two years in the Latvian financial system have been marked by rearrangement of the non-resident service business according to the new risk requirements. Taking into account that this year, on the basis of the instructions from the supervisors of financial institutions, this process has accelerated, there is a risk present that the services rendered to non-residents might fall in a steep and uncontrolled manner, creating unwanted tension in the financial sector and reducing average wages and private consumption growth. At the same time, in light of the limited number of persons employed in the business of the non-resident services, the impact of changes on the total employment in the country will be limited, as, under the circumstances of high demand for qualified labour force, the majority of people who would potentially lose their jobs would not have any problems to re-enter the labour market again.

Taking into account that the international institutions point out to the fact that the global and EU economies are on the top of the upward stage of growth, then in accordance with the economic cycle the slowdown of its rates can be expected, and it may occur earlier than expected. Therefore, the scenario provides for the slowdown of export by 0.5 and 0.9 percentage points, correspondingly, in 2018 and 2019.

²⁶ Deducting contributions into the State funded pension scheme and contributions into the 3rd pension pillar

²⁷ Changes in growth rates, as compared to the baseline scenario, in percentage points (%)

Table 4.3. Pessimistic macroeconomic scenario

	Risk scenario				Deviation from the baseline scenario			
	2018	2019	2020	2021	2018	2019	2020	2021
GDP, at current prices, million euro	28 627	30 113	31 782	33 485	-170	-559	-673	-733
- growth at current prices, %	6.6	5.2	5.5	5.4	-0.6	-1.3	-0.3	0.0
- growth at unchanged prices,%	3.4	2.1	2.7	2.8	-0.6	-1.3	-0.3	0.0
Private consumption, growth at unchanged prices, %	5.8	3.0	2.8	2.6	-0.3	-0.5	0.0	0.0
Public consumption, growth at unchanged prices, %	3.1	2.8	2.8	2.6	0.0	0.0	0.0	0.0
Gross fixed capital formation, growth at unchanged prices, %	8.0	4.0	5.5	7.0	-3.2	-5.0	-1.6	0.0
Export of goods and services, growth at unchanged prices, %	3.5	3.0	3.8	3.8	-0.5	-0.9	0.0	0.0
Import of goods and services, growth at unchanged prices, %	6.8	3.7	4.4	4.5	-0.8	-1.0	-0.2	0.0
Average wage in national economy growth at current prices, %	7.5	5.7	5.5	5.0	-0.5	-0.3	0.0	0.0
Employment growth, %	0.1	-0.1	0.0	-0.1	0.0	-0.1	0.0	0.0

In general, according to the pessimistic scenario, as the income of population decrease, the wage increases of the employed, in 2018 and 2019, would be, on average, by 0.4 percentage points smaller. Therewith, also the private consumption growth, in 2018 and 2019, would be, correspondingly, by 0.3 and 0.5 percentage points smaller than projected in the baseline scenario.

Investment growth will be supported by the EU funds investment projects for the 2014 – 2020 planning period. Nevertheless, problems in the financial sector and decrease of external demand might reduce the investment dynamics, as the companies postpone performance of investments, which would mean that the gross fixed capital formation for the period from 2018 till 2020 could be, correspondingly by 3.2 percentage points, 5.0 percentage points and 1.6 percentage points slower than in the baseline scenario.

In case of the pessimistic scenario, Latvian GDP growth at unchanged prices in 2018 would be by 0.6 percentage points less than in the baseline scenario and in 2019 – by 1.3 percentage points less.

Impact on budget and debt servicing. According to the pessimistic scenario, tax revenue would decrease significantly and the general government budget balance would deteriorate. In case of the pessimistic scenario, compared to the baseline scenario at no-policy change, the general government deficit in 2018 would increase by 50.4 million euro or 0.2 percentage points of GDP. In 2019, 2020 and 2021 the general government balance would deteriorate, correspondingly, by 0.5 (162.7 million euro), 0.6 (202.4 million euro) and 0.7 (222.1 million euro) percentage points of GDP as compared to the baseline scenario. In nominal terms, the general government deficit in 2018 would grow to 1.1% of the GDP, in 2019 – to 1.5% of the GDP, in 2020 – to 1.1% of the GDP, but in 2021 – to 1.0% of the GDP.

Table 4.4. Pessimistic budget scenario, million euro

	Risk scenario				Deviation from the baseline scenario			
	2018	2019	2020	2021	2018	2019	2020	2021
Tax revenue	8 506.6	8 768.5	9 388.8	9 843.3	-47.7	-153.1	-187.5	-203.4
Personal Income Tax	1 715.4	1 610.6	1 640.3	1 706.4	-10.2	-29.9	-34.7	-37.4
Corporate Income Tax	220.8	239.6	376.4	381.4	-1.3	-4.4	-8.0	-8.4
Value Added Tax	2 419.6	2 585.6	2 771.7	2 937.3	-14.4	-48.0	-58.7	-64.3
Mandatory State social security contributions ²⁸	2 631.3	2 732.7	2 885.1	3 041.5	-15.7	-50.7	-61.1	-66.6
Non-tax basic budget revenue	451.2	436.6	415.3	314.5	-2.7	-8.1	-8.8	-6.9
Interest expenditure in the basic budget	233.3	241.2	281.0	286.7	0.0	1.5	6.1	11.8
General government budget balance, % of GDP	-1.1	-1.5	-1.1	-1.0	0.2	0.5	0.6	0.7
General government debt ²⁹	-	-	-	-	0.5%	1.7%	2.9%	4.6%

In the case of the pessimistic scenario of the economic development, due to tax revenue decrease the State budget deficit would grow, as a result whereof the overall funding need would increase and, correspondingly, also the lending volume for the respective period, as compared to the baseline scenario. Additional borrowing would generate the interest expenditure growth. In case of the pessimistic scenario, the interest expenditure in 2019 would be by 1.5 million euro or 0.005% of GDP larger, in 2020 – by 6.1 million euro or 0.019% of GDP and in 2021, correspondingly, by 11.8 million euro or 0.035% of GDP larger than in the baseline scenario.

According to Section 25, Part (2²) of the LBFM, in the event if within the time period of three months the actual revenues from the State budget taxes and non-taxes in respect to the anticipated revenues in the relevant period decreases by more than 0.5 per cent from the forecast of the GDP determined in the annual *State Budget Law* or the actual accumulated State budget financial deficit within the time period of three months exceeds the State budget financial deficit anticipated for the relevant time period by more than 0.5 per cent from the forecast of GDP determined in the annual *State Budget Law*, or there is no sufficient amount of funds in the budgetary accounts of Treasury to cover payment commitments planned for the next month, the Minister for Finance has the right to issue an order to Treasury to delay or reduce assignments for a certain period of time if such an act is not in contradiction with the Constitution, laws and the Cabinet regulations. Therewith, the legal framework provides for the regulation in cases, which might occur in the pessimistic scenario.

In the case of the pessimistic scenario the economic growth rates would reduce, which would also mean the reduction in separate expenditure items, for example, lower GDP growth rates would result in lower contributions to the EU budget pegged to GDP, giving also a slight positive effect.

²⁸ Deducting contributions into the State funded pension scheme and contributions into the 3rd pension pillar

²⁹ Changes in growth rates, as compared to the baseline scenario, in percentage points (%)

5. COMPARISON OF THE GENERAL GOVERNMENT BUDGET BALANCE AND DEBT FORECASTS WITH THE LATVIA'S STABILITY PROGRAMME FOR 2017 – 2020

GDP growth in 2017 has been considerably steeper than envisaged by the *Latvia's Stability Programme for 2017 – 2020* scenario. Steeper economic growth was related to the improvement of situation on the external markets and considerable growth of demand, as well as significantly steeper-than-forecasted restoration of activity of investments. Also the private consumption grew steeper than forecasted, which was ensured by a stronger increase in the monthly average gross wage. According to the latest growth scenario GDP increase forecast for 2018 is 4.0%, which is by 0.6 percentage points higher than projected by the previous *Stability Programme 2017 – 2020* scenario. The GDP growth forecast for 2019 has been correspondingly increased by 0.2 percentage points, but the growth forecast for 2020 has not been changed and is close to the potential GDP growth rate.

Table 5.1. Comparison with the forecasts of the Stability Programme for 2017 – 2020

	ESA code	2017	2018	2019	2020	2021
GDP growth (%)	B1y					
2017		3.2	3.4	3.2	3.0	-
2018		4.5	4.0	3.4	3.0	2.9
Difference		1.3	0.6	0.2	0.0	-
Actual budget balance (% of GDP)	B.9					
2017		-0.8	-1.6	-1.2	-0.5	-
2018		-0.5	-0.9	-0.9	-0.4	-0.4
Difference		0.3	0.7	0.3	0.1	-
Total general government debt (% of GDP)						
2017		39.2	38.2	39.4	40.4	-
2018		40.2	38.4	37.4	38.0	35.6
Difference		+1.0	+0.2	-2.0	-2.4	-

According to the assessment of the MoF the general government budget deficit in 2017 was by 0,3 percentage points lower than forecasted in the previous *Stability Programme*. Lower-than-forecasted deficit was influenced by larger tax and non-tax revenue, as well as smaller expenditure mainly for goods and services, social benefits and contributions to the EU budget.

The updated general government budget forecasts the deficit in amount of 0.9% of GDP in 2018, 0.9% of GDP in 2019, 0.4% of GDP in 2020 and 0.4% of GDP in 2021. General government budget forecasts are based on updated structural budget balance targets, as well as taking into account the changes in the cyclical component of the budgetary balance.

General government debt forecast for 2019 – 2020, as compared to the forecasts of the *Stability programme for 2017 – 2020* (see Table 5.1.), has been reduced, correspondingly, by 2.0% and 2.4% of GDP. The changes were mainly determined by the updated economic development forecasts and adjusted borrowing strategy for the medium term.

6. QUALITY OF PUBLIC FINANCE

6.1. EFFICIENCY OF THE STATE BUDGET RESOURCES AND EXPENDITURE CONTROL

Procedures for the development, approval and implementation of the State budget and responsibilities within the budgeting process are determined by the LBFM .

According to the LBFM the Minister for Finance shall ensure the development of the Draft Annual State Budget Law, on the basis of the Medium Term Budget Framework Law and budgetary requests. The Minister for Finance shall evaluate the conformity of the budgetary requests with the budgetary purposes and priority courses of development prescribed by the Framework Law, as well as with the principles of economy and efficiency and, if necessary, shall request necessary additional information. On the basis of evaluation and the provided information, the Minister for Finance (till the submission of the Draft Annual State Budget Law to the Cabinet) shall take a decision regarding inclusion of the budgetary requests in the Draft Annual State Budget Law. The Minister for Finance may, at any stage of the examination of the Draft Annual State Budget Law, express his or her point of view, add the necessary opinions, as well as the results of separate audits.

The Minister for Finance shall also be responsible for the organisation and management of the State budget implementation process, as well as the supervision of the operation of Treasury in accordance with the requirements of the LBFM .

The Minister for Finance shall inform the Budget and Finance (Tax) Committee of the Saeima during the development of the Draft Annual State Budget Law or amendments thereof on the course of State budget planning, as well as no less than once in a quarter – on the course of implementation of the State budget.

According to the LBFM , heads of bodies financed from the budget, institutions non-financed from the budget and local governments, as well as of capital companies, in which a State or local government capital share has been invested, shall be responsible for the observance, implementation and control of the procedures and requirements prescribed by the above mentioned law, as well as for the efficient and economic utilisation of budgetary funds in conformity with purposes intended.

Starting from 1 January 2016 the LBFM includes the provisions prescribing for the Cabinet to ensure unchanged and systematic revision of the State budget expenditure, allowing for more efficient and economic implementation of the State policy, as well as optimising of the budget expenditure and evaluating the conformity thereof to the priorities and objectives set in the development planning documents. The Cabinet, on an annual basis, adopts the decision on the scope of revision of the State budget expenditure, concurrently with the approval of the schedule for preparation of the budget. The Minister of Finance in turn, in accordance with the referred to schedule, submits to the Cabinet the State budget expenditure revision results and proposals regarding the use of these results within the process of development of the Draft Medium Term Budget Framework Law and the Draft Annual State Budget Law.

State budget consists of budget programmes where the structure is determined by the operational (action) course defined in the institution's operational strategy or functions defined in the regulation of the ministry or other central State institution. Thus, the budget development is linked to the policy planning, as one of the institution's operational strategy objectives in the medium term is to ensure that budget programmes provide the achievement of objectives, planned results and performance indicators which are defined in the development planning documents. Each year Ministries and other central State institutions in their budget requests include operating results of the budget programmes which, whenever possible, are developed

in accordance with planned operating results and performance indicators of the development planning documents. It should be noted that in 2017 and 2018 legal framework has been amended to improve the existing content of the budget explanations in order to provide information on the state budget as a policy instrument, as well as to increase perceptibility of information in the budget explanations. The main innovation is the introduction of Policy and resource management cards, through which view is provided on invested resources (financial and human resources) to achieve sectoral policy outcomes and on the benefits for society in the result of sectoral activity.

In addition, the new budget format has provided for the possibility, in an interactive and more demonstrative manner, to inform the population in Latvia about the fields where and the amount in which the taxpayers' money is being invested and what are the expected outcomes. Any interested person has access to the following on the MoF website:

- interactive budget infographics, letting the user to review nine budget contribution fields (for example, health, education, social protection, etc.) and the financing allocated thereto, as well as to get to know detailed information on directions of contribution in each of the sectors and sources or financing. Additionally, information on outcomes to be expected from contributing the State budget financing into the relevant field is provided;
- budgets of the ministries and other central institutions are visualised both in summarised form and in more detail. The user can review the fields of operation of the ministries and other central institutions and the financing allocated thereto, as well as to get an insight regarding the benefits for society in the result of sectoral activity. It is reflected in the Policy and resource management cards, which in a summarised form provide possibly comprehensive and characteristic information on sectoral activity in the relevant field – the goal, inputs for the achievement thereof, expected operational outputs and the highest level sectoral policy and quality outcomes to be achieved.

When preparing a report on the analysis on the State budget execution, ministries and other central State institutions shall provide explanations about previously planned operating results and performance indicators thereof, their implementation during the year, as well as explanations about the deviations in values of the achieved and planned performance indicators if they exceed 15 per cent (both in positive and negative terms). The MoF shall summarize, evaluate and ensure the accumulation of the operational results and performance indicators of the State budget programmes (sub-programmes).

Ministries and other central State budget instructions and local government according to the procedures prescribed by the Cabinet shall prepare and submit to Treasury the monthly, quarterly and annual reports, in turn, Treasury shall arrange for the accounting of the State budget finances. Treasury shall prepare regular official and operative statements and provide information regarding the State and local government budget execution, ensuring the informing of the MoF, other institutions, as well as public regarding the process of the budget execution.

The LBFM prescribes the following organisational aspects of the State budget implementation:

- persons implementing the State budget may make the budget expenditure or assume short-term liabilities only within the limits of the assignments determined by financing plans issued by Treasury. Treasury in turn provides allocations for expenditure, on the basis of the appropriations stated in the Annual State Budget Law and ensures their execution according to the procedures prescribed by the Cabinet. Ministries and other central state authorities are responsible for the development of the system of control over the fulfilment of the appropriations determined in the

Annual State Budget Law and for the control over expenditure of the State budget funds transferred into the current accounts of Treasury in accordance with the purposes intended;

- State-financed institutions may undertake long-term liabilities of the State budget, not exceeding the ceilings of the State budget long-term liabilities for a financial year that are prescribed by the Law on the State Budget;
- State budget institutions for the receipt of assignments and for the making of expenditure from the State budget funds shall open the State basic budget and State special budget accounts only with Treasury. Institutions non-financed from the budget shall open current accounts only with Treasury. Bodies financed from the budget, except for the State budget institutions, for the receipt of the State budget funds and for the making of expenditure financed therefrom shall open current accounts only with Treasury, unless provided for otherwise in other regulatory enactments. Local governments and derived public persons partially financed from the State budget, as well as capital companies in which a State or local government capital share is invested may open current accounts with Treasury;
- ministries and other central State budget instructions and local government according to the procedures prescribed by the Cabinet shall prepare and submit to Treasury the monthly, quarterly and annual reports, in turn, Treasury shall arrange for the accounting of the State budget finances; Treasury shall prepare regular official and operative statements and provide information regarding the State and local government budget execution, ensuring the informing of the MoF, other institutions, as well as public regarding the process of the budget execution.

In order to strengthen the possibilities to control the utilization of resources, the LBFM provides that the Minister for Finance has the right to issue an order to Treasury to delay or reduce assignments for a period up to three months if at least one of the following conditions exist:

- if within the time period of three months the actual revenues from the State budget taxes and non-taxes in respect to the anticipated revenues in the relevant period decreases by more than 0.5% from the forecast of GDP determined in the Annual State Budget Law;
- the actual accumulated State budget financial deficit within the time period of three months exceeds the State budget financial deficit anticipated for the relevant time period by more than 0.5% from the forecast of GDP determined in the Annual State Budget Law;
- there is no sufficient amount of funds in the budgetary accounts of Treasury to cover payment commitments planned for the next month.

The LBFM provides for the following main sanctions in case of inappropriate utilization of budget resources:

- for late or incomplete payment of the amounts due to the State budget into Treasury budget accounts, Treasury, unless this is under the competency of another State agency, shall recover the amount not paid into revenue of the basic budget and may charge the late charges in the amount of 0.1% of the amount not paid in time for each late day of payment unless provided otherwise by regulatory enactments;
- in order to cover losses caused to the budget, Treasury may include amounts in the basic budget revenue and withdraw or suspend assignments, if the reports on budget and financial management have not been submitted in good time or are incomplete; the budgetary funds and transactions in such funds have not been registered in

accordance with the procedures prescribed by law or notice has not been given regarding them; the accounting does not comply with the prescribed procedures and, thus, funds due to the budget are concealed; or a manager of a body financed from the budget has undertaken liabilities exceeding the assignment allocated by Treasury;

- if bodies financed from the budget, institutions non-financed from the budget and local governments, as well as capital companies, in which a State or local government capital share has been invested, have violated financial management provisions provided for in the LBFM the Minister for Finance, the Treasurer or the heads of ministries and other central State institutions may in accordance with the competence withdraw for a period of time an authorisation to assign or deal with budgetary revenue or expenditures; set limitations on the use of accounts; withdraw or suspend the assignments in order that the illegally used funds be refunded or require refunding of the illegally used funds; submit a civil claim to a court or provide materials to competent officials for deciding on the issue of initiation of criminal proceedings; or withdraw or suspend payments.

In order to maintain general economic balance and to ensure a uniform State financial policy, the amounts of total increase in local government borrowings and guarantees shall be separately prescribed in the Annual State Budget Law.

Treasury has the right to withhold the sums from the amount, which is due to the local government from PIT, or from a grant of the local government financial equalisation fund in the following cases and amount:

- if the local government does not ensure timely fulfilment of the liabilities specified in State loan agreements – in the amount of sum not paid timely;
- if local government does not ensure use of the State loan in compliance with the purpose specified in the loan agreement – according to the order of the Minister for Finance in the amount of the loan sum used in non-compliance with the purpose specified in the agreement.

6.2. EFFICIENCY OF REVENUE STRUCTURE AND SYSTEM

The work on the development of the *State tax policy guidelines for 2018 – 2021* has been completed in 2017 and on 28 July 2017 various essential tax measures related to the guidelines have been approved in the Saeima (hereinafter – *Tax Reform*). The goal of the State tax policy guidelines is to introduce stable and predictable tax policy focussed on the growth of national economy and competitiveness, as well as limitation of income inequality in the country, at the same time ensuring stable and sufficient tax revenue for funding of public administration and services.

Table 6.1. Tax Revenue in General Government Budget (S.13), million euro

	Code (ESA)	2017	2018	2019	2020	2021
Tax revenue						
1. Production and import taxes	D.2	3 788.6	4 122.5	4 410.5	4 719.6	4 937.1
2. Current income and wealth taxes	D.5	2 301.0	2 042.9	1 999.0	2 179.6	2 260.0
3. Capital taxes	D.91	2.8	2.7	2.9	2.9	2.9
4. Social contributions	D.61	2 343.1	2 721.8	2 873.8	3 035.9	3 197.5
<i>Of which actual social contributions</i>	<i>D.611 and D.613</i>	2 256.5	2 635.2	2 787.2	2 949.3	3 110.9

In Latvia, the majority of all tax revenue is attributed to labour taxes. Having implemented the *Tax Reform* measures, the share of labour taxes will decrease from 46.4% in 2017 to 45.5% in 2021, therefore, the share of revenue from consumption and capital taxes in total tax revenue will gradually increase from 53.6% in 2017 to 54.5% in 2021.

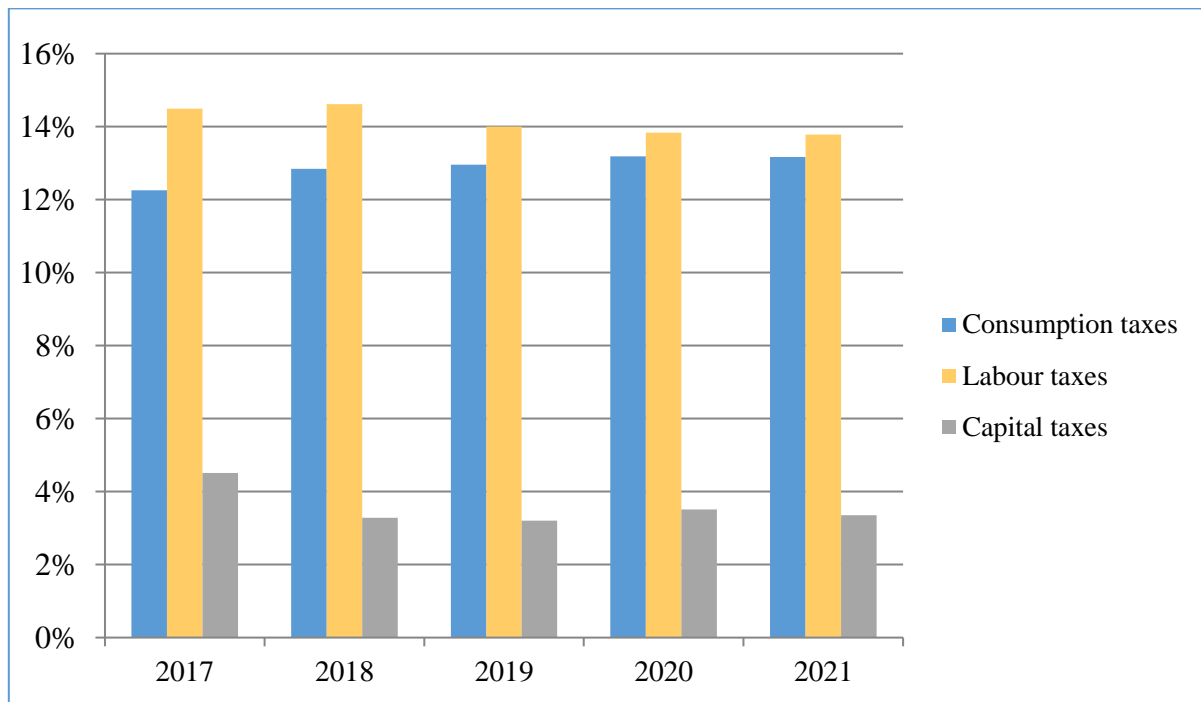


Figure 6.1. Tax Revenue According to Economic Functions, % of GDP

The main direction in the medium term tax policy is the implementation of the goal of the *Tax Reform*, ensuring stable and predictable tax policy by at least 2021, focussed on the growth of national economy and raising welfare of the population. This includes limitation of income inequality, at the same time ensuring sufficient and predictable tax revenue of due quality for funding of State and local government functions, by shifting the tax burden from the labour force to consumer, environmental and property taxes.

Tax Reform is a complex set of measures, the implementation whereof promotes the competitiveness of Latvia at the regional level, motivates population to commence entrepreneurial activity, facilitates investing into corporate development and attracts investors, encourages population to pay taxes, facilitates economic activity and willingness of the population to return to the labour market and enhances tax administration, in order to make tax payment and performance of the State control activities as simple and cost-effective as possible.

The most considerable measures implemented within the scope of the *Tax Reform* are oriented towards reduction of the labour tax burden, increase of income for the low-income employees and families with children, as well as shifting the tax burden to other types of taxes with a smaller impact on economic growth.

Therewith, the introduction of such tax measures has been supported, which is oriented towards growth of national economy and raising welfare of the population, by introducing significant changes in the largest taxes.

In the field of tax policy the CIT policy was "reformed" – in accordance with the 28 July 2017 law *On Corporate Income Tax* a conceptually new CIT payment regime was introduced as of 1 January 2018. The new model provides to postpone the moment of payment of tax till the time, when the profit is allocated or otherwise expended for such expenditure, which do not ensure further development of the company.

The PIT policy was also reformed by introducing progressive PIT, as well as increasing the differentiated non-taxable minimum and allowance for dependents, at the same time also increasing the non-taxable minimum for pensioners. Within the PIT reform, the tax rate on capital and capital gains has also been equalised, determining it in the amount of 20%.

Within the scope of the *Tax Reform*, as of 2018, the solidarity tax has been transformed – tax with the rate of 35.09% for income exceeding 55 000 euro per year, is being distributed (please see Chapter on Solidarity Tax). In 2016 and 2017 the solidarity tax had been transferred in the State basic budget to a full extent.

As of 1 July 2018, the excise duty rates for cigarettes will be increased more rapidly than initially planned. As of 1 January 2020, the excise duty rates for cigarettes, cigars and cigarillos and the smoking tobacco will be increased. As of 1 January 2018 the excise duty rates for oil products used as fuel have been increased and will be increased as of 1 January 2020 as well. As of 1 March 2018, the excise tax duty rates for alcoholic beverages and beer have been increased more rapidly as initially planned. Excise duty rates will be increased also as of 1 March 2019 and 2020. Excise duty tax for fermented beverages with the content of absolute alcohol of up to 6 volume percent will be preserved in the previous level.

The shadow economy has a negative impact on the country's overall economic growth, as well as it endangers the rule of law in the country and fair competition among businesses. Consequently, one of the government's priorities is the reduction of the shadow economy in the country for the achievement whereof, on 16 September 2014 a Shadow Economy Combating Council was set up. The Council's task within the field of combating the shadow economy is to coordinate and monitor responsible institutions in order to significantly reduce "envelope wages", combat tax fraud schemes and other unfair business principles, to which particular attention will be paid in the medium term – especially active work of the SRS against tax evasion, thus improving tax collection.

The most significant shadow economy reducing measures are related to the changes in the VAT – the reverse payment procedure has been introduced for the supplies of construction material and household appliances, as well as for the supply of metal products and services related thereto. The annual turnover threshold up to which the domestic VAT payer is allowed not to register in the VAT payers' register of the SRS has been reduced from 50 000 euro to 40 000 euro. The threshold for deciphering VAT transactions has been reduced, stating that a registered VAT payer will have to decipher transactions with registered VAT payers, the value whereof, without the VAT, exceeds 150 euro, instead of the previously deciphered transactions, the value whereof, without the VAT, exceeds 1 430 euro.

Likewise, within the scope of the *Tax Reform*, in 2018, various other measures for reduction and improvement of administration of shadow economy have taken effect.

Value Added Tax

According to the forecasted national economic growth, as well as taking into account the increase of the share of the VAT revenue in the GDP over the recent years, a stable VAT revenue growth is expected. In addition, in the medium term the VAT revenue growth will be facilitated by the continued implementation of the measures adopted by the government – the fight against tax evasion and tax avoidance, improving efficiency of tax collection. Improvements in tax collection will result in gradual increase in the amount of tax revenue to GDP.

The expansion of the VAT reverse payment procedure, by introducing the reverse payment procedure for the supplies of construction materials and household appliances, and the introduction of the VAT reverse payment procedure for the supply of metal products and

services related thereto can be mentioned as the most significant measures to affect the VAT revenue in 2018.

EC has not yet granted its accept for application of the VAT reverse payment system to the supplies of electrical household equipment and construction materials from 2018. At present, active communication is in progress for solving the referred to issue. Reverse system for the supplies of the referred to goods has been introduced in practice and operates, as a result the share of fraudulent schemes in the sectors of relevant goods is being reduced, thus reducing the total level of shadow economy, not only in the field of VAT, but also in the field of labour taxes, as whole. At present, Latvia continues the discussion with the EC on the preservation of the reverse system for the referred to groups of goods.

VAT revenue in 2018 will be affected by both the *Tax Reform* measures and other legislative changes:

- to reduce the annual turnover threshold up to which the domestic VAT payer is allowed not to register in the VAT payers' register of the SRS from 50 000 euro to 40 000 euro;
- reduction of the threshold for deciphering VAT transactions, stating that a registered VAT payer will have to decipher transactions with registered VAT payers, the value whereof, without the VAT, exceeds 150 euro, instead of the previously deciphered transactions, the value whereof, without the VAT, exceeds 1 430 euro;
- introduction of a reduced VAT rate of 5% to the fruits, berries and vegetable characteristic to Latvia. The reduced rate will be introduced for a period of time from 1 January 2018 till 31 December 2020.

In addition to the above mentioned changes, the VAT revenue is also influenced by other measures, which are not directly related to the changes in the *Value Added Tax Law*, but will promote the increase of the revenue thereof, for example, changes in the application of the excise duty, increase of the minimum monthly wage, measures for combating shadow economy and improvement of tax administration.

Table 6.2. Impact of the Changes in Tax Policy³⁰ on VAT Revenue, million euro

	2018	2019	2020	2021
Introduction of the reverse VAT payment procedure for deliveries of crops and industrial crops (starting from 1 July 2016)		-4.3		
Introduction of the reverse VAT payment procedure for deliveries of the crude precious metals, precious metal alloys, precious metal coated metals, precious scrap metal and shivers		-0.5		
Increase of the excise duty on cigarettes, cigars and cigarillos and smoking tobacco, alcoholic beverages and beer, oil products	13.4	4.1	6.9	
Reduction of the VAT registration threshold from 50 000 euro to 40 000 euro	5.9			
Reduction of the threshold for deciphering VAT transactions in the VAT returns from 1 430 euro to 150 euro;	38.0			
Expansion of the VAT reverse, introducing it in supplies of construction materials, metals and household appliances	40.2			
Measures for minimising shadow economy - improvement of administration and collection	9.5			
Tax support measure - without additional qualifying criteria, the possibility will be provided for the period of up to 2 years to repay the debt, as a result discharging the late interest and fine	10.5		-8.0	
Reduced VAT rate of 5% for vegetables, fruits and berries characteristic for Latvia	-6.0			6.0
Development of solutions for organising receipt lottery		2.9		-2.9

³⁰Here and in subsequent tables, showing the impact of tax policy changes, the annual impact of introduction is presented.

Introduction of the reverse VAT payment procedure for supplies of leguminous plants		0.5		
Total impact of changes:	111.5	2.7	-1.0	3.1

Corporate Income Tax

In accordance with the 28 July 2017 law *On Corporate Income Tax* a conceptually new CIT payment regime is provided for starting from 2018. The new model provides to postpone the moment of payment of tax till the time, when the profit is allocated or otherwise expended for such expenditure, which do not ensure further development of the company.

The most significant changes in the CIT revenue in 2018 are related to introduction of the new model. CIT revenue is influenced also by the previously adopted legislative changes with respect to the changes in the micro-enterprise tax rates.

In addition, CIT revenue in 2018 and subsequent years will be affected also by other legislative changes taking effect on 1 January 2018:

- reduction of the threshold of annual turnover of a micro-enterprise to 40 thousand euro;
- tax support measures;
- increase of the minimum share of profit to be disbursed in dividend for capital companies (for the profit of 2018), where all capital shares are directly or indirectly owned by the State, to 85 per cent.

To compensate the fall in the CIT revenue occurred in the year of introduction of the *Tax Reform*, it is planned to continue performing the CIT advance payments in the first six months of 2018.

Table 6.3. Impact of the Changes in Tax Policy on CIT Revenue, million euro

	2018	2018	2020
CIT reform (reinvested profit)	-339.4	+182.8	-10.8
CIT advance payments in the first six months of 2018	+102.0	-102.0	
Limiting the threshold of the ME operation	-0.4		
Tax support measures (possibility for the period of up to 2 years to repay the debt, as a result discharging the late interest and fine)	+1.8		-1.5
Increase of the minimum share of profit to be disbursed in dividend for capital companies, where all capital shares are directly or indirectly owned by the State, to 85%		+0.5	
Changes of ME rate	-0.376		
Total impact of changes:	-236.3	+81.3	-12.3

Excise Duty

Excise duty revenue is affected not only by the *Tax Reform* measures, but also by the changes in legal framework adopted in the previous years.

Gradual increase of the excise duty for **tobacco products** has been already planned with the amendments to the *Law on Excise Duty* adopted in the previous years:

- according to the amendments introduced on 6 November 2013, as of 1 July 2018 it was planned to increase the specific tax rate on **cigarettes** from 58.2 euro to 60.0 euro and the minimum duty level from 97.0 euro to 100.00 euro per 1 000 cigarettes, and it was planned to preserve the percentage proportion of the tax rate on cigarettes unchanged – at the level of 25%. In turn, by the 23 November 2016 amendments to the *Law on Excise Duty*, more rapid increase of the excise duty was determined, stating as of 1 July 2018 to increase the specific share of rate to 69.5 euro per 1 000 cigarettes, but the minimum tax rate to 103.5 euro per 1 000 cigarettes. The

percentage proportion of the rate of the excise duty on cigarettes had already been reduced to 20% as of 1 July 2017, and there were no plans to change it in 2018;

- according to the amendments introduced on 14 April 2011, as of 1 January 2018 it was planned to increase the excise duty rate on **cigars and cigarillos** from 42.69 euro to 45.0 euro per 1 000 cigars or cigarillos. Nevertheless, by the 23 November 2016 amendments to the *Law on Excise Duty*, more rapid increase of the rate was planned – as of 1 January 2018 – to 73.0 euro and as of 1 January 2019 – to 88.0 euro per 1 000 pieces;
- according to the amendments adopted on 30 November 2015, the increase of the excise duty rates was scheduled for **smoking tobacco** (including tobacco leaves, heated tobacco), by increasing them from 60.0 euro to 62.0 euro per 1 000 grams of tobacco as of 1 January 2018. Nevertheless, by the 23 November 2016 amendments to the *Law on Excise Duty*, more rapid increase of the rate was stated, by planning to increase them as of 1 January 2018 to 66.0 euro and as of 1 January 2019 – to 70.0 euro per 1 000 grams of tobacco.

Nevertheless, by the amendments to the *Law on Excise Duty* adopted on 27 July 2017, more rapid increase of the excise duty was determined for cigarettes in 2018 and an increase also as of 1 January 2019, but as regards to cigars, cigarillos and smoking tobacco – an increase was scheduled also in 2020. The result of all the changes with respect to the tobacco products is reflected in Table 6.4.

Table 6.4. Excise Duty Rates for Tobacco Products

Excise duty object	Effective date of the rate		
	1 July 2017	1 July 2018	1 July 2019
Cigarettes			
Duty rate, euro per 1 000 pieces	67.0	74.6	78.7
Minimum duty level, euro per 1 000 pieces	99.0	109.2	114.7
Percentage rate of the retail trade price	20%	20%	20%
Cigars and cigarillos	1 January 2018	1 January 2019	1 January 2020
Duty rate, euro per 1 000 pieces	73.0	88.0	95.2
Smoking tobacco	1 January 2018	1 January 2019	1 January 2020
Finely cut tobacco, other smoking tobacco, tobacco leaves, heated tobacco, euro per 1 000 g	66.0	70.0	75.0

Gradual increase is also prescribed for the excise duty on alcoholic beverages and beer. According to the amendments adopted on 30 November 2015 to the law *On Excise Duty*, starting from 1 March 2016 the increase of the excise duty rates on alcoholic beverages and beer was scheduled and it was planned to increase them also as of 1 March 2017 and 2018. Nevertheless, within the scope of the *Tax Reform* by the 27 July 2017 amendments to the law *On Excise Duties*, it was resolved as of 1 March 2018 to increase the rates more rapidly and to determine further increase thereof also as of 1 March 2019 and 2020. Table 6.5 reflects both the previously planned and the currently effective schedule for increasing the rates.

Table 6.5. Excise Duty Rates on Alcoholic Beverages and Beer

Type of alcoholic beverage	Rates determined as of 30 November 2015		Rates determined as of 27 July 2017		
	1 March 2017	1 March 2018	1 March 2018	1 March 2019	1 March 2020
Wine, fermented beverages with pure alcohol content exceeding 6 volume percent and intermediate products with	78.0	82.0	92.0	101.0	111.0

absolute alcohol content of up to 15 volume percent, euro per 100 litres					
Fermented beverages with absolute alcohol content up to 6 volume percent, euro per 100 litres	64.0	64.0	64.0	64.0	64.0
Intermediate products with absolute alcohol content from 15 volume percent to 22 volume percent, euro per 100 litres	130.0	135.0	150.0	168.0	185.0
Other alcoholic beverages, euro per 100 litres of pure alcohol	1 450.0	1 500.0	1 670.0	1 840.0	2 025.0.
Beer, euro per each volume percent of pure alcohol per 100 litres	4.5	4.8	6.8	7.4	8.1
Minimum level of excise duty, euro per 100 litres of beer	8.2	8.6	12.5	13.6	14.9

Excise duty on **oil products** is also affected by the changes in legal framework adopted in the previous years:

- According to the decision on amendments to the Cabinet Regulation No.194 adopted by the Cabinet on 26 May 2016, stating that, when administering the granting of fuel with reduced excise duty rate for the operating year 2017/2018 and the subsequent years, the sums of payments received in the EU support measures "Organic farming" and "Agro–environment and Climate" will not be included in the revenue. Therewith in the operating year 2017/2018 and the subsequent years the land areas, for which the rights to acquire the diesel fuel with the reduced excise duty rate are granted, will reduce and the excise duty revenue from the diesel fuel will grow;
- along with the amendments adopted by the Saeima on 23 November 2016 to the law *On Excise Duties*, it was planned, starting from the operating year 2017/2018, to abolish the rights to acquire the diesel fuel with the reduced excise duty rate for the land areas, where the corn is cultivated for the generation of the biogas (cultivated plants code 791).

Nevertheless, the most significant changes in the medium term were determined by the 27 July 2017 amendments to the law *On Excise Duties*, providing the increase of the excise duty rates on oil products used as fuel as of 1 January 2018 and 2020 (please see Table 6.6).

Table 6.6. Excise Duty Rates on Oil Products

Excise duty object	1 January 2018	1 January 2020
Unleaded petrol, euro per 1, 000 litres	476.0	509.0
Leaded petrol, euro per 1, 000 litres	594.0	594.0
Diesel fuel, kerosene, fuel oil*, euro per 1, 000 litres	372.0	414.0
Diesel fuel used in agriculture**, euro per 1, 000 litres	55.8***	62.1
Liquefied petroleum gas, euro per 1, 000 kg	244.0	285.0

* for fuel oil, the colorimetric index of which is less than 2.0 and the kinematic viscosity of which at 50°C is less than 25 mm²/s, and the substitute products and components thereof

**labelled (marked) diesel fuel (gas oil), used for production of agricultural products, cultivation of agricultural land and cultivation of such forest or marshland where cranberries or blueberries are cultivated and for cultivation of land under fishing ponds

*** rate is in effect as of 1 July 2018. Till 30 June 2018, the rate is 50.0 euro per 1, 000 litres.

Table 6.7. Impact of the Changes in Tax Policy on Excise Duty Revenue, million euro

	2018	2019	2020
Increase of the excise duty rates for cigarettes, cigars, cigarillos and smoking tobacco	+10.2	+10.2	+4.8
Increase of the excise duty on alcoholic beverages and beer	+26.9	+9.2	+14.3
When administering the granting of fuel with reduced excise duty rate for the operating year 2017/2018 and the subsequent years, the revenue does not include the sums of payments received in the EU support measures "Organic farming" and "Agro-environment and Climate".	+0.9		
As of operating year 2017/2018 the rights to acquire the diesel fuel with reduced excise duty rate for the land areas, where the corn is cultivated for acquisition of biogas, are cancelled	+0.1		
Increase of the excise duty rates for oil products, used as fuel	+26.6		+14.3
Total impact of changes:	+64.6	+19.4	+33.4

Real Estate Tax

Since 2012, local governments are entitled to determine by binding regulations the tax rate from 0.2 to 3.0 per cent of the cadastral value of real estate. The tax rate may exceed the threshold of 1.5 percent only in case the real estate is not being maintained according to the procedure prescribed by regulatory enactments. Local governments are also entitled to continue applying a restriction on increase in the tax amount for land or to keep the tax amount for land at the level of the previous taxation year as well as to determine the amount of restriction and conditions for application.

Real estate tax revenue in 2018 will be affected only by revision of separate real estate cadastral values.

Table 6.8. Impact of the Changes in Tax Policy on Real Estate Tax Revenue, million euro

	2018
Revision of separate real estate cadastral values	+7.0
Total impact of changes:	+7.0

Personal Income Tax

PIT revenue is mainly influenced by the number of population employed in national economic, income of the employed, the amount of the non-taxable minimum and exemptions of the PIT, minimum wage, as well as introduced legislative changes.

The most significant changes to affect the PIT revenue in 2018 and henceforth are attributable to the *Tax Reform* measures:

- introduction of the progressive PIT rate of 20% for the annual income up to 20 004 euro; 23% for the annual income exceeding 20 004 euro, but not exceeding 55 000 euro; 31.4% for the annual income above 55 000 euro (conditional rate, as it will not be applied during the taxation year, but, when filing the annual income declaration and performing the recalculation by three PIT rates. As it is not necessary to perform the state social security contributions above 55 000 euro, but the conditional share of the employee's solidarity tax is being included into the paid PIT, the total tax burden for the payer will not exceed the referred to threshold);
- increase of the differentiated non-taxable minimum;

Table 6.9. Differentiated Non-Taxable Minimum for 2018 – 2020

	2018	2019	2020
Maximum non-taxable minimum	200	230	250
Minimum non-taxable minimum	0	0	0
Maximum limit of taxable income	1 000	1 100	1 200
Minimum limit of taxable income	440	440	440

- increase of allowance for dependents – 200 euro per month in 2018, 230 euro per month in 2019, 250 euro per month in 2020;
- expansion of the circle of beneficiaries of allowance by the unemployed spouse, if he/she takes care of a child;
- revision of the norms of eligible expenditure, increasing the restriction for the PIT eligible expenditure for education, medicine and charitable donations of up to 600 euro per year (for a person him/herself and for each family member in the amount of 50% of the taxable income), as well as determining both proportionate (10% of the annual taxable income) and aggregate restriction – 4 000 euro per year – for eligible expenditure for contributions into private pension funds and insurance premiums;
- increase of a non-taxable income for pensioners to 250 euro per month in 2018, to 270 euro per month in 2019 and to 300 euro per month in 2020;
- raise of the monthly minimum wage to 430 euro per month;
- equalisation of the tax rate on capital and capital gains, stating it in the amount of 20% (except for the dividend, if it has already been taxed at the corporate level with 20% income tax rate at the moment of profit allocation);
- inclusion of the sum (not exceeding 80%) of income from economic activity into expenses from economic activity;
- PIT taxation, applying the tax rate of 20% for lotteries and gambling wins exceeding 3 000 euro;
- improvement of the patent fee regime, stating a unified patent fee amount of 50 euro and 100 euro, refusing from too detailed itemisation of the types of economic activity, as well as simplifying the payment thereof. To apply a reduced patent fee regime also on the persons with group I and II disability;
- changes in the dividend policy with respect to introduction of the reinvested profit regime in the field of corporate income;
- measures for reducing the shadow economy and improvement of administration;
- expansion of the VAT reverse procedure, introducing it to the supplies of construction materials, metals and household appliances, as a result the share of "envelope wages" will reduce in the sector;
- reduction of the threshold of annual turnover of a micro-enterprise to 40 thousand euro;
- transformation of the solidarity tax for PIT (10.5% above the established social contributions ceiling).

The PIT revenue will be additionally affected also by the measure approved in the Saeima with respect to the developed solution for organising the receipt lottery.

The PIT revenue in 2018 is influenced also by the legislative changes adopted in the previous years:

- the PIT relief for received amounts disbursed as the state or the EU aid for agriculture and rural development is prolonged till 2023;

- change of the PIT regulation with respect to the disbursements from the private pension funds, restricting the application of allowance in case of tax planning;
- changes in the micro-enterprise tax rates.

Table 6.10. Impact of the Changes in Tax Policy on PIT Revenue, million euro

	2018	2019	2020	2021
PIT relief for received amounts disbursed as the state or the EU aid for agriculture and rural development is prolonged	-2.2			
Change of the regulation of the PIT with respect to the disbursements from the private pension funds	+0.9			
Changes of ME rate	-4.6			
Increase of the differentiated NTM	-38.7	-25.8	-20.2	
Increase of the allowance for a dependant	-15.6	-18.7	-12.5	
Introduction of progressive PIT rates	-137.5			
Expansion of the circle of beneficiaries of allowance by the unemployed spouse	-2.7	-2.7		
Increase of the non-taxable minimum for pensioners	-22.1	-9.5	-11.5	
Raise of the monthly minimum wage to 430 euro per month	+8.8			
Determination of the PIT on capital in the amount of 20%	+11.3			
Improvement of the patent fee regime, establishing a uniform amount of the patent fee	+0.3			
Inclusion of the sum not exceeding 80% of the income from economic activity into expenses from economic activity	+12.9			
PIT application to lotteries and gambling wins exceeding 3 000 euro (exception - the 100 th anniversary lottery)	+2.6			
Increase of the PIT rate from 10% to 20% for disbursement of the ME dividend	+2.1	+2.4		
Transitional period for disbursement of a dividend from retained profit of previous years in the amount of 10%	+110.6	-69.5	-32.7	
Determination of 0% rate for dividend		-70.0		
PIT taxation of dividend received abroad	+2.1			
Expansion of the VAT reverse procedure	+8.3			
To restrict the ME operational threshold to 40 000 euro per year	-2.6			
Restriction of eligible expenditure for education, medicine and charitable donations	+5.6			
Restriction of eligible expenditure for contributions into the private pension funds and life insurance	+3.8			
Combating shadow economy in the construction sector	+4.3			
Improvement of administration and collection	+2.4			
Possibility for the period of up to 2 years to repay the debt, as a result discharging the late interest and fine	+7.1		-5.4	
Transformation of the solidarity tax of 10.5% to PIT	+9.9	+9.7		
Solution for organising receipt lottery		+0.3		-0.3
Total impact of changes:	-33.0	-183.8	-82.3	-0.3

Medium-term macroeconomic development forecasts for 2018 provide for an increase in the wage fund, which, in turn, will increase labour tax revenue also over the period of subsequent years, however, as already mentioned herein above, the PIT revenue will be mainly influenced by the *Tax Reform* measures.

Social Security Contributions³¹

As of 2018, the ceiling of the SMSIC has been changed from 52 400 euro to 55 000 euro per year. Likewise, as of 2018, the State social security contributions rate has been increased from 34.09% to 35.09%, allocating this percentage point into the State basic budget for health funding, ensuring healthcare services funded from the State budget funds for the insured persons. The rate of contributions into the State funded pension scheme remains unchanged, comprising 6 percentage points of the total SMSIC rate.

The medium term dynamics of revenue from social security contributions will be determined not only by the forecasted increase in the wage fund, but also by the *Tax Reform* measures.

The most significant legislative changes in 2018, affecting the revenue from social security contributions:

- raise of the monthly minimum wage from 380 euro to 430 euro;
- equalizing PIT rates, by improving the patent fee regime and determining the SMSIC in the amount of at least 5% of the taxable income of the self-employed persons, which compincrease 430 euro in 2018;
- determination of the SMSIC from income from the royalties in the amount of at least 5%;
- the reversible effect created by decrease of envelope wages, through expansion of the reverse VAT payment procedure, introduced for the supplies of construction materials, metals and household appliances;
- restriction of the micro-enterpincrease operational threshold to 40 000 euro turnover per year;
- measures for minimising the shadow economy – combating it in the construction sector, as well as improving administration and collection;
- tax support measure that will provide for the possibility, without additional qualifying criteria, for the period of up to 2 years to repay the debt, as a result discharging the late interest and fine;
- adjusting the criteria of anti-tax avoidance norms of the law *On Personal Income Tax* with respect to the beneficiaries of royalties, employed by the payer of the royalty and receiving at least minimum wage;
- transformation of the solidarity tax to SMSIC (13.59% above the established SOC contributions ceiling).

The revenue from social security contributions in 2018 is influenced also by the legislative changes adopted in the previous years:

- determination of the monthly minimum object of SMSIC as of 2017;
- abolition of the determination of the monthly minimum object of SMSIC as of 2017;
- changes in the micro-enterpincrease tax rates.

³¹ Except for contributions into State funded pension scheme and payment into the basic budget for funding healthcare.

Table 6.11. Impact of the Changes in Tax Policy on the Revenue from Social Security Contributions³², million euro

	2018	2019	2020
Determination of the monthly minimum SMSIC object as of 2017	+21.7		
Changes of ME tax rate	+20.0		
Abolition of determination of the employee's and employer's minimum SMSIC object for the reporting month starting from 2017	-40.8		
Raise of the minimum monthly wage	+20.0		
Equalisation of the PIT rates from patent fees	+0.7		
Equalisation of the PIT rates for economic operators	+7.0		
Expansion of the VAT reverse procedure	+13.3		
Restriction of the ME operational threshold to 40 000 euro per year	+7.2		
Transformation of the solidarity tax	+12.8	+12.5	
Application of SMSIC to royalties	+2.2		
Measures for minimising shadow economy – improvement of administration and collection	+3.3		
Measures for minimising shadow economy in construction sector	+7.4		
Possibility for the period of up to 2 years to repay the debt, as a result discharging the late interest and fine	+5.0		-3.7
Adjustment of the criteria for the anti – PIT avoidance norms with respect to the beneficiaries of royalties	+0.1		
Total impact of changes:	+79.8	+12.5	-3.7

Lotteries and Gambling Tax

Lotteries and gambling tax is paid by the companies, which, under the procedure prescribed by the law *On Lotteries and Gambling Fee and Tax*, have acquired a special permit for organisation and maintenance of lotteries and gambling.

In accordance with the 27 July 2017 amendments to the law *On Lotteries and Gambling Fee and Tax*, as of 1 January 2018, the gambling tax rates have been increased for the card, dice and roulette tables from 18 000 euro to 23 400 euro per each table, but for the slot–machines – from 3 204 euro to 4 164 euro per each slot–machine (for the current calendar year). In addition to the above, by the 22 November 2017 amendments to the law *On Lotteries and Gambling Fee and Tax*, the allocation of the gambling tax revenue among the budgets has been changed, by transferring the revenue from the gambling tax for gambling organised by means of telecommunications, irrespective of the type of game, into the State basic budget.

³² Except for contributions into State funded pension scheme and payment into the basic budget for funding healthcare.

Table 6.12. Impact of the Changes in Tax Policy on Lotteries and Gambling Tax Revenue, million euro

	2018
Increase of the gambling tax rates for gaming-tables and slot-machines	+9.0
Total impact of changes:	+9.0

Subsidised Electricity Tax

The subsidised electricity tax has been applied from 1 January 2014 till 31 December 2017 and its purpose was to restrict increase in the total electricity price, in order to ensure the competitiveness of the national economy, not to increase the expenses of households and to ensure the implementation of aid measures for electricity users. Indirect purpose of the subsidised electricity tax was to facilitate competitive generation of electricity from renewable energy resources and in efficient co-generation, motivating energy generation in the most efficient way and ensuring that only competitive technologies enter the market.

The subsidised electricity tax was imposed on the income gained from sold energy within the framework of mandatory procurement, from the received guaranteed payment for installed electrical capacity in a co-generation station or electric power station, as well as from sold electricity that was being sold to public trader (to a licenced enterpincrease for transmission or distribution of electricity).

There were three differential rates set for the subsidised electricity tax – 15% for natural gas stations, 10% for stations of renewable resources and 5% for stations which provided thermal energy to centralised systems and whose subsidised electricity tax rate had a direct impact on the final tariff of thermal energy for the users.

Table 6.13. Impact of the Changes in Tax Policy on the Subsidised Electricity Tax Revenue, million euro

	2018
Abolition of the subsidised electricity tax	-33.1
Total impact of changes:	-33.1

Natural Resources Tax

Payments of natural resources tax are directly linked to the economic activities of the Latvian enterpincreases and the environmental loads caused thereby, as well as the environmental protection measures taken. Therewith, the tax revenue both increases, as the total economic activity grows, and also reduces, as the enterpincreases and municipalities take the environmental protection measures.

To promote effective and well-considered use of resources, on 23 November and 15 December 2016 the amendments to the Natural Resources Tax Law have been adopted in the Saeima (Parliament). According to the said amendments, starting from 1 January 2017 the natural resources tax rates were increased for number of natural resources tax objects, leaving the largest impact in 2017 and increasing the tax revenue base by 7.6 million euro. For several natural resources tax objects – coal, coke, lignite and for waste disposal – it was planned to increase the rates also henceforth (please see Table 6.14):

Table 6.14. Natural Resources Tax Rates, euro

Coal, coke and lignite	01.01.2018	01.01.2019	01.01.2020
<i>Coal, coke and lignite (brown coal) with the calorific capacity specified in the supporting documents (Gj/t)</i>	0.36	0.38	0.38
<i>Coal, coke and lignite (brown coal), if the calorific capacity is not specified in the supporting documents, t</i>	10.25	10.65	10.65
Waste disposal	01.01.2018	01.01.2019	01.01.2020
<i>Municipal waste and production waste not considered hazardous waste in accordance with the legal framework on the waste classification and properties making waste hazardous, t</i>	35.00	43.00	50.00
<i>Hazardous waste and production waste considered hazardous waste in accordance with the legal framework on the waste classification and properties making waste hazardous, t</i>	50.00	55.00	60.00

In addition to the above mentioned changes, starting from 1 July 2018, according to the adopted amendments to the Natural resources Tax Law, the natural resources tax rates will be aligned for electric and electronic appliances within the scope of the category, by increasing them for separate sub-categories by 27 per cent, on average.

Table 6.15. Impact of the Changes in Tax Policy on Natural Resources Tax Revenue, million euro

	2018	2019	2020
Increase of the natural resources tax rates	+0.6	+0.3	+0.2
Alignment of the natural resources tax rates for the electric and electronic appliances	+0.03		
Possibility for the period of up to 2 years to repay the debt, as a result discharging the late interest and fine	+4.9		-4.9
Total impact of changes:	+5.5	+0.3	-4.7

Solidarity Tax

As of 1 January 2016 a new labour tax was introduced – solidarity tax, having as its aim the prevention of regressive labour tax system, originating from the restoration of the maximum amount of the SMSIC object on 1 January 2014. Along with restoration of the maximum amount of the SMSIC object, the tax burden for the taxpayers with income above the defined maximum amount of the contributions object became smaller as compared to those persons, who performed tax payments from all work income.

Solidarity tax rate is the same as the rate of SMSIC (as of 2018 – 35.09%) and it is applied to the part of income exceeding the maximum object of the SMSIC.

Within the scope of the *Tax Reform*, the solidarity tax has been transformed in 2018. In 2016 and 2017, the solidarity tax has been, to a full extent, transferred into the State basic budget, however, as of 2018, the tax with 35.09% rate for income exceeding 55 000 euro per year will be allocated as follows:

- 1% for healthcare funding (health insurance), covered in the amount of 0.5% by the employee and in the amount of 0.5% – by the employer;
- 6% – into the accounts of the socially insured persons – participants of the funded pension scheme (covered by the employer);
- 4% – into the private pension fund pension plan selected by the taxpayer (covered by the employer);
- 13.59% – into the State pension special budget revenue (covered by the employer);

- transferring 10.5% into the PIT allocation account, ensuring that the taxpayer, by filing the annual income declaration and carrying out the PIT recalculation with three rates (the third rate of 31.4%), the calculated tax payable into the budget will be equal to the already paid part of the PIT and solidarity tax (covered by the employee).

The solidarity tax revenue is influenced by the legislative changes, taking effect as of 1 January 2018 and providing for the increase of the maximum amount of the SMSIC object from 52 400 euro to 55 000 euro, as well as the transformation thereof into other taxes.

Table 6.15. Impact of the Changes in Tax Policy on Solidarity Tax Revenue, million euro

	2018	2019
Solidarity tax reform	-33.1	-31.5
Total impact of changes:	-33.1	-31.5

Vehicle Operation Tax

Vehicle operation tax has been introduced since 2004 and forms a significant component of the general budget revenue.

Previously it was planned to postpone the changes in the procedure for payment of the vehicle operation tax to 2019, when the tax is paid for actual months of operation. However, last year the referred to measure was abolished, in general, leaving a neutral effect on the vehicle operation tax revenue.

7. SUSTAINABILITY OF PUBLIC FINANCES

7.1. THE LONG-TERM DEVELOPMENT SCENARIO OF PUBLIC FINANCES

From the point of view of financial sustainability, 2017 has been stable for Latvia's general government budget and social security system. Thanks to the favourable labour market conditions and average wage growth, higher revenues flowed into the budget, which is also showing a positive trend this year. In 2017, the unemployment rate in Latvia reduced steeper than in the previous year, according to the labour force survey data forming 8.7% of the economically active population. At the end of December 2017, the registered unemployment rate was 6.8% – by 1.6 percentage points lower than at the end of 2016. In turn, the number of registered unemployed persons reduced by 19.4% in 2017 and at the end of December was 63.1 thousand. In terms of expenditure, it should be noted that the state special budget spendings for social benefits, including pensions, were by 0.5% lower than it was forecasted in the budget of 2017. In some benefit categories, the number of beneficiaries has decreased, as well as the average amount of disbursed benefits has been less compared with budgeted. Thus, for example, in 2017 the number of unemployment benefit recipients were by 6.6% lower than budgeted. Starting from the 1st April 2017, amendments to the law "On Unemployment Insurance" came into force, extending the mandatory necessary social contribution period for entitlement to unemployment benefit. Thus, the mandatory social insurance contributions for the case of unemployment shall be made for at least 12 months during the last 16 months. Similarly, in 2017, sickness and maternity benefits were lower than planned in the budget.

Fiscal sustainability of Latvia is affected by the general government budget and debt commitments, their trends and future commitments, mainly, for disbursement of pensions and benefits. The increase of the budget expenditure in the long term may be affected by demographic changes, including, the increase in expenditure related to the ageing of population. The process of ageing of population, insufficient funding in the social protection and healthcare systems, as well as poverty and social exclusion risks in separate groups of population are long-term challenges for the sustainability of Latvia's public finances, which should be considered already today. Health care sector is one of the primary ones, requiring adequate funding for improvement of the public health and ensuring the sustainability of the system. Healthy people can work longer, to serve the public and provide for themselves with income, however, the availability of the health care system in Latvia is not sufficient. The report prepared by the EC *Eurobarometer – Patient safety and quality of care* in 2014 shows that only 47% of the surveyed Latvian citizens assess the health care system as good or very good, the average EU indicator is 71%. Compared with other EU countries, in Latvia the society assess the quality of the health care system as low. In Latvia the healthy life expectancy is the shortest one among the EU countries. Mortality from cardiovascular diseases in Latvia is 2.3 times higher than in the EU on average. Waiting time for outpatient health care services ranges from 20 days to even 680 days. Long waiting time for receiving health services cause a significant impact on the service continuity and ongoing security options. On 14 December 2017 the Saeima adopted in the final reading the Health Care Financing Law, which provides to change the health care financing system and to introduce the national compulsory health insurance based on the solidarity of all public involvement for responsible payment of taxes in order to facilitate appropriate health care financing, reaching the level of funding 4% of GDP in 2020, thus facilitating access to health care and improvement of public health indicators. Health insurance contributions paid to those who will not be automatically insured will be 1% of the minimum monthly wage starting from 1 January 2018, after a year the amount will increase to 3%, and in 2020 – up to 5%. A coherent arrangement of the health care system is a priority for the government..

In February 2016 the EC published the updated *Fiscal Sustainability Report 2015*. In this report a potentially low fiscal sustainability risk is identified for Latvia in all three risk categories (short-term, medium-term and long-term). This is based upon low general government budget deficit and debt, as well as low expenditure related to the population ageing in the long term.

The EC, in collaboration with the Member States (within the scope of the AWG), once per three years develops the long-term forecasts of the public sector expenditure related to the population ageing, as well as assesses the sustainability of public finances for each Member State. The long-term budget projections are based upon demographic projections, developed by *Eurostat*, and assumptions regarding economic growth and the factors determining it in the long-term. The long-term population ageing related projections on all the Member States are included in the Ageing Report of the EC. The long-term budget forecast assumptions reflected in this Stability program are based on the latest generally agreed projection assumptions published by the AWG Working Group (*The 2018 Aging Report: Underlying Assumptions and Projection Methodologies*), which will be included in the forthcoming 2018 Ageing Report. The regular forecasting cycle is taking place within the framework of the AWG and it is planned to publish the new report at the end of the second quarter of 2018.

The economic growth in Latvia, in general, plays a significant role in ensuring the sustainability of public finances. It is forecasted that under the influence of demographic changes the changes in the development of employment will be observed. It is expected that in the long-term both the rate of participation in the labour market will increase and the current trend will continue – unemployment will continue to reduce in the medium-term. In 2017, the unemployment rate in Latvia reduced steeper than in the previous year, according to the labour force survey data constituting 8.7%. According to the forecasts, in 2018, the unemployment rate will decrease to 8.0%, but over the period till 2021, it will gradually decline to 7.0% of the economically active population. This will partially allow compensating the influence of decrease in the number of working-age population on employment. It is to be already currently observed that upon the decrease of population being in the age capable to work (15–74 years) by approximately 1.5% per year during recent years, but acceleration of economic growth, the level of economic activity of population is increasing, the economically active population reaching 66.3% in 2014, in 2015 – 67.5%, in 2016 reaching 68.2%, but in 2017 already 68.9% of all 15–74 year-old population were actively involved on the labour market as employees or job seekers, which historically is the highest economic activity level in Latvia. The increasingly growing involvement in the labour market is promoted by growing demand for employees and increase of the wage level, with the average wage last year growing at the steepest rate ever since 2008 (by 7.8%), gradual increase in the retirement age, changes in the age structure of population, where the share of economically less active youth among all working – age population is decreasing. Such increase of economic activity is concurrently indicative of both the increase in the labour force demand and further improvement in the labour market, when the offered workplaces and wage level is stimulating enough, for the previously economically inactive people to return to the labour market. The EC also forecasts that the productivity growth in the long run will be a decisive factor for the economic growth and will be the basis for convergence in the long run. It should be noted also the labour force emigration as a whole decreases.

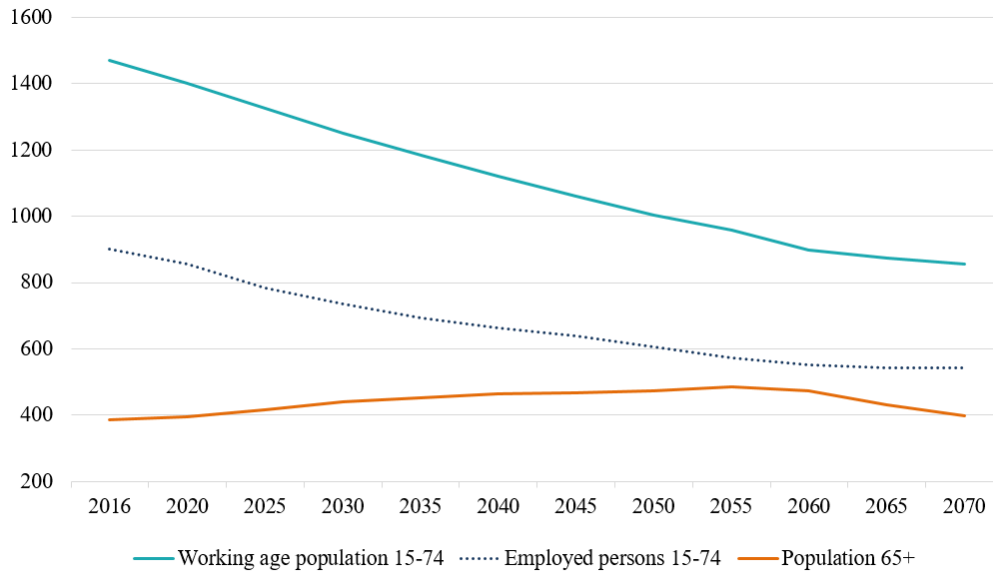


Figure 7.1. Number of Population and Employed Persons in the Age from 15 – 74 and the Number of Population in the Age of 65+ in Latvia, thousands (Data source: Eurostat, EC).

According to the data of the Central Statistical Bureau, the load of the Latvian demography and social security system is to be characterized with the following proportion: 1 pensioner per 1.5 employees. In 2016 there were 669 pensioners registered per 1000 mandatory socially insured persons. According to latest the *Eurostat* projections EUROPOP 2015, forming the basis for the projections included in the Ageing Report 2018, the reduction in the number of population is being projected in Latvia by 2070. According to the *Eurostat* baseline scenario it is forecasted that the total number of Latvia's population will decrease from 1.96 million in 2016 to 1.34 million in 2070. It is forecasted that the number of working-age (15–74) population (see Figure 7.1) will decrease by 58% or from 1.47 million in 2016 to approximately 0.85 million inhabitants in 2070. In turn, the number of population aged over 65 will increase by 2.0% in 2070 compared to 2016 and will total to 0.4 million. Decrease in the labour force will have an adverse effect on the budget. In turn, the productivity growth and labour force participation rate should have a positive effect. Fiscal policy, focusing on the long-term sustainability, should pay attention to these structural changes to ensure the ability of the state to implement consistent and effective policy actions.

Labour Force Survey data show that since 2010 the number of employees is growing in Latvia. It has a positive effect from both, the average wage increases as well as the rapid growth of the number of vacant positions (see Figure 7.2). Along with the more rapid economic growth the demand for workers has increased in the economy, while the offer is limited by the drop in the number of working-age population as a result of which the number of vacant positions has rapidly increased in last year, which has increased by 2.6 thousand or 17.9% compared with 2016. The highest share of job vacancies in 2017 was in the public administration, defence and mandatory social security sector - 4.6%, as well as in the processing industry sector and construction sector – 2.3% out of all workplaces. Since 2010 the number of employees in the age group of economically active population (15–74 years) has increased by 44 thousand from 851 thousand in 2010 to 895 thousand 2017. The MoF in its macroeconomic projections for the medium term currently forecasts that with the more rapid economic development in 2017 and 2018 the positive trends will remain and the number of employed persons in the economy will

remain at sustainable level over the next three years. Likewise, by various labour market stimulating measures, the employment for separate risk groups is facilitated, for example, for inhabitants, who have reached the threshold of 55 years. However, as already mentioned, further on the number of population in working-age will decrease in the long term, which requires to think about solutions to the problem already today.

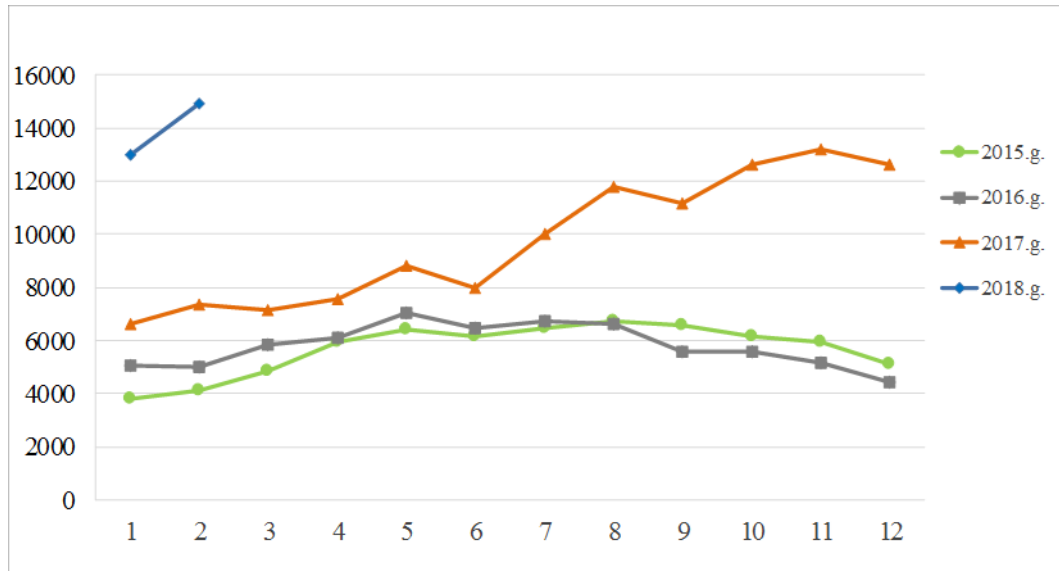


Figure 7.2. Changes in the number of vacancies by months, 2015 – 2018
(Data source: National Employment Agency).

The decrease of the overall number of population in the subsequent decades (see Figure 7.3) is determined by both negative natural growth and negative migration balance. According to the *Eurostat* long-term forecasts, the number of deaths in Latvia will gradually decrease, but it will, however, continue exceeding the number of births. Natural decrease of the number of population is strengthened by negative migration balance, which means that the number of inhabitants leaving the country will exceed the number of those entering the country, and according to the *Eurostat* forecasts this trend will continue in Latvia till 2045.

As the number of working-age population in the age from 15 to 64 years decrease, the changes in the number of the employed persons will be observed, as well (see Figure 7.1). Nevertheless, in accordance with the EC AWG macroeconomic assumptions it is forecasted that in the long term both the employment rate in this age group will increase (from 68.8% in 2016 to 70.3% in 2070) and the unemployment will decrease. It is forecasted that in the long run productivity growth will be a decisive factor for economic growth. It should be mentioned that with the above mentioned factors also the distribution of various alternative forms of employment both in Europe as well as Latvia should be taken into account. With the development of the "gig-economy"³³ phenomenon in most of the large economies, it seems attractive for companies to offer temporary work, fixed-term contract, self-employment and other forms to employees that are not included in full-time permanent employment category. More often and more narrowly used significance of this phenomenon is associated with the development of digitization process. Such forms of work at the same time provides greater uncertainty about the future, including the risk of unemployment for some time, which leaves

³³ The labour market, which is characterized by dominance of the proportion of short-term employment contracts and self-employed over the open-ended employment contracts.

an impact to a person's social security and welfare. Alternative forms of employment are one of the sustainability challenges that Latvia will have to face more and more in the future.

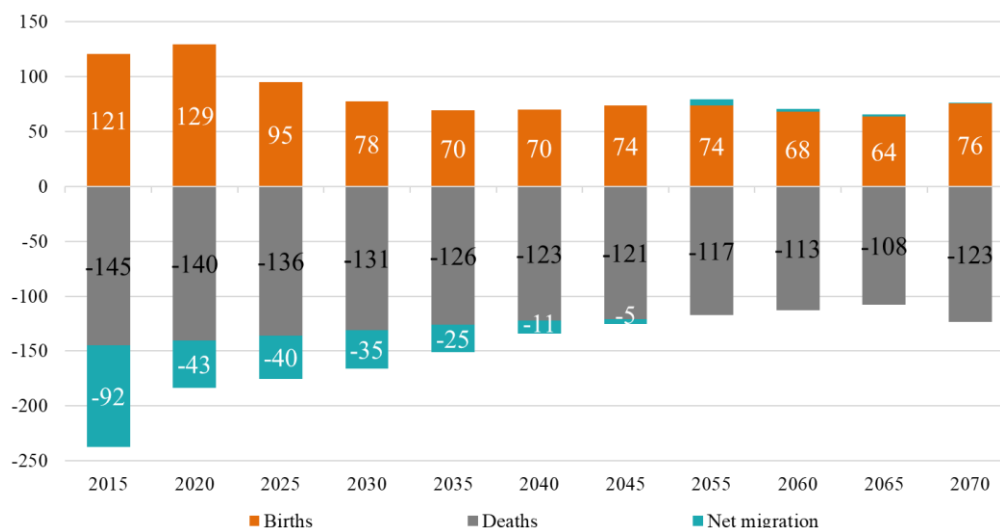


Figure 7.3. The Cumulative Impact of the Changes in the Number of Population Over the Period of 5 Years till 1 January 2070 by Factors: number of births, number of deaths and net migration, thousands (Data source: CSB, Eurostat).

At the same time, upon the improvement of employment indicators in Latvia, the issues of shortage of labour force appears in certain sectors, such as IT, manufacturing and transport, wholesale, retail, construction, as well as accommodation and food services sectors. There is a shortage of specialists of both, the higher and mid-level as well as low-skilled workers. The situation is made difficult by emigration of labour force, including the leaving university graduates. Social cooperation partners and entrepreneurs invite to review the higher education study programs, focusing more on those, where there is a lack of specialists. One of the most obvious examples is the information and communication technology area where entrepreneurs need qualified specialists. One of the possibilities the Ministry of Economics found the introduction of preferential immigration conditions for representatives of in total 29 professions sub-groups, in accordance with the Classification of Occupations, for example, scientists, physicists, chemists, engineers, builders, pilots, financial professionals, middle and high level managers, project managers and others. On 2 February 2017 the *Saeima* (the Parliament) approved amendments to the Immigration Law with the aim to facilitate entry conditions for highly qualified employees, including founders of start-ups, as well as employees in professions with significant labour force shortages.

With regards to the long-term general government budget expenditure forecasts, in accordance with the base scenario that is prepared for inclusion into the prospective Ageing Report 2018, it is forecasted that in case of no-policy change in Latvia the proportion of expenditure related to population ageing in GDP in 2070 compared to 2016 will decrease from 16.4% of GDP to 15.0% of GDP. Decrease will be mainly determined by the decline in the proportion of the State pension expenditure in GDP. The long-term public expenditure base scenario provides for:

- decline in the proportion of the State pension expenditure in GDP from 7.4% of GDP in 2016 to 4.7% of GDP in 2070;
- increase in the proportion of the healthcare expenditure in GDP from 3.7% of GDP in 2016 to 4.3% of GDP in 2070;
- increase in the proportion of long-term care expenditure in GDP from 0.4% of GDP in 2016 to 0.6% of GDP in 2070;
- increase in the proportion of education expenditure in GDP from 4.5% of GDP in 2016 to 5.0% of GDP in 2070;
- decline in the proportion of expenditure for unemployment benefits in GDP from 0.4% of GDP in 2016 to 0.3% of GDP in 2070.

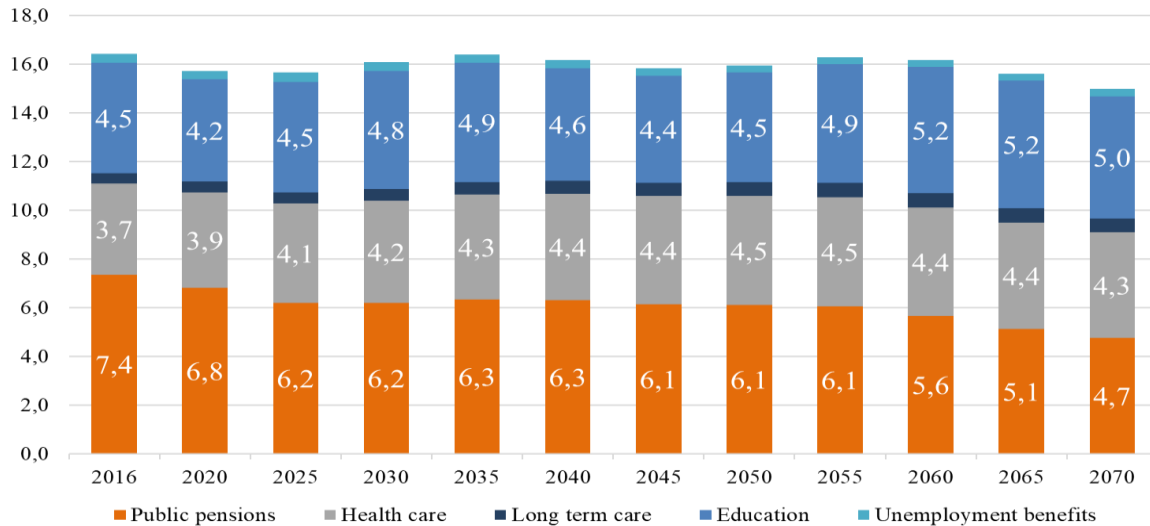


Figure 7.4. General Government Budget Expenditure Related to the Population Ageing, % of GDP (Data source: EC-EPC 2018 Ageing Report (forthcoming)).

For a well timed restriction of the negative impact of population ageing on the public sector (budgetary) expenditure in the long term, in 2012 there was a considerable reform performed in the Latvian pension system, determining a gradual increase in the retirement age up to 65 years and the minimum insurance period up to 20 years as of 2025. This factor substantially influenced the forecasted decline in the proportion of the state pension expenditure in the GDP. At the same time the recent changes in legislation should be taken into account, as listed at the end of this chapter, which entered into force in 2017 and this year with a purpose to improve the prosperity of current pensioners.

Despite the fact that the proportion of budgetary expenditure for State pensions in the GDP decreases in the long term, which improves the evaluation of the fiscal sustainability, at the same time the sufficiency or adequacy of pensions should be assessed. According to the OECD forecasts included in the *Pension Adequacy Report 2015*, in Latvia the theoretical income replacement level for a 65 year old inhabitant with 40 years working career will decrease significantly, for example, in the low income group from 69.2% of gross income in 2013 to 43.9% in 2053, in the average income group from 52.9% in 2013 to 43.9% in 2053, in turn in the high income group from 44.8% in 2013 to 32.8% of gross income in 2053. Latvia is

also among those countries, which face high poverty risk level among the older population, which, in turn, shows that these persons, while they were in the working age, have been employed either for a short period of time or have received small income, of which the social security contributions were made. This might affect the adequate pension coverage and increasing poverty among senior citizens in the future.

According to the OECD assessment (*Reviews of Pension Systems: Latvia, 2018*) the number of people is growing in Latvia, for whom the number of worked years has been shortened or is insufficient to qualify for old-age pension. In Latvia the length of employment for 11% of working-age in the age of 50 years, during which a person has been socially insured, does not exceed 15 years. In its turn, out of the persons, who have reached the age of 60, approximately 3% do not reach the insurance period of 15 years, which currently is the minimum to be able to receive an old-age pension. But already from 2025 the minimum insurance record for receipt of an old-age pension will be 20 years and the age of retirement will be 65. Upon increasing the retirement age, the burden of the state social insurance system is reduced, thus facilitating the financial sustainability of the special budget and the pension system. Also micro-enterprise payers, patent fee payers, recipients of the royalties and self-employed persons may appear in the risk group over the next decades, because they make reduced social insurance contributions or do not make at all. Until the end of 2017 the biggest proportion of self-employed practically did not make contributions into the pension system, which will, most likely, leave an impact on their social security, when they will retire. As of 1 January 2018 the permissible turnover for micro-enterprise taxpayers is reduced from 100 000 euro to 40 000 euro, but the micro-enterprise tax rate is 15% instead of the previous 9%. Since 1 January 2018 a natural person will be able to be employed as an employee of a micro-enterprise only in one micro-enterprise. Thus, the SRS will not register a micro-enterprise employee as an employee, if the person will be employed in another micro-enterprise. If an employee is employed by a micro-enterprise and will be employed by any other micro-enterprise as of 2019, another two percentage points will be added to the micro-enterprise tax 15% for each of the above mentioned employees. While the micro-enterprise taxpayer, who will employ a person, who is employed also by another micro-enterprise as of 2019, will lose the status of a micro-enterprise tax as of 2020. According to the latest information updated by 15 March 2018, there were 45 030 micro-enterprises registered in 2018 and their number, in comparison with 2017, when 50 944 micro-enterprises were registered, has decreased by 11.6%. Besides, as of 1 January of the current year the provision is deleted from the Law, allowing recipients of the royalties not to make mandatory social security insurance contributions (MSSIC) from the royalties as a self-employed person, if a person is an employee and at the same time receiver of the royalties. At the same time the provision came into force, stipulating that a payer of the royalties shall pay MSSIC in the amount of 5% of the royalty from its funds for the state pension insurance of the recipient thereof.

High poverty risk rate is to be observed in Latvia for older people – in particular women and persons being in the age over 75 years. For reduction of the poverty risk OECD recommends to increase the amounts of the minimum pension and state social security benefits, at the same time thinking about support in case of the surviving spouse.

As regards the improvement of the living standards of those receiving pensions and increase of the old-age pensions, number of measures are being taken, *inter alia*, in 2012 amendments were introduced to the law “*On State-Funded Pensions*” providing for, after financial and economic crisis, gradual restoration and increase of the contributions rate in the State-funded pension scheme. In 2016 the contributions rate has been increased for the last time to 6%. According to the AWG forecasts expenditure for the old-age pensions that would be

disbursed from the funded pension scheme or the second pillar might reach 2.6% of GDP in 2060.

The following changes in legislation came into force in 2017 and 2018 applicable to pensions:

- According to the amendments to the *Law on State–Funded Pensions* starting from 1st January 2017 the amount of pension indexation has been increased from 25% to 50% of the real percentage increase of insurance contributions wage;
- Starting from 1 January 2017, when the persons, whose insurance period is less than 15 years and who are not eligible to the State old–age pension, in accordance with the *Law on State Social Allowances* (amendments to the Law were adopted by the Saeima on 18 June 2015), reach the retirement age prescribed by the *Law on State–Funded Pensions*, they shall be granted by the State social security allowance (benefit) disbursed from the State basic budget funds;
- Since 2017, the state social security benefit is granted to a person, whose insurance period is below the minimum insurance period (or has not been at all) and who has exceeded the statutory retirement age (until 2017 – who exceeded the old–age pension by 5 years), which is funded from the principal state budget;
- As of 1 July 2018 the amount of the additional payment to the state pension for one year of insurance period that has been accumulated before 31 December 1995, will increase. The allowance for each work year will be 1.50 euros, if by the 31 December 1995 both the retirement age has been reached and the old age or disability pension has been granted;
- Since 1 October 2018, the amount of old-age pension indexation will depend on the insurance record. If the insurance record is up to 29 years, then the pensions will be indexed, taking into account 50% of the real percentage increase of insurance contributions wage, if from 30 to 39 years – 60%, if 40 years or more – 70%;
- A pension granted for work under harmful and severe or extremely harmful and difficult working conditions and a length of insurance will be up to 39 years will be indexed taking into account 60% of the real percentage increase of insurance contributions wage, but if the insurance period is 40 years or more - 70%.

7.2. STATE GUARANTEES

The law *On the State Budget for 2017* states that the Minister for Finance, on behalf of the State, may issue the guarantees for student and study lending in amount of 35.9 million euro, *inter alia*, study loans with the state guarantee in amount of 25.2 million euro and student loans with the state guarantee in amount of 10.7 million euro.

In 2017 the study loans with the state guarantee in amount of 6.1 million euro and the student loans with the state guarantee – in amount of 1.3 million euro were actually issued.

State guaranteed loans outstanding at the end of 2017 reached 441 million euro, which, as compared to the State guaranteed loans outstanding at the end of 2016, has increased by 8 million euro (see Figure 7.5).

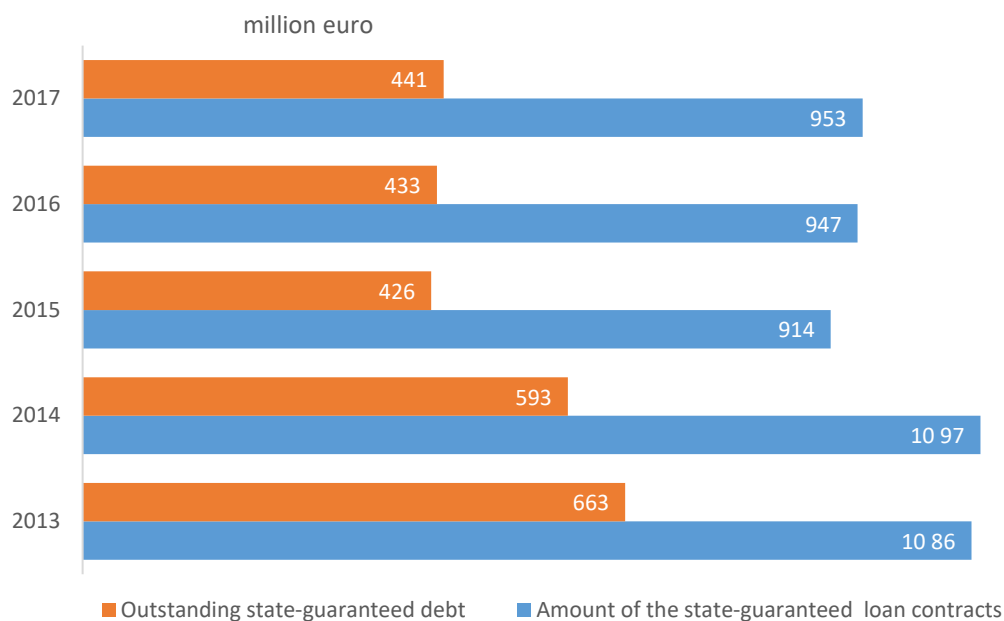


Figure 7.5. State-guaranteed loans outstanding at the end of respective year (million euro)

There are State guarantees in amount of 35.9 million euro anticipated in the law *On State Budget for 2018*, in amount of 10.7 million euro for student loans and 25.2 million euro for study loans.

Upon evaluating the financial situation of borrowers, current credit history, liquidity of the collateral and volume as well as other available information, provisions for two guarantees were established at the end of 2017. The outstanding amount of state-guaranteed loans to the mentioned borrowers accounted for 0.5% of the total amount of outstanding state-guaranteed loans on 31 December 2017.

According to the law *On State Budget for 2018*, a government subsidy for repayment of the state-guaranteed loans of medical institutions is provided in full amount, therefore provisions for state guaranteed loans of the medical institutions are no longer made on 31 December 2017.

In the law *On State Budget for 2018* allowable limits on government actions to cover expenditure that may occur in the execution of state-guaranteed debt obligations attributable to the State budget in 2018 are set at 5.8 million euro.

8. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

8.1. IMPLEMENTATION OF THE RULES ON THE STATE BUDGET AND OTHER INSTITUTIONAL DEVELOPMENTS REGARDING PUBLIC FINANCES

Along with the strengthening of the EU economic and fiscal management, in light of the new EU fiscal discipline rules, Latvia introduced the regulation of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (hereinafter – the Treaty) with two regulatory enactments – the law *On the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union* and the FDL. Since the FDL entered into force in 2013, in the process of drafting the State budget and the *Framework Law* the introduction of fiscal rules is being ensured in accordance with the SGP rules:

1. **Balance rule** The FDL provides for a balanced budget in structural terms stating that the structural balance should not be less than -0.5% of GDP.
2. **Expenditure growth rate rule** The FDL provides that, in addition to the limitations for structural deficit, expenditure, excluding the GDP deflator, should not grow faster than average potential GDP growth. It should be noted that exceptions from this rule are provided in accordance with the deviations specified in Article 9 of Council Regulation No 1175/2011;
3. **Setting government expenditure thresholds for the medium term** The FDL provides initial fiscal indicators, under which the *Framework Law* is developed. In this Law one of the key indicators is public expenditure thresholds for the next three years. The FDL provides that a standard condition for these expenditure thresholds is a stability condition – expenditure thresholds of the first and second year of the *Framework Law* are inherited from the second and third year of previous *Framework Law*. As a deviation from this condition – expenditure thresholds are not inherited, if the threshold value in accordance with the updated macroeconomic forecasts differs from inherited thresholds by more than 0.1% of GDP.

The EC is getting involved in the introduction of the fiscal rules into the national legislation of Latvia, which increases out of Clause 1, Article 8 of the Treaty, prescribing that the EC is invited to present in due time to the Contracting Parties a report on the provisions adopted by each of them. It shall be the task of the EC to supervise how each Contracting Party has introduced the rules of the Fiscal Compact into their national legal system.

On 22 February 2017 the EC Communication was published, where it was concluded that Latvia's national fiscal rules are consistent with the requirements of Article 3, Clause 2 of the Treaty, taking into account the explanations provided by Latvia on the discrepancies specified by the EC.

8.2. THE MEDIUM-TERM BUDGET PLANNING

According to the LBFM, medium term State budget planning is a process in which the resources accessible for the medium term are determined and the use of these resources is ensured in conformity with the priorities determined by the government. Medium term – a three-year period formed by the financial year for which the State budget is planned and the subsequent two financial years.

Since 2007, the Medium Term Macroeconomic Development and Fiscal Policy Framework (hereinafter – the Framework) has been prepared in the State for the next three financial years, in which there is an analysis of the medium-term State macroeconomic situation presented, as well as objectives of the government fiscal policy for medium term, forecasts on the State budget revenue and ceilings of the State budget total expenditure for each

ministry and other central State institutions for the medium term. In view of the fact that the Framework did not have legally binding nature and it only indicated the ceilings of the State budget total expenditure for the medium term, a need arose to strengthen the medium-term budget planning system. Therefore, corresponding amendments to the LBFM have been made and since 1 January 2012 the Framework, which since 2007 has been approved by the Cabinet, is drafted as a Framework Law and approved by the Saeima. Therefore, the achievable financial indicators, included in the Framework Law, have legally binding force and the drafting of the Annual State Budget Law, as well as drafting of further Framework Laws shall be based on these indicators.

The Framework Law is developed every year for the next three-year period, besides, for the first and the second year of each following period of the Framework Law, the indicators set in the previous Framework Law are used, adjusted in accordance with the cases stated in regulatory enactments, but the indicators planned for the third year are new. Furthermore, the Framework Law is associated with development planning documents ensuring coherence of available resources with the priorities of the government policy in the medium term, and it complies with the fiscal rules prescribed by the FDL, providing for a transparent and responsible fiscal policy. Thus, the Framework Law is the main tool to ensure compliance with the fiscal discipline.

The first year of the Framework Law operating period is elaborated in detail in the Annual State Budget Law. For each year of the Framework Law period the medium term budget objectives and priority development directions determined in the NDP are specified, formulation of the fiscal policy objectives of the government, the maximum permissible total amount of the State budget expenditure (also the maximum total amount for each budget sector), forecasts of the GDP, forecasts of the State budget revenue, the amount of the State budget financial balance (maximum deficit level or minimum surplus level). According to the provisions of the FDL simultaneously with the Framework Law for 2015 – 2017 for the first time the Fiscal Risk Declaration was developed aiming to ensure the overall management of fiscal risks, as well as stability of fiscal indicators in medium term.

Latvia as the Eurozone Member State has been submitting the Stability Programme to the EC. Latvia, as the Eurozone Member State, prepares the Draft Budgetary Plan of the Republic of Latvia, specifying the forecasts of the key indicators of the next year's budget – revenue, expenditure, deficit and government debt, including the State budget, local government budget, the budget of the partially State budget-funded derived public persons and the commercial companies included in the general government sector. The purpose of the said plan is to submit to the EC information, which would allow it assessing the compliance of the planned budget fiscal the norms of law of the EU in the field of fiscal discipline. If the EC detects that the budget plan considerably violates the EU fiscal discipline rules, it may reject the budget plan and request the Member State to introduce the changes and submit it repeatedly. Likewise, the EC, may, by the corresponding opinion, provide recommendation for improvement of the plan. The procedure prescribes that the national parliaments consider the opinion of the EU, when adopting the State budget in its final reading.

8.3. BUDGET PROCEDURES, INCLUDING PUBLIC FINANCE STATISTICAL MANAGEMENT

8.3.1. Budget procedures

The Constitution of the Republic of Latvia prescribes that the Saeima annually before the beginning of a financial year shall decide on the State revenue and expenditure budget, the

draft of which is submitted to the Saeima by the Cabinet. The Annual State Budget Law shall be approved by the Saeima.

When planning the expenditure of the State budget, first the base expenditure is calculated and agreed. Calculation of the base expenditure and the principles of its coherence with the Framework Law is determined by the 11 December 2012, Cabinet Regulation No. 867 *Procedure for establishing ceilings on the total amount of the State budget expenditure and on the total amount of the State budget expenditure for each ministry and other central State institutions for the medium term*. Thus, the necessary amount of expenditure is determined in order to ensure execution of the State functions at a unchanged level. Base expenditure shall be approved by the Cabinet.

Since 2016, unchanged and systematic State budget expenditure revision has been introduced as an integral part of the budgetary process, explained in more detail in Chapter 6.1 herein above.

The ministries and other central State institutions shall prepare proposals for the priority measures to be supported, if in the relevant subsequent financial years funds are available for development expenditure in accordance with the latest macroeconomic development forecasts. Proposals for the measures shall be prepared, on the basis of the priorities and goals set by the national Development Plan, the National Security Concept and other development planning documents. Thus, linking of the national priorities with the resources available within the State budget for the medium term is ensured.

When calculating ceilings of the total amount of the State budget expenditure, consisting of base expenditure of the State basic budget and the State special budget and of the expenditure for development of the State basic budget and the State special budget, the MoF shall rely on the Framework Law, forecasts of macroeconomic development, as well as observe fiscal conditions that are defined in the State. On the basis of the decisions approved by the Cabinet on the base expenditure and financing priority measures, the ministries and other central State institutions shall prepare and submit to the MoF the budgetary requests. The MoF shall prepare and submit the Draft Framework Law (with explanations, fiscal risks declaration, fiscal discipline supervision report of the Fiscal Discipline Council) and Draft Annual State Budget Law (with explanations) for the review to the Cabinet.

In order to provide the society with a clear idea of the resources used for the execution of State basic functions and implementation of activities of the EU and other foreign policy instruments, the budget shall be prepared according to the following sections:

- execution of State basic functions (except projects and activities financed or co-financed by EU policy instruments and other foreign financial aid);
- implementation of projects and activities financed or co-financed by EU policy instruments and other foreign financial aid.

Within the process of preparation of the Draft Annual State Budget Law, the following indicators shall be evaluated as a whole and then presented in the State Budget Law:

- the State budget revenue divided according to the types of revenue (divided by responsible ministries);
- the State budget expenditure divided according to programmes (sub-programmes) and the types of expenditure according to the economic nature;
- the financial balance of the State budget;
- the government debt ceiling at the end of a financial year;
- the amount of guarantees to be issued on behalf of the State;
- total increase in State budget loans;

- the amount of State budget earmarked subsidies for local governments, as well as the amount of the State budget subsidy for the local government financial equalisation fund;
- total increase in local government borrowings and total increase in the guarantees provided by local governments;
- other conditions, such as the contribution rate and contribution sum to the State-funded pension scheme.

Explanations to the Draft Annual State Budget Law include a description of the macroeconomic development scenario, fiscal review, analysis of revenue forecasts, the most significant elements of the State budget expenditure planning, explanations of tasks of the ministries, State budget expenditure divided by functional, administrative and economic categories, as well as information about the planned investment projects, information about State financial obligations (summary) and information about the amendments made to the regulatory enactments within the package of draft budget laws. Ministries and other central State institutions in the budget explanations include the Policy and resource management cards, the priority measures and the operating results and performance indicators in the result of their implementation, the optimization measures, as well for each programme (sub-programme) of the basic budget or special budget indicate the objective, main activities and performers, operating results and performance indicators, financial indicators and total expenditures changes. While the framework draft law explanatory notes include information about (i) the forecasted macroeconomic development, the medium-term risk assessment thereof, as well as a comparison with the medium-term macroeconomic forecasts laid down in the previous year's Framework Law; (ii) the medium-term objectives of fiscal policies, measures to be implemented for achievement thereof as well as their comparison with the medium-term objectives of fiscal policy determined in the previous Framework Law; (iii) revenue forecast for the medium term, as well as its comparison with the revenue forecast for the medium term laid down in the previous Framework Law; (iv) development trends of the government debt in the medium-term; (v) calculation, how the indicators defined in the Framework Draft Law are calculated; (vi) correction of the balance; (vii) differences of the accrued balances and other information.

During the process of development of the Draft State Budget Law and Draft Framework Law, negotiations between the LALRG and the MoF are being held, as a result of which a Cabinet and LALRG Draft Protocol is being prepared, which is submitted for consideration at the extended sittings of the Committee of the Cabinet. In the Draft Protocol, there are questions included on the local governments' tax revenue and other revenue forecasts, central government budget transfers to local governments, conditions of the local governments' loans, guarantees and long-term obligations, local governments financial equalization, and other issues related to the operations and finances of local governments. The Protocol is attached to the Draft Annual State Budget Law and Draft Framework Law, when the Cabinet submits it to the Saeima.

In compliance with the Law on Local Government Budgets, local governments shall develop their budgets no later than within two months following the proclamation of the Annual State Budget Law.

If at the beginning of a financial year the Annual State Budget Law has not come into force, the Minister for Finance shall approve the necessary State budget expenditure for local governments, provided that expenditure per month shall not exceed one twelfth of previous year's appropriation.

If the local government budget is not approved by the beginning of the financial years, the local government expenditure per month shall not exceed one twelfth of the previous year's

expenditure provided that the amount of functions to be fulfilled by the local government does not decrease.

The Law on Local Government Budgets prescribes strict conditions for the local government in the field of budget planning and execution – the local government budget assignments may not exceed the amounts planned in the budget.

Independent institutions (courts, the State Audit Office, the Office of the Ombudsman and other) play a special role in the budget process. The LBFM stipulates that the Cabinet when preparing the Draft Framework Law and the Draft Annual State Budget Law shall hear the view of independent institutions about the financing sections of corresponding institutions, justify the opinion of the Cabinet in case of funding reduction, and inform the legislator about the results of the aforementioned negotiations in a form of a protocol attached to the relevant draft laws.

The Cabinet has the right to determine additional conditions for planning and implementation of the State and local government budgets in order to ensure measures for reduction and prevention of the impact of the increased fiscal, economic and social risks caused by macroeconomic processes and ensure implementation of the fiscal criteria determined in international commitments.

8.3.2. Public finance statistical management

CSB compiles government finance statistics in accordance with the requirements of Regulation (EU) No 549/2013 of the European Parliament and of the Council of 21 May 2013 on the European system of national and regional accounts in the EU (hereinafter – the ESA 2010).

The framework of general government sector (S.13) in Latvia according to the ESA 2010 methodology consists of three sub-sectors: central government sub-sector (S.1311), local government sub-sector (S.1313) and social security sub-sector (S.1314).

According to Clause 6 of the 10 December 2013 Cabinet Regulation No. 1456 *Regulation Regarding Classification of Institutional Sectors* CSB prepares and maintains the list of the general government sector. In order to prepare the list and resolve upon the entities to be included therein, CSB takes into account the ESA 2010 requirements, as well as the principles defined in the EU Statistical Office Eurostat (hereinafter – Eurostat) Manual on Government Deficit and Debt, which prescribe to refer to the general government sector the capital companies controlled and mainly financed by the central and local governments.

As on 31 December 2017 in general government sector there were 1 044 independent budgetary institutions, of which 228 institutions were in central government subsector; 815 institutions – in local government subsector and one institution – in social security fund subsector; moreover, there were 131 capital companies controlled and financed by the central and local governments, of which 52 capital companies were controlled by the central, 79 capital companies – controlled by local governments.

CSB, on a quarterly basis, calculates the following general government sector indicators – revenue, expenditure, deficit, debt, and prepares the general government quarterly financial accounts. Information is posted on the CSB website and sent to Eurostat three months after the expiry of the reporting period.

Moreover, the CSB each year within the set terms until April 1 (provisional data) and until October 1 (final data) prepares and submits to Eurostat the general government budget deficit and debt notification (hereinafter – the Notification).

The Notification is prepared in accordance with the requirements of the 22 December 2015 Cabinet Regulation No. 756 *Procedure by Which the Notification of the General Government Budget Deficit and Debt Shall be Prepared*. Institution responsible for the

preparation of the Notification and submission thereof to Eurostat is CSB, which carries out regular inter-institution working group meetings. Specialists from the MoF, Treasury, Central Finance and Contracting Agency of the Republic of Latvia, the Ministry of Defence and the State Social Security Agency are involved in the preparation of the Notification. If necessary, specialists from other institutions (the Ministry of Economic, the Ministry of Welfare, Riga City Council, etc.) are involved.

Notification results are used for assessment of countries regarding how the compliance of the respective economic indicators with the criteria established by the Maastricht Treaty is ensured, that is, the ratio of the planned and actual general government sector budget deficit to the GDP at market prices must not exceed 3% and the ratio of the government debt to the GDP at market prices must not be higher than 60% which are calculated in accordance with the requirements of ESA 2010.

Latvia has implemented Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, laying down detailed provisions on the publication of the EU Member States in order to strengthen the EU fiscal and economic governance and contribute to the excessive deficit situation in the accession prevention. In order to comply with the requirements of Council Directive 2011/85/EU, with the administrative support of CS, information on fiscal indicators, as well as a detailed budget data transition table of cash flows according to the national classification of general government data according to ESA 2010 methodology is prepared and published. This information is published on the website of the MoF. The following information is made public on a regular basis:

- fiscal data (monthly and quarterly data);
- general government guarantees (annual data);
- non-performing loans (annual data);
- outstanding liabilities related to off-balance sheet public and private partnerships (annual data);
- liabilities of government controlled public capital companies classified outside general government (annual data);
- the value of the general government sector shareholding in the capital of the capital company (annual data).

ANNEXES

Table 1a. Macroeconomic prospects

	ESA code	2017 ³⁴	2017 ³⁵	2018p	2019p	2020p	2021p
		mln euro	Growth %				
1. Real GDP (at prices of the year 2010)	B1*g	22 792	4,5	4,0	3,4	3,0	2,9
2. Nominal GDP	B1*g	26 851	7,7	7,2	6,5	5,8	5,4
Real GDP by expenditure (at Prices of the year 2010)							
3. Private consumption expenditure	P3	14 395	5,1	6,1	3,5	2,8	2,6
4. Government consumption expenditure	P3	3 841	4,1	3,1	2,8	2,8	2,6
5. Gross fixed capital formation	P51	4 554	16,0	11,2	9,0	7,1	7,0
6. Changes in inventories and net acquisition of valuables	P52+P53	862	-	-	-	-	-
7. Exports of goods and services	P6	14 189	4,4	4,0	3,9	3,8	3,8
8. Imports of goods and services	P7	15 049	9,2	7,6	4,7	4,6	4,5
Contribution to real GDP growth							
9. Final domestic demand			6,8	6,6	4,6	3,9	3,7
10. Changes in inventories and net acquisition of valuables	P52+P53		0,8	-0,1	-0,5	0,0	0,0
11. External balance of goods and services	B11		-3,1	-2,5	-0,8	-0,8	-0,8

Table 1b. Price developments

	ESA Code	2017 ³⁵	2017 ³⁵	2018	2019	2020	2021
		level	Growth %				
1. GDP deflator			3,0	3,1	3,0	2,7	2,5
2. Private consumption deflator			3,0	2,8	2,4	2,1	2,1
3. HICP			2,9	2,8	2,4	2,1	2,1
4. Public consumption deflator			3,6	3,0	3,0	2,7	2,4
5. Investment deflator			0,8	2,3	3,2	2,9	2,0
6. Export price deflator (goods and services)			3,5	4,3	4,3	4,3	4,3
7. Import price deflator (goods and services)			2,8	3,6	3,6	3,6	3,6

Table 1c. Labour market development

	ESA code	2017 ³⁵	2017 ³⁵	2018	2019	2020	2021
		Level	Growth (%)				
1. Employment, persons		893	0,2	0,1	0,0	0,0	-0,1
2. Employment, hours worked		1 318 819 578	0,9	0,1	0,0	0,0	-0,1
3. Unemployment rate (%)			8,7	8,0	7,7	7,2	7,0
4. Labour productivity, persons			4,3	3,9	3,4	3,0	3,0
5. Labour productivity, hours worked			3,6	3,9	3,4	3,0	3,0

³⁴ Data published until 28.02.2018.

6. Compensation of employees	D.1	11 505	8,2	8,1	6,0	5,5	4,9
7. Compensation per employee		926	7,8	8,0	6,0	5,5	5,0

Table 1d. Sectoral balances

% of GDP	ESA code	2017	2018	2019	2020	2021
1. Net lending/borrowing vis-a-vis the rest of the world	B.9	0,0	-1,6	-2,3	-2,8	-3,7
of which						
- Balance on goods and services		-1,4	-3,6	-4,2	-4,9	-5,5
- Balance of primary incomes and transfers		0,6	0,3	0,3	0,3	0,0
- Capital account		0,8	1,8	1,6	1,7	1,8
	B.9	0,5	-0,7	-1,4	-2,4	-3,3
2. Net lending/borrowing of the private sector	EDP B.9	-0,5	-0,9	-0,9	-0,4	-0,4
3. Net lending/borrowing of general government		0,0	0,0	0,0	0,0	0,0

Table 2a. General government budgetary prospects

	ESA code	2017*	2017*	2018	2019	2020	2021
		mln euro	% of GDP				
Net lending (+) or borrowing (-) (B.9) by sub-sector							
1. General government	S.13	-125,2	-0,5	-0,9	-0,9	-0,4	-0,4
2. Central government	S.1311	-159,3	-0,6	-1,3	-1,0	-0,5	-0,4
3. State government	S.1312						
4. Local government	S.1313	-46,2	-0,2	-0,1	-0,1	-0,1	0,0
5. Social security funds	S.1314	80,3	0,3	0,5	0,3	0,1	0,1
General government (S.13)							
6. Total revenue	TR	9 964,7	37,1	36,8	36,1	36,4	35,3
7. Total expenditure	TE	10 089,9	37,6	37,8	37,1	36,8	35,7
8. Net lending/borrowing	B.9	-125,2	-0,5	-0,9	-0,9	-0,4	-0,4
9. Interest expenditure	D.41	264,8	1,0	0,8	0,9	0,9	0,8
10. Primary balance		139,6	0,5	-0,1	0,0	0,5	0,4
11. One-off and other temporary measures							
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		6 092,3	22,7	21,4	20,9	21,3	21,0
12a. Taxes on production and imports	D.2	3 788,6	14,1	14,3	14,4	14,5	14,4
12b. Current taxes on income, wealth, etc.	D.5	2 301,0	8,6	7,1	6,5	6,7	6,6
12c. Capital taxes	D.91	2,8	0,0	0,0	0,0	0,0	0,0
13. Social contributions	D.61	2 343,1	8,7	9,5	9,4	9,4	9,3
14. Property income	D.4	180,6	0,7	0,6	0,6	0,5	0,1
15. Other		1 348,6	5,0	5,3	5,3	5,3	4,8
16. Total revenue	TR	9 964,7	37,1	36,8	36,1	36,4	35,3
Tax burden (D.2**+D.5+D.61+D.91-D.995)		8 394,9	31,3	30,7	30,2	30,5	30,3
Selected components of expenditure							
17. Compensation of employees and intermediate consumption	D.1+P.2	4 417,0	16,5	16,8	16,2	16,0	14,9
17a. Compensation of employees	D.1	2 786,8	10,4	10,5	10,1	9,9	9,5
17b. Intermediate consumption	P.2	1 630,2	6,1	6,4	6,2	6,1	5,5
18. Social payments (18=18a+18b)		3 044,9	11,3	11,7	11,7	11,7	11,7
of which Unemployment benefits		112,9	0,4	0,4	0,4	0,4	0,4

18a. Social transfers through market producers	D.6311, D.63121, D.63131	315,4	1,2	1,2	1,2	1,2	1,2
18b. Social transfers which are no transfers in kind	D.62	2 729,5	10,2	10,5	10,5	10,5	10,5
19.=9. Interest expenditure	D.41	264,8	1,0	0,8	0,9	0,9	0,8
20. Subsidies	D.3	405,7	1,5	1,6	1,5	1,4	1,7
21. Gross fixed capital formation	P.51	1241,2	4,6	4,8	4,7	4,4	4,3
22. Capital transfers	D.9	34,4	0,1	0,1	0,1	0,1	0,1
23. Other		681,8	2,5	1,9	2,0	2,4	2,2
24.=7. Total expenditure	TE	10 089,9	37,6	37,8	37,1	36,8	35,7
Government consumption	P.3	4 932,5	18,4	18,9	18,3	18,1	16,9

*The MoF estimate

** Including share of taxes collected by the EU budget

Table 2b. No-policy change projections

	2017	2017	2018	2019	2020	2021
	mln euro	% of GDP				
1. Total revenue at unchanged policies	9 964,7	37,1	36,8	36,1	36,4	35,3
2. Total expenditure at unchanged policies	10 089,9	37,6	37,8	37,1	36,9	35,6

Table 2c. Amounts to be excluded from the expenditure benchmark

	2017	2017	2018	2019	2020	2021
	mln euro	% of GDP				
1. Expenditure on EU programmes fully matched by EU funds revenue	365,0	1,4	1,6	1,6	1,6	1,3
1.a Of which investment expenditure fully matched by EU funds revenue	240,6	0,9	1,1	1,1	1,1	0,9
2. Cyclical unemployment benefit expenditure	-20,7	-0,1	-0,1	-0,1	-0,1	-0,1
3. Effect of discretionary revenue measures	214,8	0,8	0,1	-0,2	-0,2	0,0
4. Revenues increased mandated by law						

Table 3. General government expenditure by function

% of GDP	COFOG code	2016	2021
1. General public services	1	4,4	4,3
2. Defence	2	1,6	2,0
3. Public order and safety	3	2,2	2,0
4. Economic affairs	4	4,9	4,6
5. Environmental protection	5	0,5	0,5
6. Housing and community amenities	6	0,9	0,8
7. Health	7	3,7	3,7
8. Recreation, culture and religion	8	1,4	1,4
9. Education	9	5,5	5,1
10. Social protection	10	12,0	11,2
11. Total expenditure	TE	37,3	35,7

Table 4. General government debt developments

% of GDP	ESA code	2017	2018	2019	2020	2021
1. Gross debt		40,2%	38,4%	37,4%	38,0%	35,6%
2. Change in gross debt ratio		-0,3%	-1,7%	-1,1%	0,6%	-2,4%
Contributions to changes in gross debt						
3. Primary balance		0,5%	-0,1%	0,0%	0,5%	0,4%
4. Interest expenditure	EDP D.41	1,0%	0,8%	0,9%	0,9%	0,8%
5. Stock-flow adjustment		-0,8%	-2,7%	-2,0%	0,2%	-2,8%
of which:		2,6%	2,2%	2,4%	2,6%	2,2%
- Differences between cash and accruals						
- Net accumulation of financial assets		8,2%				
of which:		31,9%				
- privatisation proceeds		3,8%	2,7%	1,2%	3,8%	4,2%
- Valuation effects and other		10,5%	10,0%	7,4%	4,2%	0,9%
p.m.: Implicit interest rate on debt		6.88 gadi				

Table 5. Cyclical development

% of GDP	ESA code	2017	2018	2019	2020	2021
1. Real GDP growth (%)	B1g	4,5	4,0	3,4	3,0	2,9
2. Net lending of general government	B.9	-0,5	-0,9	-0,9	-0,4	-0,4
3. Interest expenditure	D.41	1,0	0,8	0,9	0,9	0,8
4. One-off and other temporary measures						
5. Potential GDP growth (%)		3,3	3,4	3,4	3,3	3,2
contributions:						
- labour		0,0	0,0	0,0	0,0	0,0
- capital		2,1	2,2	2,2	2,1	2,0
- total factor productivity		1,2	1,2	1,3	1,2	1,2
6. Output gap, % of potential GDP		0,5	1,1	1,0	0,7	0,3
7. Cyclical budgetary component		0,2	0,4	0,4	0,3	0,1
8. Cyclically-adjusted balance (2-7)		-0,7	-1,4	-1,3	-0,7	-0,5
9. Cyclically-adjusted primary balance (8+3)		0,3	-0,5	-0,4	0,2	0,3
10. Structural balance* (8-4)		-0,7	-1,4	-1,3	-0,7	-0,5

* structural budget balance here is presented by including one-off measure – short-term revenue short-fall caused by tax reform, as in line with SGP, EC will not recognize it as one-off measure.

Table 6. Divergence from previous update

	ESA code	2017	2018	2019	2020	2021
Real GDP growth (%)	B1g					
2017		3,2	3,4	3,2	3,0	-
2018		4,5	4,0	3,4	3,0	2,9
Difference		1,3	0,6	0,2	0,0	-
General government net lending/borrowing (% of GDP)	B.9					
2017		-0,8	-1,6	-1,2	-0,5	-
2018		-0,5	-0,9	-0,9	-0,4	-0,4
Difference		0,3	0,7	0,3	0,1	-
General government gross debt (% of GDP)						
2017		39,2	38,2	39,4	40,4	-

2018		40,2	38,4	37,4	38,0	35,6
Difference		+1,0	+0,2	-2,0	-2,4	-

Table 7. Long-term sustainability of public finances ³⁵

% of GDP	2016	2020	2030	2040	2050	2060	2070
Age-related general government expenditure	16,4	15,7	16,1	16,2	15,9	16,2	15,0
Pension expenditure (public pensions) incl. state social insurance benefits, but not incl. II pillar	7,4	6,8	6,2	6,3	6,1	5,6	4,7
Old-age and early pensions	6,6	6,1	5,6	5,8	5,6	5,2	4,2
Other pensions (incl. disability, survivors)	0,8	0,7	0,6	0,5	0,5	0,5	0,5
Non-earnings related pensions (incl. minimum pension and minimum income guarantee)	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Health care expenditure	3,7	3,9	4,2	4,4	4,5	4,4	4,3
Long-term care expenditure	0,4	0,4	0,5	0,5	0,6	0,6	0,6
Education expenditure	4,5	4,2	4,8	4,6	4,5	5,2	5,0
Unemployment benefits	0,4	0,3	0,4	0,3	0,3	0,3	0,3
Social security contributions in state pension budget (I pillar), incl. contributions in the case of disability, other revenue in state pension budget	6,8	7,5	6,7	6,6	6,5	6,5	6,5
Systemic pension reforms							
Social security contributions in state funded pension scheme (II pillar)	1,7	1,9	1,9	1,9	1,9	1,9	1,9
Pension expenditure from state funded pension scheme	-	0,0	0,3	0,7	1,5	2,3	2,6
Assumptions							
Labour productivity growth	1,6	4,8	3,9	2,4	2,0	1,8	1,5
Real potential GDP growth	1,4	4,2	2,7	1,7	0,9	1,2	1,5
Participation rate, males (aged 20-64)	83,8	82,9	83,3	83,8	84,2	86,3	85,0
Participation rate, females (aged 20-64)	78,6	79,2	81,2	81,4	82,3	84,7	83,3
Total participation rate (aged 20-64)	81,2	81,0	82,2	82,6	83,3	85,5	84,2
Unemployment rate (aged 20-64)	9,8	9,0	9,7	8,8	7,9	7,9	7,9
Population aged 65+ over total population	19,8	20,8	25,4	29,2	31,6	33,1	29,6

Table 7a. Contingent liabilities

% of GDP	2017
Public guarantees	1,4%
Of which: linked to the financial sector	0,7%

³⁵ Data source: AWG, The 2015 Ageing Report: Underlying Assumptions and Projection Methodologies, 2014; The 2015 Ageing Report: Economic and budgetary projections for the 28 EU Member States (2013-2060)

Table 8. Basic assumptions

	2017	2018	2019	2020	2021
Short-term interest rate (annual average)		-0,3	0,0	0,1	0,1
Long-term interest rate (annual average)		0,7	0,9	1,0	1,0
EUR/USD exchange rate (annual average)	1,13	1,23	1,23	1,23	1,23
Nominal effective exchange rate	3,5	3,9	0,0	0,0	0,0
World excluding EU, GDP growth	3,5	3,7	3,7	3,7	3,7
EU GDP growth	2,4	2,3	2,0	2,0	2,0
Growth of relevant foreign markets	4,0	3,8	3,8	3,8	3,8
World import volumes, excluding EU	4,2	4,1	4,1	4,1	4,1
Oil prices (Brent, USD/barrel)	54,6	68,3	64,2	63,0	63,0